



Local government funding and financing

Local government funding and financing

Final report

November 2019

The New Zealand Productivity Commission

Te Kōmihana Whai Hua o Aotearoa¹

The Commission – an independent Crown entity – completes in-depth inquiry reports on topics selected by the Government, carries out productivity-related research and promotes understanding of productivity issues. The Commission aims to provide insightful, well-informed and accessible advice that leads to the best possible improvement in the wellbeing of New Zealanders. The New Zealand Productivity Commission Act 2010 guides and binds the Commission.

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Disclaimer

The Chair of the Productivity Commission, Murray Sherwin, has a financial interest in the forest sector via part ownership of a forestry block.

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¹ The Commission that pursues abundance for New Zealand

Foreword

Since the Commission was established in 2010 we have been asked to look at many issues that relate to local government. Five of our 14 inquiries to-date have looked at various aspects of local regulation, planning and funding. This highlights just how important local authorities are in New Zealand's system of government, as a provider of services and as a voice for local democracy. Council activities have a huge influence on the day-to-day lives, and wellbeing, of New Zealanders.

We have learnt a lot over the course of those inquiries, and have made many recommendations about where change is needed. But this inquiry is the first time the Commission has looked in-depth at the overall funding and financing framework within which local authorities operate.

The question of how local government funds its activities is fundamental. A fit-for-purpose funding and financing framework is vital to ensure councils can deliver quality infrastructure and services when and where they are needed, and that the services they deliver are effective, efficient and affordable.

It became clear through the course of this inquiry that the current funding and financing framework has many strengths. Councils have access to a range of different tools, and have a great deal of autonomy in how they use them. They also have the flexibility to respond to local needs and preferences, as they choose what services to deliver and how to deliver them. No two councils are quite alike in how they raise revenue and deliver services. We conclude that this autonomy is valuable, and worth preserving.

But it also became clear that councils are struggling to deal with some big pressures, including from population growth, more responsibilities passed down from central government, climate change and, in some places, tourism. We have recommended changes to the funding and financing framework to support councils in dealing with these pressures. In so doing, we have favoured targeted solutions that do not compromise councils' autonomy, or their accountability.

In this report we set out what a future funding and financing framework should look like, and how councils can more effectively manage cost pressures, make decisions and deliver their services. The core of the framework we describe in this report is not so very different from the current one. But important evolutions are recommended to enable councils to deal with some very large, emerging challenges. These challenges are highly uneven across councils and, in some cases will be large relative to their existing funding base. Some councils will likely need to rely more heavily on central government transfers in the future, and we have developed a framework to inform decisions about when and how costs should be shifted from local ratepayers to the wider taxpayer.

Our inquiries are overseen by our Commissioners. I acknowledge the support of my fellow Commissioners Professor Sally Davenport, Dr Graham Scott (until May 2019), Andrew Sweet (from June 2019) and Professor Gail Pacheco (from July 2019). We acknowledge the co-operation and support of Local Government New Zealand, the NZ Society of Local Government Managers and the many councils around New Zealand, and other stakeholders, who engaged with us on this inquiry and provided valuable information. I would particularly like to thank the councils who agreed to participate as case studies. Commissioners would also like to acknowledge the work and commitment of the inquiry team: Steven Bailey (inquiry director), Ron Crawford, Sally Garden, Geoff Lewis, Hamed Shafiee and Jo Smith. This inquiry has also benefited immensely from the work of expert consultants. Thanks to Carl Hansen (CSA), Dr Ken Palmer, Fraser Colegrave (Insight Economics), Robin Oliver and Mike Shaw (OliverShaw), Professor Ian Ball (Public Sector Performance Ltd.), Sapere Research Group and Peter Winder (McGredy Winder & Co).



Murray Sherwin
Chair, Productivity Commission
November 2019

Terms of reference

NEW ZEALAND PRODUCTIVITY COMMISSION INQUIRY INTO LOCAL GOVERNMENT FUNDING AND FINANCING

Issued by the Minister of Finance and the Minister for Local Government (the "referring Ministers"). Pursuant to sections 9 and 11 of the New Zealand Productivity Commission Act 2010, we hereby request that the New Zealand Productivity Commission ("the Commission") undertake an inquiry into local government funding and financing.

Context

In 2007, the results of the Local Government Rates Inquiry (the Shand Inquiry) were reported to the Government. Local Government cost pressures have grown significantly since the Shand Inquiry, and local authority rates and payments increases have outpaced increases in the local government cost index.

Local Government plays important roles in New Zealand society. These place-shaping roles enhance and promote local community wellbeing across physical and financial, social, human and environmental capitals. In pursuit of these wellbeing outcomes, Local Government provides essential services, including transport, water and flood protection services, social and community infrastructure services, refuse collection, local planning, regulatory services that assist with public safety, health, environmental protection, biosecurity and economic development and a range of other essential services.

Local Government makes a considerable direct impact on the economy. In June 2016, councils owned \$112 billion worth of fixed assets, employed over 25,000 full-time equivalent staff and had annual operating expenditure of \$9.3 billion and operating income of \$8.9 billion.

The costs and pressures facing local government have increased in recent years, though the circumstances of individual councils vary (e.g. urban and rural communities face differing challenges). Local authority rates increases have outpaced increases in other indices measuring average costs and incomes. In particular, local authority rates and payments increases have significantly outpaced increases in the consumer price index and the independently prepared local government costs index.

Local authorities are capital-intensive businesses. Expenditure on fixed assets has grown significantly in recent years and demand for ongoing capital expenditure is unabated or increasing due to the development, maintenance and replacement of the infrastructure required to support New Zealand's rapidly growing population (including international visitors) and support economic growth.

As a whole, local authority debt has grown steadily since 2006. Some high growth councils are experiencing constraints in their ability to finance further infrastructure investment because they are coming close to covenanted debt limits. At the same time, some local authorities take on very little debt at all.

Major factors that are influencing local authority costs include:

- for fast-growing areas, the need for local authorities to increase the supply of development capacity to address declining housing affordability
- maintaining services in areas with declining populations
- requirements for higher performance, including potentially from fresh water, wastewater, stormwater and flood protection systems to meet environmental and public health standards
- costs of adapting communities and infrastructure to mitigate risks and hazards associated with climate change
- supporting regional development (e.g. growing demand pressures from the tourism industry which may be disproportionate to the number of local residents)
- the need to replace existing infrastructure coming to the end of its useful life.

This mix of factors - rates increases, limits on borrowing, and increased expenditure demands, particularly for infrastructure - creates the need for an independent inquiry into cost pressures, decision making and affordability. Following an objective inquiry into these issues, the Commission is requested to provide an assessment and recommendations of current and alternative funding and financing options for local authorities to maintain and deliver services to their communities into the future.

Scope and aims

In light of the pressures discussed above, and in the context of a decade after the conclusion of the Shand Inquiry, the Government has selected this inquiry topic to examine and report on local government funding and financing arrangements.

Where shortcomings in the current system are identified, the inquiry is to examine options and approaches for improving the system of local authority funding and financing.

Approach to the inquiry

The Inquiry should:

- Have regard to previous reports, inquiries and reviews, but should also look to bring new and innovative thinking to these issues.
- Complement and receive existing work, (e.g. three waters review, and the Urban Growth Agenda) rather than duplicating it.
- Consult with key interest groups and affected parties including (but not limited to) ratepayer organisations, local business and community groups.
- Work closely with Local Government New Zealand, the Local Government Funding Agency, the New Zealand Society of Local Government Managers and the wider local government sector and relevant central government agencies to ensure its findings provide practical ways to improve the funding and financing of local authorities.

Scope

The inquiry would examine the adequacy and efficiency of the existing local government funding and financing framework. Specifically, the inquiry will investigate:

Cost pressures

- The factors (including the mix of services and investment) that drive local authority costs now and in the foreseeable future. This is to include an investigation of the drivers of cost and price escalation, in particular: Whether this is a result of policy, and/or regulatory settings.
 - The role of growth/decline in population (including visitors and other temporary residents).
 - The impacts of Treaty settlement arrangements and costs of climate change on local authorities.
- In addition, the Commission should have regard to current frameworks for capital expenditure decision making, including cost-benefit analysis, incentives and oversight of decision making.

Funding and financing models

- The ability of the current funding and financing model to deliver on community expectations and local authority obligations, now and into the future.
- Rates affordability now and into the future.
- Options for new local authority funding and financing tools to serve demand for investment and services.

- Appraise both current and new or improved approaches considering suitable principles including efficiency, equity, affordability and effectiveness.
- How the transition to any new funding and financing models could be managed.

Regulatory system

- Any constitutional and regulatory issues that may underpin new project financing entities with broader funding powers.
- Whether changes are needed to the regulatory arrangements overseeing local authority funding and financing.

Out of scope

The Government considers that some aspects of local government finance have been well canvassed and further inquiry into them would not assist in achieving sustainable local government financing. Therefore, the following matters are out of scope of the inquiry:

- The particular mechanisms for rating of Maori freehold land and Crown land.
- The valuation system and practices.
- Substantial privatisation.

The Inquiry is not to make recommendations that would directly affect representation or boundary arrangements for Councils.

Report and recommendations

The report should build on previous relevant inquiries undertaken by the Productivity Commission, and use the Shand Inquiry report as context.

The final report should provide findings and recommendations directed at central and local government regarding how to improve funding and financing arrangements.

Consultation

The Commission should engage with a broad range of stakeholders, including industry and non-governmental groups, Iwi, and the public.

Timeframes

The Commission should present the final report to referring Ministers by 30 November 2019.

Hon Grant Robertson



MP for Wellington Central

Minister of Finance

Minister for Sport and Recreation

Associate Minister for Arts, Culture and Heritage

29 APR 2019

Mr Murray Sherwin
Chair
Productivity Commission
PO Box 8036
The Terrace
WELLINGTON 6143

Dear Murray

It has been encouraging to see the Commission's progress with the inquiry into local government funding and financing and the high number of quality submissions and public engagement with the Commission's work.

As you may be aware the Government has received the Final Report of the Tax Working Group.

As part of their work the Group highlighted the challenges of housing affordability in New Zealand and the constraints in the supply of residential land that drive the high cost of housing. To help address this the Group recommended that the Productivity Commission inquiry into local government funding and financing consider a tax on vacant residential land.

The Government agrees with the Tax Working Group and I am therefore writing to ask the Commission to consider this issue as part of its work. The Commission should consider whether a tax on vacant land would be a useful mechanism to improve the supply of available housing for New Zealanders.

The Productivity Commission should have regard to wider work being done to help improve housing affordability. This includes work by the Government to address supply constraints in housing including through reforms to infrastructure financing and the planning system.

In addition, the Government considers that a review of options for taxing land that discourages land-bankers from holding land vacant should be a high priority for inclusion on the Tax Policy Work Programme. As part of its consideration of options for taxes on vacant land the Commission should consult with officials from Inland Revenue and the Treasury.

I look forward to receiving the report of the Commission's inquiry.

Yours sincerely

A handwritten signature in blue ink, appearing to read 'Grant Robertson'.

Hon Grant Robertson
Minister of Finance

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KEY


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Finding


R

Recommendation

Overview

The Government has asked the Commission to undertake an inquiry into local government funding and financing. The Government wants to understand the factors driving local authorities' costs, now and into the foreseeable future. It also wants to know whether current funding and financing arrangements are efficient, sustainable and affordable. If they are not, what new arrangements would better achieve these ends?

Local government matters a great deal to communities and the wellbeing of New Zealanders. High-performing local government can provide greater access to, and choices of, housing; better protection of New Zealand's natural environment and cultural values; and quality infrastructure at the right time in the right place.

Success in these roles provides the foundation for urban and rural communities that enjoy a wide range of amenities and are attractive places to live; and where people consume, work, play and create. If councils struggle to deal with rising costs, or have poor incentives for improving performance, this will lead to communities failing to reach their potential.

The funding and financing framework for local government must therefore incentivise good performance and enable local authorities to deliver quality services in line with the preferences and aspirations of their local communities. This requires that local government has the necessary autonomy, responsibility and accountability in delivering these services. This means that local ratepayers should largely pay for local-government services, and that those services must be effective, efficient and affordable.

This report sets out the Commission's assessment of the cost pressures faced by local authorities. It presents recommendations for changes to the current funding and financing arrangements, where these are insufficient to meet key pressures. It also recommends several improvements to the way councils manage cost pressures, make decisions, and deliver and fund their services.

Local government in New Zealand

A relatively narrow scope...

Local authorities play an essential role in New Zealand's system of government as both a provider of services and an enabler of local democracy. Compared to most other developed countries, the scope of local government responsibilities in New Zealand is relatively narrow. In many other countries, local government provides services such as education, social protection and health. As a result of New Zealand's unique history and context, local government here does not provide these services. Instead, many of these functions are funded centrally and provided locally through Crown entities, such as District Health Boards and schools.

In New Zealand, local government's activities are centred on regulating land use, choosing and funding a set of local amenities, and investing in essential infrastructure for transport and the three waters (drinking water, wastewater and stormwater), with the overall objective of enhancing community wellbeing.

... but with a high degree of autonomy

New Zealand's local authorities have a high degree of autonomy in choosing what activities they undertake and how they undertake them. This freedom is provided through a legislated power of general competence. It gives councils broad discretion to select the local services and amenities that best align with the preferences and circumstances of their communities. With such autonomy comes strong accountability to their own communities, through consultation and transparency requirements.

Councils' powers to levy local rates and charges also provide them with a level of fiscal autonomy that is relatively high internationally. In more devolved countries, local governments rely a lot more heavily on revenues from central government. Such funding tends to come with significant conditions on how it is spent – with central governments setting priorities and rules that limit the freedom of local governments to adapt services to local circumstances.

Not actually all that different from other countries

Despite the apparently greater taxing powers and revenues of local governments in many more decentralised countries, the reality of what is decided nationally against what is decided locally, and who pays, is not so different.

The Commission looked at how policy and funding decisions are made in Sweden, which at first glance looks much more decentralised than New Zealand. However, things are not actually as different as they first appear. For example, many of the decisions that are in the hands of municipalities in Sweden are devolved to schools in New Zealand. And New Zealand's District Health Boards look little different to the 21 counties in Sweden that are responsible for most local health services. In both countries, the funding outcomes look broadly similar – since the funding transfers (in both) from national government for health and education account for local differences in incomes, the need for services and the cost of providing them.

The current funding and financing options

New Zealand's local authorities currently have a wide range of funding and financing options to choose from, including general and targeted rates, fees and user charges, development contributions, debt and asset recycling. Councils vary widely in how they use the available funding tools, but rates are the largest overall source of local government revenue.

Providing essential infrastructure dominates council spending. Accordingly, the growth in capital expenditure has been driven primarily by roading and the three waters. Growth in capital expenditure has flow-on effects on operating expenditure in the form of increased depreciation and interest expenses. The prices faced by local government have risen more than those faced by consumers, which has contributed to expenditure growth.

Debt is an effective and appropriate way for councils to spread the burden of capital expenditure across generations, so that the people who benefit from infrastructure investments now and in the future contribute to meeting the cost. Spreading the costs in this way is fair. The Local Government Funding Agency raises debt on behalf of member councils and is the largest lender to local government. Councils may also borrow from banks and other financial institutions, and issue bonds.

Local government debt has risen significantly over the last two decades but, for most councils and the sector as a whole, this does not give cause for concern given the rapid population growth in some areas. Some fast-growing councils face debt constraints that are limiting their ability to supply enough infrastructure to meet the growth in demand for housing and other development. These debt constraints are discussed further below.

A diversity of circumstances

Local authorities span a range of sizes and circumstances, and face different challenges and opportunities. Some urban and provincial authorities are experiencing rapid population growth. Other authorities have populations that are very small, and/or are growing slowly or not at all. Some have high rates of deprivation. Physical resources and industry structure vary across the country, driving different infrastructure and service requirements. The age, quality and condition of essential infrastructure also vary. Tourism is particularly prominent in some areas.

The Commission sought to understand the nature of these differences, through broad engagement across the sector and a series of in-depth case studies of a cross-section of individual councils. The Commission found that these differences result in varying funding pressures across council types and circumstances. This variation had a strong bearing on the Commission's assessment of the current funding and financing framework, and the need for any changes.

The importance of good quality decision making

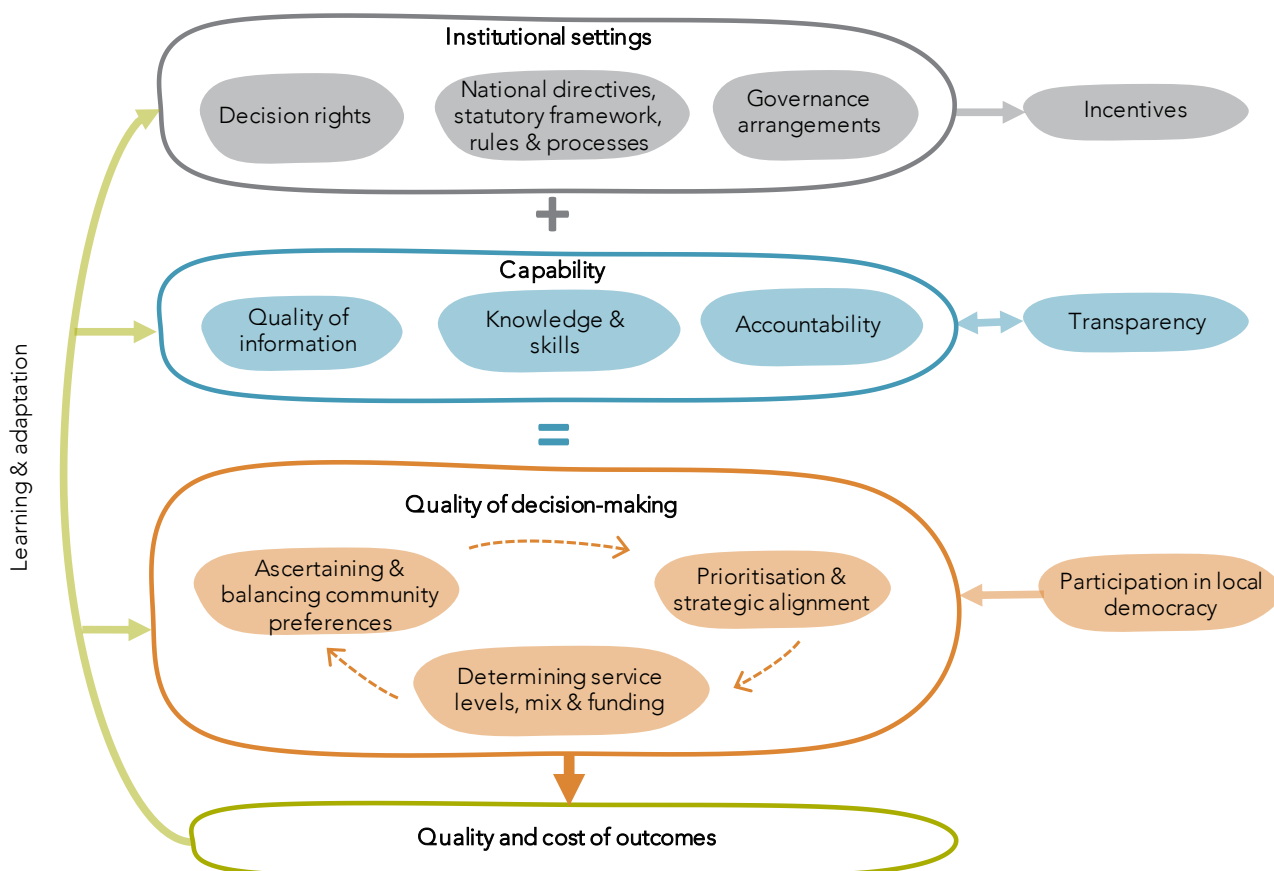
Good quality decision making is essential for councils to make the best use of available funding and financing tools, and ensure decisions are aligned with the scale and complexity of the local government task.

If councils struggle to deal with complex strategic and implementation decisions, and have poor incentives for improving performance, this will put a strain on council funding and risk poor community outcomes.

Councils’ decisions about the level of service they provide and about capital investments can have an important bearing on cost pressures, and ultimately on the costs borne by local residents and businesses. The costs of poor decisions can be significant.

Good quality decisions flow from well-designed institutional and statutory arrangements, plus the skills and capability of council decision makers. When the necessary knowledge, incentives and decision rights are all present, local authorities do – and will – make prudent, efficient and effective revenue-raising and spending decisions that reflect the preferences and aspirations of their communities (Figure 0-1). The Commission has assessed the current decision-making arrangements in local government with these features in mind, to identify where improvements are possible.

Figure 0-1 The features of good decision making



Significant scope exists for better use of current tools

Councils are complex operations, spanning many different activities. The diversity of community preferences and interests, as well as the triennial election cycle, add to the complexity. The best-performing councils are navigating this complexity well, making robust decisions and using a good range of funding tools, including user charges. Some councils have worked hard to remedy a legacy of poor financial practices and deferred maintenance. Some have confronted this legacy and sustained significant increases in rates to make necessary investments in essential infrastructure. Yet other councils still lack the necessary systems and skill-mix for effective decision making.

Significant opportunities exist for many councils to make better use of current funding tools, and to help relieve funding pressures through better organisational performance and decision making. While some high-growth councils are approaching their debt limits, most are well below. So some councils have significant scope to make better use of their balance sheets.

The political economy of setting rates provides a useful fiscal discipline, but can encourage councils to defer necessary investments so as to constrain debt and keep rates artificially low. There is also a widespread lack of understanding about the role of local government debt – among both councillors and the general public – including in promoting inter-generational equity. Indeed, many council candidates still campaign on a platform of low or no debt or rates rises. This attitude is constraining necessary investments such as upgrades to essential infrastructure.

What can be done better?

How to use the existing funding tools well

The benefit principle says that those who benefit from, or cause the need for, a service should pay for its costs. This involves determining the extent to which the beneficiaries of a service can be identified and charged. The benefit principle implies user charges (where such charges are feasible and efficient) or a targeted rate on a specific group of properties that benefit from a service. It also implies that local ratepayers should fund local services. Some local assets and services benefit local residents and national interests. In these cases, the benefit principle points to shared funding (with a contribution from central government).

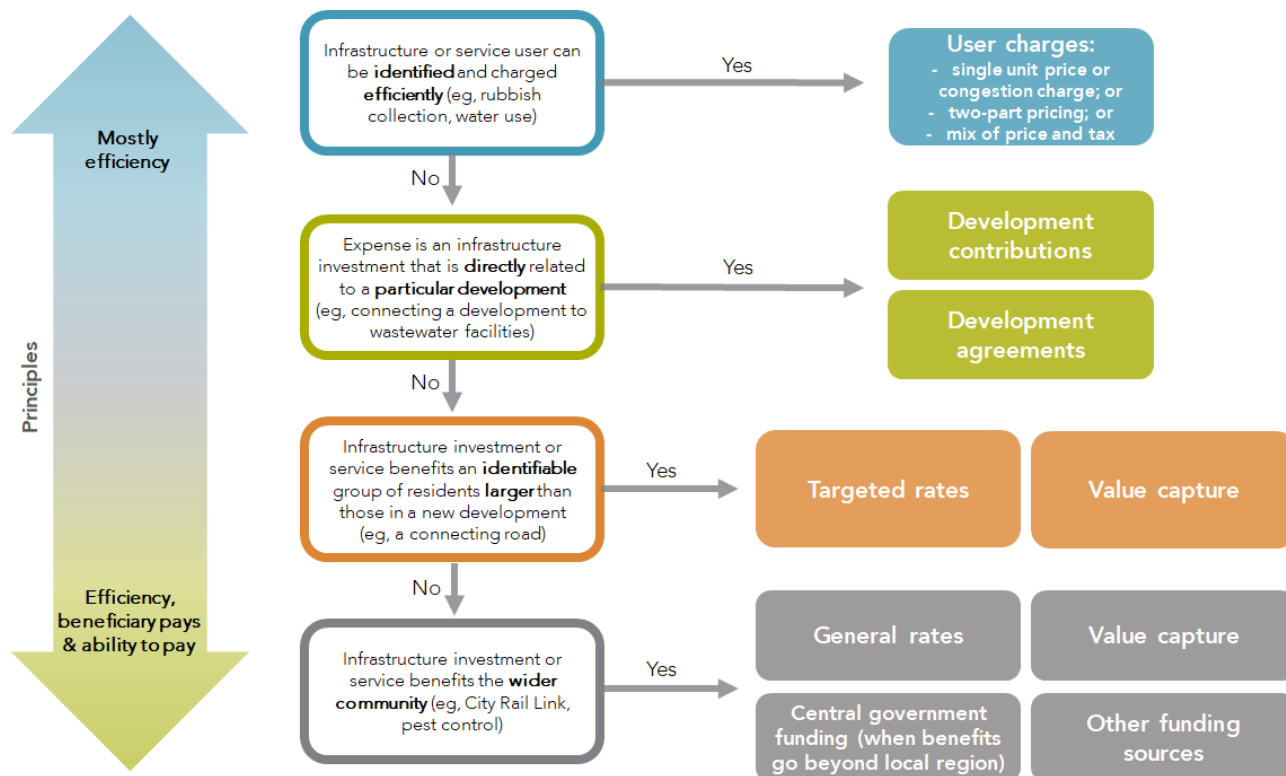
Local government's role sits alongside that of central government and they both draw on the same populations of citizens and businesses to fund these roles. Central government takes the lead on macroeconomic stabilisation and redistribution across citizens, including by providing a social safety net for the least well off.

Councils may legitimately consider ability to pay alongside the benefit principle and efficiency principles as their main guides to allocate the costs of their services. How much weight to place on ability to pay and how to give effect to it are largely political judgements of democratically elected councils. In making these judgements, it is vital that councils are transparent so that they may be held to account by their communities.

Figure 0-2 sets out a framework for guiding the selection of funding tool. The choice of funding tool is guided by what scores best on a combination of efficiency and a fair allocation of the cost. The diagram refers to "value capture". Under existing powers, councils can use targeted rates on the properties benefiting from new infrastructure to capture some of the increase in property values resulting from infrastructure investments. Even so, legislative clarity is needed to give councils the confidence to use existing instruments in this way without legal challenge.

The Government should also resolve the legislative ambiguity about councils' ability to charge for its work on compliance, monitoring and enforcement of non-consented activities. This will help councils make better use of user pays.

Figure 0-2 Decision-making framework for choosing funding tools for local government services and investments



Improving decision making

Good decision making relies on strong and capable leadership, high-quality information to support decision makers, use of independent governance expertise, and effective community engagement. The sector should work to improve elected members’ governance and financial skills through lifting participation in training and professional development. And all local authorities should be required to establish an Audit and Risk Committee, with at least one independent member, to enhance governance capability.

More collaboration across councils

The Commission sees scope for greater collaboration across councils, including through the use of shared services. The associated economies of scale, access to specialist skills, and in some cases cost savings through standardisation of processes or equipment, can be of particular benefit for smaller councils that struggle with high fixed costs and find it hard to attract and retain skilled staff.

Appropriate use of shared services can therefore provide councils with a way of better managing cost pressures, within the existing funding and financing framework. Even so, some councils are so small they are clearly unsustainable and aggregation would be the sensible way forward.

Better community engagement

Some councils are already using a variety of approaches to raise community participation in their decision-making processes, but the quality of community engagement across the sector is uneven. Overall, there needs to be better community engagement to generate productive conversations and buy-in around service levels, willingness to pay and trade-offs.

Councils need to get better at explaining what they do, what the big decisions are, and why it matters. People need to know what the genuine options are and how much they will cost – so they can choose and prioritise what they ask their councils to do. Councils also need to make it easier for a greater diversity of people to have their say so councils can better gauge community preferences.

Greater transparency around funding and investment decisions

The transparency of local government's processes, decision making and performance is the cornerstone of its accountability to local communities. Council decision making and broader performance needs to be more visible to stakeholders, including voters. This includes information about how councils are making trade-offs, and how they are allocating rates across different ratepayer groups.

The current performance reporting requirements on local authorities, including the financial information disclosures, should be fundamentally reviewed and streamlined. A small set of mandatory measures should be developed, including new measures for rates by category of rateable property as well as the unit costs of service delivery. These measures would be reported to and published by a central entity.

Other legislative changes would further improve transparency.

- Councils should be required to provide indicative itemised rates assessments that show ratepayers the dollar amounts they are contributing to each activity funded from each rate (this would not require councils to hypothecate the dollar amounts to particular activities).
- The requirements for councils' Long-Term Plans should be streamlined so that those become more accessible and can better fulfil their transparency objectives.

The ability for ratepayers to more easily scrutinise and compare their council's performance would provide incentives for councils to clearly explain their decisions. Together with improved engagement, this will help gain better community buy-in to decisions and take the political heat out of setting rates.

The property rates-based system remains appropriate for New Zealand...

The current main funding tools of local government in New Zealand measure up well against the principles of a good revenue-raising system, including simplicity, efficiency and revenue stability. The current framework provides councils with considerable flexibility in how they raise revenue, and this is reflected in the diversity of ways in which they do so. The framework also gives councils a high degree of autonomy in raising revenue and deciding how to spend it – this is a strength of the existing system, and should be retained.

Internationally, no single way of funding local government is clearly better or worse. Compared to alternatives, property taxes are simple and efficient to administer, and wholesale change to a radically different model would be costly, disruptive and of uncertain benefit. Given the modest scope of local government in New Zealand, and the benefits of a property tax-based system, rating land and property should continue as the main taxing power of local government.

... but there are areas of funding pressure

At an aggregate level, average rates revenue per person, council expenditure per person and income per person have grown at similar rates since the early 1990s. In other words, the rates "burden" has been about flat overall. This suggests that the current funding system has been adequate in the past. But in some situations, the current system is either failing to provide councils with adequate revenues or is unlikely to be sufficient in the near future. These situations are:

- adapting to climate change;
- passing of unfunded mandates from central government to local government;
- meeting the demand for infrastructure in high-growth areas; and
- coping with the growth in tourism.

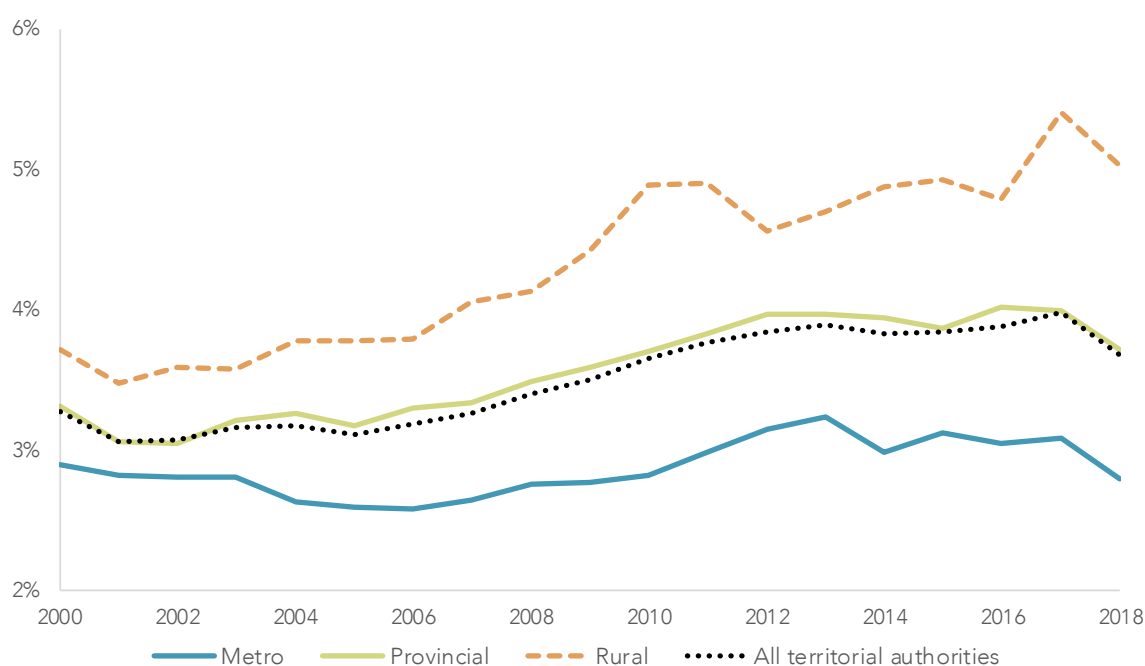
The scale of some of these pressures on local government is unprecedented. For example, around \$5.1 billion worth of local government infrastructure will be at risk from sea-level rise of one metre,

particularly roads, three-waters infrastructure and stopbanks. The upfront costs to councils of complying with the National Policy Statement for Freshwater Management have been estimated at between \$1.4 and \$2.1 billion, followed by ongoing costs of up to \$59 million a year. And complying with the new drinking water standards could cost councils around \$384 million in upfront capital costs, followed by yearly costs of \$13 million.

These pressures are highly uneven across councils. Climate change risks are not evenly distributed across the country, with some regions facing much greater exposure and higher per-capita costs to replace essential infrastructure. Tourism is particularly prominent in some areas; and councils in some visitor hotspots are managing the pressures from tourism better than others.

Some smaller, rural, lower-income local authorities are under additional strain because, to raise enough revenue, they have needed to increase rates to a high level as a percentage of incomes (Figure 0.3). Some of these small councils are already unable to comply with the cumulative burden of unfunded mandates placed on them from central government. This is clearly an unsustainable situation.

Figure 0-3 Rates per person as a percentage of median adult personal incomes, 2000–2018



Source: Stats NZ Household Labour Force Survey and Stats NZ (2019d).

Notes:

1. Incomes are measured as the median for the population aged 15 years or older.

Targeted solutions to funding pressures

The combination of these growing pressures means the ability of the current funding system to provide all councils with adequate revenues is at a tipping point. However, given the advantages of a property rates-based system, the Commission favours targeted solutions to these different and uneven pressures on councils. Rates should remain as the main taxing power of local government. This will preserve the local autonomy and accountability that are cornerstones of New Zealand's system of local government.

The fact that there are pressures on the revenue base of local government is unsurprising. Internationally, local governments are rarely completely self-funding and revenue transfers from central to local governments are the norm. However, moving the funding source from local to central government means shifting costs from local ratepayers to general taxpayers. Doing so requires principled reasons.

A principled approach to shifting costs from ratepayers to taxpayers

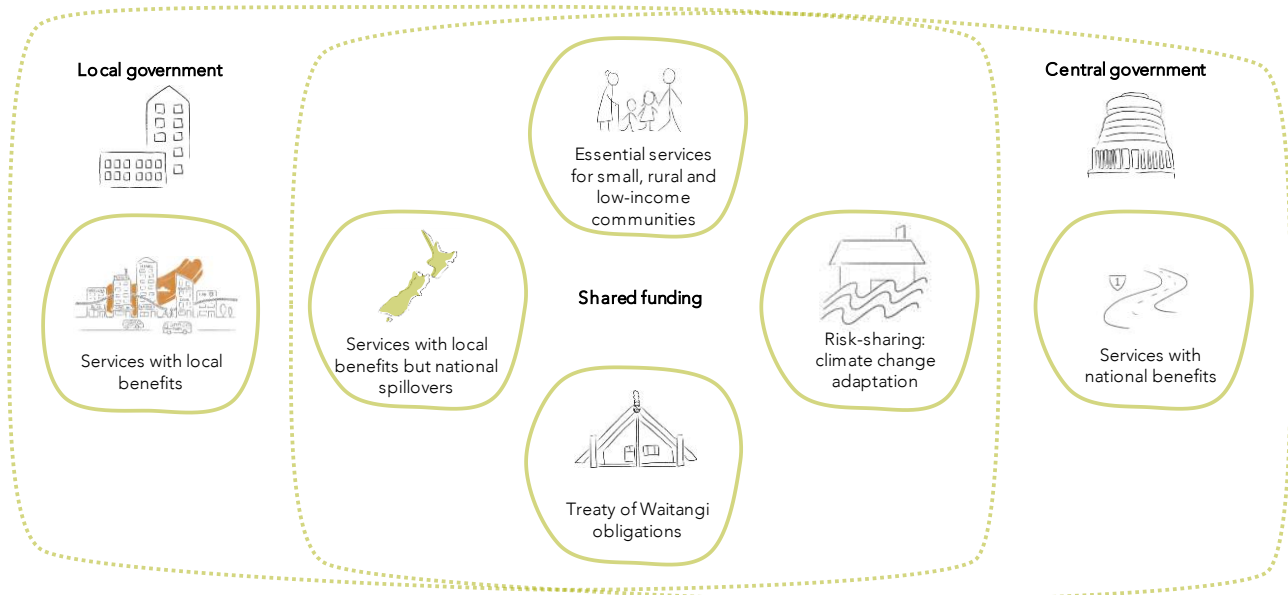
Payments from central to local government may be justified in the following situations:

- when local government activities have national-level benefit spillovers;
- sharing risks across all taxpayers, when some communities are subject to damaging shocks (such as natural disasters);
- helping low-income communities whose councils are struggling to fund essential services; and
- recycling revenue collected centrally (for administrative efficiency) to cover costs incurred locally.

It is important that payments from central government are designed with a clear purpose, reasonable simplicity and transparency, and that they are predictable and preserve local government autonomy and accountability as far as possible.

Figure 0-4 sets out where central government should be contributing funding for local government services. The diagram includes co-funding for Treaty of Waitangi obligations, which is an important area of national-benefit spillovers. The diagram also indicates two new funding streams from central to local government, in relation to climate change adaptation and provision of three-waters services, which are discussed below.

Figure 0-4 Central government funding contributions for local government services



Improving central government support

The Commission has identified two areas where existing funding streams from central to local government are not working effectively due to shortcomings in their design. In both cases, the revenue is collected by central government for reasons of administrative efficiency.

- One is the lack of connection between road user charges and the damage caused to local roads by heavy traffic, particularly logging trucks. While the vehicles pay for their damage through such charges, no mechanism currently exists to channel these funds to councils to cover the cost of the damage; councils have to bear this cost. The Government should find an efficient and effective means to fund councils for the cost of damage to local roads caused by heavy vehicles such as logging trucks.
- The other is central government funding for tourism and related mixed-used infrastructure (such as public toilets, car parks and freedom camping facilities). This funding comes from general taxpayers, with some also coming directly from international tourists (via the International Visitor Levy and GST). There are a variety of mechanisms for distributing funding to councils, including the Tourism Infrastructure Fund and the Responsible Camping Initiative, but they are operating in an ad hoc fashion that hinders the ability of councils to plan and prepare effectively for tourism. Existing central government funding for

tourism and mixed-used infrastructure should be distributed more efficiently, and in a much more predictable and fairer way, by using a transparent allocation formula.

Adapting to climate change is a significant challenge

A challenging and emerging pressure on local government funding comes from climate change – in particular, the threats from sea-level rise and more frequent and extreme weather events (and associated flooding). The most direct threat to local authorities is the damage that climate change will cause to their infrastructure such as roads and bridges, and stormwater, wastewater and flood-protection assets.

In addition, councils are responsible for planning and regulating development on at-risk land, and therefore have an important role in moderating future climate risk exposure and long-run adaptation costs. Councils are also the body closest to exposed communities and will be expected to engage with them on an adaptation strategy. They must manage both pressures from property owners to invest in defences against sea-level-rise and flooding, and retreats from at-risk locations.

Central government leadership is required

To help local governments prepare for climate change, central government should take the lead on providing high-quality and consistent science and data, standard setting and decision-making guidance, and legal frameworks. Many councils are currently facing a no-win situation where either allowing or limiting development on at-risk land might result in litigation. These uncertainties need urgent attention. Developing advice, guidance and legal frameworks to support local government decisions about land use should therefore be progressed immediately.

Institutional and legislative schemes also need to move from their current focus on recovery after an event towards reducing risk before an event. Such schemes need to resist the tendency to continue along current pathways that rely on hard structures to protect new and existing land use, encourage the use of anticipatory and flexible decision tools, and incentivise actions that reduce costs over the long term.

Assistance for land-transport infrastructure that is at risk

The Government should extend the role of the New Zealand Transport Agency in co-funding local roads to include assistance to councils facing significant threats to the viability of local roads and bridges from climate change. The amount of assistance should reflect the size of the threat facing each council, its rating capacity and its willingness to take sensible action.

A local government resilience fund

The Commission recommends that the Government creates a climate-resilience agency and associated fund to help at-risk councils redesign, and possibly relocate and rebuild, non-land-transport infrastructure threatened by sea-level rise and more intense flooding due to climate change. This support acknowledges that the impacts of climate change will be unevenly distributed across districts, and that it is fair for these risks to be shared nationally. As with the current model by the New Zealand Transport Agency, levels of assistance should be based on a transparent formula, taking into account each council's level of risk and its rating capacity.

The new entity should also assist regional councils and communities to consider the best way to lessen future risk of flooding from rivers. This could include, where appropriate, the potential for using the best-practice model of giving rivers room and developing multiple innovative uses of the wider river corridors.

Need to reset the relationship with central government

Unfunded mandates

A key cause of funding pressures on local government is the accumulation of functions and responsibilities that central government has passed to councils over the years. These include where central government has introduced or strengthened standards that councils must meet – such as various National Policy Statements, National Environmental Standards and higher standards for drinking water.

In these situations, local government should have a means to adequately fund its operations, either through recovering its costs from regulated parties; or, where there are national benefits, through a direct funding contribution from central government. Failing to give local government such means results in so-called unfunded mandates.

The increasing tasks and responsibilities being placed on local government have now reached a point where the cumulative burden is difficult for many local authorities to manage. A risk is that some councils, particularly small ones, may be unable to continue to comply with all the new responsibilities passed to them. This risk could mean that the policy objectives of central government are not achieved.

The Commission recommends the following measures to help rectify unfunded mandates.

- Removing legal constraints on cost recovery, where fees have been set in statute.
- A comprehensive and independent in-depth analysis of costs associated with implementing Treaty settlement arrangements – costs both to councils and to iwi. Such analysis would inform an update of Government policy on Crown contributions to support the implementation of Treaty settlements.
- To avoid future unfunded mandates, the Commission has reiterated its previously proposed Partners in Regulation Protocol. The protocol would set out an agreed set of behaviours and expectations when developing and implementing legislation and regulation. It would include a principle about central government explicitly considering the costs to local government of relevant new regulations, and the funding of the costs, in its Regulatory Impact Assessments.

The Crown should pay its way

Crown land includes land occupied by institutions such as schools, universities and hospitals, as well as the conservation estate. Most Crown land is currently exempt from rates, aside from a limited set of targeted rates. In previous inquiries, the Commission has recommended that central government should pay rates on its properties. As an alternative, the Commission has recommended in this inquiry that the Crown should at least pay its way in the following circumstances:

- If the Crown, as owner of property within a district, benefits directly from council services, or imposes costs on councils, then it should cover the cost of those services.
- The Government should pay development contributions on all developments it undertakes in line with the development-contributions policies of the local authorities in which the developments are located.

New funding and financing tools for growth-supporting infrastructure

The failure of high-growth councils to supply enough infrastructure to meet demand is a serious social and economic problem. Councils' failure to adequately accommodate growth has been a significant contributor to the undersupply of development capacity for housing in fast-growing urban areas. This in turn has been a major driver of rapid and harmful house price increases in New Zealand since around 2000.

Councils have funding and financing tools to make growth “pay for itself” over time by deriving revenue to fund the infrastructure for new property developments from new residents rather than burdening existing ratepayers. However, the long time it takes to recover costs, debt limits and the perception that growth does not pay are significant barriers.

User charging would help pay for and manage growth

The Government should give councils the power to levy volumetric wastewater charges and road-congestion charges. These funding tools would help give councils the means to efficiently fund the costs of growth. User charges can also help manage demand by increasing the number of people that existing infrastructure can support and extending the useable life of these assets. Applying user charges to help manage demand in this way would delay the need for new infrastructure investments.

Special Purpose Vehicles could help councils nearing their debt limits

A small number of high-growth councils face debt limits that may be impeding much needed investment in growth-supporting infrastructure. A promising option to assist these councils is a Special Purpose Vehicle (SPV). To date, Auckland Council, together with Crown Infrastructure Partners, Treasury and developer Fulton Hogan, have established an SPV that has raised nearly \$50 million in long-term finance that will not sit as a debt on the balance sheet of Auckland Council (or the Crown), and therefore not count towards the council's debt limit. The finance is being used to fund five bulk roading and wastewater infrastructure projects to service a large new residential development in Milldale.

The Government and officials are currently investigating how to expand the use of SPVs to finance different types of infrastructure investments, including SPVs that will benefit both new and existing residents. The Commission supports this work and, if necessary, any enabling legislation to expand the use of SPVs.

Considering a tax on vacant land

The Commission has examined whether vacant-land taxes would be a useful mechanism to improve the supply of available housing for New Zealanders. This responds to a request from the Minister of Finance in April 2019, following a recommendation from the 2019 Tax Working Group for the Commission to look at whether local councils should be empowered to introduce local vacant-land taxes.

The Commission has concluded that while vacant-land taxes could temporarily reduce land banking and increase housing supply, these effects are likely to be small. Indeed, over several or more years, such taxes would prove to be taxes on development of new housing and have harmful effects. They would likely reduce housing supply responsiveness by reducing developer flexibility and risk-taking, which is the opposite of what is needed in New Zealand. The Government should not further advance the idea of implementing a vacant-land tax.

Improving the supply of infrastructure for development and overcoming regulatory barriers to development would be better ways of increasing the supply of housing. The Commission has previously made recommendations for tackling both these problems.

Funding amenities and services for tourists

Tourists' use of local infrastructure and services imposes costs on councils. International tourists provide revenues at least equal to the costs they create, but not as revenue to councils. Councils may face a funding shortfall for the costs associated with local public-good type amenities and services used by international and domestic tourists, such as public toilets, car parks and walkways. This funding shortfall is modest, likely amounting to less than 2% of total council revenue in most districts.

In its draft report, the Commission discussed a range of options for funding this small shortfall, including an accommodation levy. On further analysis of these options, the Commission's view is that any new funding tool would have high costs, and so be unlikely to deliver a net benefit to councils unless the shortfall was large. Existing revenue-raising arrangements provide appropriate ways for meeting these costs. Councils should make better use of their available tools, including more user charging, greater use of debt, raising more in rates (including from efficient targeted rates), and better use of strategies and tools to plan for tourism and manage peak demand.

In addition, significant scope exists to improve central government funding flows to councils for tourism-related amenities and services. As explained above, funding should be distributed in a more systematic, ongoing, predictable and fairer way by using a transparent allocation formula. This would help preserve local government autonomy and avoid disadvantaging well-run councils.

Affordability for households

The Rates Rebate Scheme is not well targeted and needs replacing

Ultimately all households pay rates either directly or indirectly through the price they pay for rents and buying goods and services. Concerns about the affordability of rates typically focus on low-income

(particularly elderly) households who own their own homes, usually without a mortgage. Yet such households generally have much lower housing costs than other low-income New Zealand households who rent or who have a mortgage.

The Rates Rebate Scheme (RRS) provides financial support to help homeowners on a low income to pay their rates bills. The Commission's analysis shows that the RRS is unfair because renting households in similar circumstances do not qualify. It is also administratively cumbersome for modest impact (the maximum payment amounts to a little over \$12 a week). The Accommodation Supplement is the Government's principal form of assistance for accommodation costs to low-income households living in private residences. Most recipients of the RRS would not qualify for the Accommodation Supplement because their housing costs are too low.

The Commission considers that a revamped national rates postponement scheme would better fulfil the purposes that the RRS is designed to address. Currently, rates postponement happens when a local authority agrees to delay the due date of a rates payment until a specified time or a specific event occurs, such as the sale of the property. Under a national scheme, the finance providers would carry the debt needed to finance rates postponement. The Government should collaborate with local government and suitable financial institutions to design, implement and promote such a scheme. Once a successful national rates postponement scheme is in place, the RRS should be phased out.

If the Government wishes to retain the RRS, it should improve the scheme's administrative efficiency by shifting to fully online application and processing capabilities. This could be achieved by extending the current trials undertaken by the Department of Internal Affairs, or by moving administration to the Ministry of Social Development or Inland Revenue.

The 30% cap on uniform charges should be removed

The 30% cap on uniform charges (under the Local Government (Rating) Act 2002) was intended to prevent the rating system being too regressive. However, the Local Government Act 2002 provides sufficient guidance for councils to consider wellbeing in setting rates, and councils are keenly aware of ability to pay when they make rating decisions. The cap is inconsistent with local government autonomy to set rates according to local preferences, and is not necessary to prevent rates being overly regressive. It should be removed.

Improving the performance of the three-waters sector

Fundamental reform of the sector is required

Under current arrangements, the provision of safe drinking water and cleanly disposing of wastewater and stormwater are key responsibilities of local government. Some councils have taken the tough decisions to improve their performance, and they should be applauded for doing so. Yet considerable evidence shows poor performance of the three-waters sector in many parts of New Zealand, in terms of its impact on human health, the natural environment, productivity and costs to consumers and ratepayers.

Local authorities spend a high proportion of their funds on three waters. Achieving better safety and environmental records is expected to create additional funding and financing pressures on local councils, with some small populations potentially incurring very large cost increases. Tackling these pressures requires fundamental reforms that sustainably lift councils' safety and environmental performance as well as their productivity and cost effectiveness.

The Government has announced that existing drinking water standards will be mandatory for almost all suppliers and is establishing a new drinking water regulator to monitor and enforce compliance with those standards. The new regulator will also oversee wastewater and stormwater regulation but day-to-day regulation will remain with regional councils.

The previous regulatory regime imposed weak disciplines and incentives on council-led water suppliers to meet safety and environmental minimums, and no independent oversight of supplier charges and/or costs.

Regulators did not prosecute for breaches of health standards, and allowed too many suppliers of wastewater to continue operating with expired consents.

A new regulatory regime to substantially lift performance

The performance of the three-waters sector would be substantially improved through an approach that rigorously enforces minimum performance standards; and is permissive about the way councils structure and operate their three-waters businesses. However, the Government should encourage the adoption of better governance and the aggregation of council water businesses. It should also consider having backstop arrangements to deal with councils that fail to lift performance sufficiently to meet minimum health and environmental performance standards.

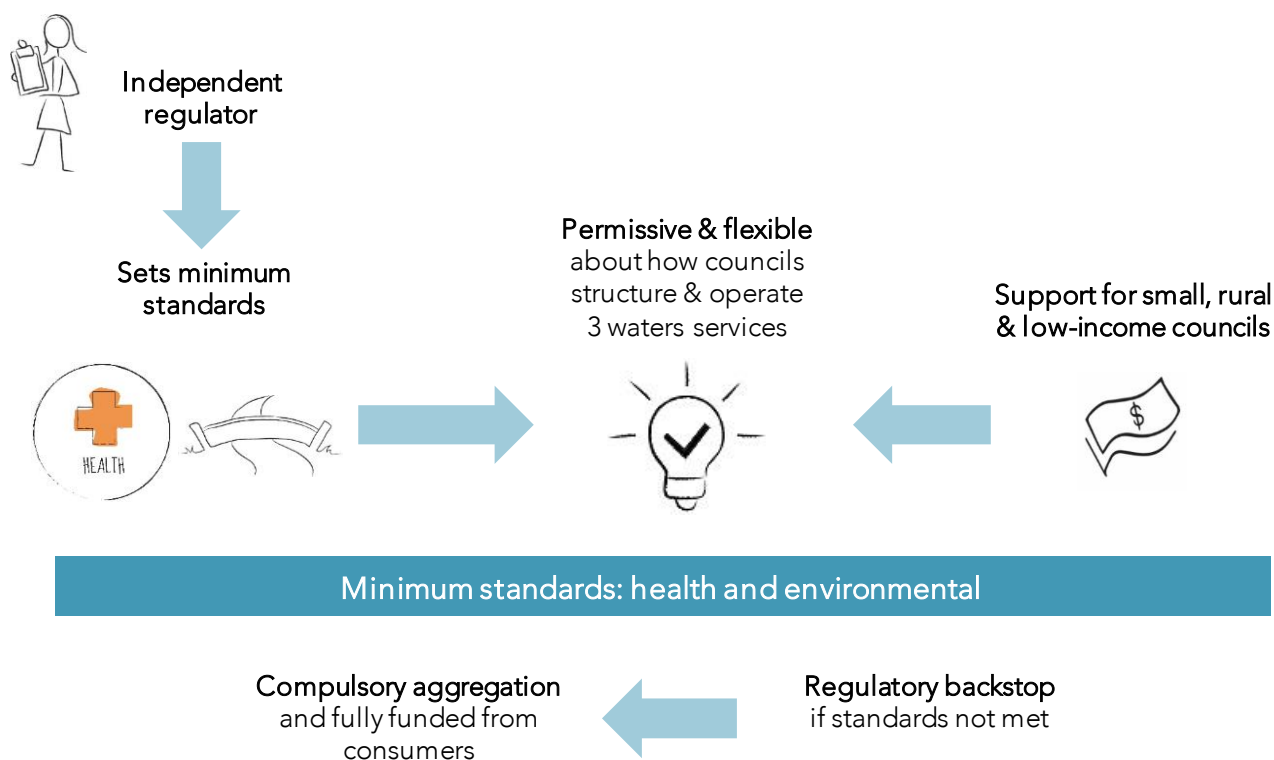
The Government should legislate to enable council-owned water businesses to directly charge water users for their services, in the same way that Watercare (owned by Auckland Council) can do now. It should also allow councils to adopt volumetric charging for wastewater, similar to what is currently allowed for drinking water.

The Government is currently considering the funding and delivery of the three-waters sector and may introduce economic regulation in the future. Independent and effective economic regulation is needed to encourage fit-for-purpose investments to lift the sector’s performance and assist with affordability (by minimising costs).

Funding support for small, rural and low-income communities

While significant cost efficiencies should be possible for most council-led water services, some communities will need financial assistance from government to help them make the transition to achieving minimum performance standards. The Commission recommends a new central government funding stream to assist small, rural and low-income communities make the required upgrades to their three-waters infrastructure (Figure 0.5) As with the new funding for climate change adaptation, this support should be based on a transparent formula and require co-funding from councils.

Figure 0-5 Lifting the performance of the three-waters sector



Making it happen

This report sets out a suite of recommendations for improving local government funding and financing arrangements. The combined scale of the pressures identified in this report is very substantial, as illustrated in the cost estimates provided above. As outlined above, there are principled reasons why central government should contribute a share of some of these costs.

The Commission's recommendations will entail a significant fiscal cost on central government. It is difficult to estimate these costs with any precision. By far the largest item that can be estimated is the cost of proposals to help councils whose assets are threatened by climate change. Central government's share of this cost could be in the order of \$150 million per year over twenty years. The cost to central government for support to small, rural and low-income councils for upgrades to their drinking water supplies will likely be much smaller (in the order of \$10 million per year).

The Commission sees regional spatial planning as key to getting the benefits from the Commission's proposed changes. As councils plan and respond to the many and varied challenges facing their communities, spatial planning will aid in coordinating their efforts across councils, and with central government.

Currently, only the Auckland region has a statutory basis for regional spatial planning. The government is undertaking a fundamental review of the resource management system. This review offers an opportunity to develop and embed an effective regional spatial-planning approach as a standard and mandatory part of the planning process.

Given the place-based nature of infrastructure, the new Infrastructure Commission's work will inform and be informed by regional spatial plans. This will be critical to the coordination, planning and delivery of significant infrastructure around the country.

The new Climate Change Commission will undertake a national level risk assessment at least every six years. The information gathered through those risk assessments will also be important to inform regional spatial plans. Climate change will impact how and where people live, and the risks will change over time. Spatial planning can help councils prepare effectively for this so that responses to climate impacts do not happen in an ad hoc way.

The Commission therefore looks forward to resource management reforms elevating the status of regional spatial plans and giving them a statutory basis.

1 About this inquiry

Key points

- Local government plays an essential role in New Zealand’s system of government as both a provider of services and a voice for local democracy. High-performing local government matters a great deal to communities and the wellbeing of New Zealanders.
- The Government has asked the Commission to undertake an inquiry into local government funding and financing. It wants to know what is driving the cost of local-government services and whether the current funding and financing arrangements are adequate and efficient. If they are not, the Government wants to know what options and approaches will improve the arrangements.
- The Terms of Reference (TOR) for this inquiry identify pressures that are putting a strain on local government costs, now and in the future. The pressures stem from population changes, the need to adapt to climate change, the need for new growth infrastructure, the rapid growth of tourism, and the ever higher and wider service standards expected of local government. The TOR call for an in-depth investigation into the adequacy of local government funding and financing arrangements.
- The following principles are used to evaluate the adequacy of funding and financing tools currently available to local governments in New Zealand and the need for additional tools.
 - Appropriate for local government use – given the role of local government; and the need for local autonomy (flexibility to align with local preferences) and accountability.
 - Coherent with national policy objectives and the wider tax system.
 - Efficient, such that instruments should minimise harmful incentive effects on resource allocation, investment and innovation, and minimise compliance and administration costs.
 - Fair – taking account of who benefits from local government services, including current and future generations.
 - Sustainable, through minimising avoidance and providing adequate, stable and predictable revenue over time.
 - Transparent – the reasons for funding and financing decisions should be clear to those who are paying and to the community as a whole on behalf of whom councils make decisions.
- Revenue transfers from central to local government may be justified in a range of situations. These situations include when services provided by local government confer national benefits. It is important that such transfers are designed with a clear purpose, reasonable simplicity, are transparent and predictable, and preserve local government autonomy and accountability as far as possible.
- The quality of councils’ decision-making is vital to making best use of available funding and financing tools. This quality flows from well-designed institutional and statutory arrangements, plus the skills and capability of council decision-makers. When councils have the right knowledge, incentives and decision rights, they will make prudent, efficient and effective revenue-raising and spending decisions that reflect the preferences and aspirations of their communities.
- The Commission has identified the three-waters sector (drinking water, wastewater, and stormwater) as an important area for investigation. This report makes recommendations to improve outcomes in the three-waters sector and ease funding pressures.

1.1 What the Commission has been asked to do

Local government plays an essential role in New Zealand's system of government as both a provider of services and a voice for local democracy. Local government promotes community wellbeing through regulating land use (managing the activities of people and businesses so they do not negatively impact on others or the natural environment), choosing and funding local amenities, and planning and investing in essential infrastructure.

The Government has asked the Commission to undertake an inquiry into local government funding and financing. It wants to know what is driving the cost of local-government services and whether the current funding and financing arrangements are adequate and efficient. If neither adequate nor efficient, the Government wants to know what options and approaches will improve these arrangements. The Terms of Reference (TOR) exclude several topics from the inquiry (Box 1.1).

It is important to be clear about what local government *financing and funding* means.

- Financing refers to the arrangements put in place to ensure money is available to pay for an investment project or service at the time payment is due. So, for example, a council may finance an infrastructure project through borrowing to ensure that it has the cash on hand to pay the upfront bills.
- Funding refers to the sources of money that the ultimate payers of infrastructure and services provide over time. For example, a council may fund an infrastructure project through sources such as rates or user charges and use this revenue to cover the costs of financing (which would comprise interest and capital repayments in the case of borrowing).

Box 1.1 Matters excluded from this inquiry

The local government funding and financing inquiry excludes the following topics:

- mechanisms for rating Māori freehold land and Crown land;
- the valuation system and practices;
- substantial privatisation; and
- recommendations that would directly affect representation or boundary arrangements for councils.

The inquiry's TOR do not call for an assessment of, or changes to, the current scope and responsibilities of local government. Any significant change to the scope and responsibilities would require a fresh look at the appropriate range of funding and financing tools.

On 29 April 2019, the Minister of Finance wrote to the Chair of the Productivity Commission asking for the inquiry's TOR to be expanded to incorporate the recommendations of the 2019 Tax Working Group (TWG) relating to taxing vacant land. The TWG highlighted the challenges of housing affordability in New Zealand and how constraints on the supply of land for housing contribute to the high cost of housing. The TWG recommended that the Productivity Commission's inquiry into local government funding and financing consider whether a tax on vacant residential land would be a useful mechanism to improve the supply of housing for New Zealanders.

1.2 Why this inquiry is important

High-performing local government matters a great deal to communities and the wellbeing of New Zealanders. Local government (through its planning and land use regulatory role) can provide greater access to, and choices of, housing; better protection of New Zealand's natural environment and cultural values; and quality infrastructure at the right time in the right place. Success in these provides the foundation for urban and rural communities that enjoy a wide range of amenities and are attractive places to live; and where people consume, work, play and create.

If councils struggle to deal with rising costs and have poor incentives for improving performance, then this will lead to poor community outcomes. For example, the inquiry into contaminated drinking water in Havelock North found about 759 000 people in New Zealand (20% of the serviced population) are supplied with water that is not demonstrably safe to drink. Of these, 92 000 people risk getting a bacterial infection, 681 000 risk getting a protozoal infection, and 59 000 risk suffering from the long-term effects of exposure to chemicals (Havelock North Inquiry, 2017, p. 25). In addition, many council wastewater systems are performing poorly. They are degrading freshwater and coastal water quality, and sewage overflows are occurring at a frequency that communities no longer accept.

The funding and financing framework for local government must therefore incentivise good performance and enable local government to deliver quality services when and where needed in line with the preferences and aspirations of the local community. This requires that local government have the necessary autonomy, responsibility and accountability in delivering these services. In turn, this requires that local-government services are largely paid for by local ratepayers, and that the services are effective, efficient and affordable.

1.3 The context of this inquiry

The TOR for this inquiry identify pressures that are putting a strain on local government costs, now and into the future. Accordingly, the TOR call for the Commission to conduct an in-depth investigation into the adequacy of local government funding and financing arrangements to cope with these pressures. Those pressures are:

- for areas with rapid population growth, the need for local authorities to increase the supply of development capacity to tackle declining housing affordability;
- the need to maintain services in areas with declining populations;
- requirements for higher standards of quality for fresh water, wastewater, stormwater and flood protection to meet environmental and public-health standards;
- the need to adapt to the increasing hazards and rising risks due to climate change;
- the pressures from the rapid growth of tourism, especially where tourist numbers have become large relative to residents; and
- the need to replace existing infrastructure that is coming to the end of its useful life, especially where this has been neglected in recent times.

These pressures vary according to the type of council as well as size, location, demographic and other characteristics. The impact and fiscal adequacy of the funding system in dealing with these and other pressures facing councils are investigated in Chapter 6. Adapting to climate change stands out as a relatively new area that is putting significant additional funding pressure on local government.

Previous and current work in this area

Some significant aspects of local government have been the subject of significant investigation and analysis by the Productivity Commission in recent years. In particular, the Commission:

- evaluated the demand and supply factors influencing the affordability of housing and examined potential opportunities to increase housing affordability (*Housing affordability*, 2012);
- investigated local government regulatory performance and identified key areas for improvement (*Towards better local regulation*, 2013);
- examined local government processes for the supply of land for housing in high-growth areas and recommended improvements (*Using land for housing*, 2015); and
- undertook a first-principles review of the urban planning system in New Zealand and set out what a high-performing urban planning system would look like (*Better urban planning*, 2017).

These inquiries examined important issues relevant to this inquiry, such as local government approaches to rating and to funding and financing the infrastructure needed to accommodate population growth.

In addition, existing government work programmes are relevant to this inquiry.

- The Ministry of Housing and Urban Development is leading the *Urban Growth Agenda* – a programme of work to improve housing affordability underpinned by affordable land. That programme aims to remove undue constraints to land supply, development capacity and infrastructure provision (Office of the Minister of Housing and Urban Development & Office of the Minister for the Environment, 2018).
- The Department of Internal Affairs is reviewing the organisation and management of drinking water, stormwater and wastewater (the “three waters”). So far, the Government has announced that existing drinking water standards will be mandatory for almost all suppliers and is establishing a new drinking water regulator to monitor and enforce compliance with those standards. The new regulator will also oversee wastewater and stormwater regulation, but regional councils will deal with day-to-day regulation. The Government is currently considering the funding and delivery of the three-waters sector and may introduce economic regulation in the future.

The last comprehensive review of local government funding and financing was the *Report of the Local Government Rates Inquiry* (the so-called “Shand Report”) published in 2007. More than 10 years later, this inquiry presents an opportunity to take another comprehensive look at the funding and financing system across the range of local government functions.

1.4 Gathering evidence

The Commission’s findings and recommendations have been informed by a comprehensive engagement with interested and expert parties. The inquiry received 271 submissions from a diverse range of sector participants; including from councils, business groups, property developers, infrastructure providers, academics and researchers, farming bodies, ratepayer groups, individual ratepayers and government agencies.

The inquiry team met with a wide variety of interested parties across New Zealand. These included several “cluster meetings” of councils (where a council hosted neighbouring councils) in Dunedin, Christchurch, Palmerston North, Tasman, Porirua, Auckland and Hamilton. The Commission has appreciated the large turn-outs at these cluster meetings. The Commission also met with provincial chambers of commerce members, Federated Farmers members, and property developers.

The Commission undertook five in-depth case studies. Four of these were with a cross-section of individual councils, including one regional council. The fifth case study was a thematic study focused on climate change adaptation. It involved visits to the three councils involved in the Clifton to Tangoio Coastal Hazard Strategy process in the Hawke’s Bay.

The case studies involved a comprehensive document review and face-to-face interviews with elected members and key staff. These “deep-dive” case studies have allowed the Commission to “get below the averages”. They have provided it with a detailed understanding of the diversity of issues facing different councils.

The Commission is grateful to the experts who provided advice and input on several technical, data, policy and institutional-design issues. These include Dr Kenneth Palmer (University of Auckland); Professor Ian Ball (Public Sector Performance (NZ) Ltd); Robin Oliver and Mike Shaw (OliverShaw); Fraser Colegrave (Insight Economics); Ashley Milkop, Michael Young, and David Moore (Sapere Research Group); Carl Hansen (Capital Strategic Advisors); Peter Winder (McGredy Winder & Co); and Professor Jonathan Boston and Dr Judy Lawrence (Victoria University of Wellington).

This evidence has provided a rich picture of the funding and financing pressures facing councils, the adequacy of current funding and financing arrangements, and the need for any additional funding and financing tools.

1.5 The Commission's approach

Principles for local government funding and financing

The Commission has reviewed the taxation and funding literature, past reviews of local government funding and reviews of the national taxation system. From these, it has distilled a set of principles to evaluate the adequacy of the funding and financing tools currently available to local government, and to assess possible new tools (Box 1.2) (also see Chapter 6). These principles can conflict with each other. The design of a local government funding system needs to make clear which principles prevail and strike a balance between them.

In the New Zealand context, the Treaty of Waitangi is an important frame when thinking about principles for local government funding and financing. Local government decisions have a strong impact on Māori interests, which are explicitly recognised in legislation. Councils are required to facilitate Māori participation in council processes and decision making. In doing so, councils are giving effect to the Crown's Treaty obligations, for which the Crown retains ultimate responsibility. Different aspects of these obligations are discussed in Chapters 2, 4 and 5.

Box 1.2 Principles for funding and financing

The Commission has used the following principles to evaluate the adequacy of the funding and financing tools currently available to local governments in New Zealand and to assess any possible additional tools.

Funding and financing instruments for local government should be:

- **appropriate for local government use** – given the role of local government; and the need for local autonomy (flexibility to align with local preferences) and accountability;
- **coherent** with national policy objectives and the wider tax system;
- **efficient**, such that instruments should minimise harmful incentive effects on resource allocation, investment and innovation, and minimise compliance and administration costs;
- **fair** – taking account of who benefits from local government services, including current and future generations;
- **sustainable**, through minimising avoidance and providing adequate, stable and predictable revenue over time; and
- **transparent** – the reasons for funding and financing decisions should be clear to those who are paying and to the community as a whole on behalf of whom councils make decisions.

Local government's role sits alongside that of central government and they both draw on the same populations of citizens and businesses to fund these roles. Central government takes the lead on macroeconomic stabilisation and redistribution across citizens, including by providing a social safety net for the least well off. Even so, local government may legitimately consider ability to pay alongside the benefit principle and efficiency principles as its main guides to allocate the costs of its services.

Payments from central to local government may be justified in the following situations:

- when local government activities have national-level benefit spillovers;
- sharing risks across all taxpayers, when some communities are subject to damaging shocks (such as natural disasters);
- helping low-income communities whose councils are struggling to fund essential services; and

- recycling revenue collected centrally (for administrative efficiency) to cover costs incurred locally.

In the New Zealand context, an important category of national-benefit spillovers relates to fulfilling Treaty of Waitangi obligations. While the primary obligations under the Treaty lie with the Crown, local governments often fulfil responsibilities with respect to local iwi. It is vital that central government ensures that local government has the funding to carry out these responsibilities to an acceptable standard.

It is important that payments from central government are designed with a clear purpose and show reasonable simplicity, are transparent and predictable, and preserve local government autonomy and accountability as far as possible.

Alternative models of local government funding

To test whether any radically different approaches to raising local government revenue would be superior in terms of local government use, coherence, efficiency, equity and sustainability, the Commission examined the main alternatives. It looked at a variety of systems in use around the world, including several in Europe where local governments have larger scope and access to significant income tax revenues (Crawford & Shafiee, 2019).

The quality of decision making by local government

The focus of this inquiry is the adequacy of funding and financing tools that local government needs to carry out its role in providing services for local residents and businesses. However, importantly, the quality of decision making by local government is critical to making best use of available funding and financing tools and resources, and to ensuring decisions align with community needs and preferences.

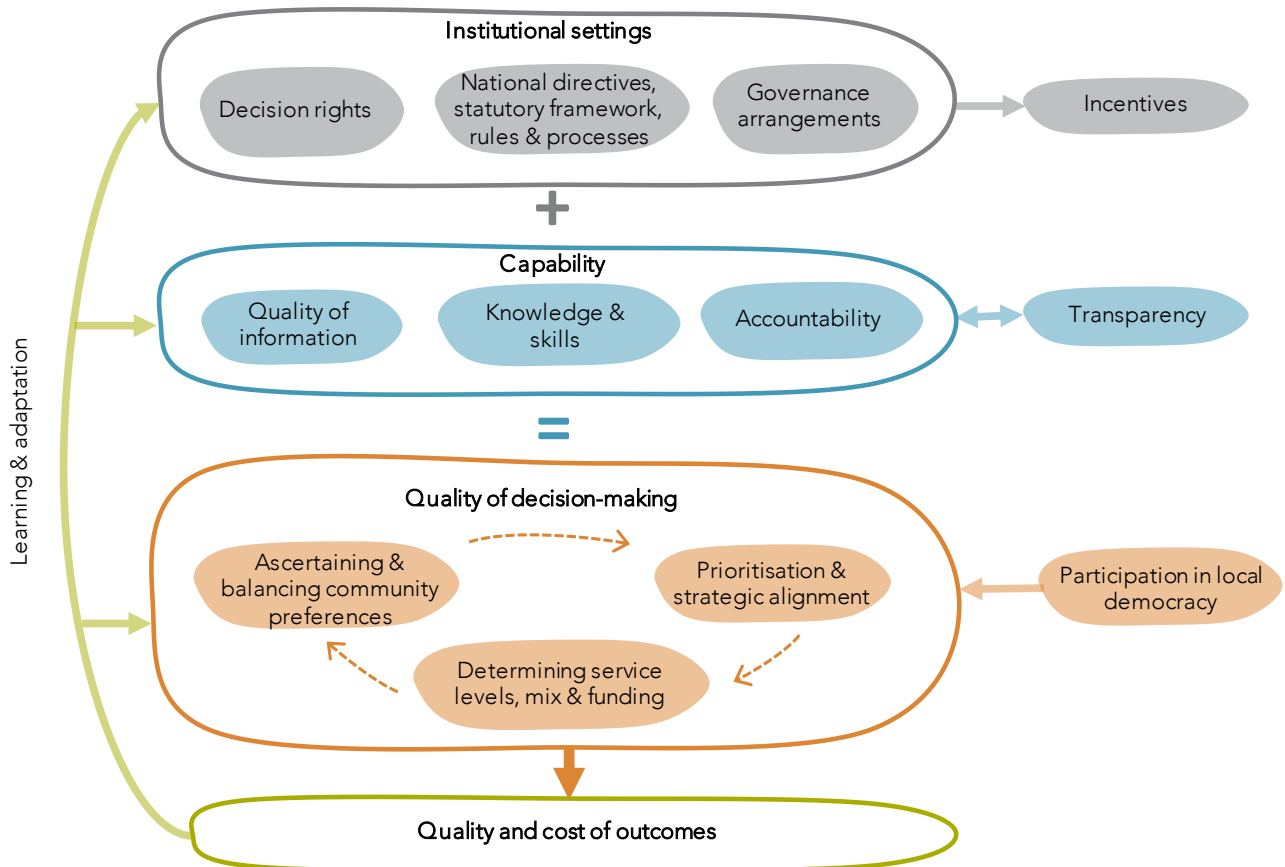
Councils undertake many activities. They make choices about the mix of activities, the levels of service, how each activity is provided and funded and who pays. Councils have many choices about how to fund their activities (Chapter 2). These choices (eg, the mix of general and targeted rates, differentials, and fees and charges), affect the amount that different groups of people pay (Chapters 6 and 7).

How well councils make use of current funding and financing tools has a material impact on the quality of outcomes. The disciplines and incentives on councils to make good decisions are examined in Chapter 5. The scope for improving the quality of decision making so as to achieve better long-term outcomes is assessed in regard to:

- *institutional settings* (ie, the statutory framework for decision making, as well as council governance arrangements and where decision-rights sit); and
- *council capability* (ie, the quality of information put to decision makers, the relevant knowledge and skills of decision makers and those supporting them, and accountability arrangements) (Figure 1.1).

The chapter recommends ways to improve the quality of council decision making.

Figure 1-1 Key elements of good decision making



Dealing with funding pressures

Chapter 11 applies the above decision-making framework to the water sector in New Zealand. The Commission decided to investigate this area in depth given that local governments spend a high proportion of their funds on the three waters. For example, for local government, drinking water and wastewater accounted for nearly 14% of total operating expenditure (opex) and 22% of capital expenditure (capex) in 2018. Local government capex on these activities is projected to be 25% of total capex over 2019–2028, according to their Long-Term Plans. Also, poor-quality water services in New Zealand are common. Achieving higher safety and environmental standards is expected to create additional funding and financing pressures on councils, with some districts with small and rural populations expected to incur very large increases in costs.

Dealing with these pressures will require reforms that can enable a sustainable lift in council performance – in safety, in environmental outcomes, and in productivity and cost effectiveness. Better investment choices are essential to minimise additional costs and harms on communities. Chapter 11 identifies a way forward that would substantially improve the performance of the three-waters sector.

A new, challenging and growing pressure on local government funding comes from climate change – in particular, the threats from sea-level rise and more frequent and extreme weather events. The most direct threat is climate-induced damage to local-government infrastructure such as roads, bridges, three waters and flood-protection assets. Two broad principles guide the Commission’s analysis and advice on funding of climate adaptation: minimising long-run cost; and fairness (Chapter 9). The two principles imply avoiding moral-hazard behaviour that leads to increased risk exposure for private gain at the expense of others. The second principle brings into play New Zealand’s strong tradition of societal support and risk sharing, and inter-generational equity.

2 The context

Key points

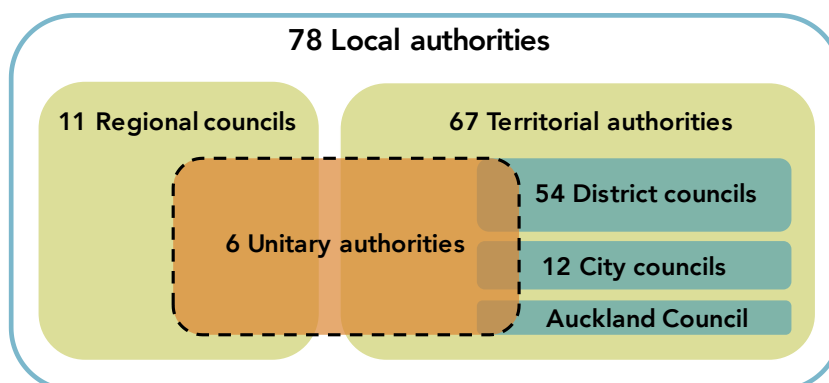
- New Zealand's 78 local authorities are set up under statute to enable democratic local decision making by their communities, to provide local infrastructure and to undertake specified regulatory functions. Under the Local Government Act 2002 (LGA), promoting the four wellbeings of communities (social, economic, environmental and cultural) is a main purpose of local government.
- Local authorities are accountable to and largely funded by their own communities. The LGA provides local authorities with the power of general competence (the ability to choose the activities they undertake to fulfil their statutory role and how they should undertake them subject to public consultation). The LGA and other Acts set out the power of councils, including the power to make local bylaws, the power to raise revenue, and councils' planning and accountability requirements.
- The scope of responsibilities of local government in New Zealand is narrower than in most other developed countries. Local government in New Zealand makes up a smaller proportion of total government spending than in most other jurisdictions.
- Local authorities have widely different circumstances that are material to this inquiry. A small number of urban authorities are experiencing rapid population growth. Other authorities are growing slowly in population, or not at all. Physical resources and industry structure vary across the country, driving different infrastructure requirements. Tourism is particularly prominent in some areas.
- Physical infrastructure provision dominates local government operating and capital expenditure, though the details vary greatly across councils. Rates provide the largest source of revenue (just under 50%), with grants and subsidies (particularly from central government for roading and other transport costs) and fees and user charges also important.
- The Local Government Funding Agency is the largest lender to local government. Other lenders include banks and financial institutions and purchasers of local bonds. Various laws and regulations set out financial reporting and prudential requirements.

This chapter sets out the basis for local government in New Zealand, the activities that it funds and sources of revenue. It identifies the significant variation in circumstances across local authorities that impact their ability to raise revenue to fund activities and to finance their investments.

2.1 Local government in New Zealand

Local government is a term used to collectively describe New Zealand's 78 regional, district, city or unitary councils (Figure 2-1)

Figure 2-1 Types of local government



Notes:

1. The 67 territorial authorities include 54 district councils (four of which are unitary authorities), 12 city councils (one of which is a unitary authority) and Auckland Council (which is a unitary authority).

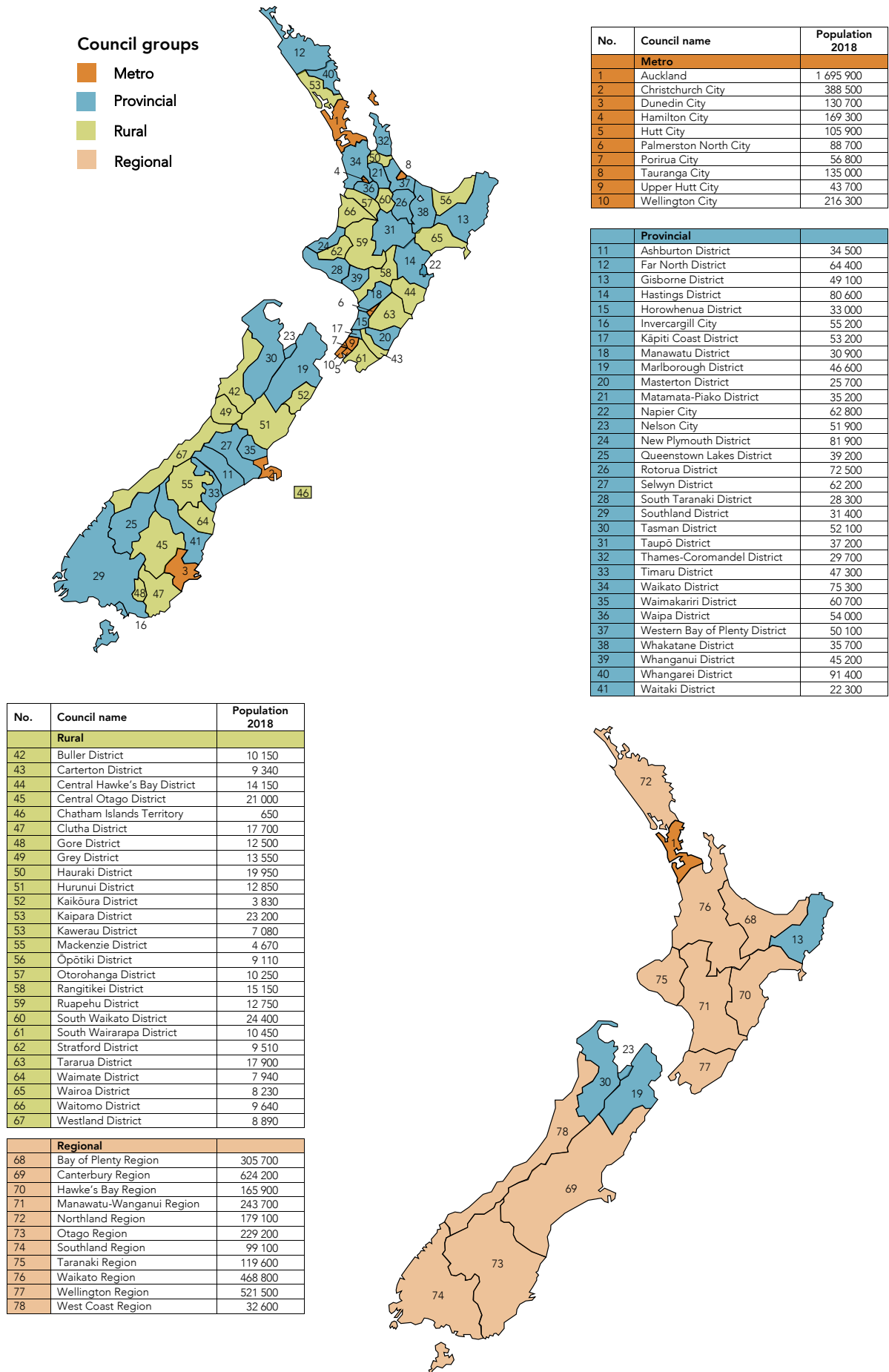
Regional councils are responsible for the physical environment and cross-boundary functions that require an integrated approach, which include regional land transport, flood protection, biosecurity, civil defence and some resource management.² The functions of territorial authorities (city and district councils) are broader, encompassing physical infrastructure such as roads, water supply, wastewater and stormwater, recreation and cultural activities, land-use planning, building standards and some public health and safety functions. A unitary authority is a territorial authority that also has all the responsibilities of a regional council.

The scale of local government is significant. In June 2018, local government owned fixed assets worth \$123 billion, and had a yearly operating expenditure (opex) of \$10.3 billion and an operating income of \$9.9 billion (Stats NZ, 2019d). Local government employs around 23 000 staff (DIA, 2019d).

Figure 2-2 shows the location and population of local authorities. It also groups local authorities into sector groups: metropolitan; provincial; rural; and regional. These sector groups are based on Local Government New Zealand (LGNZ) membership.

² Wellington Regional Council is also responsible for bulk water supply through its participation in Wellington Water, a jointly owned Council Controlled Organisation.

Figure 2-2 New Zealand local authorities: population and sector group



Source: Stats NZ (2019e).

2.2 The purpose and powers of local government

The Local Government Act 2002 (LGA) (s 10) states that the purpose of local government in New Zealand is:

- to enable democratic local decision-making and action by, and on behalf of, communities; and
- to promote the social, economic, environmental, and cultural well-being of communities in the present and for the future.

The powers of local government

Local government is a creature of statute – it is established and empowered by legislation. The main laws that currently govern and empower local government are set out below.

- The LGA provides local authorities with the power of general competence (the ability to choose the activities they undertake in pursuing their statutory role and how they should undertake them, subject to public consultation). It sets out the powers of councils, including the power to make local bylaws, and councils' planning and accountability requirements.
- The Local Government (Rating) Act 2002 (LGRA) sets out the methods by which councils raise revenue through rates.
- The Local Government Act 2002 Amendment Act 2010 prescribes rules for council performance standards for core services of the LGA.
- The Local Electoral Act 2001 sets out the process for council elections.
- The Local Government (Auckland Council) Act 2009 sets out the governance structure for the Auckland Council.
- Local government activities (especially regulatory functions) are governed by a number of statutes, such as the Resource Management Act 1991 (RMA) and the Building Act 2004.

The functions and roles of local government have been frequently restructured and reshaped over the years by central government through legislative change. For example, under the previous legislation (the Local Government Act 1974), before local authorities did anything, they needed to check whether or not they were empowered to do it. The LGA abandoned this prescription and moved towards a power of general competence. However, this does not mean local authorities have a free hand to do whatever they wish. The powers of local authorities are limited by:

- the LGA (eg, local authorities must follow the process set out in the LGA when they make decisions), and local authorities cannot divest themselves of water and wastewater assets;
- other legislation (eg, local authorities cannot levy a poll tax or conduct an election on a different election cycle);
- the requirement that any action must promote the purpose of local government and be consistent with the principles set out in section 14 of the LGA; and
- the needs and wants of the community, as indicated through the decision-making and consultation processes set out in the LGA.

A range of types of powers

The powers invested in local authorities span a spectrum – from the powers that confer substantive discretion and autonomy through to delegated powers to implement regulation with little or no discretion.

Some powers conferred on local authorities are prescriptive and do not permit any discretion on the part of local authorities. The role of local authorities in this context is to deliver services according to national standards. These are often referred to as “delegated” powers. An example is the Building Act 2004, which requires local authorities to issue building consents and undertake building inspections. Local authorities have no role in setting building standards and cannot set higher or lower building standards than the

Building Code. For delegated powers, the performance of local authorities is mainly assessed on their capacity and ability to carry out regulatory functions to nationally determined standards.

Other powers granted to local authorities confer on them substantial discretion and autonomy as to when and how to exercise those powers. These types of powers are often referred to as “devolved powers”, and they give effect to local government’s role as the voice of local democracy. In this context, local authorities operate largely autonomously of central government, and are empowered to choose which activities to undertake and how to pay for them. Their performance will be judged on their ability to consult and reflect community interests and preferences, and to reconcile different community interests and reach a decision. The powers granted under the RMA and LGA are good examples of devolved powers.

In the middle of the spectrum are regulations that have been conferred on local authorities because local government is considered best placed to tailor regulation to the specific characteristics, needs and preferences of diverse local communities. Different regulations require different types of local input and decision making. For example, the role of local authorities under the Sale and Supply of Alcohol Act 2012 is quite different to their role under the Gambling Act 2003.

Chapter 5 explores the implications of devolved powers on the decision-making processes of local authorities, in particular the role of consultation in determining community preferences, and the importance of transparency in fulfilling the purposes of consultation.

Constitutional relationships with central government

Local authorities are accountable to and largely funded by their own communities.

While local government is a creature of statute, it operates as a largely autonomous provider of services, funded separately by property taxation and held accountable by voters. In the absence of well-defined constitutional or fiscal relationships, local and central government are most accurately regarded as two spheres of a system of collective decision-making, each with revenue-collection powers to fund the implementation of its particular policies and programmes. (Local Futures Research Project, 2006, pp.13–14)

Local authorities are sometimes characterised as agents of central government, required to implement national priorities and central government’s directions, and accountable to central government. However, in reality, the nature and extent of local authorities’ relationship with central government is context-specific, depending on the particular regulatory framework.

Some regulatory frameworks (such as for building) specifically provide that a local authority is accountable to the relevant minister or government department. However, in the absence of explicit statutory recognition of a line of accountability, a local authority is not accountable to the relevant minister or government department for the exercise of its statutory powers.

Constitutional relationships with Māori

The LGA 2002 includes a specific Treaty of Waitangi clause, which provides that the Crown’s obligations under the Treaty are recognised and respected by placing obligations on local authorities to facilitate participation by Māori in local authority decision-making processes (s 4).

Local iwi have a strong interest in local authority functions. This is especially so for resource management decisions under the RMA. Section 6 of the RMA recognises “the relationship of Māori and their culture and traditions to their ancestral lands, water, sites, waahi tapu, and other taonga” as a matter of national importance. Section 7(a) requires persons exercising functions and powers under the Act to have particular regard to kaitiakitanga, while section 8 requires them to take into account the principles of the Treaty of Waitangi. “[K]aitiakitanga means the exercise of guardianship by the tangata whenua of an area in accordance with tikanga Maori in relation to natural and physical resources; and includes the ethic of stewardship” (s 2).

Māori engagement in the decision making of local authorities

The LGA includes requirements for each council to:

- provide opportunities for Māori to contribute to decision-making processes (s 14);
- establish and maintain processes for Māori to contribute to decision making (s 81(1)(a));
- consider ways in which they can foster the development of Māori capacity to contribute to decision-making processes (s 81(1)(b));
- provide relevant information to Māori (s 81(1)(c));
- set out in their LTP the steps that the local authority intends to take to foster the development of Māori capacity to contribute to decision-making processes (cl 8 of Schedule 10); and
- identify in their annual report the activities undertaken to foster that development (cl 35 of Schedule 10).

The RMA also imposes obligations of consultation with tangata whenua.

Local authorities currently use a range of mechanisms to engage Māori in decision making, including:

- representation on council through Māori wards; or appointed Māori members;
- Māori committees and Māori representation on council committees;
- joint management and co-governance arrangements;
- statutory consultation; and
- Mana whakahono ā rohe (iwi participation arrangements) (see Chapter 4).

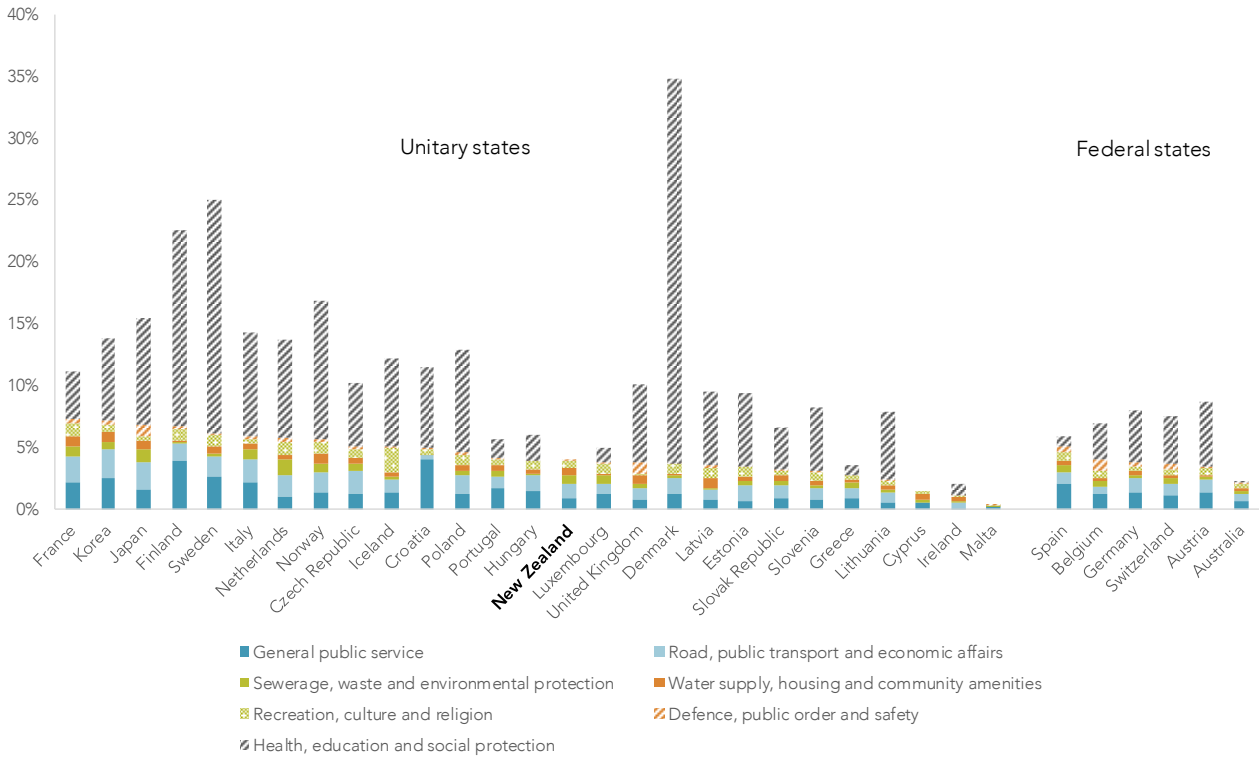
As an alternative to Māori representation on Auckland Council, the Local Government (Auckland Council) Act 2009 established the Independent Māori Statutory Board (IMSB). Section 81 of that Act charges the IMSB with assisting Auckland Council to make decisions, perform functions and exercise power by promoting issues of significance to Māori in Tāmaki Makaurau and ensuring the council complies with statutory provisions referring to the Treaty of Waitangi. The Commission's *Better urban planning* inquiry found the IMSB model was suited to some regions, particularly those with a large number of mana whenua groups (NZPC, 2017).

Other councils have used Wairoa District Council's Māori Standing Committee as a model (CouncilMARK, 2017b, p. 13). Also, CouncilMark reviewers described Ruapehu District Council's longstanding Ruapehu District Māori Council as an effective way of providing a way for local iwi to engage in council governance (CouncilMARK, 2017a, p. 14).

The scope of local government

Local government in New Zealand currently has a smaller scope of responsibilities than local governments in many other countries, and this is reflected in local government spending as a percentage of GDP (Figure 2-3). This is in part because many of the functions undertaken at the local level in other countries, such as health services and education, are funded centrally in New Zealand and provided through devolved Crown entities. High-income countries with decentralised delivery of health, education and social services by local government typically rely heavily on central government grants as a source of revenue. Even where local taxes partly fund these services, central government has a substantial influence on service design, delivery and monitoring (Crawford & Shafiee, 2019).

Figure 2-3 Local government spending by function as a percentage of GDP, 2016



Source: OECD & UCLG (2019b).

New Zealand is one of mostly anglophone countries which rely heavily on property taxes as a source of revenue (Figure 2-4).

Figure 2-4 Local government tax revenues across high-income countries, 2017



Source: OECD (2019a).

2.3 Differing circumstances across local authorities

Local authorities vary considerably in size and population dispersion

Local authorities vary considerably in population size. Auckland Council, the largest authority, has a population of about 1.7 million, while the smallest mainland authority, Kaikōura District Council, has a population of just under 4 000. All councils are responsible for local roading and the three waters; yet the share of expenditure allocated to different services can vary significantly between councils (section 2.4).

Councils also vary in the dispersion of their population. Some councils have several small population centres and so lack economies of scale in the provision of some infrastructure and services (see eg, Ōpōtiki District Council, sub. 126; Hauraki District Council, sub. 43; Federated Farmers of New Zealand, sub. 75; South Wairarapa District Council, sub. 104).

Population growth and decline across local authorities

New Zealand has experienced significant population growth since the 1990s. As a result, the populations of most local authorities have grown over recent decades; some have grown considerably (Figure 2-5). For instance, Queenstown Lakes district's population more than doubled, partly because of strong growth in its tourism industry. Selwyn district's population also doubled.

In absolute terms, a high proportion of recent population growth has occurred in large urban councils, particularly Auckland, Christchurch, Hamilton, Tauranga and Wellington. The scale of Auckland's population growth is unique (Box 2.1).

Box 2.1 The unique case of Auckland

About 35% of New Zealand residents live in Auckland. Over the past two decades, Auckland has grown rapidly and its population is projected to increase by over 500 000 people during the next 20 years. That increase is more than three times Hamilton's total population. The size of Auckland, combined with its rapid growth, brings about unique challenges.

- The Council needs financing and funding to deliver significant additional infrastructure to service new developments associated with population growth.
- Population growth has put substantial pressure on the transport network, resulting in increased traffic congestion, particularly at peak periods. It has also demanded large investment in roading infrastructure and public transport (eg, the CityRail link).

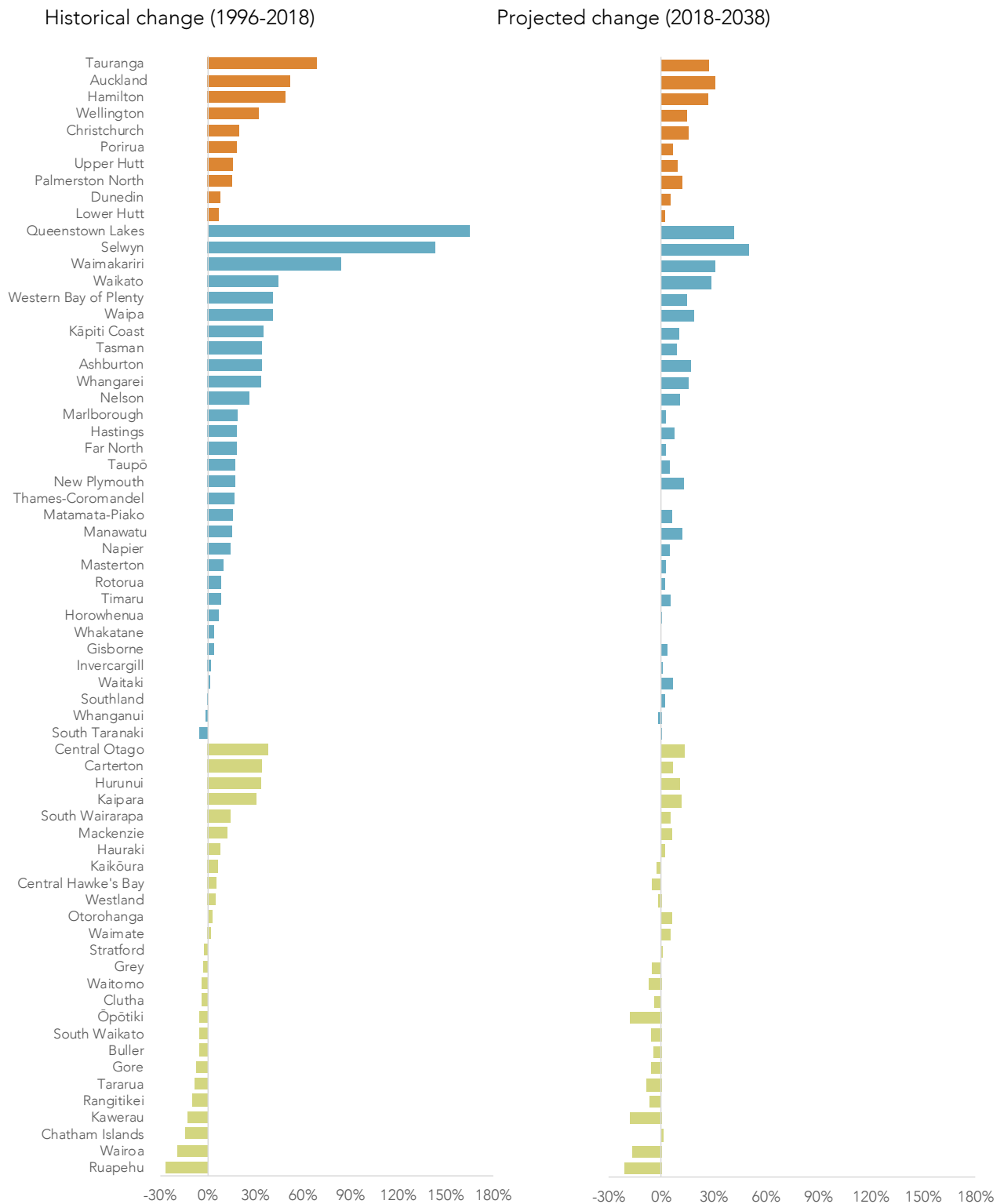
Given Auckland's size, failing to effectively tackle these challenges has indirect (and material) effects on the prosperity of the wider New Zealand economy. So, central government is working with Auckland Council to address some growth-related issues; for example, through the Auckland Transport Alignment Project and the Congestion Question project. Also, a recent legislative change enables Auckland Council to implement a regional fuel tax as a new tool to fund transport projects (section 2.5).

Yet, not all local authorities have seen growth – several faced a decline in population between 1996 and 2018. With the exception of Whanganui and South Taranaki, declining councils are smaller rural councils. For example, the population of Ruapehu district reduced by roughly a quarter, from 17 300 to 12 750, between 1996 and 2018. Wairoa district reduced in size by about 20% (Figure 2-5).

These trends reflect a general trend of urbanisation as people move from smaller centres to larger towns and cities. While predicting future population changes is inherently difficult, projections from Stats NZ suggest these trends may continue (Figure 2-5). Specifically, Auckland, Hamilton and Tauranga, commonly referred to as the Golden Triangle, along with Queenstown, Selwyn, Waimakariri and Waikato, are projected to grow the fastest, while 18 provincial and rural local authorities are projected to decline at varying rates. Even so, most of the councils projected to decline have, in fact, had stable or even growing populations in recent years (see eg, Tararua District Council, sub. 18). Domestic migration resulting from a period of

unusually high net international immigration and jobs created through the growth of tourism might be some of the reasons. Chapters 6 and 7 discuss funding pressures on small councils.

Figure 2-5 Historical and projected population change across local authorities



Source: Stats NZ (2018b, 2019e).

Notes:

1. Population projections based on 2013 population estimates.

Age structure

The average age of populations in towns and cities has been increasing as a result of historic reductions in birth rates and increasing life expectancy. Across New Zealand as a whole, the median age is projected to increase from 37.5 years to 42.9 years between 2013 and 2043. Projections vary across councils – for example, the median age in Ashburton district is projected to increase from 39 to 40 in the years to 2043. By contrast, the median age in Porirua city is projected to increase from 35 to 45 (Stats NZ, 2018b). These trends will be discussed in more detail in Chapter 4.

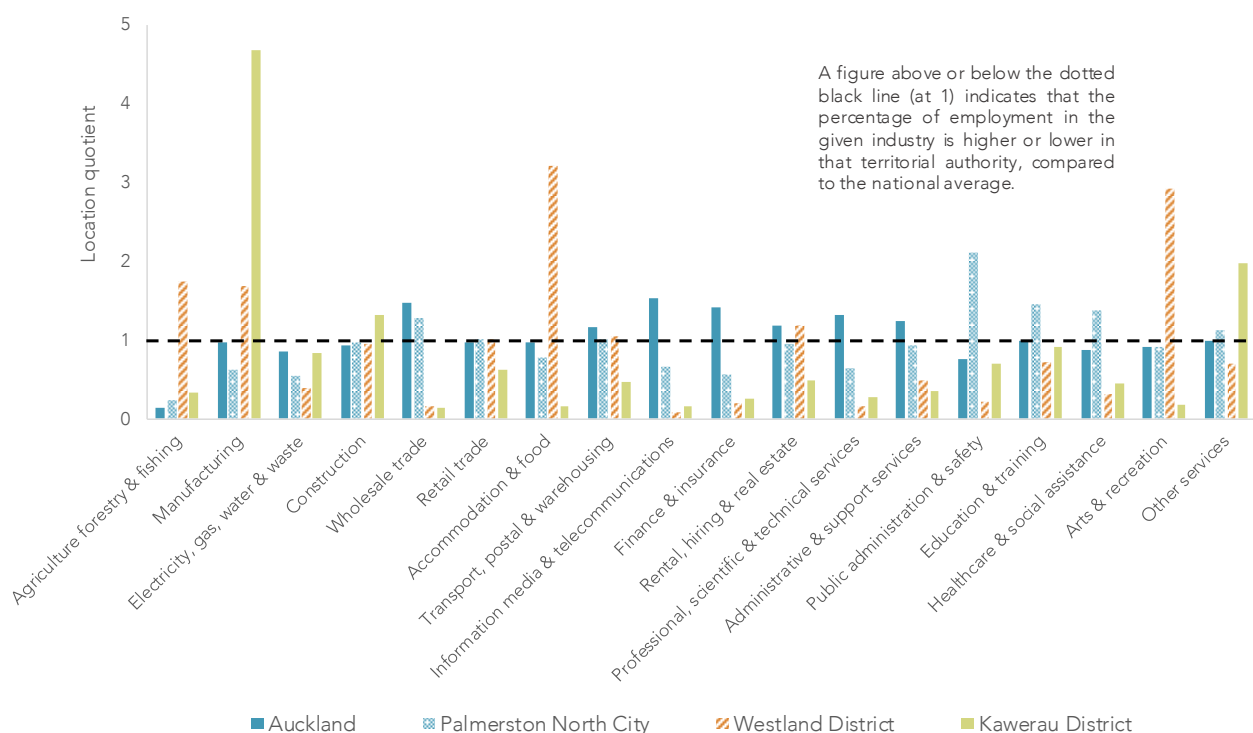
High-growth areas tend to have younger populations than slow-growth areas (NZPC, 2015), although areas attractive for retirees, such as Kāpiti Coast and Tauranga, are exceptions where population growth among older residents has been fast. In towns and cities facing decline, the younger demographic is often the first to leave. This in turn reduces the share of people at reproductive age, which slows the rate of natural increase in population and leads to further slow growth (or decline) over time. The factors driving population decline can be highly challenging (and in some cases impossible) to reverse (NZPC, 2017).

Physical resources and industry structure

Physical resources and industry structure vary across the country, driving different infrastructure and regulatory requirements. In larger “hub” territorial authorities, employment is distributed across a range of industries, while smaller territorial authorities are more specialised in a few industries (Figure 2-6).

Some areas have very specialised industries. For example, employment in Kawerau is heavily concentrated in manufacturing, reflecting the importance of the nearby Norske Skog newsprint mill in the local economy. In Westland, employment is most concentrated in accommodation and food, followed by agriculture, forestry, and fishing. Palmerston North has a similar industry structure to the national average, reflecting its position as a regional hub providing goods and services for a wide area. A similar industrial structure is seen in Auckland (Figure 2-6).

Figure 2-6 Industry structure in selected territorial authorities compared to the national average, 2017-18



Source: Productivity Commission estimates using Stats NZ Business Demography Statistics.

Notes:

1. Location quotient refers to the percentage of employment in each industry compared to the percentage of employment in that industry across the country as a whole.
2. Mining, which accounts for a very small share of employment in the selected territorial authorities, is not included.

Other relevant issues

Other differing circumstances relevant to funding and financing local government services include:

- some local authorities (eg, Queenstown Lakes District Council) experience much higher tourism levels than others, placing pressure on their local infrastructure network (Chapters 4 and 10);
- the potential impacts of climate change and other environmental issues (eg, deteriorating water quality) differ across councils (Chapters 9 and 11);
- differences in access to income from assets such as ports and airports; and
- a small number of councils, including Christchurch and Wellington City Councils and Kaikōura District Council, face particular funding challenges due to the impacts of severe earthquakes.

Councils also differ in:

- physical terrain and geography (eg, soil types and river catchments) that place differing demands on infrastructure provision;
- the extent of non-rateable land and of underutilised Māori freehold land;
- the age and quality of their infrastructure, where they are in the infrastructure replacement cycle, the timing and size of past investments and the debt incurred to finance such investments;
- community expectations (for instance for the provision of social infrastructure and social services); and
- their prevailing level of ratepayers' incomes; which in turn affects the affordability of infrastructure and services.

2.4 What do councils currently need to pay for?

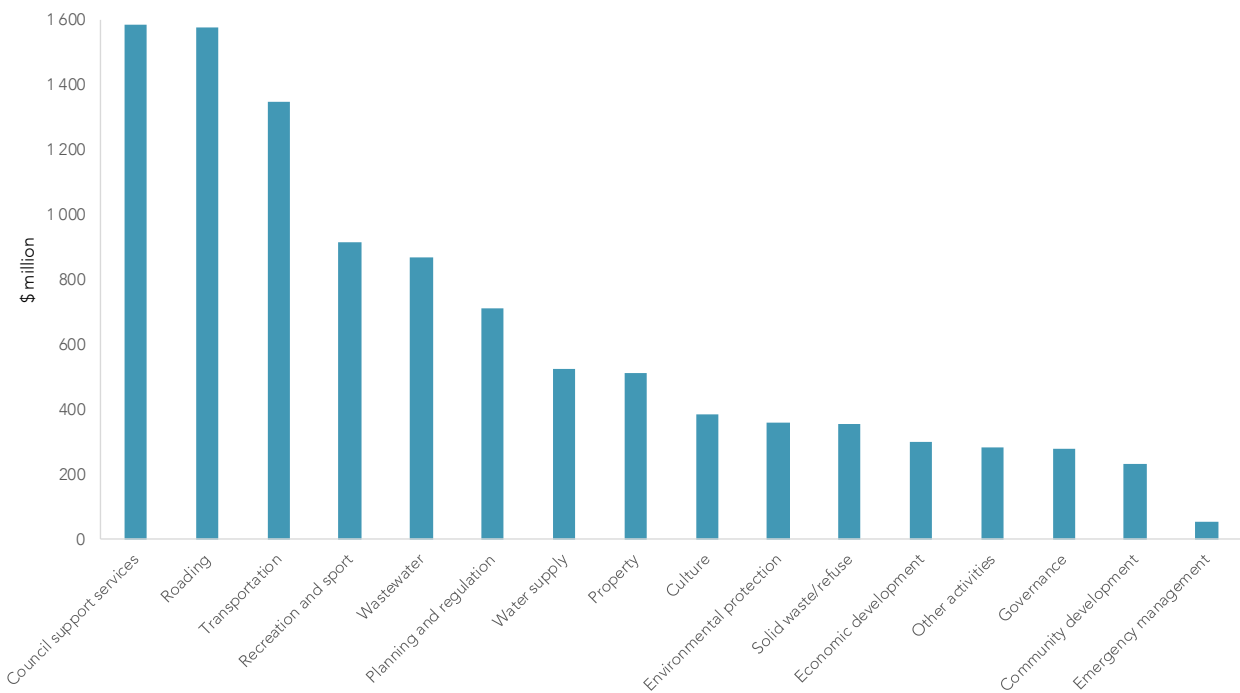
Operating expenditure

Councils had a total opex of \$10.3 billion in 2018. Operating expenditure is the ongoing cost of providing day-to-day council services.³ The five largest sources of expenditure account for nearly two-thirds of the total opex (Figure 2-7).

- *Council support services* (which include overheads for local authority administration, finance, IT, and HR functions as well as preparation of reports such as Long-Term Plans (LTPs)) is the largest expenditure area, making up about 15.4% of total expenditure.
- *Roading* (maintenance of gravel and tar-sealed roadways, bridges, cycle lanes, verges, and footpaths) make up the second largest expense (15.3%).
- *Transportation* (bus and all other forms of passenger transport such as rail, trams and ferries, parking, airports, and transport planning) makes up 13.1% of total expenditure.
- *Recreation and sport* (which includes swimming pools, sports facilities, reserves, playgrounds, and bike and walking tracks) make up about 8.9% of total expenditure.
- *Wastewater* makes up 8.4% of total expenditure.

³ A significant and growing component of opex for services involving infrastructure assets is depreciation (see Chapter 3).

Figure 2-7 Total operating expenditure for all councils by activity, 2017-18

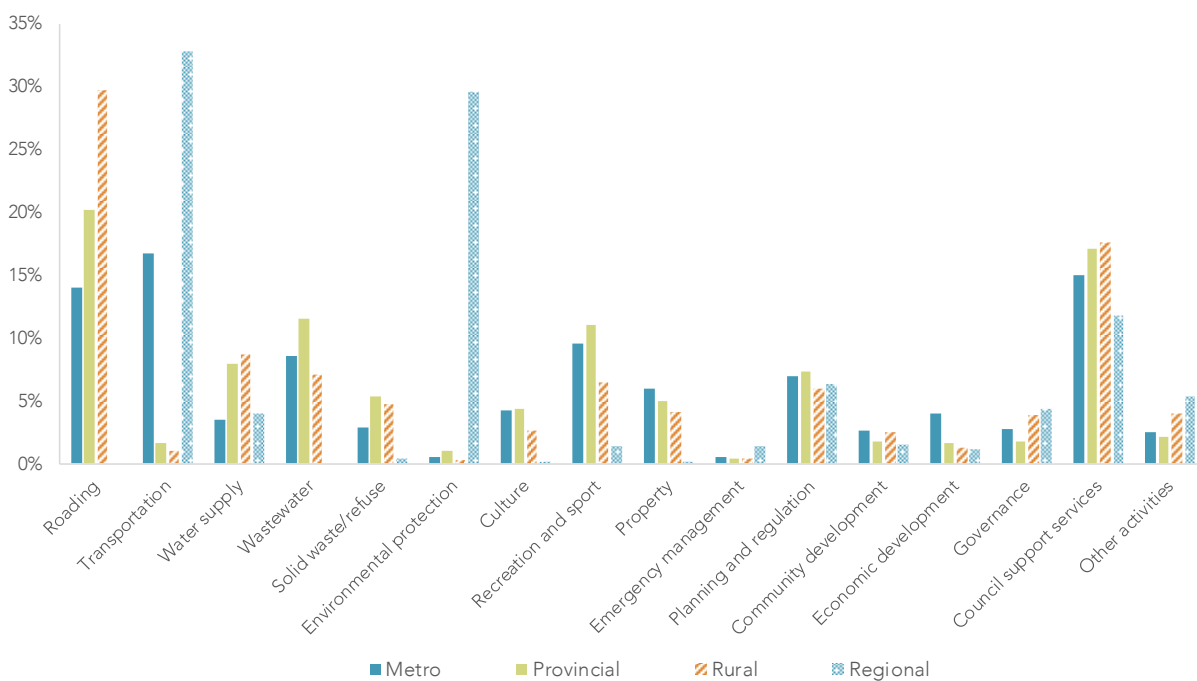


Source: Stats NZ (2019d).

Different councils face significantly different demands. As an example, Figure 2-8 shows expenditure on different activities as a share of total opex for different types of councils. Small rural councils spend about 30% of their total expenditure on roading while transportation accounted for just 1%. Large urban councils, however, spend 14% of their budget on roading and a larger amount (17%) is spent on transportation.

Transportation and environmental protection are the two major activities of regional councils. In 2018, they spent about a third of their total expenditure on transportation and another 30% on environmental protection.

Figure 2-8 Operating expenditure by activity and council type, 2017-18

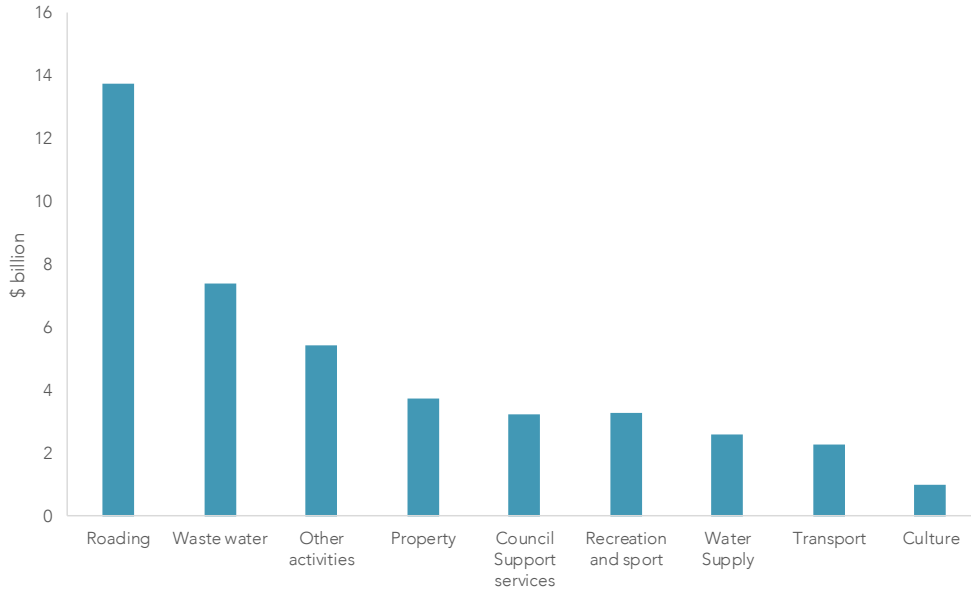


Source: Stats NZ (2019d).

Capital expenditure

Local government capital expenditure (capex) in 2018 was \$4.9 billion, up from \$4 billion in 2009⁴ – a real increase of 23% (Stats NZ, 2019d). Capital expenditure pays for building or buying new assets to meet additional demand, replacing existing assets, and improving assets to deliver better levels of service. Roothing and wastewater were the two largest areas of capital spending in the last decade (Figure 2-9).

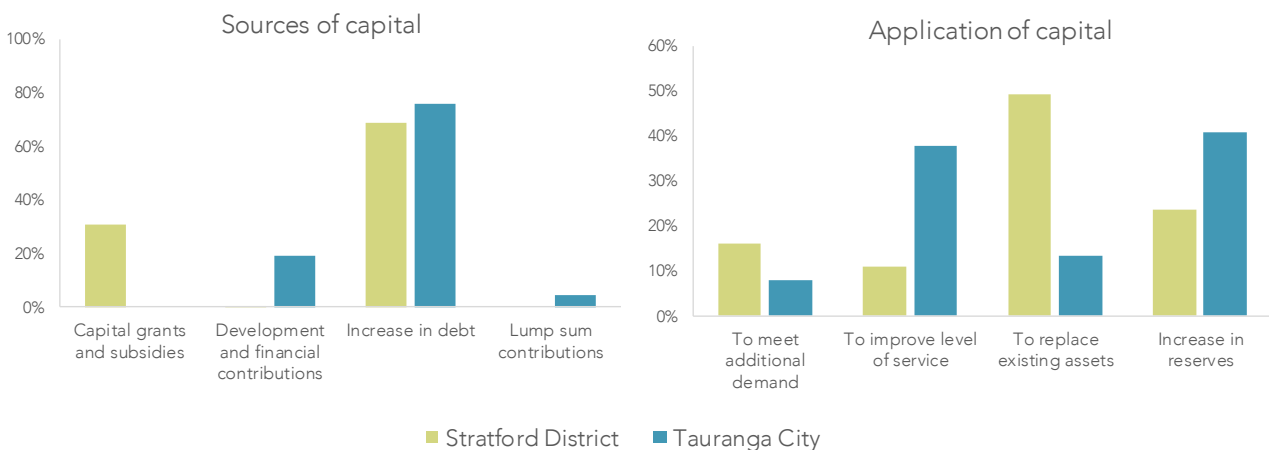
Figure 2-9 Total capital expenditure by activity, all councils, 2009-2018



Source: (DIA, n.d.a).

As with opex, the variability across councils as to where they direct capital spending and how they raise funds for capital projects is significant. For example, Figure 2-10 shows the sources and application of capex for Tauranga City Council and Stratford District Council. Tauranga is a fast-growing city. A relatively large share of its capital in 2018 came from development and financial contributions, and a large share was directed towards improving levels of service. Stratford district has a relatively small and stable population. A large share of its capital in 2018 came from grants and subsidies—largely New Zealand Transport Agency (NZTA) contributions — and was directed towards replacing existing assets.

Figure 2-10 Capital expenditure, Stratford district and Tauranga city, 2017-18



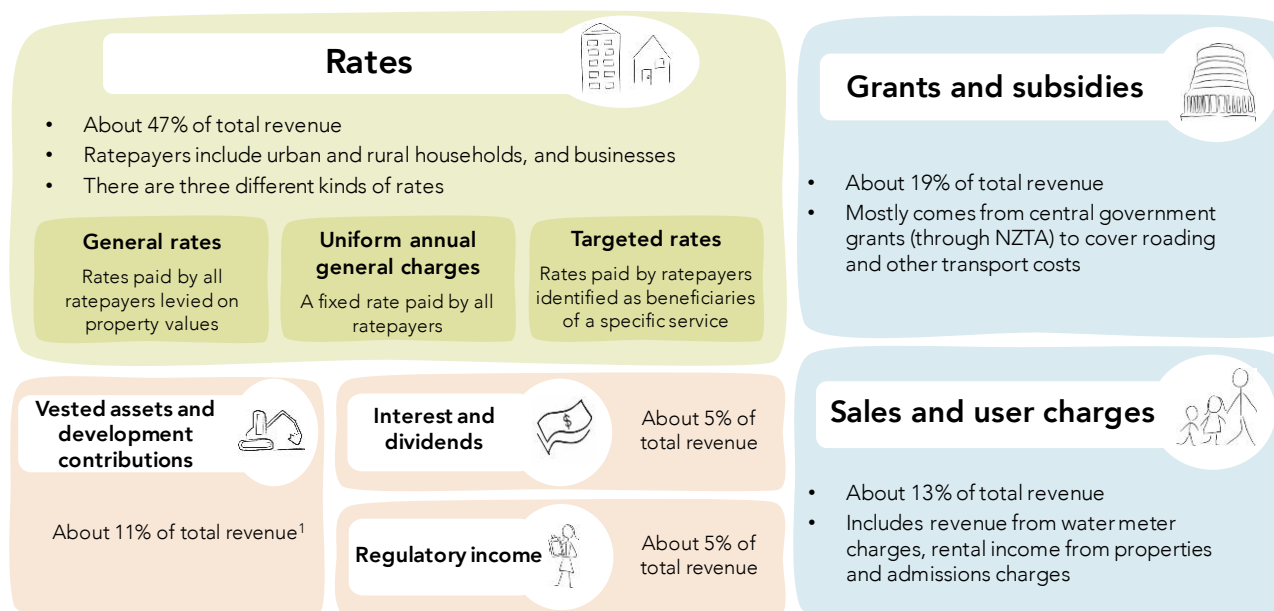
Source: Stratford District Council (2018); Tauranga City Council (2018).

⁴ All expenditure and revenue data, unless stated otherwise, are adjusted for inflation using the Consumer Price Index (CPI) and expressed in 2018 dollars.

2.5 What funding sources are available to local government?

Councils can access a variety of revenue sources to fund infrastructure and other services (Figure 2-11). These can pay for both opex and capex. Total revenue across all local authorities in 2018 was about \$12.4 billion. This does not include \$3.8 billion in income generated by valuation changes and other non-operating income.

Figure 2-11 Main sources of funding available to local authorities, 2017-2018



Source: Stats NZ (2019d).

Notes:

1. Includes financial contributions.
2. Estimates exclude income from valuation changes and other non-operating income.

Rates

Under the LGRA, local authorities may set a general rate for all rateable land within a district. Rates are councils' major revenue source, making up 47% of total revenue in 2018. Rates revenue is used mainly to fund opex, but it can be used in a variety of other ways, including funding new infrastructure assets or the interest costs on debt incurred to finance those assets.

The relationship between property values and rates is frequently misunderstood, with many assuming that increasing property values translates to increased rates. However, this is not correct. By law, councils must decide how much they will spend in the coming year and then set rates to cover those expenses. Property values are used to allocate the burden of rates. The share of general rates paid by an individual household or business depends on the value of their property relative to the value of other ratepayers' properties in the council area. Where property values change differently, then the rating burden will change. One example is if property values in a certain suburb are assessed to have increased more than another suburb. Then property owners in the higher-value suburb will pay a greater proportion of total rates. The total amount of revenue raised does not change just because property values change.

Many councils apply a rating differential to groups of ratepayers, which adjusts the proportion of rates paid by different groups of ratepayers. Differentials are usually expressed as multipliers of the residential rate. For instance, if the residential rate is \$1.00 per \$1 000 of property value and the business rate is \$2.50 per \$1 000 of property value, then the business differential is 2.5 (Colegrave, 2007).

Most often differentials are used to:

- reduce rates revenue from rural properties (with a median current rural differential across councils of 0.7, reflecting reduced access to urban services, facilities and amenities); and

- increase revenue from urban business properties (with a median business differential across councils of 2.5) (Insight Economics, 2019a).

Targeted rates and uniform annual general charges

The LGRA allows councils to set targeted rates to fund infrastructure and services that benefit identifiable taxpayers. Christchurch City Council, for example, has targeted rates for properties near new cycleway projects, properties that benefit from land drainage and some properties connected to specific water and sewerage schemes.

Councils can base targeted rates on land or capital value; or on any of the following:

- the value of land improvements;
- land area;
- area of land paved, sealed, built upon or protected;
- area of floor space of buildings on the land;
- number of connections to the local authority reticulation system;
- number of toilets and urinals;
- number of separately used or inhabited parts of the land; and
- extent of services provided to the land occupier (LGRA, Schedule 3).

Targeted rates provide councils with a transparent means to raise revenue from those who benefit from particular services or amenities or who impose costs on services.

Local authorities are also able to set a uniform annual general charge (UAGC), which is a fixed charge per rating unit. Targeted rates may also be uniform. To limit the potential impact of fixed charges on the overall rating burden for low-income households, the LGRA specifies that revenue from uniform charges (including UAGCs and uniform targeted rates applying across the district, but excluding uniform water and wastewater rates) must not exceed 30% of rates revenue.

Fees, user charges and regulatory income

Under the LGRA, councils can set volumetric charges for drinking water. Charges may be calculated as either a constant price per unit of water supplied and consumed, or according to a scale of charges. Councils can also charge for services such as solid waste collection, swimming pools, facilities hire, regulatory services (eg, building consent and liquor licensing fees), and other council-provided services. Such charges help recover operating costs and may contribute to capital costs.

Fuel taxes are also a source of income for local authorities, and recent legislation allows for the collection of regional fuel taxes (Box 2.2).

Box 2.2 Fuel taxes

Under the Local Government Act 1974, local authorities fuel tax is levied on petrol and other fuels, at between 0.33 and 0.66 cents a litre. The tax is collected and distributed to local authorities through 21 designated distribution authorities (MBIE, 2019a); (DIA, pers. comm., 5 February 2019).

The Land Transport Management (Regional Fuel Tax) Amendment Act (enacted 26 June 2018) provides a funding tool for Auckland Council to raise revenue to fund transport projects that would otherwise be delayed or not funded. A regional fuel tax of 10 cents a litre (plus GST) applies from 1 July 2018 within the Auckland region. From January 2021, other councils will be able to apply to establish a regional fuel tax. Applications will be subject to a Ministerial approval process (Ministry of Transport, 2019).

Grants or subsidies

Central government provides grants to support council operations, particularly roading and public transport (via the NZTA). Central government funds national roads, while local and central government jointly fund local roads. Overall, central government covers 53% of the cost of local transport (NZTA, 2018a).

Interest or dividends

Many local authorities own (or part own) business enterprises such as ports, airports, forests and farms, or have investments in financial assets such as bonds and shares. Income from these sources amounted to 5% of local authorities' total operating income in 2018.

Development and financial contributions

Development contributions are charges levied on developers under the LGA to recover the portion of new infrastructure that is related to growth. Developers can be charged for the capital costs of connections to trunk infrastructure and for needed expansions to bulk infrastructure (water, wastewater, stormwater, roads and other transport), and for community infrastructure (such as neighbourhood halls, reserves, playgrounds and public toilets). They can be charged when a resource consent, building consent or service connection is granted. Councils are required to set out a development contributions policy that explains how contributions are calculated. Chapter 6 provides further details.

Financial contributions are charges set under the RMA that provide councils with resources to avoid, remedy or mitigate adverse environmental effects. Contributions can take the form of money or land and must promote the sustainable management of natural and physical resources. Councils may use those contributions to fund capex on similar assets to development contributions. But councils cannot use them to fund the same expenditure for the same purpose, or to fund operating spending.

Parliament recently legislated the phase-out of financial contributions by 2022. The purpose of the phase-out, according to the previous Government, was to avoid overcharging (on top of development contributions) and simplify the process of recovering infrastructure costs (New Zealand Government, 2015).⁵

Vested assets

When developers provide and pay for water and road infrastructure within a subdivision, this is generally vested in the council upon completion. No development contributions are chargeable where the developer provides the infrastructure. As a rarely used alternative to development contributions, developers also sometimes directly provide trunk infrastructure through development agreements (a form of contract with local authorities). Once completed, the infrastructure is vested in the council. In both these cases, the council does not bear any capital costs for the infrastructure, but needs to meet ongoing operational, maintenance and depreciation costs.

2.6 Sources of finance

Financing refers to how debt, equity or both is raised for the delivery of a project or service when needed. Local authorities can finance projects on a pay-as-you-go basis (eg, through current revenue, grants or accumulated savings) or through borrowing.

With pay-as-you-go financing, councils purchase or construct only those capital assets made possible by financial resources currently at their disposal, such as cash in the capital budget, savings and reserve funds, or other cash on hand. Proponents of pay-as-you-go financing argue that it avoids interest costs, supports local government's fiscal flexibility, and maintains borrowing capacity. However, because pay-as-you-go limits investment essentially to what can be funded from cash in hand, it is likely to lead to large projects being delayed. Given this, pay-as-you-go may not effectively or efficiently fund the infrastructure needed to support a growing population. The approach is also inconsistent with inter-generational equity. If pay-as-you-go is employed for assets with a long lifespan, then only the current generation of users bear the costs.

⁵ In September 2019, the Government introduced the Resource Management Amendment Bill which proposes the re-instatement of various financial contributions (that were set to phase out under the 2017 amendments to the RMA).

Future generations pay nothing and yet still enjoy the benefits, although they may be required to pay for the next investments in infrastructure that will primarily benefit subsequent generations.

Borrowing enables the matching of an asset's costs with its benefits over its life. This promotes inter-generational equity, since those who benefit from the infrastructure contribute to the cost of that infrastructure. Other benefits of debt finance include:

- councils can deliver infrastructure earlier than they otherwise could have;
- local governments' steady and secure income from rates can be used to meet debt-servicing obligations and to secure debt facilities; and
- it can facilitate institutional investment, such as from superannuation funds, which can bring with it additional rigour and discipline (Ernst & Young, 2012).

Options for raising debt

Local authorities have three main options for raising finance.

- *Banks and other financial institutions* – Since 1996, local authorities have been able to borrow directly from banks (previously, with the approval of the Local Government Loans Board, councils could only borrow by issuing local authority stock (DIA, pers. comm., 5 February 2019)).
- *Bonds* – Local authorities may issue bonds. For example, Auckland Council has issued fixed-rate retail bonds that are listed on the NZX Limited Debt Market (Auckland Council, 2019a).
- *The New Zealand Local Government Funding Agency (LGFA)* – The LGFA was established in 2011 to raise debt on behalf of local authorities on more favourable terms to them than if they raised the debt directly (LGFA, 2018). The LGFA is a Council Controlled Organisation (CCO) and is jointly owned by central government (20% shareholding) and 30 councils (80% shareholding). Other than central government, each shareholder must be a guarantor.

Since its establishment, the LGFA has been the largest lender to local government, accounting for approximately 60% to 85% of all lending to local government. Fifty-six councils are borrowers from the LGFA, with total borrowing at just under \$8 billion. LGFA lent councils just over \$1 billion in the 2017-18 financial year (LGFA, 2018).

2.7 Laws and regulations for funding and financing

Local Government Act

The LGA (and its various amendments) establish processes that shape the provision of infrastructure and other local government spending. The Act also sets out planning requirements for the provision of infrastructure (Table 2.1).

Table 2.1 Local Government Act 2002 planning processes

Requirement	Main purpose
Long-Term Plan	To plan activities and service provision over a timeframe of at least 10 years. As part of Long-Term Plans, local authorities must prepare and adopt a financial strategy. The strategy's purpose is to facilitate prudent financial management, and to provide transparency about the effect of funding and expenditure proposals on rates, debt and investments.
Infrastructure strategy	To set, over at least 30 years, the local authority's approach to the development of new assets and the management of existing assets.
Annual Plan and Annual Report	To set out and report on planned activities, revenue and expenditure for a financial year.

Source: NZPC (2015); Local Government Act 2002.

The LGA (s 14 (1)(g)) also specifies that a local authority should “plan...effectively for the future management of its assets”. While not required by the LGA, asset management plans help local authorities meet the auditing requirements under the LGA. The LGA requires the Auditor-General to report on “the quality of the information and assumptions underlying the forecast information provided in the [long-term] plan” (LGA s 94(1)(b)).

Financial reporting requirements

Regulations introduced under the LGA in 2014 require every local authority to report in its Annual Plan, Annual Report and LTP on its planned and actual performance against a number of financial prudence benchmarks (Table 2.2). The regulations were introduced to help identify local authorities where further inquiry is needed into their financial management; and to promote prudent financial management by local authorities (DIA, n.d.b).

Table 2.2 Local authority prudential benchmarks

Benchmark	A local authority meets the benchmark if:
Rates affordability	<ul style="list-style-type: none"> Actual or planned rates income for the year \leq quantified limits on rates income set by the authority in its financial strategy Actual or planned rates increases for the year \leq quantified limits on rates increases set by the authority in its financial strategy
Debt affordability	Actual or planned borrowing for the year is within the quantified limits on borrowing set by the authority in its financial strategy
Balanced budget	Revenue for the year \geq operating expenses
Essential services	Capital expenditure on network services for the year \geq depreciation on network services
Debt servicing	Yearly borrowing costs \leq 10% of its revenue (15% for high-growth councils)
Debt control	Actual net debt at the end of the year is \leq planned net debt
Operations control	Actual net cashflow from operations for the year \geq planned net cashflow from operations

Source: Local Government (Financial Reporting and Prudence) Regulations 2014.

Local authorities are also required to disclose in their Annual Report certain information about core infrastructure assets (water, wastewater, stormwater, flood protection and roading). The information includes the closing book value, the value of acquisitions made during the financial year, and estimates of replacement costs.

Under the Financial Reporting Act 2013, local authorities are required to comply with the requirements of GAAP. For local authorities, GAAP constitutes the Public Benefit Entity (PBE) Public Sector standards. These standards predominantly relate to the preparation of annual ex post financial statements, but also include PBE Financial Reporting Standard 48 Service Performance Reporting (which specifies the requirements for reporting on service delivery and outcome achievement) and Public Benefit Entity Financial Reporting Standard 42 Prospective Financial Statements (which specifies the requirements for prospective financial information as contained in annual and long-term plans).

Non-financial performance reporting

Rules under section 261B of the LGA specify mandatory performance measures for service delivery from core infrastructure. Local authorities must set out their performance targets for these measures in their LTP, and then report on performance against those targets in their Annual Reports. The purpose of the Rules under the Act is to “provide standard performance measures that are applicable to local authorities so that the public may compare the level of service provided in relation to a group of activities by different local authorities” (s 261A).

Local Government (Rating) Act 2002

The purpose of the LGRA is to promote the purpose of local government set out in the LGA by

- providing local authorities with flexible powers to set, assess and collect rates to fund local government activities;
- ensuring that rates are set in accordance with decisions that are made in a transparent and consultative manner; and
- providing for processes and information to enable ratepayers to identify their liability for rates (LGRA, s 3).

In particular, Part 1 of the LGRA sets out who is liable to pay rates, what land is rateable, what kinds of rates may be set, and how rates are set. Other parts contain administrative provisions and liability for rates on Māori freehold land.

Land Transport Management Act 2003

The Land Transport Management Act 2003 governs the funding of major transport projects and services, including road policing, public transport, and maintaining and developing the state highway network and local roads.

Through its Government Policy Statement (GPS) on Land Transport, central government sets the overall objectives and long-term results sought over a 10-year period, and expenditure ranges for each class of transport activity. The NZTA then develops a three-year National Land Transport Programme (NLTP), which gives effect to the GPS and outlines the activities that will receive funding from the National Land Transport Fund (NLTF).

Once the NLTP is confirmed, local authorities can seek funding for activities carried out in their area. They are required to develop a Regional Land Transport Plan that sets out the region's land transport objectives, policies, and measures for at least 10 financial years. The plan must include all significant activities in the first 6 financial years where funding from the NLTF or other sources is required.

The NLTF typically does not cover the full cost of these local activities. It meets an average of 53% of costs across the country. Local authorities contribute the rest, from sources such as rates, development contributions and passenger fares. The exact funding rate varies between 51% and 75% depending on the ability of local authorities to deliver transport outcomes.⁶

⁶ NZTA also uses targeted enhanced funding assistance rates (TEFARs) to support new high-priority activities. TEFARs are currently only applied to support eligible projects in the Safe Networks Programme. TEFAR rates of assistance are higher than normal FARS – they are set halfway between a council's normal FAR rate and 100% (but capped at 90%) (NZTA, 2019).

3 Trends in local government revenue, expenditure, prices and debt

Key points

- In aggregate, local government operating revenue and rates revenue has been roughly stable as a proportion of gross national income and household incomes over many decades. Even so, growth in rates revenue per person varies greatly across councils, reflecting different circumstances and the timing and size of past investments. High-population-growth councils are less reliant on rates than other councils.
- While broadly matching national and household income growth, local authority capital expenditure (capex) and operating expenditure (opex) have risen strongly over the last two decades, mostly as a result of population growth and price inflation. Spending on roading and wastewater have been the biggest components of capex since 2009.
- Councils have increased borrowing over the last two decades to finance infrastructure investments and allocate the costs to those who will benefit in the future. Even so, council debt generally remains within accepted prudential limits. Total debt was \$16.2 billion in 2018.
- Growth in capex has flow-on effects on opex. Notably, depreciation and interest have grown as a proportion of local government opex, and now stand at 28% of the total.
- Apart from public transport (which central government substantially subsidises), the activities contributing most to increased opex are roading and council support services. Spending on employee costs and to cover depreciation makes up around 70% of spending on council support services.
- The prices faced by local government have been rising faster than the Consumer Price Index (CPI). Among the drivers of opex, the prices of water, sewerage and drainage services have risen particularly strongly. The prices of the main components of capex, (earthmoving and siteworks; reclamation and river control; and pipelines) have also risen faster than the CPI.
- Excluding depreciation and interest, local government opex per person grew at an average of 1.2% per year between 2007 and 2017 (after adjusting for inflation using the Commission's preferred price index). Regional and rural council opex per person grew faster than metro and provincial council opex.
- Long-Term Plans forecast rates revenue continuing to rise at a yearly average of almost 5% over the years to 2028 (after adjusting for expected price inflation). Depreciation and interest are projected to be the fastest-growing costs. Yet projected growth in capex levels off in the 2020s. History suggests that in practice spending plans will be moderated to match the growth in incomes, but new cost pressures are emerging (as described in Chapter 4).

This chapter sets the scene for later chapters by identifying key funding, expenditure and financing trends for local authorities over recent decades, and looking forward. All expenditure, revenue and debt data, unless stated otherwise, are adjusted for inflation using the Consumer Price Index (CPI) and expressed in 2018 dollars. The CPI best captures the effect of the growth in council revenues on the households who have to pay. In contrast, section 3.4 uses specially constructed local government price indices to adjust for inflation in the prices that local government faces when paying for goods and services.

Section 3.1 compares growth in council revenues with growth in national and household incomes. Section 3.2 looks at trends in capital expenditure (capex) and operating expenditure (opex). The opex data in this section includes depreciation and interest payments. Section 3.3 briefly covers debt trends.

Section 3.4 looks at trends in local government prices adjusted for inflation, using local government price indices constructed for the purpose. Unlike in section 3.2, the measure used for opex in section 3.4 does not include depreciation. Section 3.4 then uses the local government price index to derive the growth rate in real (after inflation) opex per person, nationally and for different types of councils. Section 3.5 looks at projected revenue and spending trends to 2028.

This chapter distinguishes between high-growth, medium-growth, and low-growth (and declining) councils,⁷ based on population data between 1996 and 2018.

3.1 Trends in council revenue and rates

The inquiry's Terms of Reference (TOR) note concern about the rate of increase in rates revenue in recent years and effects on affordability. Yet, as Figure 3-1 shows, local government operating income and rates revenue have remained in relatively narrow bands as a percentage of Gross National Income (GNI) and household disposable income over the last 25 years. While revenue and rates continued to rise during the Global Financial Crisis (while incomes stagnated), none of the ratios has shown an upward trend over the last five years. Chapter 6 shows how rates as a proportion of incomes in small, rural, low-income districts have grown significantly faster than in metropolitan areas since the early 2000s. Chapter 7 discusses funding policies to address these growing disparities in rating capacity. Chapter 8 discusses the affordability of council rates for low-income households.

Figure 3-1 Ratios of council revenue and rates to national and household income, 1993-2018



Source: Perry (2018a); Stats NZ (2019e, 2019d).

Notes:

1. Gross National Income (GNI) is all income received by New Zealand residents from participating in a production process (domestic or foreign) or from assets they own.
2. Household disposable income is equivalised disposable income before housing costs as reported in Perry (2018a) and derived from the Stats NZ Household Economic Survey. Disposable income refers to after tax and transfers income; equivalised income is income adjusted for household composition.

⁷ High-growth councils (18 in total) are defined as those with population growth greater than 30% between 1996 and 2018. Medium-growth councils (26 in total) are defined as those with growth between 5% and 30% between 1996 and 2018. Low-growth (and declining) councils (23 in total) are defined as those with growth less than 5% between 1996 and 2018.

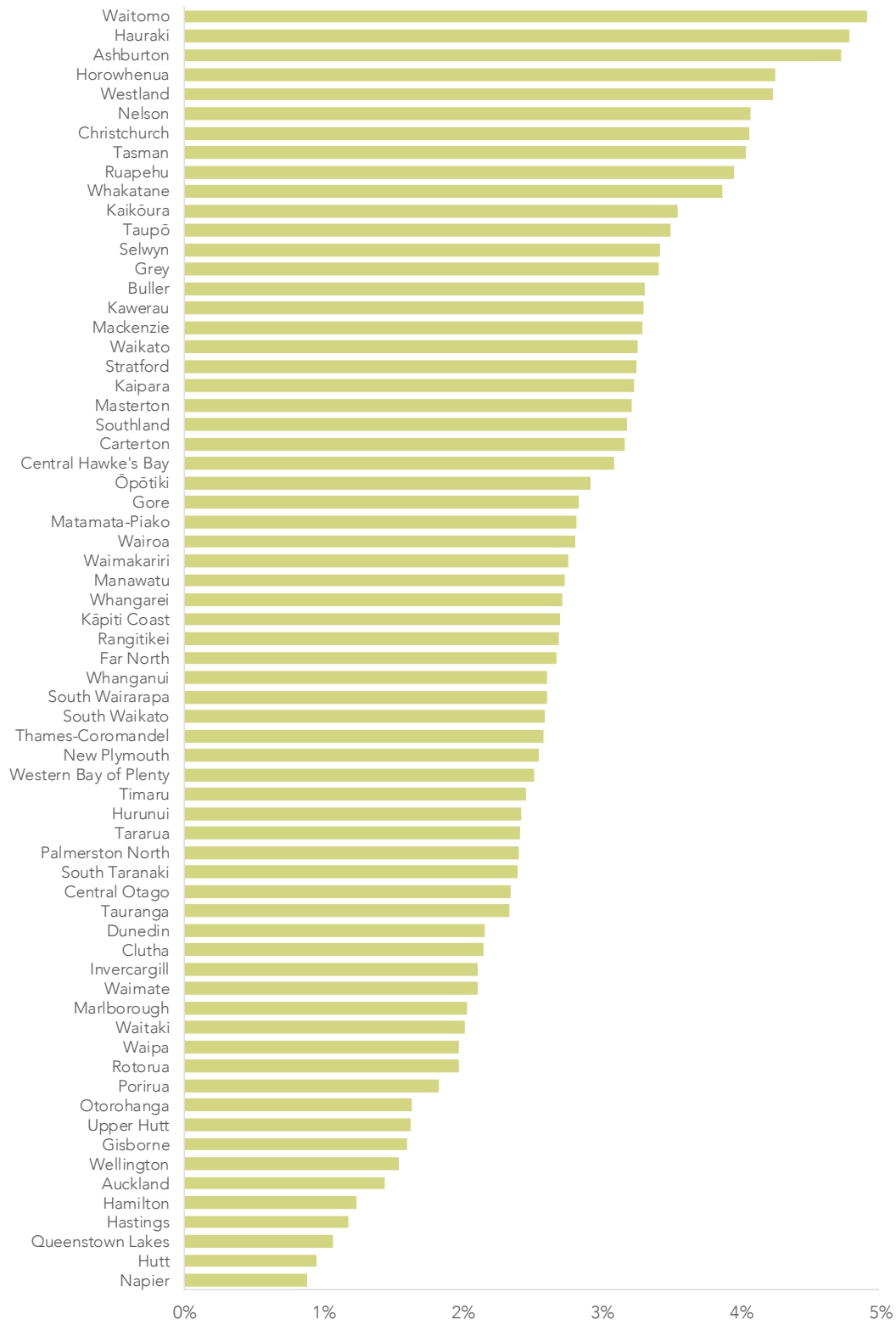
F3.1

Over long periods of time, and with some variation, increases in local government revenue and rates have roughly matched increases in national and household income.

Rate trends vary greatly across local authorities

Growth in rates per person over the past 20 years has varied greatly across councils (Figure 3-2).

Figure 3-2 Average yearly growth in rates per person across territorial authorities, 2000-2018



Source: Stats NZ (2019e, 2019d).

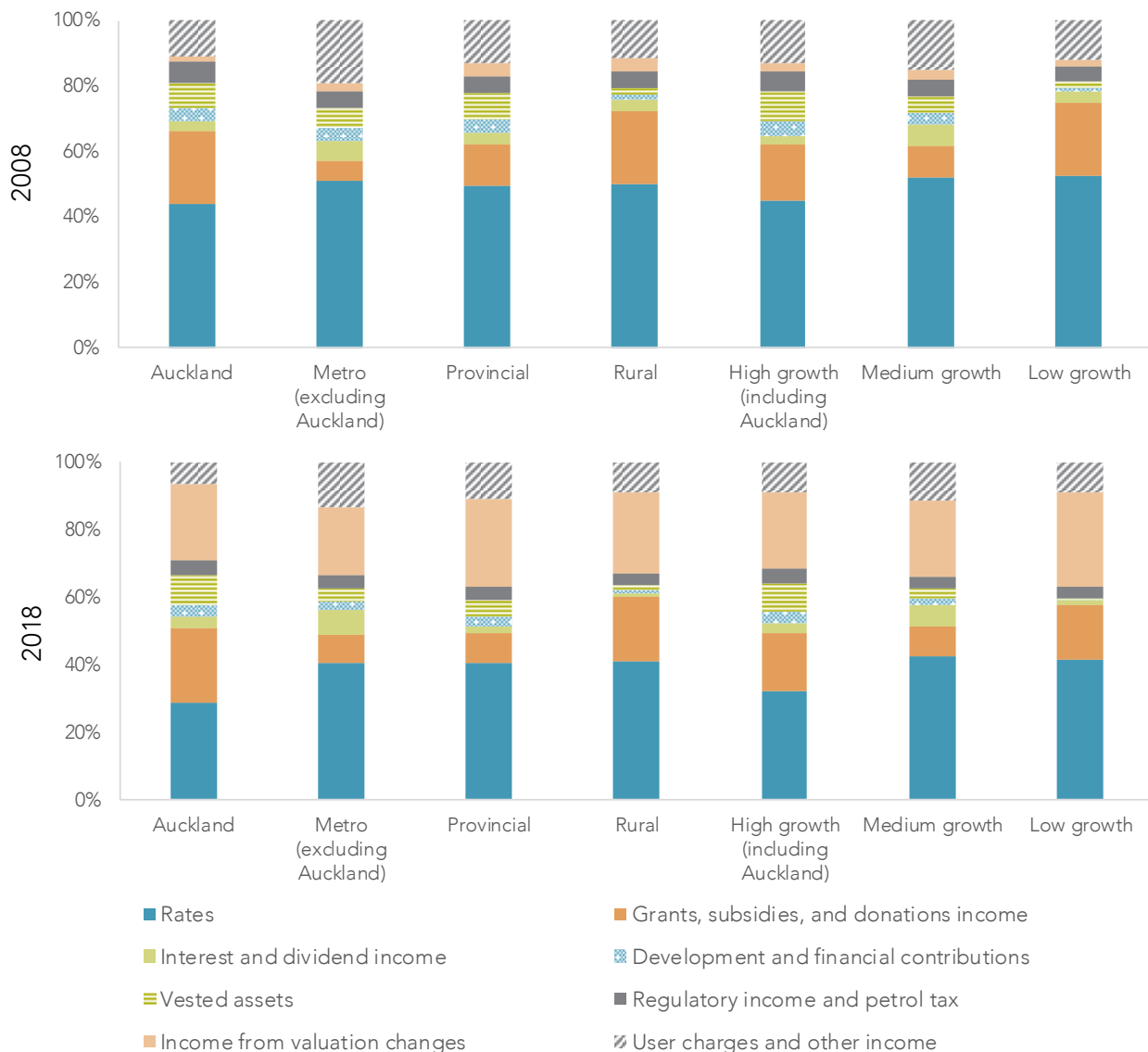
The fastest growth was about 5% a year for Waitomo District Council, and the slowest growth was about 0.8% a year for Napier City Council. Yet, fast growth in rates may reflect decisions to upgrade essential infrastructure (such as water supply). As such, growth comparisons across councils in their rates must also consider differences in the quality and age of infrastructure (and the prudence of investment decisions).

The growth of rates over time shows no clear pattern, though some of the high-growth councils have relatively low growth in rates. Such councils now rely more on development contributions.

The composition of council revenue varies across council types

Rates, at around 60% of operating income, have remained a dominant and relatively stable source of revenue for local authorities over the last two decades. Even so, rates have been declining as a percentage of total income,⁸ partly as a result of the increasing importance of valuation changes in recent years (Figure 3-3). High-growth councils tend to be less reliant on rates than slower-growing councils. Low-growth and rural councils and Auckland Council tend to be more reliant on central government grants and subsidies.

Figure 3-3 Average composition of revenue across different councils, 2008-2018



Source: Stats NZ (2019d).

Notes:

1. In this figure and later figures in this chapter, data for Auckland includes Auckland Transport and Auckland Tourism, Events and Economic Development; and excludes all other Auckland Council Controlled Organisations (eg, Watercare).

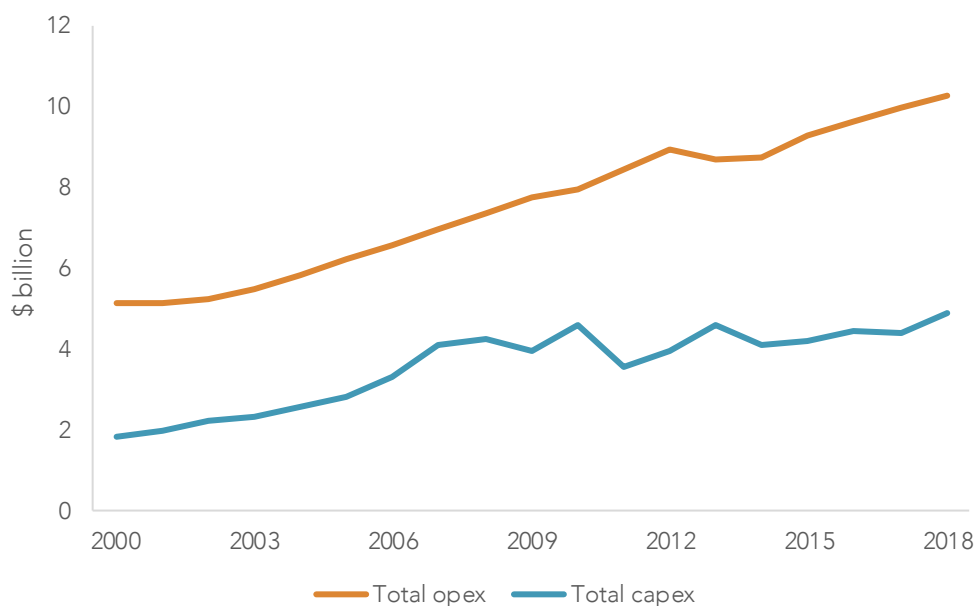
⁸ Total revenue includes operating income plus income from non-operating incomes (such as valuation changes) plus income from capital transactions (such as development and financial contributions and vested assets).

One important change to the composition of revenue since the early 2000s has been the introduction of development contributions and vested assets (Chapter 6). Relative to other revenue sources, development contributions are small for most councils (and some councils do not apply them), but they are a key funding source for some high-growth councils. This helps explain why fast-growing councils are less reliant on rates. For example, in 2018, development contributions made up about 10% of Selwyn District Council's total revenue, 6% of Waimakariri District Council's revenue, and 7% of Tauranga City Council's revenue.

3.2 Trends in expenditure

Councils adjust their rating policies to meet expenditure plans (Chapter 2). As a result, planned expenditure drives the growth in rates. Local authority opex and capex (after adjusting for inflation) have grown significantly since 2000 (Figure 3-4). Total expenditure (opex and capex) increased from \$7.0 billion to \$15.2 billion between 2000 and 2018. This growth in expenditure pressures was one of the main motivations for this inquiry. This section provides a breakdown of the growth in opex. (Chapter 2 gives a breakdown of capex by activity aggregated over the last 10 years).

Figure 3-4 Local authority spending, 2000-2018



Source: Stats NZ (2019d).

Notes:

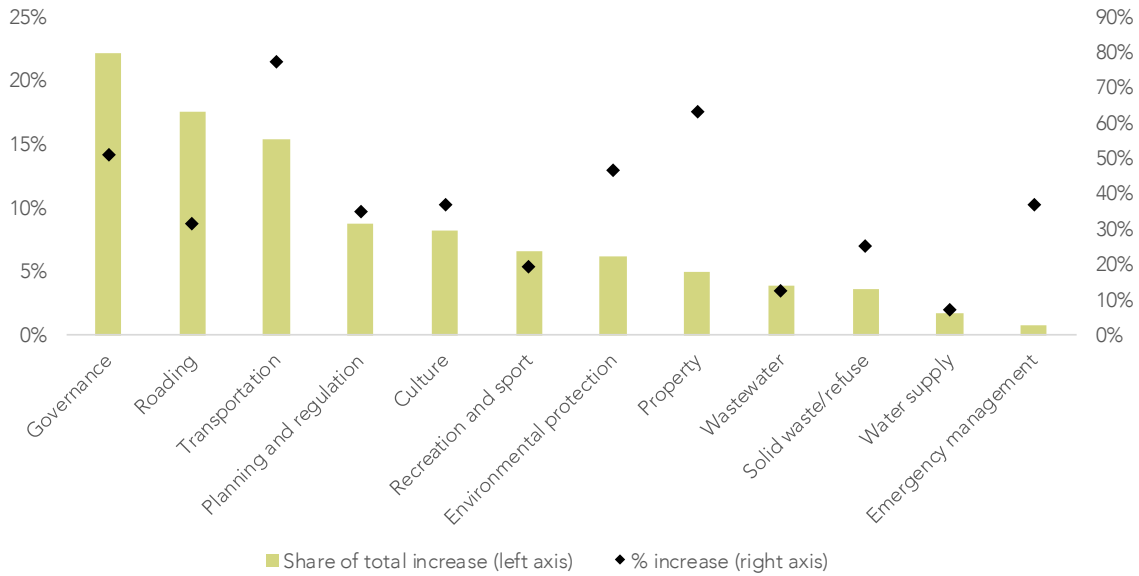
1. Capex is estimated as "additions to fixed assets" from council financial statements.

What activities contributed most to the growth in opex?

In 2009 Stats NZ introduced a new way of classifying local authority opex by activity. As a result, valid analysis of detailed expenditure trends for 2003 to 2018 requires breaking the data into two series: 2003 to 2008 and 2009 to 2018. Stats NZ draws its data from a yearly local authority census and from audited annual reports; and therefore relies on councils to classify their opex into broadly defined activities. The consistency of accounting practices to allocate expenditure by activity over time or across councils is unknown.

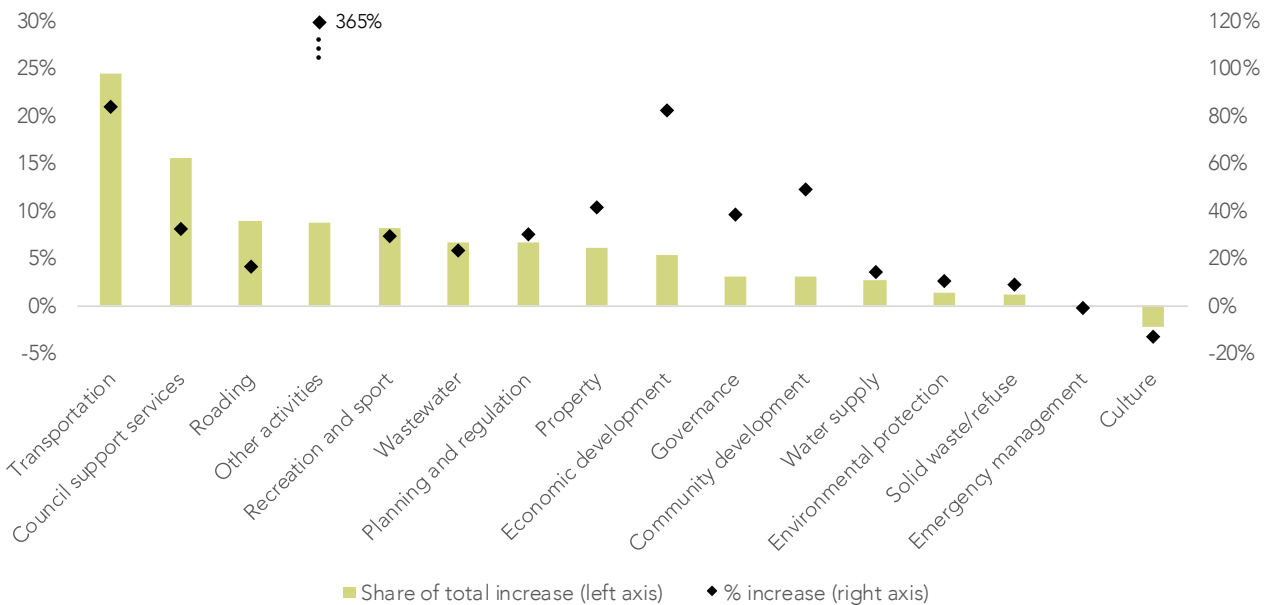
Local government opex grew by 34% or \$1.9 billion between 2003 and 2008. Figure 3-5 shows the percentage increase in expenditure on each activity, and its share of the total increase. Growth in expenditure on governance, roading, and transportation together made up over half of the total increase. Transportation, in particular, saw rapid growth. Spending on "culture" (libraries and galleries) grew by 37% over the period, making up 8% of the total increase.

Figure 3-5 Growth in local government opex by activity, 2003-2008



Source: Stats NZ (2019d).

Figure 3-6 Growth in local government opex by activity, 2009-2018



Source: Stats NZ (2019d).

Notes:

1. "Other activities" includes expenditure not included under other categories and is highly variable from year to year. Some of the largest fluctuations appear to be associated with the early years of the new Auckland Council from 2009; with the Christchurch earthquakes recovery and with Auckland Transport in more recent years. The high apparent growth rate appears to result from a recategorisation of expenditure rather than from a large increase in activity.

Local government opex grew by 32% or \$2.5 billion between 2009 and 2018. Figure 3-6 shows the percentage increase in expenditure on each activity, and its share of the total increase. Growth in expenditure on transportation, council support services and roading together made up more than half of the total increase. Of the expenditure on transportation in 2018, 44% (or \$595 million) was spent on grants and subsidies. Most of this expenditure is funded by central government.

Growth in spending on council support services made up around 15% of all expenditure growth between 2009 and 2018. A comparison of data for 2008 and 2009 suggests that most of the expenditure on "governance" was reclassified as "council support services" in 2009. Council support services cover

[o]verheads for local authority administration, finance, IT, and HR functions as well as report preparation (such as annual reports and long-term council community plans [now Long-term Plans]). (Stats NZ, 2019d)

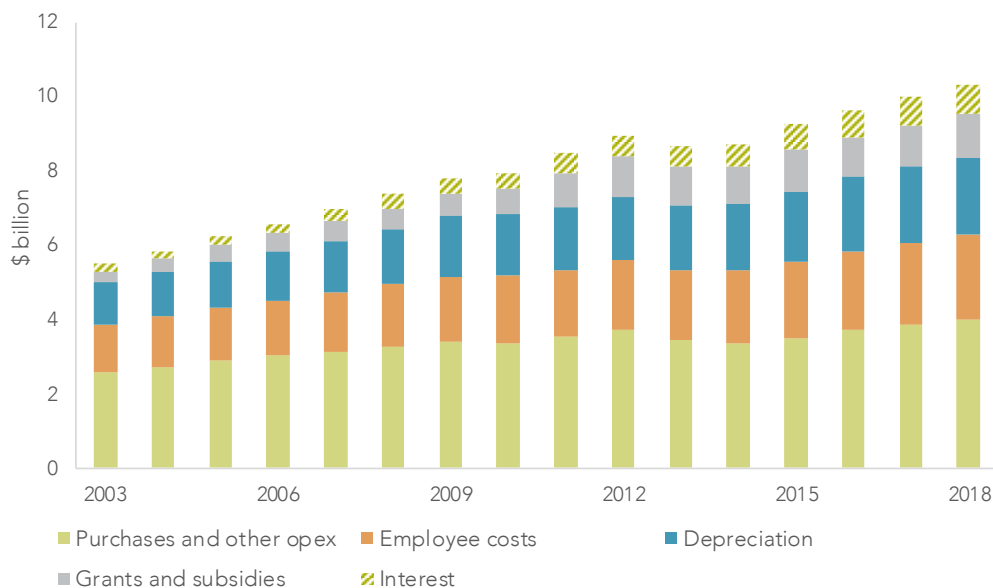
Further analysis of the data shows that around a quarter of spending on council support services in 2018 was on depreciation and interest, while around 45% was on employee costs. This suggests that some councils, at least, may be accounting for some depreciation and employee costs as an overhead rather than under specific activities.

Economic development and community development together made up about 8% of the increase in total expenditure between 2009 and 2018. In 2009 they made up only 4% of all opex, so they could not have made up very much of the total increase in expenditure over the previous period from 2003 to 2008. This in turn suggests (see Chapter 4) that legislative changes to the scope of local government in 2002 that mandated a focus on the “four wellbeings” was not a material driver of increases in local government opex over this period.

What types of cost contribute most to opex?

Figure 3-7 breaks down council opex by type of cost. It shows that three significant components of opex are the depreciation of assets, interest payments and grants and subsidies. Depreciation and interest made up 24% of opex in 2003; by 2018 they made up 28% of opex. Central government funds most council spending on grants and subsidies (particularly for public transport). Chapter 7 discusses local government practices in accounting for depreciation.

Figure 3-7 Total opex by type, 2003-2018



Source: Stats NZ (2019d).

Growth in capex

Capex grew rapidly, by 133%, between 2000 and 2008, but growth has tapered off since then. An absence of historical data that breaks down capex by activity makes it difficult to determine the specific drivers of growth in spending during the earlier period. Chapter 2 shows that spending on roads and wastewater were the main components of capex by activity between 2009 and 2018.

Capex and opex per person grew more slowly in high-growth councils

Growth in population is an important driver of council expenditure (Chapter 4). New Zealand’s population has been growing relatively quickly since 2013 (compared to the previous decade) as a result of strong net migration from abroad. Growth (including from internal migration) has been concentrated in some centres.

High-growth councils had the lowest growth in capex per person, and a relatively low growth in opex per person. Even so, all councils experienced strong growth in both capex and opex per person.

Table 3.1 Growth in expenditure, 2000-2018

Type of local authority	Total growth	Capex		Opex		
		Annual growth	Annual growth per person	Total growth	Annual growth	Annual growth per person
High growth	136%	5.5%	3.4%	115%	4.3%	2.6%
Medium growth	123%	5.1%	4.2%	81%	3.3%	2.6%
Low growth	64%	3.1%	4.6%	61%	2.7%	3.3%

Source: Stats NZ (2019e, 2019d).

Notes:

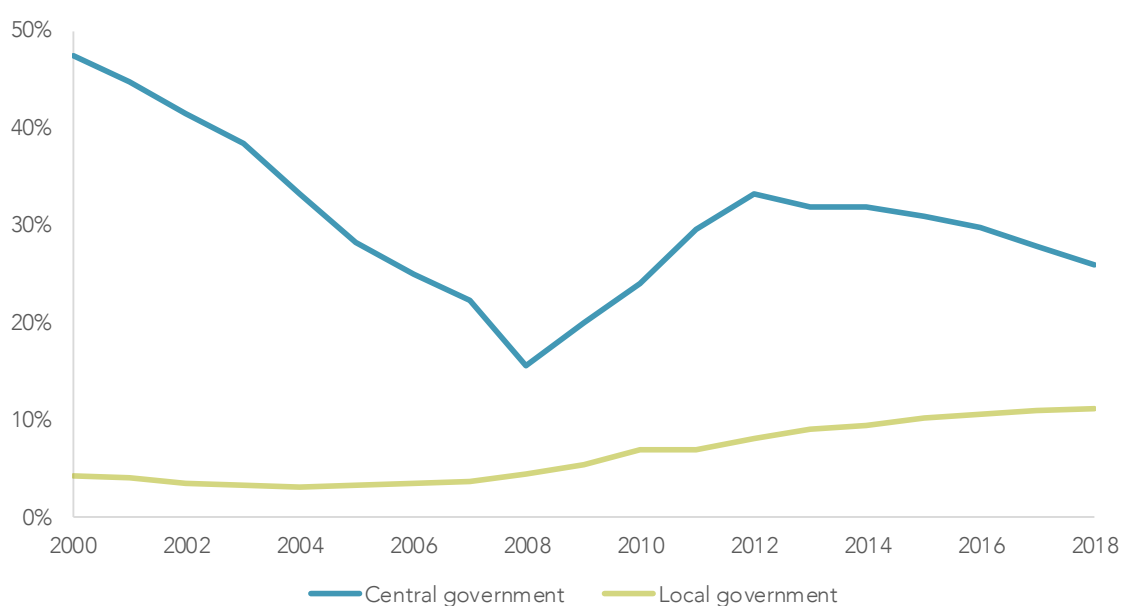
1. Each statistic is the weighted average across all local authorities in each growth category.
2. The total growth in capex refers to the percentage increase in total capex in 2016-2018, compared with 2000-2002. Therefore, total growth in capex presents the increase in capex over 16 years. This is more useful than comparing capex between two single points in time since capex can be highly volatile (as a result of the lumpy nature of infrastructure investments).
3. Regional councils are excluded.
4. The annual growth rates in opex per person in this table differ from those set out in section 3.4. because this table uses the CPI to adjust for inflation, while section 3.4 uses a local government price index constructed by Sapere (2019). In addition, this table includes depreciation and interest as part of opex; section 3.4 excludes these items.

3.3 Financing trends

Debt is a good way for councils to spread the burden of capex across generations so that the people who benefit from infrastructure investments contribute to meeting the cost. In this way, and particularly for high-growth councils, debt shifts the cost of development capacity away from existing residents to those who benefit from growth (Chapter 6).

Consistent with this rationale, councils have been, on average, accumulating debt over the last two decades. Between 2000 and 2018, total local authority debt increased from a low base of \$2.7 billion to \$16.2 billion. As a result, the ratios (debt as a share of total assets) of local authorities have been rising (Figure 3-8).

Figure 3-8 Local and central government gearing ratios, 2000-2018



Source: Stats NZ (2019d); The Treasury (2018a).

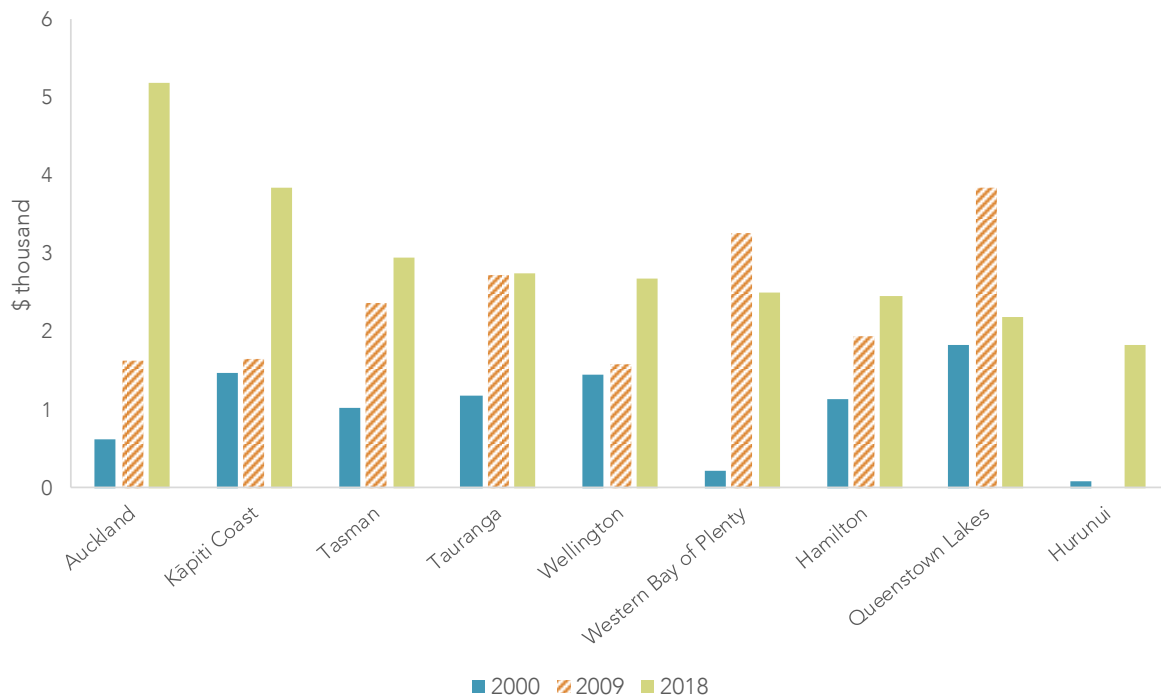
Even so, local government debt remains in aggregate at prudent levels (NZPC, 2015). Gearing ratios of local authorities remain much lower than for central government (Figure 3-8) and large companies in the private

sector. A Grant Thornton study developed a proxy for council financial health using a range of metrics (including debt per head, and debt as a proportion of assets). The study concluded that the overall financial health of all but four councils was “sound” or higher (Grant Thornton, 2014). More recently, the OAG (2018a) concluded that “overall, local authorities continue to manage their debt prudently” (p. 14).

High-growth councils have increased debt from a low base

High-growth councils have increased their debt per person, reflecting their need to finance the supply of development capacity (Figure 3-9).

Figure 3-9 Debt per person across selected high-growth councils



Source: Stats NZ (2019e, 2019d).

Some councils (eg, Auckland) are now approaching their debt servicing limits imposed by financial agencies (Auckland Council, sub. 120). Chapter 7 analyses the issues for high-growth councils around the financing of development capacity.

3.4 Trends in local government prices

This section presents new local government price indices for capex and opex. It then uses the opex index to assess how much the growth in opex (net of depreciation and interest) is attributable to:

- price increases;
- population growth; and
- growth in the quantity of council services per person.

Measuring price inflation in local government goods and services

Rising prices for inputs contribute to growth in local authority spending. The Local Government Cost Index (LGCI) is a price index developed by Business and Economic Research Limited (BERL). The LGCI monitors changes in the cost of goods and services for local authorities. Costs include capex on pipelines, earthmoving and site works, and opex such as local government sector salaries and wages.

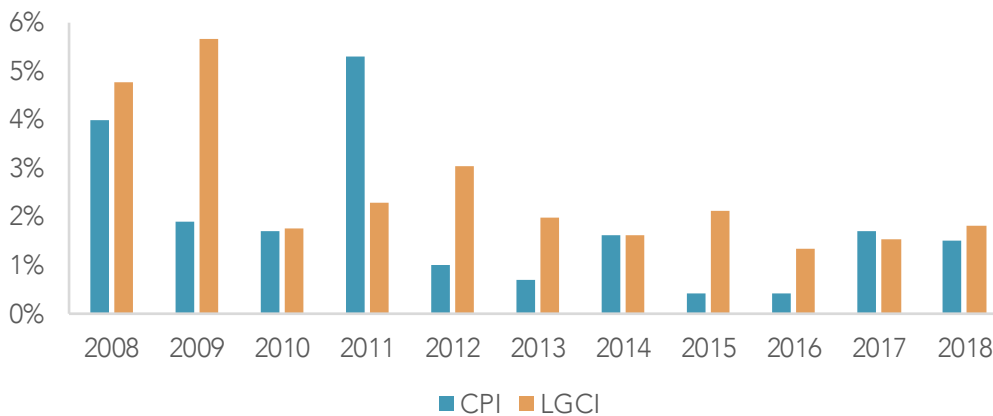
BERL uses a range of Stats NZ price indices, such as the Capital Goods Price Index (CGPI), Labour Cost Index (LCI) and Producers Price Index (PPI), to estimate the price of expenditure items that comprise the LGCI (BERL, 2010). For example, to estimate the price of capex for roads, BERL uses a mix of the CGPI

estimate for roading construction projects and the PPI estimate for inputs into road transport. The LGCI weights these indices to reflect the aggregate expenditure of local authorities on different items.

BERL forecasts price-level changes for local authorities to use in developing their Long-Term Plans (LTPs). Councils commonly set rates by adjusting the previous year's rates by the forecast LGCI, with additional adjustments for anticipated population growth.

The LCGI has generally grown faster than consumer prices (CPI) (see Figure 3-10 below). That the two measures are different is unsurprising, as LGCI measures the prices for a basket of goods and services more relevant to the expenditure of local authorities than the CPI basket, which reflects the expenditure patterns of households.

Figure 3-10 Yearly percentage change in the CPI and LGCI, 2008-2018



Source: Stats NZ; BERL.

An alternative measure of price inflation in local government goods and services

The Commission engaged Sapere Research Group to analyse the drivers of local government costs and prices. Sapere (2019) used the following criteria to assess the LGCI against a range of alternative index methodologies:

- best practice methodology and conceptual soundness;
- practical to implement;
- usefulness (clear and understandable); and
- analytical adequacy (including ability to disaggregate by type of council).

The preferred option from this review was a chain-weighted Laspeyres index.⁹ The preferred index updates expenditure weights each year, and so differs from the LGCI which updates weights every five years. As such, the preferred index accounts for yearly changes in the composition of councils' spending.

The Sapere index uses the same Stats NZ price indices as the LGCI, but adds the PPI output series for water and environmental management. An input index is best used for activities that councils usually undertake themselves, and an output index for work that councils typically outsource. So using a combination of input and output indices reflects that councils use a mix of in-house provision and outsourcing for different activities. The Sapere index for all council spending is made up of separate indices for capex and opex.

⁹ A chain-weighted index takes into account the changes in the composition (mix) of spending over time. It therefore reflects changes in purchasing decisions (primarily purchasers substituting away from goods that have become more expensive and towards goods that have become relatively cheaper). This contrasts to a fixed-weight index which measures price changes based on a fixed composition (or basket) of spending. A conventional Laspeyres price index is a fixed-weight index, which measures changes in the cost of a basket of goods and services over time relative to its cost in the initial base period. A chain-weighted Laspeyres price index is periodically reweighted, in this case each year, using expenditure weights based on purchases in the previous period.

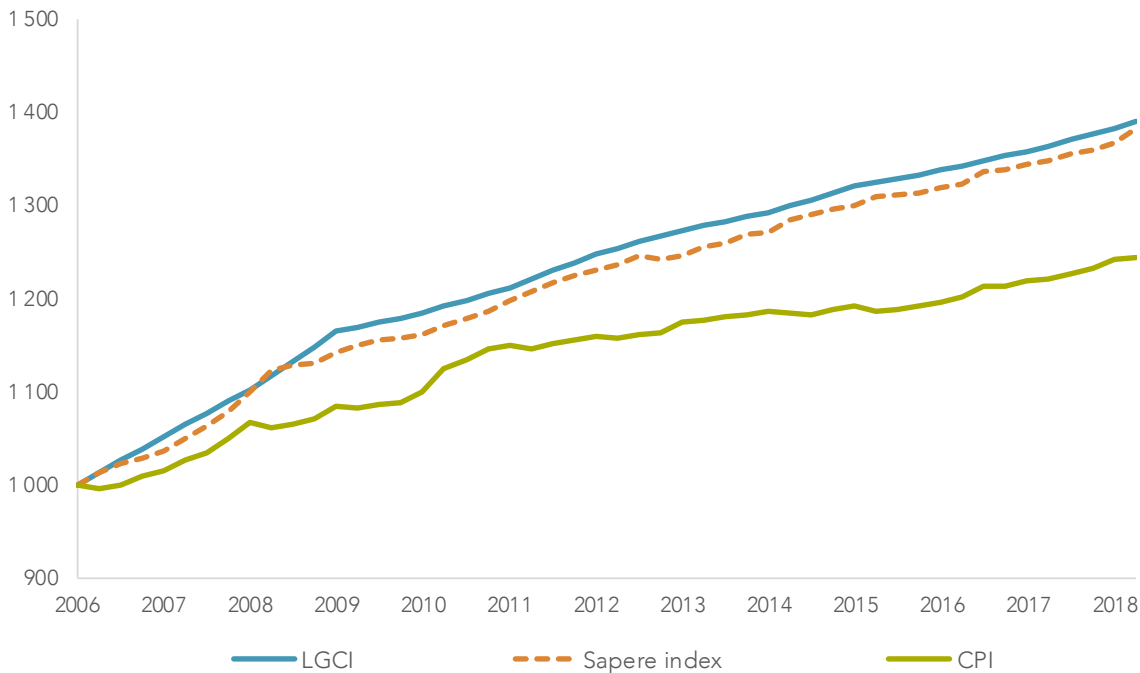
The Sapere index excludes land purchases, as information about the contribution of land prices to council expenditure is limited. The sale of land can also benefit councils, so the net effect of purchases and sales is uncertain.

The Sapere index for opex excludes depreciation from the measure of opex. Sapere's modelling included capex, so including depreciation in the opex would, in effect, result in double-counting of that expenditure. Sapere's preferred index also excluded interest costs, so that it reflects the direct cost of goods and services rather than their financing.

Figure 3-11 compares the LGCI against the alternative index. It shows that between 2007 and 2017¹⁰, Sapere's index was lower than the LGCI in all but one quarter, though total growth over the period was not materially different (32% compared to 31%). Even so, Sapere's adjustments to the LGCI resulted in offsetting movements that were material. The two changes that differ most from the LGCI were:

- around a 3.5% decrease in observed inflation, due to the more frequent reweighting (0.34% on a yearly basis); and
- around a 1.3% increase in inflation due to the inclusion of output series for producer prices (or 0.12% on a yearly basis).

Figure 3-11 Comparison of measures of price inflation in local government goods and services



Source: Sapere (2019); Stats NZ (2019d).

Notes:

1. Figures noted in the text refer to the period of analysis (2007–2017); the chart includes the most recent data (up to and including 2018).

Future projections of price inflation in local government goods and services

The Sapere work revealed a number of potential changes to current practice in the way price inflation in local government goods and services is forecast.

- **More frequent reweighting**, to better reflect the changing composition of actual council expenditure. Sapere concluded that “[i]t would be hard, but not impossible, to forecast changes in weights and consideration could be given to that action if it would result in material changes” (Sapere, 2019, p. 21).

¹⁰ Sapere's analysis used data based on calendar years (ie, years ended 31 December), rather than local government financial years (ie, years ended 30 June).

- **Introducing output indices** to the index, in particular the PPI output series for water and environmental management.
- **Disaggregating by council type**, such as the sector groupings of Local Government New Zealand (LGNZ). Price trends by council type are presented below.

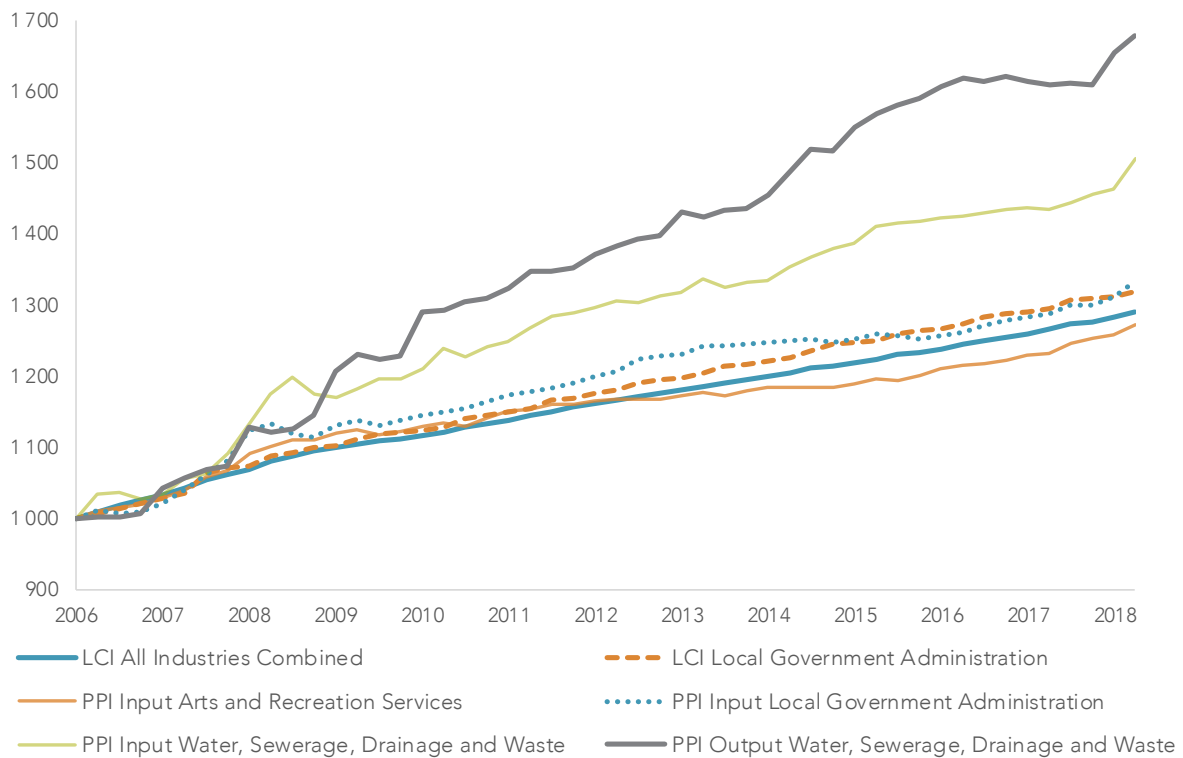
A number of councils expressed support for some of these changes, or interest in exploring them further (in particular, Northland Regional Council, sub. DR158, Waipa District Council, sub. DR178; Whangarei District Council, sub. DR203). Northland Regional Council supported disaggregating by council type, to better reflect the differences in spending between regional and district councils (Northland Regional Council, sub. DR158, p. 2). Federated Farmers also supported the potential changes (Federated Farmers of New Zealand, sub. DR21, p. 16).

SOLGM submitted that they will be considering more frequent rebasing of the LGCI. Their submission included a response from BERL, who noted that consideration of such changes should involve assessment of the costs and benefits of doing so (SOLGM, sub. DR176).

Trends in local government prices

Figure 3-12 and Figure 3-13 show the trends in the individual indices that make up the Sapere index. For opex (Figure 3-12), the input and output series for water, sewerage and drainage services, which rose 38% and 61% respectively over the period, grew fastest. By comparison, labour prices (as measured by the LCI for local government administration) grew by 27%. In terms of capex (Figure 3-13), the biggest increase was in the index for earthmoving and siteworks, which rose by 36% over the period.

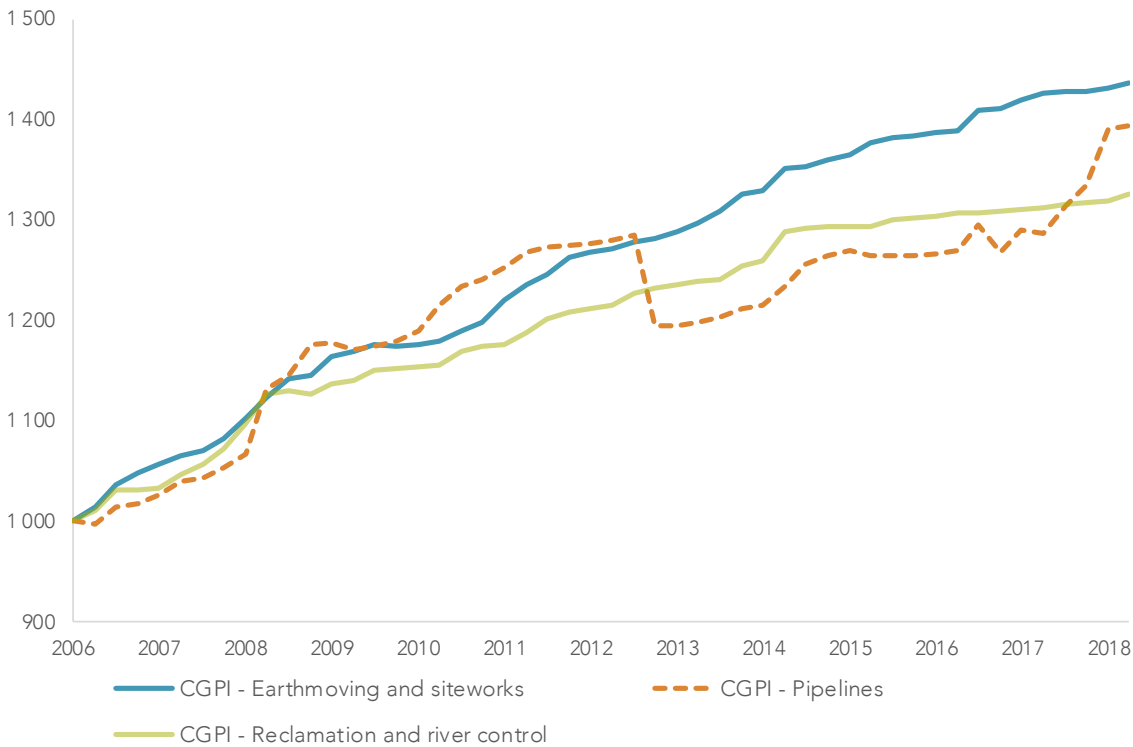
Figure 3-12 Trends in indices that form the opex index



Source: Sapere (2019); Stats NZ (2019d).

Notes:

1. The figures in the text refer to the period of analysis (2007–2017); the chart includes the most recent data (up to and including 2018).

Figure 3-13 Trends in indices that form the capex index

Source: Sapere (2019); Stats NZ (2019d).

Notes:

1. The figures in the text refer to the period of analysis (2007–2017); the chart includes the most recent data (up to and including 2018).

Drivers of local government price inflation

Sapere found that 40% of total price growth from 2007 to 2017 could be attributed to changes in general economic factors.¹¹ Variables with the strongest correlations to local government price inflation were:

- inflation expectations;¹²
- demand pressures in the economy;¹³ and
- world prices of some imported goods into New Zealand, and the exchange rate.

Councils raised the impact of demand pressures in a number of submissions, and in case studies and interviews with local government managers. They identified demand for construction services related to post-earthquake rebuild activity in the South Island as a particular driver of construction capacity constraints. In one case study, a high-growth council commented that competition with the Australian market is providing additional price pressure, as demand there is also strong (this could be a factor where firms or specialist staff are operating in both markets).

For smaller councils, lack of competition in tendering also places pressure on prices. Tararua District Council submitted:

Competition in the construction sector can be low in rural areas.... there is a shortage of both capability and supply of contractors. This has resulted in costs increasing by well above CPI in the last decade (as shown in the BERL LGI [Local Government Cost Index]), and sometimes capital projects have to wait or

¹¹ Attributed in a statistical sense, indicating correlation but not necessarily causation.

¹² Firms who provide goods and services to local government are more likely to increase their prices if they think inflation will be higher (as they expect higher input costs).

¹³ As measured by the output gap, which measures the difference between the potential output of an economy and the actual output. It provides an indication of how close an economy is to capacity.

be staged until contractors are available. Generally the Metro Councils have more competition for infrastructure contracts and professional services. (Taranua District Council, sub. 18, p. 3)

This concern was echoed by Ruapehu District Council:

Rural Councils face higher prices for services due to a lack of competition driven by their comparatively small, dispersed populations and somewhat isolated location. In one instance, this resulted in a quote \$100k – 300k above the engineering estimate. (Ruapehu District Council, sub. 85, p. 6)

The lack of tendering competition will affect councils differently, depending on the extent to which they outsource various services.

Councils also referred to difficulty in recruiting staff in specialist areas (including planning, consenting, and water quality science), suggesting that some areas are facing supply constraints. For small rural councils, the general difficulty in attracting and retaining good quality staff compounds the problem. Both difficulties place pressure on the price of specialist labour.

The Commission sees scope for greater demand-side management in the face of these supply constraints, such as through more regional collaboration and use of shared services, and better planning, commissioning and management of capital projects. Ways to improve the decision-making of councils are discussed in Chapter 5. An approach for incentivising more efficient and effective management of three-waters services is explored in Chapter 11.

Councils also identified other New Zealand-specific price pressures, including:

- the scarcity of supply of aggregate (used for construction and roading), which has pushed up its price; and
- increased insurance premiums – as New Zealand insurers exit the market, some local authorities have had to seek out more expensive foreign underwriters.

F3.2

Local governments face higher price inflation than general consumers largely because of the specialised inputs councils use to construct and operate infrastructure. Councils have little direct influence on the prices of many of these inputs, but can adjust their demand and mix of inputs, in response to changes in prices.

F3.3

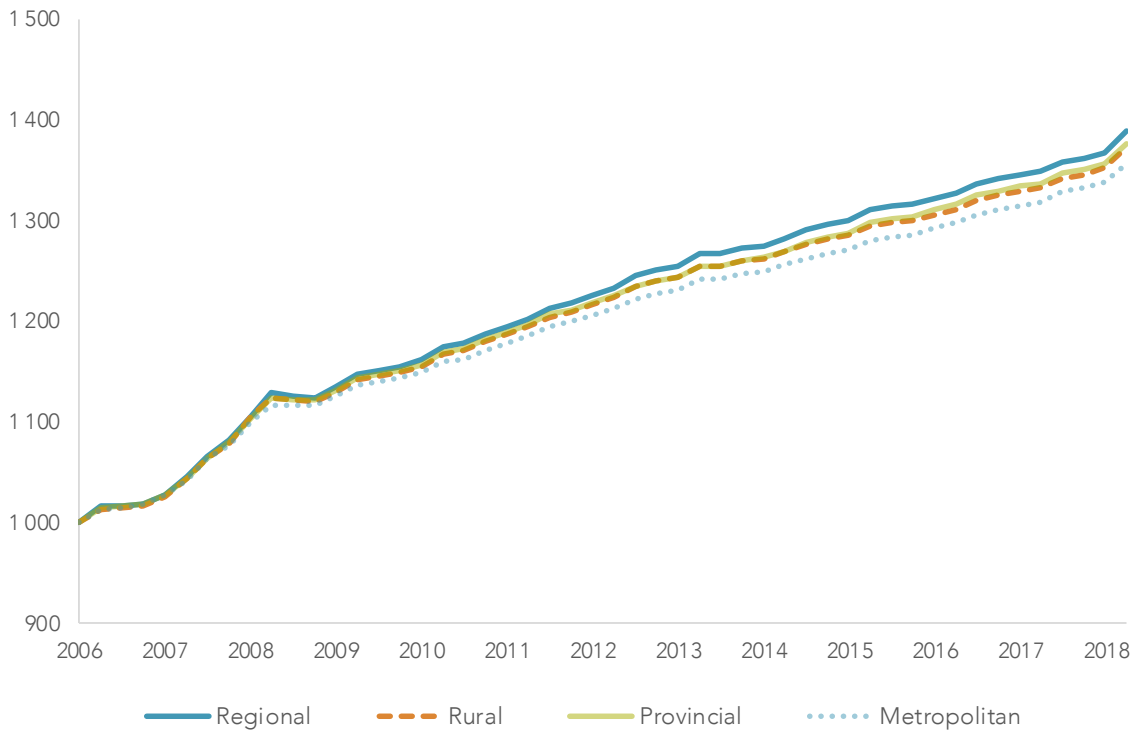
Modelling of price inflation in local government goods and services, using an index that reflects yearly changes in the composition of expenditure, produces a slightly lower measure of inflation than the Local Government Cost Index currently used by councils. This suggests that councils do adjust their mix of inputs in response to prices, to some extent.

Price trends for different types of council

Every council undertakes a different mix of activities, depending on its role and circumstances and the needs and preferences of its local community (Chapter 2 and section 3.2). For example, regional councils are more heavily focused on regulatory activities. So they have a higher proportion of opex compared to other types of councils. As rural councils tend to have large roading networks, they undertake more roading construction and maintenance. As a proportion, metropolitan councils spend more on community activities (such as libraries, museums and sports facilities). In addition, councils may be at different stages in their asset replacement cycles.

Sapere produced sub-indices of their price index, by LGNZ sector group (metropolitan, provincial, rural and regional). They found that, for opex (excluding interest), regional councils have faced the highest price pressures, largely due to their greater level of spending on water and environmental management (which includes irrigation and flood control schemes). Metropolitan councils have faced the lowest price growth (see Figure 3-14). However, the differences across council types are small.

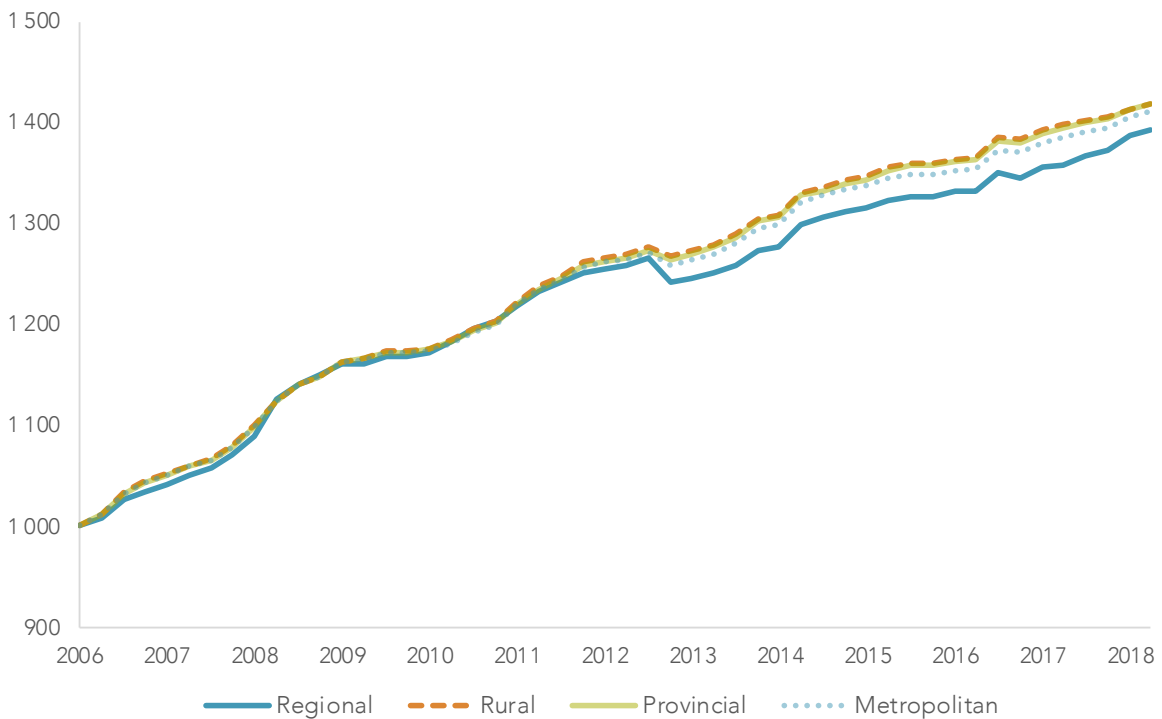
Figure 3-14 Sapere price index by type of council: opex



Source: Sapere (2019); Stats NZ (2019d).

For capex, price inflation has also been very similar across the types of councils. It has been lower for regional councils (see Figure 3-15).

Figure 3-15 Sapere price index by type of council: capex



Source: Sapere (2019); Stats NZ (2019d).

Analysing the increase in opex

Table 3.2 shows the growth in nominal opex between 2007 and 2017 for the different types of councils and adjusts them for price inflation (using the Sapere index) and for population change. The table aggregates the expenditure values for each council within a category to calculate “weighted averages”. This has the

effect of giving larger councils (such as Auckland in the “metro” category), with higher expenditure and larger populations, a higher weighting.

Adjustments for price inflation and population change show the changes in councils’ real expenditure and in real expenditure per person for each category. The table then shows the compound annual growth rate in real expenditure per person. The last two lines therefore show the growth in expenditure that is associated with an increase in council activities (ie, the quantity of goods and services purchased by councils), as the effects of prices and population growth have been removed. The pressures underlying this growth in activity are explored in Chapter 4. The data show that real per person opex growth was strongest for rural and regional councils, averaging 1.7% and 1.5% a year respectively, compared to the national average of 1.2% a year.

Table 3.2 Growth in nominal, real and real per person opex, 2007-2017

	National aggregate	Metro	Provincial	Rural	Regional
Change in total nominal expenditure	64%	67%	56%	58%	71%
<i>Price inflation (Sapere index)</i>	<i>29%</i>	<i>28%</i>	<i>30%</i>	<i>30%</i>	<i>31%</i>
Change in total real expenditure	27%	30%	20%	22%	31%
<i>Change in population</i>	<i>12%</i>	<i>15%</i>	<i>13%</i>	<i>5%</i>	<i>11%</i>
Change in real per person expenditure	13%	13%	7%	16%	18%
Compound annual growth rate in real expenditure per person	1.2%	1.3%	0.7%	1.7%	1.5%

Source: Sapere (2019); Stats NZ (2019d).

Notes:

1. Figures were calculated by aggregating the values for all councils within a category and then calculating the relevant figures for these.
2. The per person growth rates of opex in Table 3.2 differ from those in Table 3.1 because the latter uses the CPI to adjust for inflation and includes depreciation and interest as components of opex.

F3.4

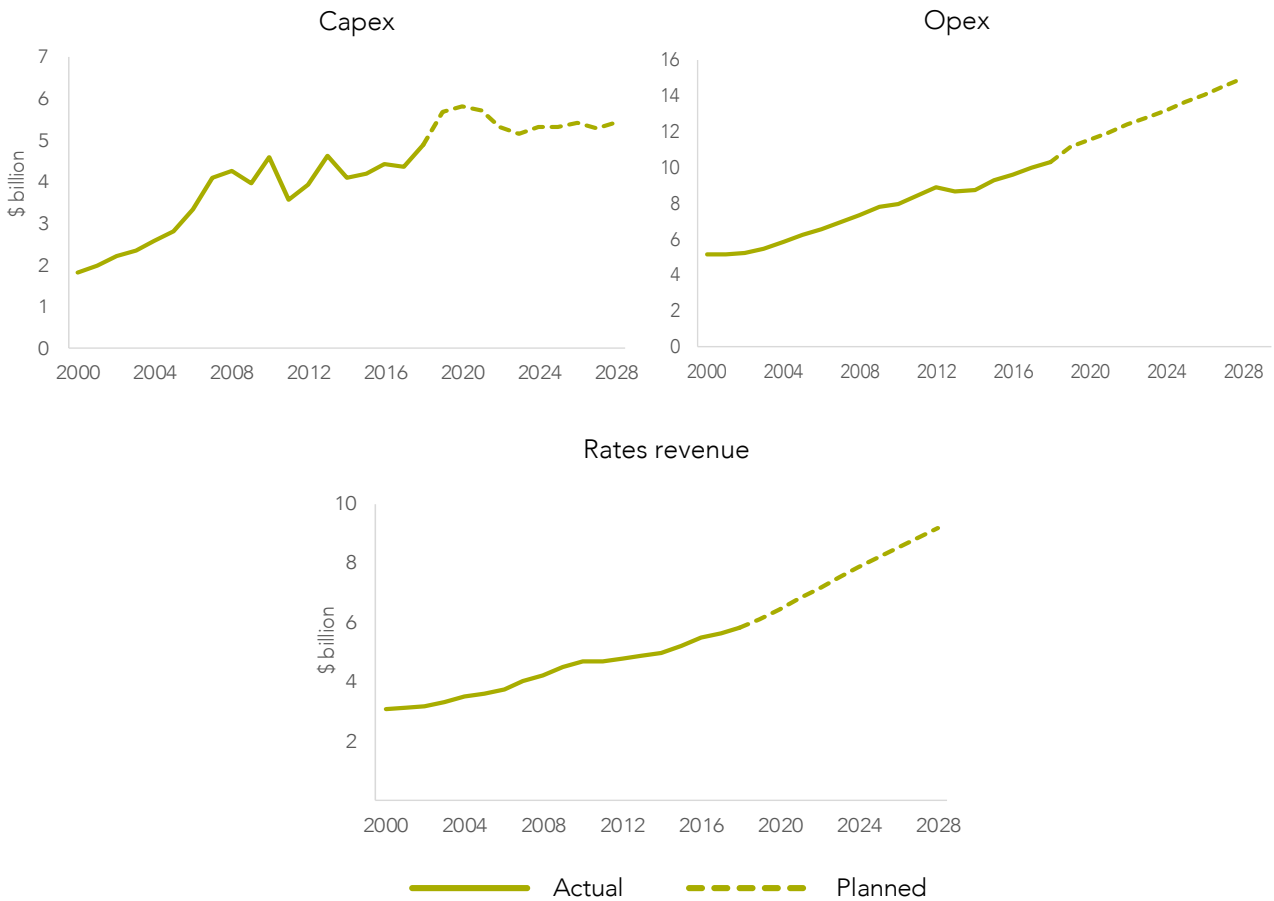
After adjusting for price inflation using the Commission’s preferred price index, local government operating expenditure (opex) per person (excluding depreciation and interest) grew at an average of 1.2% a year between 2007 and 2017. The opex per person of regional and rural councils grew faster than that of metropolitan and provincial councils.

3.5 Projected expenditure and revenue trends

Every three years, local authorities (including regional councils) prepare an LTP that forecasts their revenue and expenditure over the coming decade. Councils may revise future spending plans as the need to fund and finance them becomes pressing, and as priorities change, for instance as a result of unanticipated external events. As a result, the projections are indicative of future trends rather than firm commitments to expenditure and revenue paths.

Figure 3-16 shows the actual capital and opex as well as rates across all councils between 2000 and 2018, and the forecast figures between 2019 and 2028, based on LTP data. The forecast to 2028 shows total rates revenue across all councils growing at an average of almost 5% a year, as a result of the projected increase in opex.

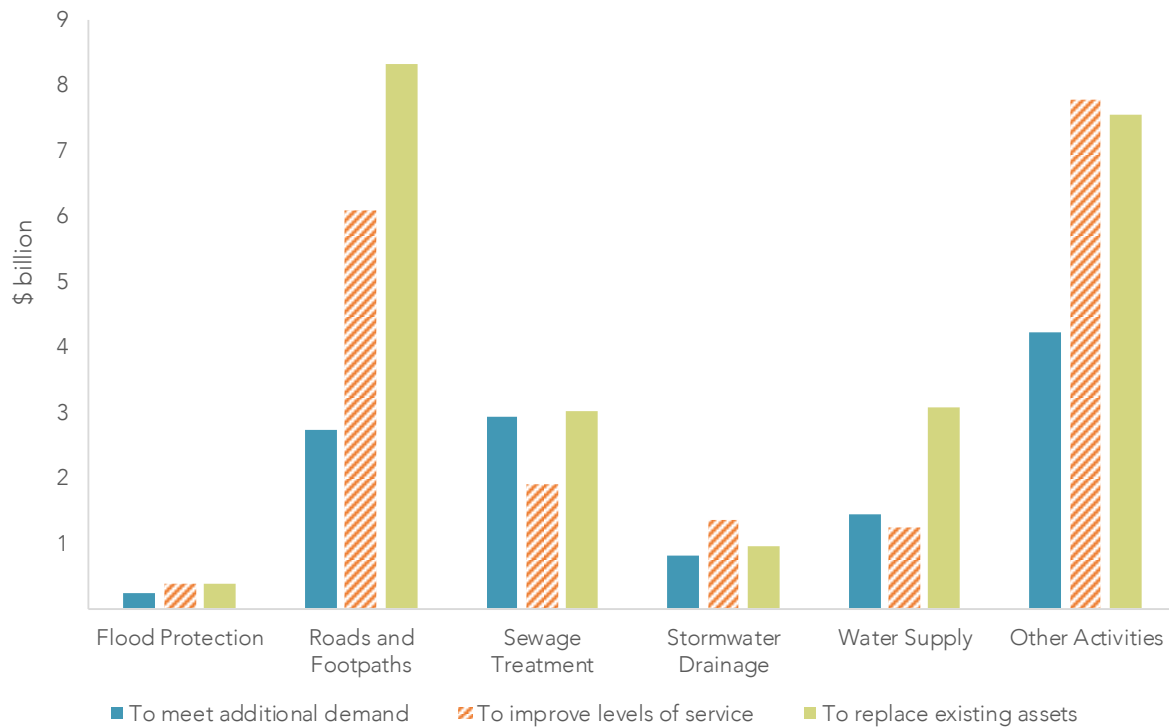
Figure 3-16 Actual and planned revenue and expenditure by councils, 2000-2028



Source: DIA (2019c); Stats NZ (2019d).

Depreciation and interest are projected to grow strongly over the forecast period, with projected growth of 54% and 56% respectively. Rising interest costs are unsurprising given the recent growth in debt; yet it does expose councils to the risk of future adverse movements in interest rates (OAG, 2019b).

While projected opex continues to rise, projected capex levels off during the 2020s. Perhaps councils expect their demand for investment to moderate. Alternatively, funding and/or financial pressures on councils may be causing them to scale back investment in capital projects. Of the roughly \$55 billion capex forecast over the next 10 years, just under 43% is to replace existing assets (Figure 3-17). Replacing roads and pathways is the biggest item of capex for councils.

Figure 3-17 Forecast capex (all councils) by purpose and activity, 2019-2028

Source: DIA (2019c).

The TOR identify new and existing cost pressures facing councils into the future, including pressures arising from fast population growth; the need to adapt to climate change; rising tourism; Treaty settlement arrangements; and rising standards in the supply of drinking water and wastewater services. Councils are keenly aware of these pressures. Even so, the summary data does not clearly show how far councils factor such pressures into their latest LTPs. Chapter 4 describes the pressures in more detail, and subsequent chapters explore ways to address the funding and financing challenges these pressures pose.

3.6 Conclusion

One motivation for this inquiry was a concern that rising local government revenues and especially rates are outstripping the ability of local communities to pay. Yet, over a long period the ratios of revenue (and rates) to national and household income have remained in relatively narrow bands. These ratios show no evidence of any recent upward trend. This suggests that local democratic decision making and the discipline provided by statutory accountabilities, have constrained expenditure growth to match the growth in incomes.

While the ratio of rates to income has been generally stable, councils serving small, low-income mostly rural districts experienced strong pressure on their rating capacity (Chapter 6). Chapter 7 discusses policy approaches to address these pressures. Chapter 8 looks at rates affordability for low-income households.

Constraining expenditure to match ability to pay does not necessarily mean that councils' spending choices best match the challenges they and their communities face. Chapter 5 describes improvements to council decision-making processes and the regulatory environment that governs them.

Councils have increased their debt over the last two decades, reflecting a strategy to allocate some of the cost of investments to future generations who will benefit from them. In aggregate, council debt is not excessive, though (as illustrated by an example in Chapter 5) individual councils have sometimes gone beyond what their communities can easily manage.

Looking forward, councils, in aggregate, expect expenditure and rates to continue to rise. Past history suggests that in practice spending plans will adjust to prevailing incomes. Even so, the inquiry's TOR identify challenges for councils from specific cost pressures – some relatively longstanding; others newly emerging. Chapter 4 describes these challenges and subsequent chapters consider how to tackle them.

4 Pressures on funding and financing

Key points

- Local authorities face several rising funding pressures, which vary according to the type of council as well as size, location, demographics and other characteristics. While no two councils are quite alike in the pressures they face, there are some common challenges.
- Population changes are creating pressure in many districts. Rapid population growth in some areas means some councils struggle to provide enough new infrastructure, while other areas with small, static or declining populations struggle with high fixed costs compared to their ratepayer base. New Zealand's population is projected to become more geographically concentrated, which will exacerbate these pressures.
- Local demographics can add to this challenge. Districts with a high proportion of residents relying on low fixed incomes, or with high levels of deprivation, are under pressure because residents may struggle to afford rates increases. This impacts councils' ability to provide infrastructure and services to expected standards. An ageing population can also bring increased demand for accessible infrastructure and social services.
- Central government has long tended to pass new responsibilities to local government. It has passed down a steady stream of new standards, regulations and requirements without financial resources to cover their costs – even those that provide national benefits. These “unfunded mandates” have now reached a point where the cumulative impact is difficult for many local authorities to manage.
- Co-management and co-governance arrangements established through Treaty of Waitangi settlements can impose considerable costs on councils, and these costs are not evenly distributed among local authorities. To date, the Crown's support for such arrangements has fallen short of covering the initial costs to councils.
- Many of these challenges are not new, although some are increasing. And the cumulative impact of the range of pressures, some of which combine and interact in complex and costly ways (and will do so more in the future), is reaching a point where some councils are finding it difficult to manage. Improved decision making and processes (Chapter 5), more effective use of current funding and financing tools, and more carefully designed central government policy and regulation (Chapter 7) will help to ease this pressure, but will not remove it.
- A significant new, and growing, cost pressure on local government comes from climate change. The scale of the investments that will be needed go beyond what local authorities can reasonably manage with current funding and financing tools. New approaches will be needed to deal with this issue, which is discussed in Chapter 9.

As discussed in Chapter 2, New Zealand's 78 local authorities vary widely in terms of the communities they serve, and the specific circumstances they face. Regional councils, territorial authorities and unitary authorities also have different scopes of responsibilities and therefore the pressures they face can be very different. Likewise, the handful of councils experiencing rapid population growth faces different challenges to the small provincial and rural councils with static, or even declining, populations.

While no two local authorities are quite alike in the specific combination of pressures they face, there are common challenges. This chapter examines the pressures affecting local government funding and financing, and identifies key challenges. It provides context for later chapters about managing cost pressures (Chapter 5), and where, and how, changes to funding and financing may be needed (Chapters 6, 7, 8 and 9).

This chapter discusses five well-established pressures facing local authorities:

- changing population;
- high rates of deprivation;
- increased functions and responsibilities from central government;
- Treaty of Waitangi obligations and Treaty settlements; and
- scope of local government and rising community expectations.

This chapter also highlights some significant additional pressures, which are discussed in greater detail later in the report:

- increasing risks from climate change (discussed in detail in Chapter 9);
- pressure in some districts from tourism (discussed in Chapter 10); and
- three-waters infrastructure (discussed in detail in Chapter 11).

4.1 Changing population

The two main components to population increase or decrease in any given region or district are: natural increase (births minus deaths); and net migration (arrivals minus departures).

In the last five years, external migration has been the largest component of New Zealand's population growth – contributing about 57 000 migrants in the year ended December 2018, compared to a natural increase of around 25 000 (Stats NZ, 2018c). This national trend is reflected at the sub-national level, with population growth in most regions and districts driven by the combined effect of international and internal net migration. Net migration can be influenced by several factors, including economic or employment opportunities, natural and cultural lifestyle opportunities (including the “sunshine effect”), or access to essential services (Brabyn, 2017).

As noted in Chapter 2, New Zealand's population has grown by about 30% since 1996, but that growth has been unevenly distributed. At a district level, since 1996 it has varied between a 165% increase in Queenstown Lakes District, and a 26% decrease in Ruapehu and Wairoa Districts.¹⁴ Councils in areas experiencing high growth rates, and those with static or declining populations, face different cost pressures.

Councils in areas experiencing high population growth

Recent trends of urbanisation have seen a lot of growth occur in large metro centres – including those often referred to as the “Golden Triangle” of Auckland, Hamilton and Tauranga. But while growth in urban areas is large in absolute terms, some smaller districts have also grown rapidly. The two fastest-growing districts are classed as “provincial” – Queenstown Lakes and Selwyn. The rural districts of Mackenzie, Central Otago, Hurunui, Carterton and Kaipara have also shown strong growth.

The drivers for growth vary for metro, provincial and rural districts. Migration to cities is often driven by availability of economic opportunities, and access to services and amenities (Coleman, Mare, & Zheng, 2019). The booming tourism sector has buoyed high net migration to the Queenstown Lakes District. More people have also moved into the Selwyn and Waimakariri Districts (both close to Christchurch) partly due to the 2011 earthquake.

Most of the smaller communities experiencing high growth are close to larger centres, with net migration reflecting spillover benefits as workers take advantage of employment opportunities in nearby urban centres, while also benefiting from the natural and cultural lifestyle opportunities those smaller communities offer (Cochrane & Mare, 2017). Auckland, for example, has been at times a net-supplier of population to other areas. Between 2008 and 2013 more New Zealanders migrated from Auckland than to it – many to nearby districts such as Waikato, Thames-Coromandel, and Whangarei (NZPC, 2017).

¹⁴ Based on recently released census data, the increase in Queenstown Lakes District between 1996 – 2018 is likely to have been even higher, around 218%.

Population growth has many benefits. It fuels economic activity, bringing new businesses and with them more and higher-quality jobs for residents. As communities grow, economic and social vibrancy also generally increase, with residents having more choice around jobs as well as amenities like schools, sports and entertainment. As the population increases, councils are also able to spread their costs among more ratepayers and more rateable properties.

Another benefit of growth is that large urban centres are generally more productive than smaller communities. The drivers of this increased productivity are twofold: larger cities are able to attract more productive people and businesses due to the availability of opportunities; and people and businesses are themselves more productive if they locate in larger cities. Bigger cities allow easier matching of skills to jobs, better links between suppliers and industry, and more efficient sharing of ideas that stimulate innovation and productivity growth (NZPC, 2017).

But growth also brings challenges. Quality of life for residents can suffer if existing infrastructure fails to keep up with the growing population – roads can become congested, housing can become less affordable, and amenities can become crowded. To accommodate growth, councils need to keep up with demands for more maintenance, renewal and upgrading of existing infrastructure (such as roading, drinking water and wastewater infrastructure). Many fast-growing communities face high house prices and pressured rental markets as more people enter the community. Auckland Council, for example, highlighted that new and current residents face high housing costs, and estimates that the Auckland region currently has a shortfall of around 35 000 dwellings to meet demand for housing (sub. DR185, p. 6). Councils may also face pressure for investments to cater to more diverse community needs, to improve community wellbeing and keep communities safe.

Relieving the pressure that rapid growth puts on infrastructure and enabling housing development are key challenges for fast-growing councils. Territorial authorities enable housing development through their planning functions, and through provision of infrastructure. Significant population growth can be accommodated by expanding new “greenfield” developments (the creation of new housing areas on the city outskirts), and/or through urban intensification. Both approaches come with significant upfront costs.

Greenfield development requires the construction of significant bulk infrastructure to service new housing areas or connect them to existing council infrastructure. Infrastructure must be in place to “unlock” development. The construction of bulk housing infrastructure is a large upfront cost – for example, bulk housing infrastructure for the Milldale development in Wainui, north of Auckland, is estimated to cost around \$91 million for a development of about 9 000 sections (4 000 in the Milldale development and 5 000 in the surrounding area) (Crown Infrastructure Partners, 2018).

Urban intensification, or “brownfield” development, happens on developed land, so infrastructure is already in place. However, existing infrastructure may need upgrading to accommodate development.

Several previous reports by the Commission have looked at the challenges councils in high-growth areas face to provide growth infrastructure and enable housing development, including *Better urban planning* (NZPC, 2017) and *Using land for housing* (NZPC, 2015). A consistent theme through these inquiries is that some councils and existing residents perceive that growth does not pay for itself. This issue is discussed in more detail in Chapter 7.

Funding growth is expensive, and councils have several options for recovering associated costs, such as:¹⁵

- development contributions;
- targeted rates; and
- general rates revenue.

¹⁵ Auckland Council’s water utility, Watercare, also uses Infrastructure Growth Charges (ICG) to fund new water infrastructure to accommodate growth. Watercare introduced ICGs in 2011. An ICG is levied on new or existing customers who increase their demand on Watercare’s services, in line with the beneficiary pays principle (the customer who benefits from the service pays for it), and varies depending on the costs of the new infrastructure required (Watercare Services Ltd, 2019).

The costs of investments that councils make in infrastructure to accommodate growth are generally large and lumpy – unevenly distributed over time as the population grows. In their submissions, many councils highlighted the lag that exists between when a council incurs capital costs of constructing new or upgraded infrastructure and when costs are recovered from developers or residents through the tools identified above (eg, Northland Regional Council, sub. 32; Whangarei District Council, sub. 46; and Tauranga City Council, sub. 119).

Because many councils do not have funds available upfront to build growth infrastructure, they will initially borrow to pay for it. Some councils find this challenging, either because of ratepayer resistance to debt or because they are close to their debt limits. Being close to the limits constrains the ability of councils to borrow because going beyond those limits would result in a credit-rating downgrade, and make borrowing more expensive. Although this is a challenge for some councils (eg, Auckland and Tauranga City Councils), most operate well within their debt limits.

Using debt to fund growth costs also means that councils will incur debt servicing costs before income is received from the developers, new ratepayers or service users (Whangarei District Council, sub. 46). In this way, existing ratepayers may bear the burden of growth infrastructure costs before councils can recover the costs (Tauranga City Council, sub. 119). For these and other reasons, ratepayers can be resistant to councils taking on debt to fund growth infrastructure. That resistance creates an additional political challenge for councils. Elected members may fail to understand debt, including how it can be used to support inter-generational equity. This lack of understanding can also inhibit a council's use of debt – as discussed in Chapter 5.

In planning for growth, good growth forecasting models and population projections are important, as they provide the basis for future planning. Growth forecasts are used to determine not only the extent of capital works and renewals needed to service growth, but also the number of additional residents and businesses over which costs can be spread (OAG, 2013b). Spatial and growth management plans can then be effective tools to set strategic goals and guide decisions around accommodating that growth (see Chapter 5). Councils use different methods to predict growth, but forecasting growth accurately is challenging. And getting it wrong can be costly, as it can be difficult for councils to adjust if the infrastructure they have planned and constructed turns out to be inadequate in the face of higher-than-expected growth (Hauraki District Council, sub. 43), or surplus to requirements when growth is lower than expected.

Regional councils also face some additional costs associated with growth, including costs associated with planning and responding to growth through regional policy statements and other strategies. Regional councils also directly face some costs from growth, such as from increased demand for public transport or flood protection.

Box 4.1 **Large numbers of commuters**

In addition to changing population and demographics, some councils also deal with a large influx of people into the district during the work week as commuters. As noted above, some small communities close to large centres have faced rapid growth as people move to take advantage of lifestyle opportunities outside the city while also benefiting from employment opportunities available in the nearby centre.

Changing lifestyle choices can also mean increased funding pressures, for example in our region we have seen a growth in people living in areas further away from employment centres (for lifestyle or affordability reasons) yet commuting into our regional CBD – for instance Wairarapa and Kapiti. (Greater Wellington Regional Council, sub. 68, p. 4)

Numbers of commuters can be very large in some places. Wellington City Council noted that during the work week the city supports an additional 82 000 commuters (sub. DR245). Other major centres, such as Hamilton and Christchurch, also receive a lot of commuters, which can put pressure on local infrastructure.

Greater Wellington Regional Council noted that commuters necessitate “significant expenditure on transport services to provide sufficient capacity and the levels of service demanded by customers” (sub. 68, p. 4). Christchurch City Council also noted that commuters who come into the city from neighbouring districts cause “a significant issue for Christchurch with our ratepayers funding significant growth capacity in our road network to cater for the thousands of [them]” (sub. DR- 200, p. 3).

Councils are unable to directly rate commuters from outside their region or district to recover such costs, although some costs may be recovered through user charging (for example, fees for public transport and parking). Some councils try to recover costs associated with commuters through business rates. Yet, like population growth more broadly, commuters can also bring several benefits, supporting economic activity within the districts they work.

Councils in small districts, or experiencing low or static growth

While some districts have experienced strong population growth, others have experienced static or even declining populations. Most of these local authorities are in small rural or provincial districts – between 1996 and 2018 about 15 rural councils and five provincial councils were located in districts with static or declining populations. The main driver of the declining population in these communities is migration, as residents move to pursue economic and employment opportunities elsewhere. Because it is the young, economically active residents who tend to move to pursue study and job opportunities, population decline also tends to correlate, in most cases, with an ageing population and lower or fixed incomes.

A static or declining population can create significant challenges for local authorities. A declining population means that council costs are spread among a smaller group of ratepayers. Districts with static or declining populations also often have high levels of unemployment and deprivation, which means lower disposable incomes after housing costs are met.

Physical infrastructure dominates the operating and capital expenditure of local government. This is particularly the case in many rural or provincial communities with dispersed populations and a large amount of roading and water infrastructure per head. The need to maintain and renew infrastructure (often to higher standards required by regulation) may result in the councils in these communities having high fixed costs and a limited ability to reduce levels of service. This can lead to higher costs per ratepayer if the rating base is not growing.

Small communities often each have their own water treatment plant, wastewater treatment plant, as well as other infrastructure like libraries and other amenities. In Hauraki District, for example, the council provides seven separate wastewater schemes, and several of those schemes service towns with fewer than 1 000 people (sub. 43). Because wastewater treatment is subject to scale economies, this raises per-capita costs. As

noted by Federated Farmers, councils without a growing rating base have more limited funding options, with little access to development contributions (sub. DR217).

The high per-capita infrastructure costs for small dispersed communities are highlighted in Boffa Miskell's cost estimates for upgrading wastewater infrastructure to meet National Policy Statement for Freshwater Management (NPS-FM) objectives. They estimate that upgrading wastewater treatment plant to meet the NPS-FM requirements will cost between \$1.4 and \$2.1 billion across New Zealand, but that the impact will be largest for small communities. In communities with up to 500 residents, households face a yearly cost impact about three times the average because upgrade costs are spread between fewer households (GHD Limited & Boffa Miskell, 2018).

New Zealand's population is projected to become increasingly concentrated, and fewer territorial authorities will have growing populations (Jackson, 2017). As more councils face a static or declining rating base, they are likely to find it more challenging to meet fixed infrastructure costs.

F4.1

New Zealand's population has grown by about 30% in the last twenty years, but this growth has not been evenly distributed. Councils in high-growth areas are facing pressure from the costs of funding growth infrastructure, while some councils in small districts or districts with declining populations face pressure from high fixed costs distributed between a relatively small number of ratepayers. These challenges are likely to increase as New Zealand's population becomes increasingly concentrated in the future.

An ageing population

New Zealand's population is growing older. In 1970 the median age in New Zealand was 26 years. By 2018 it was 37, and in 2043 it is projected to be 43 years. The median age vary widely between districts, however, with median age of 32 years in Hamilton city and 54 years in Thames-Coromandel district in 2018. By 2043, the median age is expected to range from 37 years in Palmerston North city to 60 years in Thames-Coromandel district. It is also projected that 12 territorial authorities will have a median age of 50 years or older by 2043, compared to just one in 2018 (Stats NZ, 2019c).

In 2018, over 15% of New Zealand population was at least 65 years old. This proportion is smaller than the OECD average of around 19% (in 2017), but it is the fastest growing age group nationally. Into the future, all districts are expected to have a greater proportion of people who are at least 65 years old than they do now (see Figure 4-1). Increased life expectancy and the ageing of the "baby boomer" generation are major drivers of this national trend. Yet some districts are ageing more rapidly than others as more older residents move into them, and/or as younger residents move out – known as "age-selective migration" (Jackson & Brabyn, 2017).

Several factors can drive age-selective migration. Some districts with the most rapidly ageing populations are "sunshine areas" (eg, Thames-Coromandel and Tasman districts). Many others are within easy reach of larger urban centres with amenities, but which offer cultural or natural lifestyle opportunities (eg, Hauraki, Kāpiti and Central Otago districts).

A rapidly ageing population, and a high proportion of residents who are aged over 65, can create cost pressures for councils. Residents of that age often have different needs, in terms of accessible infrastructure and the types of services they require. For example, elderly residents are often less mobile, and require wider, smoother footpaths and modified street design that can safely accommodate mobility scooters. This can be costly – Hauraki District Council, for example, has allocated \$700 000 over 10 years to widen footpaths to accommodate its ageing population (sub. 43).

Several councils highlighted in their submissions that ageing populations can lead to demand for a different mix of services, including increased demand for social housing and other social services (Manawatu District Council, sub. 57; Hurunui District Council, sub. 110; and Ōpōtiki District Council, sub. 126). Communities can expect councils to provide social services for elderly residents if central government or the private sector

does not provide these services. Accessible public transport can also be an issue for older residents. Public transport can be important for ensuring older residents can access services, remain self-sufficient and avoid social isolation.

Box 4.2 Impact of an ageing population on Tasman street design

The New Zealand Society of Local Government Managers (SOLGM) provided a useful case study, looking at some of the impacts that an ageing population has had on how Tasman council is deciding to design the district's streets.

In Tasman, the proportion of the population aged at least 65 has doubled in the last 20 years, and a significant share of them have a physical disability and/or a sensory impairment.¹⁶ This shifting population profile has led to demand for changes in the way streets and facilities in Tasman region are designed. For example, the council recently undertook a major upgrade of the main street of Richmond, Tasman's largest town, to improve flood resilience, but the improvement was also designed with the needs of elderly and disabled residents in mind. The upgrade included widening footpaths, smoothing out kerbs and channels between the footpath and the road, installing seating for people to rest and mingle, and installing tactile signal crossings.

Similar upgrades will take place in communities around the region over the next 10 years.

Source: SOLGM submission (sub. 24).

Many submitters also raised the concern that, as populations age, more residents move onto fixed incomes (often low fixed incomes) as they leave the workforce and rely on one or both of superannuation and savings. This can lead to concerns about affordability, and the ability of residents to pay rising rates (eg, SOLGM, sub. 24; Hauraki District Council, sub. 43; Manawatu District Council, sub. 57; Ruapehu District Council, sub. 85; Environment Canterbury, sub. 111; LGNZ, sub. 112; and Ōpōtiki District Council, sub. 126).

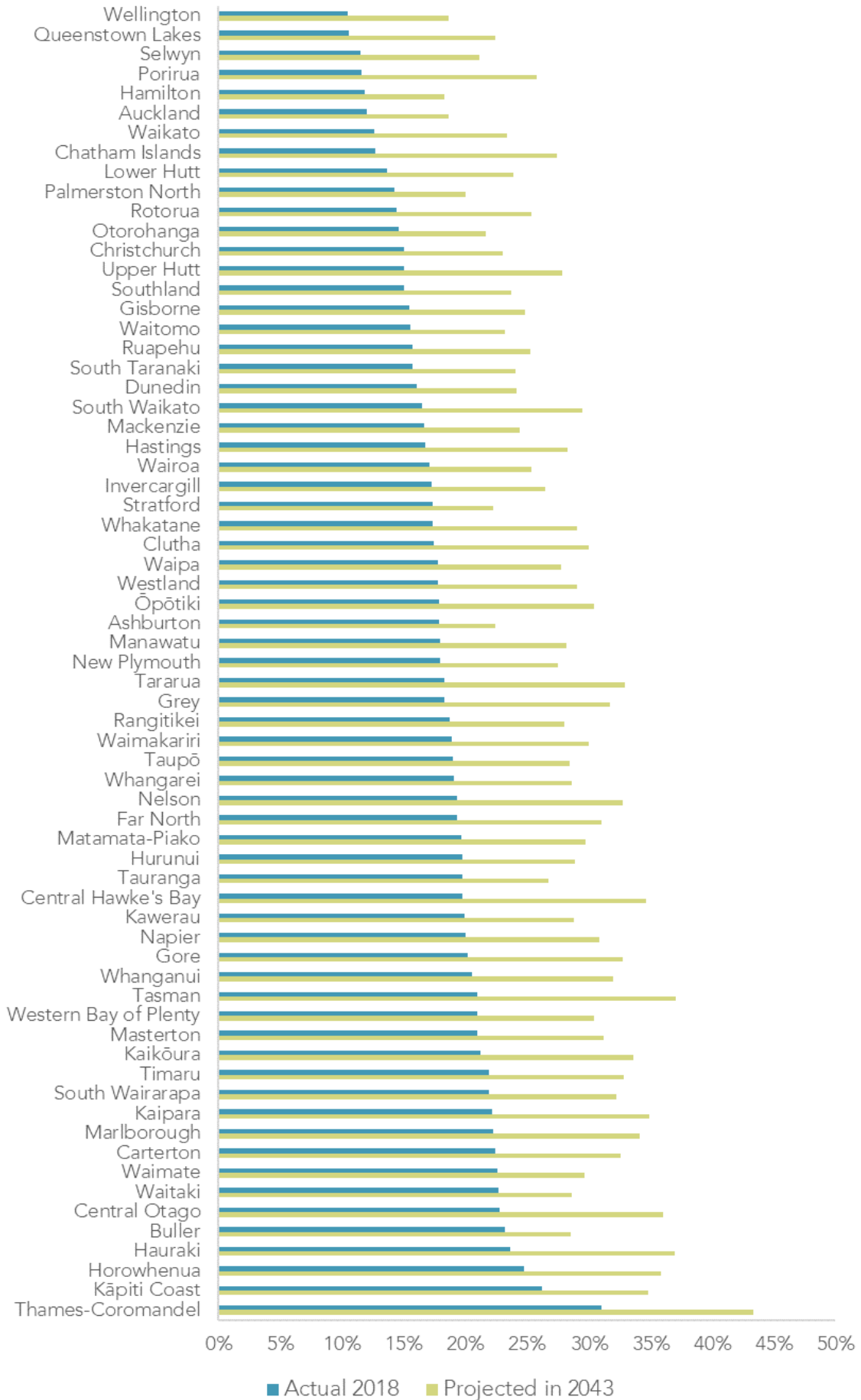
Many councils perceive that their ability to increase rates is constrained as the proportion of the population on fixed incomes grows, because those residents may struggle to pay their rates. Even so, as discussed in the following section, older residents living in their own home are among those least likely to be experiencing material hardship. Districts with a high proportion of older residents are therefore not necessarily among those with the highest proportion of residents that struggle to afford rates (as can be seen by comparing Figure 4-1 and Figure 4-2).

F4.2

All districts across New Zealand are ageing, and this is happening much more rapidly in some districts. An ageing population creates additional costs for councils as elderly residents require a different mix of accessible infrastructure and services.

¹⁶ The submission cites a 2013 disability survey, which found that 47% of residents 65 years or older had a physical disability and 31% had a sensory impairment.

Figure 4-1 Proportion of population 65 years or older – 2018 and projected in 2043



Source: Stats NZ (2018b, 2019c).

4.2 High rates of deprivation

Some participants submitted that high rates of deprivation in their populations put pressure on revenue-raising and on their councils' ability to provide infrastructure and services to expected standards (Northland Regional Council, sub. DR158; Waiheke Local Board, Auckland Council, sub. DR185; Horowhenua Grey Power Assoc., sub. 21; Hauraki District Council, sub. 43; Ōpōtiki District Council, sub. 126). Also, as explained later in this chapter (section 4.3) such councils often feel pressured to provide services to disadvantaged members of their communities, to compensate for the lack of, or withdrawal of, central government social services.

The previous section identified pressures from ageing populations, including concerns that elderly residents on fixed-incomes may struggle to afford rates. Yet, as explained in Chapter 8, older people living in their own homes without a mortgage are a group that is among the least likely to be experiencing material hardship. This is because their housing costs are usually low relative to other low-income households who rent their homes or are paying off a mortgage.

After housing costs are paid, young low-income families, particularly sole parents, are much more likely to be experiencing hardship (Chapter 8). While such families do not usually pay rates directly, they effectively pay them through their rental payments – because landlords generally pass on the costs of rates to their tenants.

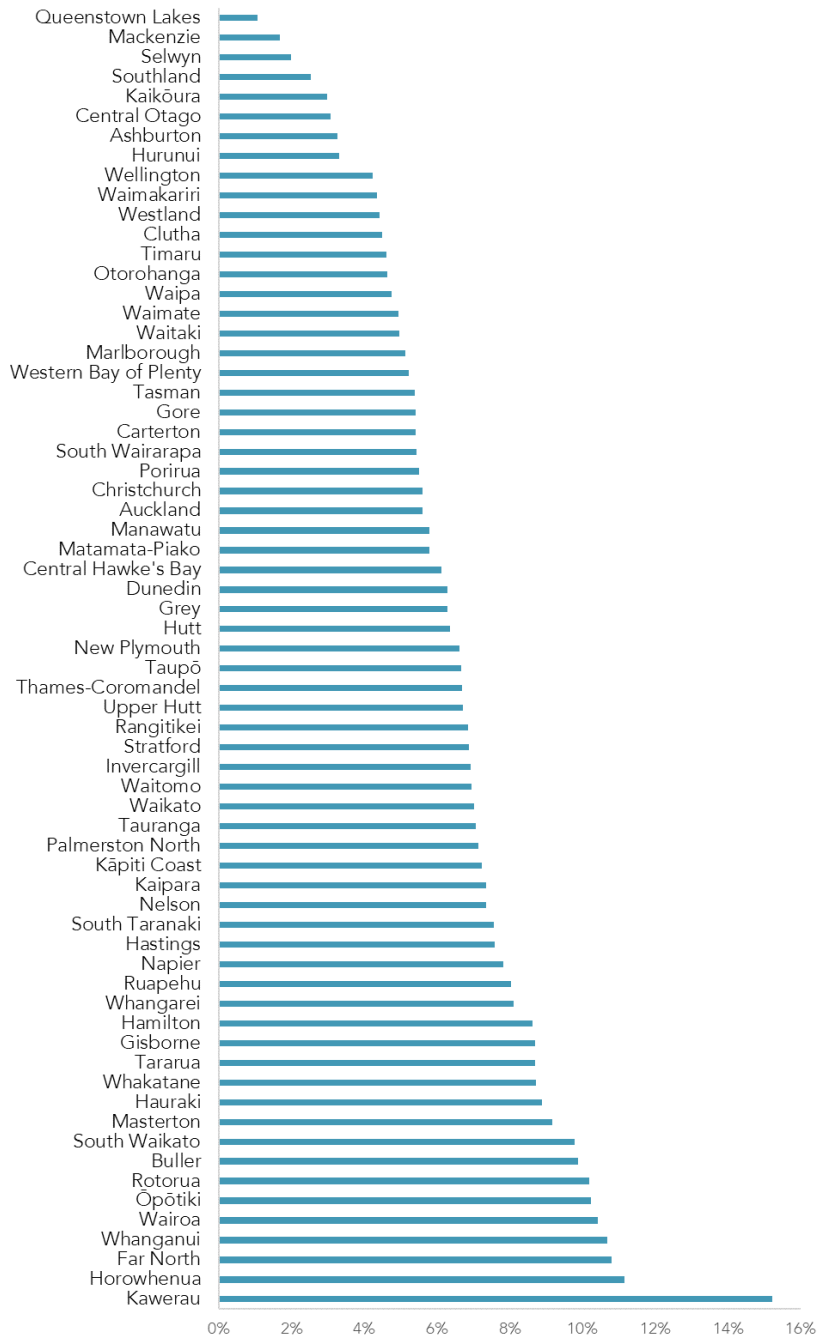
Receipt of the central government's Accommodation Supplement (AS) payments is a good indicator of those experiencing difficulty in meeting housing costs (Chapter 8). Rural districts, often with a high proportion of Māori residents, and mostly in the North Island, are likely to have relatively higher proportions of households dependent on the AS to meet their housing costs. These districts sometimes face additional challenges, because multiply-owned Māori land is often relatively unproductive, and councils find it difficult to raise rates from such land.

The issue of prevailing low incomes making affordability of council services difficult is discussed later in this report (Chapter 8). Central government policies that subsidise local roads consider the rating base of territorial authorities when setting the level of subsidy (Chapter 7). Similar policies may be required to help councils with relatively weak rating bases meet the costs of adapting to climate change (Chapter 9), and to meet rising standards in the provision of the three waters (Chapter 11).

Figure 4-2 shows AS recipients as a percentage of the local population, across territorial authorities.

The issue of prevailing low incomes making affordability of council services difficult is discussed later in this report (Chapter 8). Central government policies that subsidise local roads consider the rating base of territorial authorities when setting the level of subsidy (Chapter 7). Similar policies may be required to help councils with relatively weak rating bases meet the costs of adapting to climate change (Chapter 9), and to meet rising standards in the provision of the three waters (Chapter 11).

Figure 4-2 Accommodation supplement recipients as a percentage of the population, 2018



Source: Ministry of Social Development (2019) Stats NZ (2019).

Note: Accommodation Supplement data is for December 2018; population data is for June 2018.

4.3 Increasing responsibilities

As noted in Chapter 2, local government has a range of responsibilities and functions, which vary depending on the type of council (regional council, territorial authority or unitary authority). During engagement and through submissions, many councils expressed concern that central government has shifted responsibilities to local government without adequate funding provision, and this is creating cost pressure. The process of expanding local government responsibilities without commensurate funding is sometimes referred to as “cost shifting”, and the resulting responsibilities or functions as “unfunded mandates”.

Concerns around unfunded mandates are not new. Local Government New Zealand (LGNZ) has conducted three local government surveys to gauge the extent of central government cost shifting, covering three

periods from 1989 to 2012.¹⁷ Each survey identified a broad range of legislation and regulation transferring responsibilities to local government with limited financial support. Most recently, LGNZ released a report in 2012 looking at the extent of costs imposed on local government by legislation and regulation since 2006 (LGNZ, 2012).

For some new functions and responsibilities, councils are able to recover costs from the regulated party. Also, some new regulation applies across the economy, not just to councils – such as health and safety regulation.

The examples of new responsibilities and unfunded mandates identified in the LGNZ surveys vary widely in terms of their cost impacts on councils. Likewise, the examples highlighted to the Commission in submissions, and during discussions with councils around the country, are very diverse in form and scale. Broadly, unfunded mandates can be broken down into four types, outlined in Figure 4-3.

Figure 4-3 New responsibilities passed from central to local government

Type of unfunded mandate	Examples	Example costs
New or stronger standards that councils must meet – without commensurate funding	<ul style="list-style-type: none"> New National Environmental Standards (NES) New National Policy Statements (NPS) Strengthened drinking water standards Health and safety regulations 	<ul style="list-style-type: none"> Training staff on new standards Monitoring and reporting, including science and data costs Large infrastructure costs for some councils, to update infrastructure to meet new standards
New responsibilities, functions or processes that councils must undertake – without commensurate funding	<ul style="list-style-type: none"> Food and liquor licensing Long Term Plan (LTP) provisions in the Local Government Act (LGA) Earthquake Prone Buildings measures 	<ul style="list-style-type: none"> Training staff on new regulations or procedures Preparing and consulting on policies Monitoring and enforcing compliance LTP audit costs
Reduction, cessation or removal of central government funding, or of government funded programmes and services within the community	<ul style="list-style-type: none"> Changes to the Funding Assistance Rates of the NZTA Removal of funding for community services, such as health and aged services 	<ul style="list-style-type: none"> Increased roading and infrastructure costs for some councils Councils face decision of whether to take over costs of a service, or lose it
Restrictions on the ability of councils to set cost-recovery fees for services or functions	<ul style="list-style-type: none"> Problem-gambling levies under the Gambling Act Limited/unclear cost recovery provisions for monitoring of permitted activities under the RMA 	<ul style="list-style-type: none"> Unable to recoup total costs associated with delivering a service

New standards, or strengthening of existing standards

The introduction of new standards, or the strengthening of existing standards, is the most significant form of cost shifting for many councils. Many councils have raised the impact of introducing National Environmental Standards (NESs) and National Policy Statements (NPSs) under the Resource Management Act (RMA) as a particular concern.

All five NPSs have come into effect during the last ten years, so the costs of “giving effect to” NPSs is a reasonably new pressure for councils. Similarly, the first of the current six NESs came into effect in 2004, so the costs of amending plans and rules to bring them in line with NES provisions, and of meeting and monitoring the standards, are relatively recent. Currently two new NPSs and three new NESs are being developed.

Councils have highlighted that significant costs also arise from changes to existing standards and policies, which can result in much previous work no longer being relevant or requiring review, resulting in duplicated processes and consultation costs (Northland Regional Council, sub. DR158).

¹⁷ The three LGNZ surveys cover the periods: 1989–2000, 2000–2006 and 2006–2012.

SOLGM referred to increasing standards as the “coming storm” (sub. 24). As LGNZ noted in their 2012 review of cost shifting, national standards have different impacts on different councils, depending on the degree of change required to bring plans, processes, policy settings and infrastructure in line (LGNZ, 2012).

The cost impacts of giving effect to the NPS-FM were noted by several councils in their submissions. For example, South Wairarapa District Council stated that to comply with the NPS-FM they need to construct three wastewater systems, which will be a \$30 million project over 4 000 connections. The project will unfold over 30 years as the council does not have the funds to accelerate it (sub. 103). Hauraki District Council has forecast that the NPS-FM will require them to spend \$38 million to upgrade wastewater infrastructure, resulting in a cost of \$6 975 for each connected property (sub. 43).

Boffa Miskell has estimated that, across New Zealand, the total capital costs associated with upgrading wastewater treatment plant discharges to meet the NPS requirements is \$1.4 to \$2.1 billion (GHD Limited & Boffa Miskell, 2018). Boffa Miskell also estimated an additional \$39–\$59 million of operating costs each year. The report notes that these costs will not be spread evenly. Not all wastewater treatment plants will require upgrading to meet the NPS-FM, but a large proportion of those that do require upgrading serve small populations. The result is having to spread the cost between fewer connections.

Beyond the significant infrastructure costs falling on district councils, regional councils also noted other costs associated with giving effect to the NPS-FM. These include the costs of making changes to regional and sub-regional plans, costs for increased monitoring, reporting, associated science, consultation, hearings and appeal processes, as well as mātauranga Māori requirements (Environment Canterbury, sub. 111; Northland Regional Council, sub. 32; and Greater Wellington Regional Council, sub. 68). While hard to quantify, such operational costs are also incurred for other NPSs and NESs, as councils amend regional and district plans and policy statements to implement the standards, policies and objectives contained in the national direction.

Environment Southland also noted the significant costs that regional councils incur for freshwater management more broadly:

The amount of expenditure that regional councils are applying to the freshwater issue is hugely significant to the point that other regional council obligations are being side-lined or halted in order to funnel the limited available funding into water management. (sub. DR195, p. 1)

The strengthening of drinking water standards, which are currently under review following the Havelock North Drinking Water Inquiry, will also create significant cost pressure for some councils. Potential changes being considered include either or both of:

- making compliance to minimum standards mandatory, by removing a current provision that allows councils not to meet those standards if they have taken “all practicable steps” to do so; and
- abolishing the secure groundwater classification, which currently places reduced requirements on groundwater considered at low risk of infiltration by pathogenic bacteria, protozoa and viruses (Ministry of Health, 2008).

In a recent report prepared for the Department of Internal Affairs (DIA), Beca estimated that the costs of upgrading council-owned water treatment plants to meet both requirements would be \$384 million, with an increase in operational costs of \$13 million a year. Water New Zealand noted in their submission that this estimate “is considered by many in the industry at the low end of the scale, most believe the actual cost will be significantly higher” (sub. DR147, p. 2). The cost of upgrading the additional 181 plants not owned by councils is estimated at \$57 million, with an increase in yearly operating costs of \$3 million (Beca, 2018).¹⁸

As with the costs of upgrading wastewater treatment infrastructure, these costs are not distributed evenly. The three regions facing the largest total capital costs are Canterbury (\$102–\$190 million), Otago (\$66–\$123 million) and Waikato (\$30–\$56 million). Per person, however, the highest capital costs will be faced by Otago, Tasman and West Coast.

¹⁸ Plants not owned by councils, and which supply communities, are generally owned by community organisations, although some are owned by private companies (Beca, 2018).

Table 4.1 Estimated costs of meeting the NPS-FM and proposed drinking water standards

	Capital costs	Yearly ongoing costs
NPS-Freshwater Management	\$1.4–\$2.1 billion	\$39–\$59 million
Drinking water standards: council owned	\$384 million	\$13 million
Drinking water standards: non-council owned	\$57 million	\$3 million

Source: Beca (2018); GHD Limited & Boffa Miskell (2018)

In some cases, increasing national standards (for example, freshwater or drinking water standards) can require councils to raise the level of service beyond that for which local ratepayers would otherwise be prepared to pay. LGNZ refers to this as *raising the bar*. For example, Beca estimated that across New Zealand about 497 non-compliant water treatment plants currently serve a combined population of 866 000. About two-thirds of these plants are council owned, and many serve small populations (Beca, 2018). As noted above, the costs of upgrading these plants to meet drinking water standards is significant. Without the new standard, a council might prioritise the spending in a different way to better meet the needs and preferences of their local population. As Tararua District Council noted in their submission, “the choice of appropriate standards and timing of upgrades has been removed from local residents” (sub. 18, p. 2).

This tension was also highlighted in a survey of local authorities conducted as part of the Commission’s 2013 inquiry into local regulation. Around half of the survey respondents agreed or strongly agreed that local political pressures conflict with the regulatory objectives of central government regulations (NZPC, 2013).

At least one council submitted that, despite the considerable costs of complying with new standards, little real benefit would result from that investment. With respect to the NPS-FM, Hauraki District Council stated:

Not only will this require a huge investment, but it will result in very little environmental benefit. Modelling shows that the risk of illness from our treated wastewater in one of our rivers is already lower than the upper catchment of that river. Treatment plant improvements will result in the environmental benefits to receiving waterways being very limited. (sub. 43, p. 7)

Regional councils already face costs associated with monitoring and protecting biodiversity, and this may increase when the NPS on Indigenous Biodiversity is introduced. Currently, councils have a role under the RMA for maintaining indigenous biodiversity, and the proposed NPS will provide national direction and guidance for improving biodiversity management. The draft NPS will be released for consultation later in 2019, but (based on an early draft) it will likely require councils to assess the ecological significance of all areas of indigenous vegetation and fauna habitat, to identify and map “significant natural areas” and protect the ecological integrity of those areas by managing a number of effects (Biodiversity Collaborative Group, 2018).

Regional councils also have some biosecurity responsibilities with respect to weed and pest management. Under the Biosecurity Act 1993, the Ministry for Primary Industries (MPI) is the lead agency nationally for biosecurity, with a focus on reducing the risk of new pests (plants, animals and diseases) entering New Zealand. Once new pests become established, however, regional councils have a long-term pest management role (including monitoring, surveillance and control) under the Act through their regional pest management plans. Several councils indicated during engagement meetings that they currently focus only on high-priority pests, and that they lack the capacity and resources to manage all established pests. With climate change and increased movement of people (through tourism and migration), pest incursions will likely increase. This may put increased pressure on the pest-management activities of regional councils.

Many councils also noted they are experiencing higher costs from strengthened health and safety regulations under the Health and Safety at Work Act 2015, both in higher direct costs for councils and in higher costs for council contractors.

Box 4.3 National Policy Statements and National Environmental Standards

National Policy Statements

National Policy Statements (NPSs) are instruments issued under section 52(2) of the Resource Management Act 1991 (RMA). They state objectives and policies for “matters of national significance” relevant to achieving the purpose of the RMA, and guide decision making under the RMA at the national, regional and district levels. Regional policy statements, regional plans, and district plans are required to “give effect” to NPSs.¹⁹ When a new NPS is introduced, or an NPS is updated, councils need to amend policy statements and plans to give effect to the objectives or policies contained in the NPS. Also, consenting authorities must have regard to relevant policy statements when considering applications for resource consent.

Five NPSs are currently in effect, and two are being developed:

- NPS on Urban Development Capacity (2016)²⁰
- NPS for Freshwater Management (2014, with amendments that took effect in 2017)
- NPS for Renewable Electricity Generation (2011)
- New Zealand Coastal Policy Statement (2010 – replaced the New Zealand Coastal Policy Statement 1994)
- NPS on Electricity Transmission (2008)
- NPS on Highly Productive Land (being developed)
- NPS on Indigenous Biodiversity (being developed)

National Environmental Standards

National Environmental Standards (NESs) are regulations made under the RMA, which set out technical standards, methods or requirements relating to matters under the RMA. NESs provide consistent rules nationwide by setting planning requirements for certain specified activities. An NES may set minimum standards, and can also prescribe technical standards, methods or requirements for monitoring. When a new NES is introduced, or an NES is updated, councils must amend their regional and district plans if any rule in those plans conflicts with an NES provision. NESs can also lead to compliance and enforcement costs for councils, although councils can recover some of these costs from the regulated parties. Consenting authorities must have regard to relevant NESs when considering an applications for resource consent. An NES will not apply to a pre-existing resource consent, but will apply whenever a review of permit conditions or designations takes place.

Six NESs are currently in effect, and three are being developed:

- NES for Plantation Forestry (2018)
- NES for Telecommunication Facilities (2017)
- NES for Assessing and Managing Contaminants in Soil to Protect Human Health (2012)
- NES for Electricity Transmission Activities (2010)
- NES for Sources of Drinking Water (2008)
- NES for Air Quality (2004)
- NES on Ecological Flows and Water Levels (being developed)
- NES for Marine Aquaculture (being developed)
- NES for the Outdoor Storage of Tyres (being developed)

Source: New Zealand Environment Guide (2019) and Ministry for the Environment.

New responsibilities, functions or processes that councils must adhere to

The passing of new responsibilities and functions from central to local government is not new. However, many councils have pointed to an “incremental expansion of local government responsibilities” (Ōpōtiki

¹⁹ Under sections 62(3), 67(3) and 75(3) of the RMA.

²⁰ The government is currently consulting on a proposed National Policy Statement on Urban Development, which would replace the NPS-UDC.

District Council, sub. 126), the cumulative impact of which can create significant cost pressure. Quantifying the costs of new responsibilities and functions imposed on local government is hard, but many councils noted that they are facing pressure from a steady expansion of their responsibilities, requiring increases in staff or consultant resources (eg, Tararua District Council, sub. 18).

The Commission's 2013 inquiry into local government regulation found that a steady stream of new statutes had been introduced over the previous decade, each affecting local government regulatory activities to varying degrees (NZPC, 2013). The inquiry also noted, however, that not all new statutes entail significant new costs for councils, as some require little change to existing regulatory processes.

That inquiry identified about 50 pieces of legislation (primary and secondary legislation) that required local government to undertake significant regulatory activities. Since the Commission published the report from that inquiry, several new pieces of legislation with significant impact on local government have been passed, including the Food Act 2014, Health and Safety at Work Act 2015, the Building (Pools) Amendment Management Act 2016, and the Building (Earthquake-prone Buildings) Amendment Act 2016. This flow has resulted in a large stock of legislation affecting local government, which many councils can find challenging to manage.

The costs that councils might incur as a result of this central government legislation vary, and can include costs associated with training staff, preparing and consulting on policies, developing implementation systems and processes, monitoring, reporting and compliance, as well as enforcement costs. Many councils noted that they face increased cost pressures from this new legislation, although the impact is hard to quantify. For example, several councils noted increased compliance and monitoring requirements for food and liquor licensing, buildings and swimming pools (eg, Timaru District Council, sub. 25; Mackenzie District Council, sub. 27; Whangarei District Council, sub. 46; and Hurunui District Council, sub. 110). However, councils can collect a fee or charge to cover all or some of the costs of issuing licences and consents, and for compliance and monitoring requirements, in relation to those functions.

Some councils, particularly small ones, are clearly finding it difficult to manage the expansion of responsibilities and functions. A risk is that such councils may be unable to comply with all the new responsibilities and functions being passed to them. This would ultimately lead to the objectives of central government legislation not being achieved.

Ōpōtiki District Council, for example, noted that their small team is responsible for administering many different pieces of legislation or functions, and that

[k]eeping up with the ongoing changes to legislation is an ongoing battle. Government needs to be more aware that the number of changes being made and the timing of those changes can have real deliverability issues at the coal face, particularly in small councils where even delivering the status quo can be a challenge. (sub. 126, p. 7)

Ruapehu District Council raised similar concerns:

Without additional and adequate support, an expansion of responsibilities results in an increased workload for Councils as well as pressure on budgets. Additional responsibilities place particular pressure on those Councils already at capacity in terms of staff budgets. This is especially true for small Councils, as although Councils must perform the same functions, meet the same levels of services, and meet statutory requirements, small authorities do this with less resources both financial and human. (sub. 85, p. 5)

Reviewing regulation regularly to keep it up to date and ensure that it remains fit for purpose is important to prevent the stock of legislation from becoming unwieldy. As highlighted in the Commission's inquiry *Towards better local regulation*, a mechanism is needed to regularly review the quality of regulations that local governments administer on behalf of central government. Reviews need to assess whether regulations continue to achieve their desired outcomes and amend them as required (NZPC, 2013).

F4.3

Central government has shifted many responsibilities to local government without adequate funding provision. If some councils are not able to comply with all the responsibilities and functions being passed to them, then the objectives of central government legislation will ultimately not be achieved.

Reducing, ceasing or removing central government funding

When central government removes or reduces funding for a role, function or service, local governments often face additional costs. A example of this form of cost shifting that many councils cited is changing the funding assistance rates (FARs) of the New Zealand Transport Agency (NZTA). The FARs set the share of central government funding for road construction and improvements in different districts around the country. NZTA completed a review of the FARs in 2014, and is phasing in adjustments to them between 2015 and 2021. For most councils, FARs are increasing or will remain the same. However, for about 20 councils the FARs will reduce slightly, with implications for their roading costs (NZTA, 2014).

Councils can find themselves under pressure to take on new roles or take over certain services when communities demand these roles and services continue but the funding for them from elsewhere has ceased. This pressure can take several forms, such as:

- withdrawal of central government staff from the community (eg, withdrawal of Work and Income, immigration or other services from a community);
- withdrawal or cessation of central funding for a programme or service (eg, reduction in funding for the Enviroschools programme, reduction in funding to local road-safety programmes, or reduction in CreativeNZ funding for cultural organisations and events); and
- withdrawal of services or funding previously provided by other organisations or businesses (eg, withdrawal of funding for St John Ambulance, homeless shelters, or of other sporting, social or aged services).

This form of cost shifting differs in that the pressure does not stem from new responsibilities or functions being passed down to local government. Rather, councils have found that their communities are increasingly turning to them to deal with social and other issues, and to fill the gaps left as central government and other service providers withdraw. Ōpōtiki District Council summarised this challenge in their submission:

[W]e have witnessed over the last few years a systematic withdrawal of government responsibilities from our district. In this situation we are faced with a decision of whether to subsidise the service or lose it entirely making Ōpōtiki District Council an organisation of last resort. In many scenarios, ratepayers do not appreciate the difference between central and local government, government and non-government organisations. They just see a decline in the availability of services and we are the organisation they turn to, complain to, ask to advocate on their behalf, or to seek funding to continue providing the service. For this reason we end up involved in services that are well outside the traditional remit or mandate of local government, but in the absence of anyone or anything else, we fill the void. (sub. 126, p. 8)

Wellington City Council also noted this challenge:

Council is increasingly being turned to by community organisations and the public to deal with issues like homelessness, alcohol abuse and associated crime... In some cases council is turned to because central govt funding and support has been reduced or removed. (sub. 61, p. 6)

Restricting the ability of councils to set adequate fees for services or functions

Some of the regulatory powers and functions passed down to local government incur direct costs for processing applications, issuing permits or licences and enforcement. Setting fees for these types of services allows councils to recover these costs from the users of services or those subject to regulation rather than from general rates – in line with the benefit principle (discussed in Chapter 6).

For some services, councils can exercise some discretion over the fees they charge. For example, councils have flexibility in what they charge for consents issued under the RMA and the Building Act, and for fire permits. Where such discretion is allowed, councils can generally recover “reasonable” or “actual” costs of performing the function. Due to this discretion, councils differ in how much they charge for services. Often councils recover direct costs (eg, the costs of receiving applications, processing and issuing permits) through fees and charges, but other associated costs such as developing policies, consultation, and other overheads are funded through general rates.

For some other services, regulations constrain councils in how much they can charge users to deliver that service. Only a few regulations that contain this level of prescription remain, but those that do can create costs for councils. Remaining examples include:

- Amusement Devices Regulations 1978, which sets the fees to pay when applying for a permit;
- Land Transport (Certification and Other Fees) Regulations 2014, which sets the fees to pay to obtain a permit to exceed mass limits; and
- Sale and Supply of Alcohol (Fees) Regulations 2013, which sets the fees (within different fee categories) that premises must pay to obtain a licence.

Fees or maximum penalties in legislation tend to become outdated, and no longer reflect the costs that councils incur to provide the service or function.

A lack of clarity around legislative provisions for cost recovery has also had the effect of constraining funding for the compliance, monitoring and enforcement (CME) activities of councils.

Both the RMA and LGA contain broad provisions for councils to recover the “reasonable” costs of monitoring and enforcing compliance with policies, plan rules and consent conditions. Yet legislative ambiguity surrounds their ability to recover costs for monitoring permitted activities – it is not explicitly provided for, and guidance from the Ministry for the Environment (MfE) states that a council cannot charge for it. Waikato Regional Council raised this matter in its submission:

The Council has no ability to charge for non-consented activities under the RMA (for example, farming services team and monitoring). It would be preferable to be able to charge for non-consented activities, to allow for charging those who are undertaking the activity, than charging everyone through general rates. (sub. 125, p. 17)

Recent amendments to the RMA allow cost recovery for CME of permitted activities under an NES, where the NES explicitly provides for it. Just one new NES has been introduced since the amendment (the Plantation Forestry NES), which allows for such charges. The 2015 Regulatory Impact Statement for the plantation forestry NES noted:

At present councils often fund compliance and monitoring programmes by directly charging for consent monitoring activities; this is provided by s36(1)(c) of the Resource Management Act. MPI is also aware that a number of councils currently operate permitted-activity regimes for forestry activities; some of these councils charge for permitted activity monitoring activity through s150 of the Local Government Act. However, **the legal legitimacy of this is unclear and permitted activity charging is not explicitly provided for in the RMA.** (Ministry for Primary Industries, 2015, p. 24) (emphasis added)

Nothing has changed for the other existing NESs, and there appears to be no clear legislative provision to cost-recover for other permitted activities. The MfE guidance on the 2017 RMA amendments states that “[t]his change does not allow councils to charge for monitoring permitted activities generally” (MfE, 2017b, p. 3). And an MfE report from 2016 states that “no cost recovery mechanisms are provided for plan rule monitoring” (ie, monitoring of permitted activities) (MfE, 2016, p. 25).

In general, CME activities are under-resourced, and practices vary significantly across councils. This weak resourcing stems at least in part from confusion or uncertainty around the legislative authority for cost-recovery. This situation can result in insufficient compliance monitoring and enforcement activity across the sector, with ratepayers bearing costs that should be allocated to the resource users who bring about the need for the activity. As such, this situation may ultimately compromise environmental outcomes. Chapter 7 further examines user charging and cost recovery by councils.

F4.4

Central government's passing of new responsibilities and functions on to local government is not new. However, this process has continued, and the cost burden on councils has continued to increase. Some councils are finding the cumulative impact increasingly difficult to manage.

Unfunded mandates fall broadly into four categories:

- new or stronger standards that councils must meet – without commensurate funding;
- new responsibilities, functions or processes that councils must undertake – without commensurate funding;
- reduction, cessation or removal of central government funding, or of government-funded programmes and services within the community; and
- restrictions on the ability of councils to set cost-recovery fees for services or functions.

Good regulatory design

When central government considers policy changes that may make, change or repeal an Act or regulation, it must provide a Regulatory Impact Assessment (RIA) to Cabinet, summarising the problem being addressed and potential options to address it. A RIA must also include an analysis of the costs, benefits and risks of each option. The quality of this process is important because, as noted in the Commission's 2013 inquiry *Towards better local regulation*, good regulatory design is founded on rigorous analysis of the problem and options for response (NZPC, 2013).

During that inquiry, the Commission found that, for several years, officials and others had highlighted the need for the government to undertake a more thorough analysis of impacts on local government. The Commission also found that councils strongly perceived that central government agencies did not have a good understanding of the costs and impacts of new regulations on local government (NZPC, 2013).

As noted above, a steady stream of new legislation with significant implications for local government has been passed since that inquiry. Councils continue to believe that central government does not adequately consider costs and funding implications for local government when designing such legislation. Hurunui District Council, for example, pointed to a "one size fits all" approach to central government regulation that can lead to disproportionate costs on small rural communities (sub. 110, p. 6). Other councils noted concerns in their submissions; for example:

The government needs to have a better awareness around the expectations associated with new/amended legislation that then has to be picked up by territorial authorities. Government (RIS) first look is superficial and does not take into account all costs and funding requirements, nor the unintended consequences associated with such. (Ōpōtiki District Council, sub. 126, p. 23)

We would recommend (where relevant) policy / initiatives be co-designed by central and local government as those who are expected to implement policy should have a say in its architecture to ensure it is a) achievable, b) effective and c) efficient and affordable. (Northland Regional Council, sub. DR158, p. 4)

[I]dentifying costs, where they fall and consequent funding implications, should be done when the policies are being developed, not as an afterthought. In doing so, local government experts should be genuinely involved, not just consulted and asked to provide information. (Western Bay of Plenty District Council, sub. 34, p. 4)

Consideration should be given to placing a statutory obligation on Central Government policy development to better identify costs and effects of their decisions on local government. (Palmerston North City Council, sub. 124, p. 6)

Regulatory Impact Statements provided to Cabinet at the time these mandates are agreed to are usually underdone in terms of financial impacts and resilience on communities across the country. The "one size

fits all” approach will be unaffordable in some communities, but that is not recognised or thought about at the time of Cabinet consideration. (Environment Southland, sub. DR195, p. 2)

Based on conversations with councils involved in central government consultation processes, the quality of consultation can vary considerably. This variability is reflected in associated Cabinet documents, and noted in council submissions (see, for example, Environment Canterbury sub. DR207, p. 4). Some consultation processes involve significant engagement with local government, and may offer some support to councils to engage as legislation is developed. Yet in-depth engagement processes can still lead to considerable costs for councils that are not funded or not fully recoverable, as noted by Environment Canterbury and Horizons Regional Council:

There are recent examples of regional council staff having worked alongside Ministry for the Environment in Wellington that has been of benefit to designing national direction although it does take in-house expertise away from council while staff are in Wellington. (ECAN. sub. DR207, p. 4)

We note that even when local government is heavily involved in developing or otherwise contributing to central government policy, a second policy cycle cannot be avoided as local government works through the implementation of national level policies into the local (or regional) context. This is likely to be the largest cost (and least well understood by central government) of the local government policy cycle. (Horizons Regional Council. sub. DR153, p. 2)

In May 2019 the government released new guidance for engaging with local government, laying out the key elements of good practice for central government agencies to follow. The aim of this guidance is to “make central government engagement practices with local government more timely, effective and consistent across central government” (Department of Prime Minister and Cabinet, 2019).

F4.5

Central government is often passing new responsibilities to local government without adequate analysis, including consideration of the range of council circumstances. This can result in regulation that is “one size fits all”, making it unfit for purpose, or particularly costly to implement, in some localities.

4.4 Treaty of Waitangi settlements and other Treaty obligations

The principles contained in the Treaty of Waitangi (the Treaty) are the foundation of the relationship between the Crown and Māori. The Treaty partnership is fundamental, and all legislation is enacted against the backdrop of the Treaty and its principles. The three main statutes underpinning local governance – the RMA, the Local Government Act 2002 (LGA) and the Land Transport Management Act 2003 (LTMA) – include recognition and active protection of Māori customary rights, taking into account the values and interests of Māori, and providing ways and means for Māori interests to be represented in the development of plans and decisions (NZPC, 2017). These Acts place obligations and requirements on local government with respect to iwi. Requirements included in the LGA are discussed in more detail in Chapter 5.

Under the RMA, for example, local authorities are required to consult with iwi authorities when preparing or changing policy statements, regional and district plans, and to engage with tangata whenua in other resource management decisions. The LGA requires councils to establish and maintain processes for Māori to contribute to decision making, and to foster the capacity of Māori to contribute to those processes.²¹ The LTMA also requires consultation with Māori about proposed activities.²²

The legislation noted above requires councils to act in a way that gives effect to the Crown’s responsibility under the Treaty. However, the Treaty obligations and responsibilities themselves ultimately remain with the Crown (DIA, 2006). The Crown can only delegate its responsibilities if it does so on terms that ensure its Treaty duties continue to be fulfilled (Waitangi Tribunal, 1993).

Local government decisions and services closely involve iwi and hapū interests. Regulation of the use of natural resources and land is especially significant. Te Rūnanga o Ngāi Tahu emphasised this in their

²¹ LGA 2002, sections 14); 81(1)(a); and clause 8 of Schedule 10.

²² LTMA 2003, section 18g(1)(c).

submission, stating that “the Treaty partnership is central in interactions between local authorities and Papatipu Rūnanga within Ngāi Tahu takiwā” (sub. 53, p. 6).

Previous inquiries have noted the challenges of effectively engaging and involving Māori in local decision making. The 2013 *Towards better local regulation* inquiry found that this process requires meshing two systems of governance: the tikanga of local iwi; and local representative democracy. It recommended that local authorities aim to support Māori who are involved in decision making with sufficient inclusion of tikanga Māori in plans, and appropriate legal backstops and safeguards to be able to meaningfully judge whether or not particular proposals align with tikanga Māori (NZPC, 2013).

The Commission’s 2017 *Better urban planning* inquiry also found that while many inquiry participants supported the broad framework for Māori engagement and participation in planning, many were disappointed by poor practice and weak commitment to effective engagement in some areas. Many argued for the need for additional measures to address uneven practice and capabilities, including around building the capability of councils and of mana whenua groups. The Commission recommended the development of guidance, including around the possibilities for co-governance and joint management arrangements (NZPC, 2017).

Te Rūnanga o Ngāi Tahu’s submission to this inquiry emphasised the significance of long-term planning between local authorities and iwi and hapū in enabling ahi kā.

Opportunities exist for long term planning between councils and iwi that helps identify Treaty partnership priorities. For example, many traditional areas of Māori settlement have suffered from low levels of council expenditure and support. New papakainga provisions being introduced into local planning instruments are providing for improved ways to utilise Māori lands and enable iwi and hapū to invest in these areas. This enables growth where there has been stagnation and facilitates potential for return of whanau to lands of cultural significance. (Te Rūnanga o Ngāi Tahu, sub. 53, p. 6)

CouncilMARK™ assessments (discussed further in Chapter 5) show councils’ relationships with iwi are at different stages of development and maturity. Awareness of Māori priorities and issues has improved, but some councils still have some way to go to establish meaningful engagement. A common finding of the assessments was the need to further strengthen working relationships. While relationships with iwi are often strong at the Mayor and Chief Executive level, assessors found that some councils need to build an understanding and knowledge of Māori tikanga at the senior management and staff levels. A number of councils have staff development programmes in place.

Changes to the RMA in 2017 placed new responsibilities on councils to facilitate Māori participation in resource management processes and decisions. The responsibilities require councils to engage with iwi, and consider and report on the advice from iwi authorities. Those authorities can invite regional or district councils to form a Mana Whakahono ā Rohe – a binding statutory arrangement that provides for a more structured relationship between the iwi and the local authority under the RMA.

The purpose of a Mana Whakahono ā Rohe is “to provide a mechanism for iwi authorities and local authorities to discuss, agree, and record ways in which tangata whenua may, through their iwi authorities, participate in resource management and decision-making processes under this Act”.²³ Upon receiving an invitation to form a Mana Whakahono ā Rohe, councils are required to begin a process of engagement and negotiation with the requesting iwi, and any resulting Mana Whakahono ā Rohe arrangements must be completed within 18 months.

Councils and mana whenua have a choice of mechanisms and processes to facilitate Māori participation in the decision making of local government (NZPC, 2017). Like the decisions of other local authorities, the choice is a local one and reflects local circumstances and preferences. These are likely to evolve over time as both parties work out what is effective, efficient and practical. Different mechanisms will involve different costs to either or both parties, and it is in everyone’s interest, including the Crown’s interest, to search for the best way to meet statutory obligations.

²³ RMA 1991, section 58 M(a).

Māori are a significant community of interest for local authorities, and one to whom there are specific statutory obligations to include in decision making. This creates expectations on councils in terms of engagement and relationship management, as well as in administering iwi arrangements under the relevant legislation.

The draft report posed a question about the extent to which councils should bear any Treaty-related costs associated with fulfilling obligations and requirements under local government statutes. In response, many councils emphasised that they consider building, enhancing and supporting engagement with Māori is good practice. For example

Waipa District Council considers that building and enhancing positive relationships with Maori is critical. Accordingly, considerable time and resource is spent on strengthening these relationships. It is relevant that this relationship building was undertaken independently of any Treaty settlements, and from that perspective, could be considered an accepted part of our partnership approach. (sub. DR178, p. 3)

Much of our non-regulatory work carried out with iwi is in recognition of building and strengthening relationships, and recognising the value of their knowledge of our environment. It would be useful if this activity that is part of our business-as usual would be considered as complementary to, rather than only as a result of, treaty obligations. (Horizons Regional Council, sub. DR153, p. 5)

The DCC, recognises good local democracy often calls for extensive engagement from community partners, in particular with Mana Whenua as Treaty of Waitangi partners. (Dunedin City Council, sub. DR179, p. 5)

All public sector agencies have obligations under the Treaty that must be treated as “business as usual”. Local government is required to take the Treaty into account, which is the “business as usual” part. (Upper Hutt City Council, sub. DR216, p. 2)

Yet councils also highlighted the resource intensiveness of fulfilling Treaty-related obligations and requirements:

At Tasman District, we currently spend a lot of time fulfilling our local government statutory requirements, but we are being impacted by and drawn into more Treaty of Waitangi issues. We are embracing and responding to this willingness to engage by iwi, but it is taking significant time and resources as we navigate this area... Under section 81(1)(b) of the Local Government Act 2002 a local authority must consider ways in which it may foster the development of Maori capacity to contribute to the decision making processes of the local authority. In many cases, this is manifesting itself in an expectation from iwi that local authorities reimburse the costs of iwi staff participating in engagement and consultation processes. (Tasman District Council, sub. DR236, p. 2)

These engagement processes can often be long-running and resource intensive. Rather than just examining the Treaty cost on councils, the DCC encourages the Commission to investigate and comment on how central Government might assist councils to enable their partners, particularly Treaty partners, to engage where their resources are put under pressure by such processes. (Dunedin City Council, sub. DR179, p. 5)

It is reasonable that local government bears the costs of developing and maintaining effective relationships with Māori as a significant community of interest, as part of business as usual under best practice. Yet there is also a clear view among councils that at least some of this cost is incurred to meet the Crown’s Treaty obligations, and that an ongoing contribution from the Crown would be reasonable. Further, the Crown, under its Treaty partnership obligations, has a clear interest in ensuring that Māori and councils can work in partnership in a constructive and meaningful way.

Treaty settlements

The Crown is committed to settling historic breaches of the Treaty through Treaty settlements. One outcome of many recent Treaty settlements has been the creation of co-governance and co-management arrangements over significant natural resources and reserve lands. Co-governance and co-management arrangements vary, but can include independent statutory bodies, statutory boards, or joint council committees, with different mixtures of council, iwi and other participants.

As the regulatory authority for natural resources and land, councils – particularly regional councils – play a critical role in implementing these arrangements. They establish the various co-governance entities required

in the settlements, and support their ongoing functioning and effectiveness once established. In this way, while the Crown settles historical breaches of the Treaty with iwi, under these arrangements local authorities essentially become the co-governance and co-management partner with Treaty settlement groups (LGNZ, 2018b).

The impact of Treaty settlement arrangements is not evenly distributed across the country. Some councils have several different arrangements in place, while others have none. This is partly due to large differences in the size and distribution of iwi and hapū groups around the country and across council boundaries, and partly a reflection of how the Treaty settlement process has unfolded and evolved over time.

Waikato Regional Council, for example, currently has one co-management agreement and five joint management agreements with iwi partners: the co-management agreement for the Waikato river; and five joint committees under joint management agreement. Bay of Plenty Regional Council has three arrangements in place, and anticipates more will be established in the near future (Bay of Plenty Regional Council, sub. 95). Auckland Council currently has three arrangements provided through Treaty settlement legislation that require the establishment of co-governance bodies. Auckland Council expects to be responsible for another three co-governance bodies when all Treaty settlement negotiations are completed (sub. DR185, p. 1).

Treaty partnership between local government and iwi, as well as Treaty settlements and the co-governance and co-management arrangements they establish, provide opportunities for local authorities and iwi to develop relationships that provide many benefits for their communities, as well as for the environment and natural resource management. Te Rūnanga o Ngāi Tahu emphasised this point in their submission:

While the focus is on costs to local authorities, the benefits of working with iwi and hapū as primary partners need to be acknowledged. Te Rūnanga each bring resources to the table to enable the Treaty partnership and support positive outcomes for environmental management. (sub. 53, p. 6)

Many councils also noted during engagement meetings, and in their submissions, the benefits from their relationships with iwi, including through Treaty settlement arrangements. Wellington City Council noted that Treaty settlements create “significant opportunities and benefits... that should be recognised” (sub. 61, p. 2). Bay of Plenty Regional Council also noted that “co-governance and co-management arrangements provide invaluable connectivity with Iwi and an opportune platform for council to assist in building Iwi capacity and capability” (sub. 95, p. 3).

Yet many councils also emphasised the large costs they can incur as a result of Treaty settlement arrangements, and the challenges this can create. In its recent report on Treaty settlement costs for local government, LGNZ noted a range of ongoing costs on councils from settlement arrangements, including:

- administrative support, democratic and other council staff services required to ensure the exercise of powers and functions of the co-governance entities;
- specialist technical staff time spent developing and implementing co-governance entity plans, documents and joint management agreements, including legal, scientific, policy, planning and resource consenting advice;
- assistance to build iwi capacity so they can participate in Treaty settlement arrangements; and
- additional RMA policy development activities required under a Treaty settlement.

Central government has made one-off contributions towards local government costs for some Treaty settlements. The government’s approach has been to provide contributions towards certain costs, including the set-up costs of new arrangements, the costs of preparing any new plans not provided for in councils’ LTPs, and ongoing costs for a transitional period of up to three years (Te Arawhiti, sub. DR 269). The Crown’s contribution policy, provided by Te Arawhiti as part of their submission, clearly states that contributions are intended to be modest and short term, to ensure that settlement arrangements become embedded into business as usual.

The level of contribution provided to councils is at the government’s discretion, and is determined using criteria including complexity, a council’s ability to pay, iwi’s capacity to participate, the council’s existing

commitment to involving iwi in natural resource management, and the likely difference between existing and new arrangements (Te Arawhiti, sub. DR 269, p. 2).

Yet the flexibility inherent in the policy, which requires contributions to be set on a case-by-case basis, has clearly resulted in widely varying contributions. Crown contributions have ranged from no contribution for establishing some joint arrangements to about \$800 000 in contributions towards arrangements under the Te Hiku Claims Settlement Act 2015 to support Northland Regional Council (LGNZ, 2018b). Some councils have raised this inconsistency as a serious issue that “risks reinforcing inequality between settlements, iwi, and regions” (Bay of Plenty Regional Council, sub. 95, p. 3).

Where the Crown has provided one-off contributions, they have often been insufficient to cover council costs. For example, Waikato Regional Council estimated total Treaty settlement costs of more than \$13.18 million to date for the six arrangements it has in place, while one-off Crown contributions for the settlements provided about \$1.3 million (sub. 125, p. 8).²⁴ Although one-off contributions can cover most establishment costs for some arrangements, ongoing costs can also be significant. For example, the Crown made a one-off contribution to Auckland Council of \$400 000 towards establishing the Maunga Authority. The council has since estimated that \$400 000 was spent during the establishment phase, but that ongoing costs associated with the Authority are about \$634 000 each year (LGNZ, 2018b).

Similarly, the Crown made a one-off contribution to the establishment of the Hawke’s Bay Regional Planning Committee (RPC), which was initially established through the Crown’s settlement with Ngāti Pāhauwera. The initial Crown contribution was \$100 000, and was intended to cover establishment costs and meeting and mandating expenses. The Regional council estimates that the actual cost of operating the RPC to date has been nearly \$800,000, with an ongoing yearly cost of \$163,000 a year (sub. DR248).

Bay of Plenty Regional Council also noted that their experience, as a council with multiple co-governance arrangements, has shown

limited knowledge by central government of actual implementation costs of Treaty settlement arrangements that operate at local government level. We have on several occasions been asked to provide costs estimates to assist central government in seeking to determine a cost contribution in particular cases. The approach and categorisation of costs by central government for this purpose is often at odds with the reality of what our experience is and what the actual costs are. (sub. DR187, p. 3).

In the absence of adequate Crown funding to support Treaty settlement arrangements, councils need to use ratepayer funds to meet the funding shortfall. In its submission, Bay of Plenty Regional Council noted that “the lack of resourcing from central government places significant financial and staff resource burdens which have to be met from ratepayer and other council funding sources” (sub. 96, p. 3). Other councils also noted this point, including Greater Wellington Regional Council:

Settlements are an opportunity for the Crown to settle long standing grievances with iwi. Once agreed and signed, the responsibility for implementation of settlements shifts to agencies including local government. The Crown’s policy is to provide one-off establishment costs for the implementation of Treaty Settlement outcomes. These contributions are welcomed; however, councils nationally are engaging in discussions on the true cost to implement settlements and note that the Crown’s contributions are often not reflective of the true costs of implementation. We also note that the ongoing financial costs to implement settlements (through the current mechanisms of funding) have shifted from the Crown and become the responsibility of ratepayers. This means that, in regions where there are multiple settled iwi, there are also multiple ongoing costs. (sub. 68, p. 6)

It is also important to note that iwi can also find the implementation of co-management and co-governance agreements very costly. The costs in time and other resources are significant. Te Rūnanga o Ngāi Tahu emphasised this point in their submission by stating “it is important to note that for every new responsibility that must be met by council, there will be a corresponding resource implication for Ngāi Tahu” (sub. 53, p. 6). Bay of Plenty Regional Council also highlighted this challenge:

²⁴ This figure includes plan development and plan-change process costs, development and establishment of the co-governance and joint-management entities, and ongoing administration and implementation costs (sub. 125, Appendix A).

There are also costs borne by iwi, particularly in relation to capacity and capability. While Councils generally have the staff to support the administration of these entities, iwi are not equipped to deal with many of the technical (and potentially highly political) aspects arising from these groups. Iwi participants in most cases have to take time off work, are not supported by staff who are able to respond to complex matters, and have other issues to address that also compete for their time. (sub. 95, p. 3)

In implementing Treaty settlement arrangements, local government plays an important role. However, a key concern is that the limited financial support provided by central government to implement those agreements jeopardises councils' ability to implement them in a robust and enduring way, and some councils are questioning how much longer they can fully deliver on those arrangements. Waikato Regional Council stated that funding challenges mean the council is now "actively considering the extent to which it continues to deliver on Treaty settlement obligations" (sub. 125, p. 7). Bay of Plenty Regional Council submitted that "Treaty settlements impose real new costs and without increased and consistent funding for co-governance implementation, the durability and effectiveness of these settlements will be undermined" (sub. 95, p. 2). And Northland Regional Council noted that "government funding for co-governance / co-management has been ad hoc and inadequate and could put the durability of these arrangements at risk" (sub. DR158, p. 2).

The Office of the Auditor-General also noted this challenge, and the risks involved:

Over the last few years, the Office has actively considered examples of co-governance and co-management. We have found that the commitment required to establish relationships, to establish processes and to build and maintain a shared understanding of what everyone is trying to achieve is significant and is often underestimated. An underestimation of resources (both time and financial commitment) can undermine the effectiveness of the arrangements, resulting in more costs in the long run. (sub. 70, p. 5)

Many councils have highlighted a funding gap with respect to implementing Treaty settlement arrangements, but to date there has been no comprehensive, independent and in-depth analysis of the associated costs – either to councils or iwi. The Crown has recently recognised that its contributions policy should be applied more systematically, based on accurate assessments of actual costs to councils and iwi. To this end, Te Arawhiti indicated in their submission that they are working to develop an assessment methodology to better understand associated costs (sub. DR 269, p. 4). This will be important, because in the absence of such analysis, it is not possible to identify the additional resources that councils must deploy to carry out this role.

Initial and ongoing costs of establishing and supporting such arrangements can be considerable, and central government support has, to date, fallen far short of covering these costs. It is also worth noting that most councils submitting on this issue are seeking fair cost sharing between councils and the Crown, rather than for the Crown to cover the full cost of such arrangements (see, for example, Auckland Council sub. DR185, p. 1; Hawke's Bay Regional Council sub. 248, p. 4).

Given that the requirements and responsibilities passed to councils through Treaty settlement agreements derive partly from the Crown's obligations under the Treaty, and given the primacy of the Treaty partnership, adequate resourcing from the Crown to support settlement arrangements should have high priority. As the Mana Whenua Kaitiaki Forum noted in its submission, "the Crown has a significant and ongoing interest to ensure the successful implementation of these Treaty settlement outcomes. Ongoing financial support should be provided that properly reflects this interest" (sub. DR175, p. 2).

F4.6

To date there has been no comprehensive, independent and in-depth analysis of costs associated with implementing Treaty settlement arrangements – either to councils or iwi. Such analysis would be valuable to clearly identify the additional resources that councils must deploy to carry out this role.

F4.7

Co-governance and co-management arrangements established through Treaty settlement agreements between the Crown and Māori impose considerable costs on local authorities. So far, central government support has been ad hoc, and fallen short of covering the initial and ongoing costs to councils.

F4.8

Some councils are struggling to meet the costs of implementing Treaty settlement arrangements. The durability and effectiveness of some Treaty settlement arrangements may be at risk if funding issues remain unresolved.

R4.1

The Government should commission a comprehensive, independent and in-depth analysis of costs associated with implementing Treaty settlement arrangements – to councils and to iwi. Such analysis should inform an update of Government policy on Crown contributions to support the implementation of Treaty settlements.

4.5 Scope of local government and community expectations

The scope of local government in legislation

Actual operating expenditure by local government rose by 95% between 2000 and 2017; and grew at a faster yearly rate between 2003 and 2012 than between 2012 and 2017 (Chapter 2). Some commentators, including the Local Government Business Forum (sub. 52) have suggested that legislative changes to the scope and powers of local government in 2002 may have contributed to these increased operational costs. Some of these changes were repealed in 2012, giving more weight to this suggestion.

Yet the analysis of expenditure trends in Chapter 3 strongly suggests that the main drivers of increased expenditure between 2000 and 2017 were activities (such as roading and transport) that have long been the central responsibilities of local government. The same drivers are largely responsible for the faster rate of expenditure growth from 2003 to 2012. Analysis of the relevant legislative changes in 2002 and 2012 suggests that their effect on the scope of local government was limited, and so reinforces this conclusion.

First, on its enactment in 2002, the LGA gave local authorities *powers of general competence* (LGA (2002) (s 12 (2)(a)(b)). Under these provisions, local authorities have “full capacity to carry on or undertake any activity or business, do any act, or enter into any transaction” and “full rights, powers and privileges” in performing their role. Yet the intention of these powers was to give local authorities greater flexibility in carrying out their role rather than to expand that role. The amendment achieved this by replacing a large volume of specialist local government law with the general law applying to local government (Minister of Local Government (Hon. Sandra Lee), 2001).

Second, the LGA introduced “[promoting] the social, economic, environmental and cultural wellbeing of communities, in the present and in the future” as part of *the purpose of local government* ((LGA (2002) (s 10 (1)(b) as enacted in 2002). Even so, this 2002 change was more about increased focus than an extension of scope. The 1974 LGA (s 598(1)) already enabled councils to provide such services they thought necessary to promote the wellbeing of the public. Shand notes that the 2007 Rates Inquiry, which he led, “found no evidence that the provisions of the Local Government Act 2002 had been a significant driver of rates increases” (Shand, 2019, p. 7). Similarly, LGNZ submitted that “[t]here is no evidence of major shifts in the nature of the services and activities that local governments fund” (sub. 112, p. 11).

In 2012 these provisions were replaced by a new purpose: “to meet the current and future needs of communities for good-quality local infrastructure, local public services, and performance of regulatory functions in a way that is most cost-effective for households and businesses” (LGA, s 10(1)(b)). Knight (2015) assessed how New Zealand courts would likely interpret these 2012 changes, considering their wording and contextual material. He concluded that, largely because of imprecise wording, the amendments did not

introduce substantial changes in the scope of local government. Rather, he argued that they unhelpfully introduced doubt and uncertainty around the mandate of local government. Parliament reintroduced promoting the four wellbeings as a purpose of local government in May 2019 (in the Local Government (Community Well-being) Amendment Act).

Many council participants in the inquiry told the Commission that the 2012 changes to the statutory purpose of local government made little or no difference to the scope and extent of their services, as they responded primarily to the expectations of their communities (as discussed later in this section). Yet some councils submitted that re-introducing the wellbeings might increase costs. Manawatu District Council, for example, noted that “expectations and demand for cultural and recreational facilities may increase with the reintroduction of the four wellbeings to the purpose of local government” (sub. 57, p. 3).

Other submitters expressed concern that reintroducing the four well beings would lead to more council activities and spending. Federated Farmers, for example, noted that recent statements in the media indicate that “an evolving and expanding role is envisaged (for councils) by leaders in both central and local government” (sub. DR217, p. 6), and the Local Government Business Forum noted that “the requirement to promote the four wellbeings provide added impetus or at the very least act against restraint and efficiency” (sub. DR177, pp. 5-6).

In August 2019, Cabinet agreed to a programme of work led by DIA. The programme aims to:

- improve alignment between central and local government in providing public services;
- improve engagement between councils and communities on community wellbeing priorities; including particular attention to strengthening partnerships with Māori; and
- improve processes to help councils and communities to identify wellbeing priorities, and develop supporting indicators.

The focus is on better processes for communities and councils to identify their own community wellbeing priorities; and better prioritisation of, more than an expansion of, local government services (Minister of Local Government (Hon. Nanaia Mahuta), 2019).

Expanding services beyond the “core”?

Related to concerns about an expanding scope of local government, several inquiry participants expressed concern about increasing council expenditure on “non-core” functions and services as a cost pressure. Other participants doubted that the concept of “core services” was appropriate for local government. As LGNZ noted in its submission, “attempting to define activities as core or not is always problematic” given the broad range of services that have been funded historically and the impact of changing circumstances on what communities want” (sub. 112, p. 11).

The LGA’s definition of core services was repealed in the Local Government (Community Well-being) Amendment Act 2019, which was passed in April 2019. Previously, core services were defined in the Act:

In performing its role, a local authority must have particular regard to the contribution that the following core services make to its communities:

- (a) network infrastructure:
- (b) public transport services:
- (c) solid waste collection and disposal:
- (d) the avoidance or mitigation of natural hazards:
- (e) libraries, museums, reserves, and other recreational facilities and community amenities. (s 11A)

This definition of core services was broad in scope, and did not prevent councils offering other services (Knight, 2015); therefore its repeal is unlikely to affect the types of services councils provide.

The LGA also mandates one purpose of local government as enabling “democratic local decision-making and action by, and on behalf of, communities” (s 10 (1)(a)). This emphasises the role of community expectations in shaping the types of services that councils provide.

Views at the local level will always differ about what councils should or should not provide (as many submissions show). Even so, the statutory democratic and decision-making processes provide for communities to collectively identify preferences, and make decisions about funding different services, as discussed further in Chapter 5.

Box 4.4 Council provision of social housing

Social housing provision differs considerably across councils, even among those with otherwise similar communities. How councils manage and fund social housing also varies, reflecting not only local preferences but also different approaches to sharing costs of social housing with central government.

Most councils provide some social housing (Johnson, Howden-Chapman, & Eaqub, 2018; LGNZ, n.d.). Many councils provide housing for elderly residents, while a smaller number provide social housing for other low-income tenants. In total, 67 councils own 12 881 housing units, with 48 of these councils managing their own housing assets (LGNZ, n.d.). Councils provided an estimated 7 706 units of social housing in 2017, with 2 583 of these in the Wellington region (Johnson et al., 2018).

In 2014 the central government extended income-related rents subsidies (IRRS) to registered community housing providers (CHPs). In response to this, two councils – Auckland (in 2017) and Christchurch (in 2016) – leased their housing stock to CHPs as a way to make tenants eligible for such subsidies. In Auckland’s case this was through Haumarū Housing, a limited partnership venture with the Selwyn Foundation covering 1 452 units. Christchurch City council leased 2 250 units to a Council-owned entity, Otautahi Community Housing Trust (Johnson et al., 2018). Smaller councils (such as Hamilton and Whakatāne) have sometimes adopted a similar strategy (Community Housing Aotearoa, 2016).

The IRRS provides a subsidy that limits rents to 25% of household gross income. The Ministry of Social Development (MSD) determines eligibility for IRRS. MSD also determines access to some social housing (that provided by central government through Housing New Zealand and by CHPs) through maintaining and prioritising a register of applicants.

The eligibility of most council social housing stock for IRRS “is an important unresolved policy issue with national implications” (Johnson et al., 2018, p. 26). In 2017, councils were providing 7 700 social housing units that were not eligible for IRRS (Johnson et al., 2018).

Central government has used other mechanisms to support council-provided social housing. For example, in the early 2000s it provided half the capital for the refurbishment of 10 apartment blocks owned and administered by the Wellington City Council – for the purposes of providing social housing for low-income residents.

LGNZ continues to advocate for councils to have access to the IRRS (LGNZ, n.d.). Wellington City Council submitted on the difficulty posed by the inability of its social housing tenants to access IRRS (sub. DR245). Instead, tenants pay 70% of market rentals, with the council covering the shortfall through forgone revenues, raising questions about the sustainability of the programme. Waitemātā Local Board of Auckland Council also submitted on this issue, requesting that the policy be amended (sub. DR185, Attachment C, p. 41).

Rising community expectations

Many councils submitted on the pressure they feel from their communities to increase levels of service in many areas.

[A]s with consumers of private goods and services, our people and businesses request and sometimes demand higher standards and variety. They want all weather playing surfaces, more variety and better-quality play equipment, more exciting and engaging events, better equipment in recreation centres, safer roads and footpaths, more public transport and more responsive and supportive regulatory services. They also make it clear they want council to support economic development and jobs, stadia and health services in rural areas and community development in urban areas. Some of these resource intensive requests are related to increased diversity but others are natural expectations from the community. (Waitematā Local Board, sub. DR185, Attachment C, p. 44)

Community expectations of both the scope and standard of council services are constantly growing. In addition to core infrastructure, regulatory and community services, the community expectation is now that council will routinely deliver economic development, events and marketing and community development activities. Year on year, expectations for the level of Council services also increase. Public halls need to have video and sound systems, the swimming pool needs a splash pad for children, the library should deliver more adult programmes and so on. These activities require new and additional funding. (Kawerau District Council, sub. 97, p. 3)

Residents want big-city amenities. Dunedin has observed demand for longer opening at community pools, and demand for more activities in public spaces to accompany major events. (Dunedin City Council, sub. 17, p. 1)

[A]s population changes with more people moving from larger towns and cities into rural areas, expectation changes. Communities are more likely to expect similar facilities that are provided in larger towns such as squash courts, swimming pools, dedicated cricket and rugby grounds, better quality playgrounds and dog parks, all of which are community facilities passed to Councils to maintain. (Hurunui District Council, sub. 110, p. 6)

As our nation, district, and communities change and evolve, so too does the demand for Council services. This change in demand relates to both 'what' Councils deliver but also 'how', 'how much' and 'how fast'. As a general observation, demand for Council services has matured over time. Core services are now a basic expectation albeit with increasing pressures on costs and levels of service that will provide a substantial hurdle going forward. Councils are also place-makers, broadly responsible for advancing quality-of-life for their communities. (Whakatane District Council, sub. 121, pp. 7-8)

Community expectations will inevitably shift over time. As discussed elsewhere in this chapter, causes may include factors such as:

- changing perceptions of risks (eg, from climate change, poor-quality water supply or discharges into waterways);
- expectations of increased standards of service (including by people who have moved from or have visited wealthier communities);
- changes in the age composition of the local population; and
- rising incomes (which make it easier for people to meet the cost of better quality and additional services).

Other types of community pressure and demands on councils have been highlighted in submissions and engagement meetings. For example, Museums Aotearoa noted that "providing museum services to the community is seen as a local council responsibility" (sub. DR222, p. 2), and Hawke's Bay Regional Council noted increased community expectations for a better-quality environment (sub. DR248). Some councils also face pressure to improve the working conditions of their employees, particularly those who are the lowest paid. The Public Service Association noted in their submission that while some large local government employers have agreed to pay their employees the living wage as minimum, smaller councils may find it difficult to do this (sub. 86).

The mix and quality of central government services changes over time in response to the same sorts of factors. The key issue for councils experiencing this pressure is that rising community expectations are not necessarily accompanied by the community's willingness to pay.

Some submissions also highlighted that the financial implications of making investments in new facilities and services are not always made clear to the community (see for example, Porirua Economic Development Group, sub. DR161, p. 2). Chapter 5 assesses how councils determine priorities and investments in response to community preferences and through ongoing engagement with the community.

F4.9

Evidence reveals no major shifts over the last several decades in the range of services that local government generally provides. The Local Government Act 2002 defines the purpose of local government as to "enable democratic local decision-making and action by, and on behalf of, communities". The quality of councils' democratic decision-making influences the nature, quality and extent of services provided by councils.

F4.10

Community expectations for levels of service from local (and central) government are rising over time in response to factors such as:

- changing perceptions of risk from climate change;
- drinking water quality and impacts of discharges into waterways;
- changes in the age mix of local populations; and
- rising incomes (which make it easier for people to meet the cost of better quality and additional services).

4.6 Climate change and natural hazards

Due to its geology and position in the South Pacific, natural hazards have always been part of life in New Zealand. Floods, storms, earthquakes, landslides, droughts and cyclones have been an ever-present risk throughout the country's history.

Planning for (and responding to) natural hazards has been an important role for both central and local government for a long time. The risks associated with natural hazards are varied, and some impacts are more predictable than others. Further, anthropogenic climate change is affecting the nature, severity and predictability of extreme events – including flooding, storms, landslides and droughts – and the level of risk that communities face.

Earthquakes

The costs associated with planning for, and responding to, earthquakes are of particular concern for many communities around New Zealand. Carrying out building safety inspections, retrofitting earthquake-prone buildings and facilities owned by councils, and ensuring that new infrastructure is constructed in a way that is seismically appropriate can all be costly.

Several councils noted in their submissions the cost pressure from preparing for future earthquakes.

[T]he costs for strengthening buildings and infrastructure is growing steadily as the impacts of the November 2016 earthquakes continue to be uncovered. Since this event there has been a significant reduction of capital value in the CBD as a result of demolition following the quakes, which has eroded the rating base that must share the 40% of recovery costs the Council is required to fund. To compound this issue, insurance premiums continue to rise as the risk becomes more evident. (Wellington City Council, sub. DR245, p. 6)

The new national system for managing earthquake-prone buildings is now operative. Waitemata Local Board area has 50% of all earthquake prone buildings with 795 buildings already assessed as 'earthquake prone'. Of these a number are valued public community facilities, which will require

significant investment to meet the national standards over the next 10-30 years. (Auckland Council, sub. DR185, Attachment C, p. 42)

Some councils raised the broader issue of costs associated with Civil Defence and Emergency Management (CDEM). Bay of Plenty Regional Council, for example, noted:

The level of CDEM services required to be delivered for and with communities is continuing to increase. The increasing frequency of disasters and the magnitude of their consequences (direct and compounding), higher level of response capability and capacity expectation from the community, central government and supporting agencies and an increasing expectation to provide a 24/7 warning and response capability all add pressure on Local Government to deliver an affordable but quality emergency management capability. (sub. DR 187, p. 13)

Adaptation to climate change

Climate impacts create a significant cost pressure for local government on several fronts. For instance:

- councils are the owners of a large amount of the infrastructure directly at risk from the impacts of climate change;
- councils are the authorities responsible for planning and development on at-risk land, and therefore have an important role in minimising future risk exposure and long-run costs; and
- councils are the governing body closest to communities, and have a clear role in supporting community wellbeing in the face of adverse climate impacts.

The Commission has identified planning for and adapting to climate change as a major increasing cost pressure on local government. Given the complexities and scale of the challenge, adaptation to climate change is treated as a separate topic in Chapter 9.

Climate mitigation

New Zealand has committed to transition to a low-emissions economy. The government has recently enshrined in law an emissions-reduction target through the Climate Change Response (Zero Carbon) Amendment Act. This legislation sets a target of reducing carbon dioxide and nitrous oxide emissions to net zero by 2050. It also sets a target for reducing gross emissions of biological methane (from livestock agriculture) to within the range of between 24% and 47% below 2017 levels by 2050. This represents a significant increase in ambition from previous emissions-reduction targets.

Transitioning to a low-emissions economy will require action across all sectors of the economy, and has significant implications for local authorities. Reducing emissions in the transport sector, for example, will likely require major investments in public transport, network planning and infrastructure, and investments from many territorial authorities to encourage “mode-shifting” away from cars to cycling and walking.

Reducing New Zealand’s emissions may also result in major pressure for some communities that currently rely on fossil-fuel intensive or extractive industries – for example, communities in Taranaki with large oil-and-gas-processing industries. Councils will also incur some direct costs associated with mitigation, including Emissions Trading Scheme (ETS) costs associated with operating landfills, as well as other costs passed through the ETS. Ruapehu District Council noted in their submission that its ETS costs have quadrupled in the last four years (sub. 85, p. 5). This trend is likely to increase significantly as the carbon price rises.

Several submitters noted that while responsibility for mitigation policy lies chiefly with central government, local government also has an important role to play (see for example Gray Southon, sub. DR238). Many councils are facing pressure from their communities to support the transition to a low-emissions economy more directly. In response to community pressure, some councils have recently declared a “climate emergency”. Others are beginning to report on greenhouse gas emissions generated through their own activities and setting targets to reduce emissions, or developing climate action plans. Wellington City Council, for example, has set a target to achieve an 80% reduction in emissions from 2014 levels by 2050, and Dunedin City Council has a target to reduce the city’s emissions to net zero by 2030 (Wellington City Council, 2016; Dunedin City Council, 2019).

Pressure from new forestry

A large cost for some local governments will come from increased forestry. As described in the Commission's 2018 *Low-emissions economy* report, transitioning to low emissions will require a significant amount of land-use change. In particular, modelling undertaken for that report estimated that between 1.3 million and 2.8 million hectares of new forestry could be required – up to a third of this would be permanent native forest, and the rest would be exotic plantation forest (NZPC, 2018). This represents a significant amount of new forestry, given that New Zealand currently has about 1.7 million hectares of land in plantation forest (Ministry for Primary Industries, 2018).

Increased amounts of forested land will have an impact on councils in several ways. In some areas the change from pastoral agriculture land into forestry will be significant, and will represent an economic transformation that will inevitably affect some communities in terms of the local workforce and culture. Tararua District Council noted this challenge in their submission (sub. DR240). The biggest cost impact for councils, however, is likely to come after 25 or 30 years, at harvest time, when forestry puts pressure on local roading infrastructure.

As SOLGM noted, forestry puts very specific demands on local infrastructure. The forestry cycle requires intensive use of the forest for only two periods: planting; and harvest about 30 years later. SOLGM has described this as “an investment decision having an infrastructural echo” (sub. 24, p. 37). The impacts of forestry on local roads are significant, particularly during harvesting when a large amount of heavy machinery and timber is transported. Although the specific impacts vary depending on certain conditions, such as the types of roads and vehicle tonnage, this leads to considerable wear and tear on roads. This results in roads needing more frequent maintenance and renewal.

The Whanganui district is already experiencing cost pressure from forestry, with 24 000 hectares of plantation forest across 230 properties (SOLGM, sub. 24). Much of this timber will reach harvestable age between 2020 and 2030. This is part of the so-called “wall of wood”, which refers to the large amount of forestry currently reaching harvestable age, which is the legacy of a surge in forest planting that happened across the country in the 1990s. In its submission, Whanganui District Council noted the large cost impact this is expected to have in the district.

Within the Whanganui District, the transportation of timber has, and will continue to have, a significant impact on our roads. Over the next thirty years, renewing sealed roads directly resulting from forestry traffic is estimated to cost around \$67M with a peak between 2024 and 2029. While the Council's modelling predicts that the major costs will impact Council after 2024, as roads are repaired following peak harvest, Council is already experiencing significant damage on our roading network. (sub. 93, p. 2)

The council has tried to deal with this anticipated cost impact by introducing a new targeted rate on plantation forest owners. That rate aims to recover 60% of the council's forest-related roading costs, with the remaining 40% funded from general rates. This approach has faced opposition from the forestry sector, for creating a new and unanticipated cost late in the forestry cycle. The council, at the same time, has tried to “strike a balance between loading the substantial forestry related roading costs onto 230 forestry property owners or 21 000 general ratepayers in a low socioeconomic district who see little benefit from this activity” (SOLGM, sub. 24, p. 39).

As rates of afforestation increase to support New Zealand's transition to a low-emissions economy, more councils will face similar challenges. Councils are responsible for a significant portion of local roading costs. So, they will need to ensure that they plan and account for the future infrastructure costs associated with this large-scale afforestation, much of which will occur on marginal farmland often in districts that are relatively socioeconomically deprived.

In New Zealand all road users directly contribute towards road construction and maintenance. Most light-vehicle drivers pay through levies on vehicle fuel, but heavy vehicles pay a Road User Charge (RUC). RUCs are calculated based on dollars per thousand kilometres travelled, and vary depending on the size and class of the vehicle to reflect the damage they cause to roading infrastructure. All funds collected through RUCs go to the National Land Transport Fund (NLTF), which the NZTA uses to fund road maintenance and improvements.

As with other industries, forestry companies therefore already contribute to road-maintenance costs through RUCs. The challenges that councils like Whanganui District are facing from forest sector activity therefore indicates a need to re-examine how RUC funds are distributed. This issue is discussed in Chapter 7.

F4.11

Rates of afforestation are expected to increase as New Zealand transitions to a low-emissions economy. This increase in forested land will result in considerable new pressure on many local roads, particularly at harvest time. This will, in turn, lead to a need for more frequent maintenance and replacement of roads, resulting in increased costs. The cost pressure this creates for some councils indicates that Road User Charges collected from heavy vehicles are not reaching the areas where damage is occurring.

4.7 Tourism

The number of international visitor arrivals has increased faster than predicted over recent years; yet councils have limited control over where and when tourists travel, and the tax benefits from tourism growth accrue mainly to central government.

Meanwhile, local governments in tourism hotspots (and their ratepayers) fund the construction and maintenance of significant parts of the infrastructure that tourists use, largely through general rates revenue. Councils in tourist districts are citing difficulties in funding the needed expansion in facilities and infrastructure. While central government provides some support for local infrastructure for tourists, the Commission has identified measures to tackle pressure on local mixed-use infrastructure in some tourism hotspots. This issue is discussed in detail in Chapter 10.

4.8 Three-waters infrastructure

As noted earlier in this chapter, physical infrastructure dominates the operating and capital expenditure of local government. This includes the three-waters infrastructure: drinking water, wastewater, and stormwater. Small and dispersed communities with a large amount of water infrastructure per person face a particular challenge in funding and financing the maintenance and renewal of that infrastructure. This pressure is compounded by requirements to meet strengthened safety and environmental regulations.

The government is currently considering extensive reforms to the three-waters sector, including to regulatory standards and the regulatory regime (including how the regime is funded and delivered). Within this context, the Commission has identified three-waters infrastructure as a major cost pressure on local government. It has looked at how altering current arrangements could improve performance and lift productivity. Chapter 11 describes the problems and challenges with the current three-waters system and discusses potential changes to improve its performance, and its environmental and safety outcomes, while easing cost pressures.

4.9 Conclusion

Local governments face a broad range of cost pressures, which vary between regions and districts. Looking to the future, many of these pressures will increase as:

- New Zealand's population becomes more concentrated;
- the population ages;
- more regulation is passed down from central government;
- community expectations increase; and
- the impacts of climate change are increasingly felt.

It is also important to note that none of the individual pressures described in this chapter happens in isolation. Some challenges will combine and interact with each other in complex and costly ways. For example, ageing water infrastructure will need upgrading to meet strengthened environmental and safety

standards while also adapting to the impacts of climate change and a changing population. Some regions and districts will face far greater challenges in this respect.

Many challenges identified in this chapter are not new. Some pressures, such as increasing responsibilities from central government, have been growing for a long time but appear to be reaching a point where the cumulative impacts of incremental change are having a significant impact.

However, while such challenges may result in cost pressure on local authorities, the causes of that pressure are not necessarily lack of funding or financing by itself. Rather, cost pressures often flow from other causes – such as:

- poor prioritisation or decision making by councils, poor business models and processes that stymie innovation and the adoption of more efficient technologies (Chapter 5); or
- poorly designed central government policies and regulation that do not adequately consider council costs (Chapter 6).

An additional new pressure comes from climate change – in particular the threats from sea-level rise and more frequent and extreme weather events. The scale of the investments local authorities will need to make go beyond what they can reasonably manage with current funding and financing tools. New approaches will be needed for councils to plan for and adapt to the impacts of climate change. This issue is discussed in Chapter 9.

5 Improving decision making

Key points

- The focus of this inquiry is the funding and financing arrangements that local government needs to carry out its role in providing services for local residents and businesses. The quality of councils' decision making is essential to making best use of the available funding and financing tools, and to ensuring decisions are aligned with the scale and complexity of the local government task.
- Local authorities make numerous decisions that are significant in monetary terms, and in their impact on people's day-to-day lives. Councils' decisions about the level of service they provide and about capital investments can have an important bearing on cost pressures, and ultimately on the costs borne by local residents and businesses. The costs of poor decisions can be significant.
- Some councils are managing well with the current suite of funding and financing tools. They are making good use of targeted rates, development contributions and user charges, and taking the tough decisions needed to improve the performance of their essential infrastructure.
- However, the diversity of practice across councils is striking. Across the sector as a whole, there is clearly a need for better use of the full palette of funding and financing tools, and better-quality investment decisions.
- The elected member model is not consistently delivering a mix of councillors who collectively possess the full range of skills required for effective governance, and evidence shows that many councils lack the necessary expertise for effective decision making. This is compounded by the politics of rate-setting, which places pressure on elected members to avoid debt and keep rates growth low.
- These problems are not easily fixed, and are largely outside the scope of this inquiry. Further, any solutions must respect local autonomy and avoid perverse outcomes from being too prescriptive. The Commission's approach is to increase the transparency of council performance and foster the success factors underpinning good decision making.
- Good decision making relies on strong and capable leadership, high-quality information to support decision makers, use of independent governance expertise, and effective community engagement. Sector organisations should work to improve elected members' governance and financial skills, through lifting participation in training and professional development. And all local authorities should be required to establish an Audit and Risk Committee, with at least one independent member.
- The current performance reporting requirements on local authorities, including the financial information disclosures, are excessively detailed, inappropriately focused and not fit for purpose. The framework requires fundamental review, with a mind to significantly simplifying the required disclosures, and improving their overall coherence and fitness for purpose. This review should develop a small set of mandatory measures to be reported to and published by a central entity, to assist transparency and comparability of councils' performance.
- Councils' Long-Term Plans (LTPs) are long, complex and contain duplication. This is partly a feature of the legislative requirements, which are disjointed and require an unnecessary level of detail. The Commission recommends that the requirements are streamlined so that LTPs become more accessible documents which can better fulfil their transparency objectives.

5.1 The importance of good decision making

Local authorities make numerous decisions that are significant in monetary terms, and in their impact on people's day-to-day lives. Councils' decisions about the level of service they provide, and about capital investments, can also have an important bearing on managing cost pressures. Decisions to invest in large new capital assets (eg, transport infrastructure or sports stadia) have the potential to add significant costs that ultimately must be recovered – largely from local residents and businesses.

The costs of poor decisions can be significant, as the story in Box 5.1 below illustrates. On the flip side, sound and timely decision making supports the efficient allocation and use of resources, and delivery of good quality outcomes. It is therefore essential that councillors have the necessary skills and expertise to ensure good decision making, including a good grasp of governance principles and financial management concepts. Where these skills are lacking, suitable supports (such as professional development and external expertise) should be drawn on. There should also be robust checks and balances to help incentivise good decisions and avoid poor decisions.

An important aspect of councils' decision making is how it promotes innovation and learning. Continuous improvement, including adoption of new technologies, and disciplined learning and adaptation, is an important driver of good outcomes.

Firms operating in a competitive market face incentives to continually innovate. They experiment with ways to better attract and satisfy customers, and to reduce their costs of supply. They also learn and adapt to the changing needs and preferences of their current and future customers. Successful innovation is fostered by having a number of competing firms and by customer choice.

The incentives on councils are different. As a single supplier for most of its services, the incentives on a council to continually improve its use of resources, and better match consumer preferences, are more muted. And as a democratically elected body, a council is governed by elected members (rather than a professional board of directors), accountable to its wider community (rather than shareholders) and subject to a triennial electoral cycle. Community preferences are diverse and the interests of different parts of the community may conflict. The election cycle and the need to make trade-offs across these preferences adds to the complexity of councils' decision making. Having robust processes around these decisions then becomes particularly important, as does transparently demonstrating to the community how and why councils have made these decisions.

Councils undertake a large number of activities. They make choices about the mix of activities, the levels of service provided, how each activity is provided, how they are funded and who pays. As explained in Chapter 2, councils have a range of choices for how they fund their activities. How these funding tools are used (eg, the mix of general and targeted rates, differentials, and fees and charges), affects the amount that different groups of people pay.

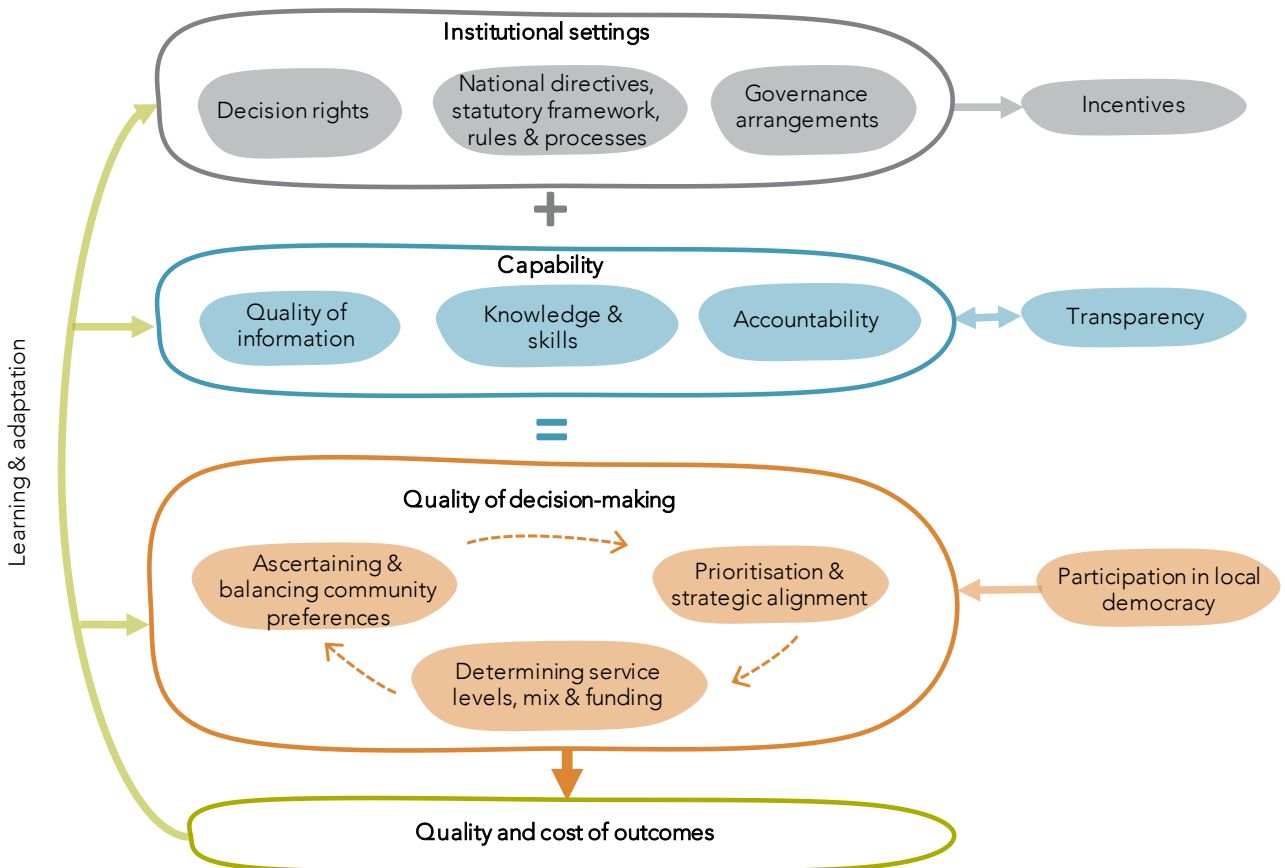
How well councils are making use of the current funding and financing framework has a material impact on the quality of outcomes. This chapter explores the disciplines and incentives on councils to make good decisions. It assesses the scope for strengthening the quality of decision making so as to achieve better long-term outcomes. The appropriate use of funding tools is explored further in Chapter 7.

To assess the scope for improving councils' decision making, this chapter examines the following dimensions (illustrated in Figure 5-1, below).

- The **institutional environment**. This includes where the decision rights sit, the statutory rules and national policy directives around decision making, and councils' governance arrangements (section 5.2).
- Councils' **capability** for sound decision making (section 5.3). This includes:
 - the quality of information put to decision makers; and
 - the relevant knowledge and skills of decision makers, and those supporting them.

- The **incentives** to make good decisions. This includes the accountability mechanisms (section 5.4). In the local government context, these are underpinned by the **transparency** of decision making (section 5.5).
- The **quality of decisions** about service levels, mix and funding. This includes how community preferences are identified and balanced, and how potential actions are prioritised and aligned with strategic objectives (section 5.6).
- Community participation in **local democratic processes**. This includes long-term planning engagement and consultation processes, and local body elections (section 5.7).

Figure 5-1 The features of good decision making



Box 5.1 The costs of poor decision making

Kaipara District Council (KDC)'s management of the Mangawhai wastewater scheme is often cited as an example of the costs of poor decision making. It also illustrates the importance of good governance.

Between 1996 and 2012, KDC oversaw the development of a reticulated wastewater disposal scheme in Mangawhai, a small coastal community south of Whangarei. The history of the project is long and complex. It was plagued by numerous problems, including significant cost escalation, and culminated in ministerial intervention to appoint a Commission to manage the council, and to postpone the local election. The likely cost for the scheme as presented to the community in a 2006 consultation document was \$35.6 million. The final cost is unknown, but estimated to be around \$63.3 million, most of which was debt-funded. This significant increase in costs occurred in the absence of any further public consultation.

In 2012, KDC asked the Auditor-General to undertake an inquiry into its decision-making, financial, and contract management processes for the scheme. The inquiry concluded that KDC failed to meet its fundamental legal and accountability obligations and the council effectively lost control of a major infrastructure project. The underlying causes of this failure included poor governance, management and record-keeping by KDC. The issues of most concern were "the lack of attention that KDC gave to its legal obligations and to its obligation to be able to account to the community for its decisions and actions" (OAG, 2013a, p. 16). Legal requirements that KDC failed to meet included how it sets rates, the need for it to take decisions at formal Council meetings (or people with delegated authority to take decisions), and its record-keeping requirements.

The inquiry reported that one of the key lessons from the "woeful saga" was the importance of governance, including the need for members of a governing body "to have the courage to keep asking questions until they understand what they are deciding" (OAG, 2013a, p. 13).

The Terms of Reference for the inquiry included some of the work done on behalf of the Auditor-General through the course of the project, which did not identify audit risks with the scheme. The inquiry found that the audits completed during 2006 and 2009 were substandard in some respects, and it questioned whether they satisfied the audit objective. KDC subsequently took legal action against the OAG for not identifying the failings (outlined in the inquiry report) in a timely manner or taking appropriate steps to bring them to the Council's attention. Following mediation, the OAG made a settlement, though neither party admitted liability.

The appointed Commissioners took significant measures to rebuild the organisation. They:

- brought activities back in-house;
- rebuilt organisational capacity, capability and systems, including for core council functions such as consenting, rate-setting and asset management;
- put in place basic business systems and policies that were previously inadequate or absent, including records keeping and management, financial reporting and financial delegations;
- introduced policy frameworks to guide decision making; and
- established an Audit and Risk Committee, along with a risk management framework and a Chief Executive Performance Review Committee (Kaipara District Council Commission, 2016; Robertson, 2016).

In his outgoing letter to the Minister of Local Government, the Chair of the Commission identified a number of lessons from the experience. These included:

- the need for elected members to be aware of their purpose and roles as established in legislation;

- the importance of strict legislative compliance, and strict legal oversight of processes such as rate-setting;
- the need for councils to have an Audit and Risk Committee, with an independent member; and
- the need for an independent panel of experts to peer review large project proposals.

The council has now returned to a fully elected council, with a new Mayor and Chief Executive, and a restructured senior leadership team. The council is in a sound financial position, having paid down debt, and is a member of the New Zealand Local Government Funding Agency (LGFA). By 2018, KDC had completed its first Long-Term Plan (LTP) overseen by elected members (and adopted within statutory timeframes) since 2009, and published its first annual report from a full year of an elected council, since 2011 (Kaipara District Council, 2018).

Source: Kaipara District Council (2018); Kaipara District Council Commission (2016); Robertson (2016); OAG (2013a).

5.2 Decision rights and decision-making rules

Decision rights

Elected members agree to council strategies, plans, policies and their associated budgets. The Chief Executive is the only staff member appointed by a council. The Chief Executive is the principal advisor to the council, and employs all other staff on behalf of the council. They are responsible for implementing council decisions, with delegated authority for operational decisions.

Within these parameters, councils have discretion as to how they assign decision-making responsibilities. Most councils have either a number of standing committees or a portfolio system. Standing committees consider particular issues, such as planning, finance or regulation. Some have delegated decision-making authority while others are advisory. A portfolio system involves individual councillors taking a leadership role on specific policy matters (LGNZ, 2017c).

Councils may also have sub-municipal bodies (such as community boards) and/or some services in Council Controlled Organisations (CCOs). A CCO is an entity in which one or more local authorities control 50% or more of the voting rights, or appoint 50% or more of the members of the governing body. A CCO can be a company, trust, partnership, incorporated society, joint venture or other profit-sharing arrangement. A CCO's constitution sets out, among other things, what things the CCO's directors can decide, and what they must refer back to the local authority (OAG, 2015b).

Council staff provide input to decision making, preparing supporting analysis and advice for consideration by councillors (including around options, costs and benefits), and drafting documents such as the LTP, for council approval. The Chief Executive delegates day-to-day decisions on operational matters such as regulatory compliance and enforcement, and asset management, to staff. These decisions must be consistent with (and give effect to) the strategic direction and policies, and within the budgets, as approved by council.

Statutory principles

Local authorities are required to manage their resources prudently, and to ensure efficient and effective use of resources. This is made clear in section 14(1) of the Local Government Act 2002 (LGA), which emphasises the requirement for efficiency.

In performing its role, a local authority must act in accordance with the following principles:

- a) a local authority should—
 - (i) conduct its business in an open, transparent, and democratically accountable manner; and

- (ii) give effect to its identified priorities and desired outcomes in an **efficient and effective** manner:
- b) a local authority should make itself aware of, and should have regard to, the views of all of its communities
....
 - e) a local authority should actively seek to collaborate and co-operate with other local authorities and bodies to improve the **effectiveness and efficiency** with which it achieves its identified priorities and desired outcomes
....
 - g) a local authority should ensure **prudent stewardship** and the **efficient and effective** use of its resources in the interests of its district or region, including by planning effectively for the future management of its assets. (emphasis added)

The focus on prudence is further emphasised in the balanced budget requirement of section 100, and the financial prudence regulations (described in Chapter 2).

The LGA sets out specific principles for decision making. Section 77 requires councils to consider “all reasonably practicable options” for achieving its objectives, and “assess the options in terms of their advantages and disadvantages”. Section 79 specifies that the extent of options analysis, including the degree to which costs and benefits are quantified, should be commensurate with the significance of the decision; and councils have discretion in both developing and applying their significance and engagement policy (required to be adopted under s 76AA).

National policy directives and rules

Central government also imposes requirements that affect local government funding and decision making, through national policy directives. For example, financial assistance for roading is available through the National Land Transport Fund, which the New Zealand Transport Agency administers. Territorial authorities can seek funding for roading activities in their area, but must meet a range of planning and procedural requirements before applying. Once funding is approved, councils must then comply with a suite of rules and obligations around the use of this funding.

Other national policy directives include National Policy Statements (NPSs), such as those for Urban Development Capacity and Freshwater Management. NPSs, and the obligations they impose on councils, are explained further in Chapter 4.

Governance arrangements

Section 39 of the LGA sets out the following governance principles.

A local authority must act in accordance with the following principles in relation to its governance:

- a) a local authority should ensure that the role of democratic governance of the community, and the expected conduct of elected members, is clear and understood by elected members and the community; and
- b) a local authority should ensure that the governance structures and processes are effective, open, and transparent; and
- c) a local authority should ensure that, so far as is practicable, responsibility and processes for decision-making in relation to regulatory responsibilities is separated from responsibility and processes for decision-making for non-regulatory responsibilities; and
- d) a local authority should be a good employer; and
- e) a local authority should ensure that the relationship between elected members and management of the local authority is effective and understood.

Point (a) is reinforced by section 40, which requires every newly elected council to publish a local governance statement. Point (c) seeks to avoid conflicts of interest in regulatory decision making, and this separation is echoed in section 42(3)(a) which requires equivalent separation in councils’ management structures.

Point (e) is particularly important, as it emphasises the distinction between the governing body (political decision makers) and the management (executive arm) of the council. The Office of the Auditor-General (OAG) has described this distinction.

Generally, the roles are for:

- the governing body to set direction and policy, make important decisions, report to the public, and oversee the functioning and health of the organisation including its long-term capability and sustainability, and its compliance with the law; and
- management to focus on putting policies and decisions into effect, carrying out the organisation's functions, and providing information and advice to the governing body. (OAG, 2014a, p. 10)

The OAG has also explained the need for this distinction:

Good governance requires a clear distinction between the role of governance and the role of management. Governance involves ensuring that systems and processes are in place that shape, enable, and oversee the management of an organisation. Management is concerned with carrying out the day-to-day operations of the organisation. There is a need to guard against the risk of governors becoming involved in operational decisions because it limits their ability to then hold management to account. (OAG, 2016, p. 11)

The Chief Executive is appointed by the local authority and therefore accountable to elected members. Elected members are "responsible and democratically accountable for the decision making of the local authority" (s 41(3) of the LGA).

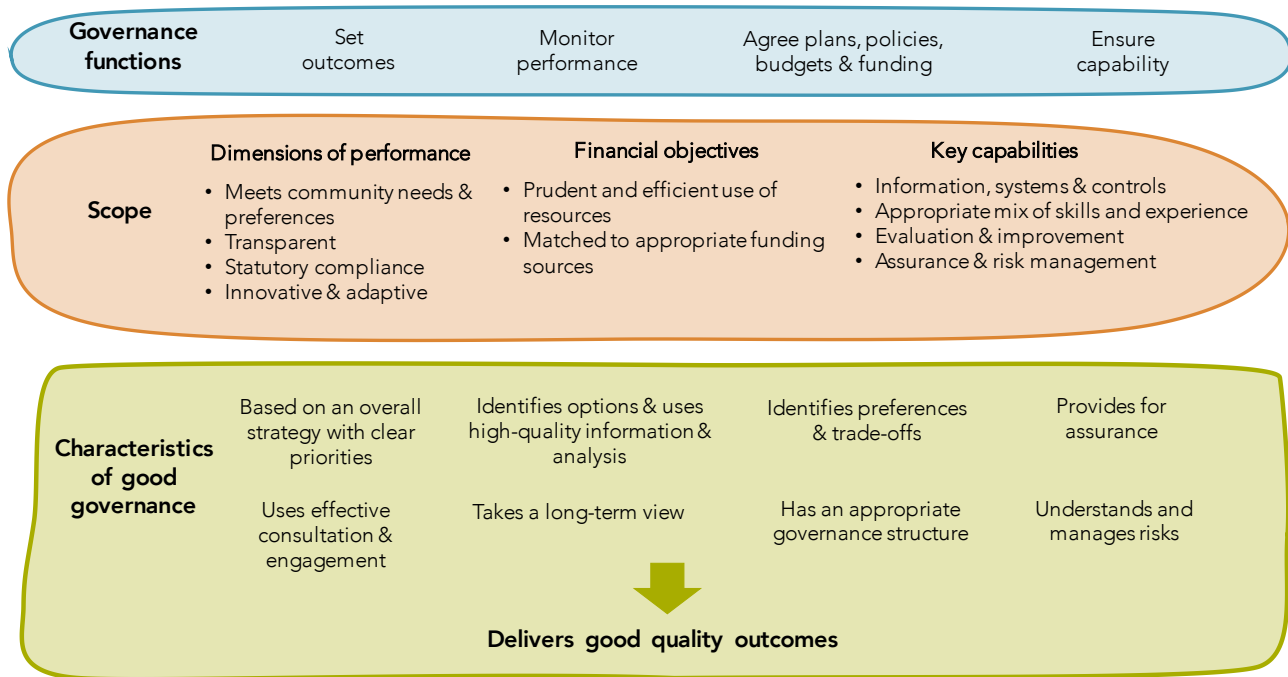
5.3 Decision-making capability

A framework for effective governance

The OAG (2016) has set out eight generic elements essential for effective governance.

1. Set a clear purpose and stay focused on it.
2. Have clear roles and responsibilities that separate governance and management.
3. Lead by setting a constructive tone.
4. Involve the right people.
5. Invest in effective relationships built on trust and respect.
6. Be clear about accountabilities and transparent about performance against them.
7. Manage risks effectively.
8. Ensure that you have good information, systems and controls (OAG, 2016).

A 2017 report by MartinJenkins presented a governance framework tailored to the area of water asset management (MartinJenkins, 2017). The diagram below is an adapted version of this framework. The Commission has broadened it to both encompass the range of council responsibilities and draw on advice from the OAG. A key challenge for councils is ensuring that decisions take a long-term view, in light of the political incentives imposed by the triennial election cycle (which can encourage a short-term focus).

Figure 5-2 Framework for effective governance

Adapted from: MartinJenkins (2017).

Councils often lack the range of necessary governance skills

MartinJenkins (2017) examined the water asset governance practices across 12 councils (including Auckland and Wellington where the water services are delivered via CCOs²⁵). The authors found that, across the 10 councils where water assets are governed by elected members, councillors typically lacked understanding of what is involved in good governance of water assets. The report notes:

The elected member governance model relies on elected community representatives having the skills required for governing a complex set of assets and engineering systems, and there is no way to provide assurance of that if no external expertise is sought to complement elected member governance. (MartinJenkins, 2017, p. 9)

While it is possible that some elected members on a council will have some of the skills and experience required, it is unlikely in practice that a council will have them to the full range and extent appropriate. They may also not have the right focus given the varied interests and priorities among members. (MartinJenkins, 2017, p. 17)

The report concluded that there is a lack of assurance that governance will be robust, and a number of indications show that governance is not consistently at the appropriate level (p. 15). The report set out a range of options for improving governance, including:

- stronger governance guidelines and peer support for asset governance;
- incentivising shared service arrangements and incentivising the development of external governance groups; and
- establishing CCOs (pp. 15-16).

The authors expressed a preference for incentivisation rather than mandating such arrangements, on the basis that a “coalition of the willing” was most likely to be effective. The Commission agrees that mandating CCO structures (eg, for particular council activities) is unlikely to be the most effective way of improving governance in all situations. The potential for greater use of CCOs in general is discussed further in Box 5.2. The incentives on councils to consider shared services arrangements are explored in Box 5.3. The rest of this section considers councils’ governance skills, and ways to build this capability.

²⁵ Wellington Water delivers three waters services (drinking water, wastewater and stormwater). In Auckland, Watercare delivers two of the waters (drinking water and wastewater), and Auckland Council delivers stormwater services.

Box 5.2 The potential for greater use of CCOs

CCOs offer a number of benefits, including:

- the ability to specialise, and attract and retain skilled board members and staff, who might not be available to a local authority;
- an improved commercial focus (on achieving operational efficiencies);
- independence from political pressures;
- economies of scale (eg, where shared services CCOs combine several local authorities' similar activities); and
- greater nimbleness and agility (due to less bureaucracy around decision making).

Yet establishing such entities also has disadvantages. These can include:

- loss of coordination;
- lack of responsiveness to the owner;
- higher overhead costs; and
- lower community accountability (NZPC, 2015, p. 253; OAG, 2015b, p. 16).

In its *Using land for housing* inquiry, the Commission recommended that councils should consider the CCO model when reviewing their service delivery arrangements (as required under section 17A of the LGA). It noted that a cost-benefit analysis is needed before deciding on a CCO approach, to determine whether it would offer net benefits over alternative delivery models (NZPC, 2015, p. 255).

Guidance by the OAG outlines the considerations in determining whether a CCO is the best option. That guidance includes whether a CCO would be a cost-effective and sustainable way of achieving the objective the local authority is trying to achieve, and whether the council has the capacity and capability to manage a relationship with a CCO as well as monitor its performance. The guidance notes there is no "perfect model" for the form of a CCO, but that councils need to set clear objectives, appoint the right people to govern, monitor performance and be clear about their appetite for risk. Formal accountability documents negotiated with the local authority include a Statement of Intent and a Constitution for the CCO. These, and non-statutory measures such as a Letter of Expectations, play an important role in ensuring that the decisions made by a CCO are aligned with the council's objectives for the organisation, as well as the council's wider aims (OAG, 2015b).

While a CCO model will not be suitable in all circumstances, overall the Commission considers there is scope for greater use of CCOs, particularly in light of their potential to deliver efficiency improvements and greater access to specialised resources.

Chapter 11 discusses how to incentivise councils to aggregate provision for three waters services, where this makes economic sense, via CCOs. This includes having independent directors, rather than councillors, as CCO board members – both to ensure the necessary skills and to take the political dimension out of decision making.

CouncilMARK™ assessments explore governance and financial decision making across the gamut of council responsibilities. They have found that councils have a generally sound approach to financial management, noting that some have come from a background of poor practices, and are in the process of building more robust systems and processes. However, they have frequently noted that councillors lack financial literacy. This limits councils' ability to make robust decisions around debt, rates increases, consumption and investment, with some resorting instead to "intuition".

As shown in Chapter 2, a number of councils have low or no debt. The Commission learned through its engagement and submissions, and review of council documents, that many councillors are concerned with the political optics of taking on debt, and focused on keeping debt low. This appears to be driven by a lack of understanding of local government debt and its implications for inter-generational equity, both among elected members and the general public. The implication is that some councils may be deferring necessary investment (eg, in infrastructure renewals or upgrades). This may delay inevitable increases in rates. The Property Council New Zealand submitted:

Many enter local politics with the sole agenda of ensuring that rates are kept low and do not increase. This is often their platform and they spend their entire time ensuring that rates do not increase. This has in part led to some of the significant under-investment across New Zealand that we are now facing. Keeping rates so low has not kept pace with the infrastructure requirements. However, we agree that the true rates increases required for the proper levels of maintenance and improvements would have likely been unsustainable by most communities....

The use of debt for inter-generational equity is often beyond the understanding of many councillors and takes a significant period to truly understand its complexities. They have often come in hoping to manage the council finances like their own. They want to ensure there is no debt or that it should be reduced. They also wish to ensure that rates are maintained at the lowest levels possible. (Property Council New Zealand, sub. 117, p. 7)

Councillors' insufficient knowledge of governance principles and insufficient understanding of risk management were other weaknesses identified through CouncilMARK™ assessments. A common recommendation was for councils to have additional, independent and suitably qualified members on their Audit and Risk Committees. Many reports also point to the need for training and capability development in finance and governance.

Some submitters discussed the barriers to attracting a diversity of high-quality council candidates, including the remuneration and time commitment. The National Council of Women of New Zealand emphasised that having a representative range of elected members is important in supporting sound decision making. They submitted on the barriers to attracting female candidates.

A greater focus on diversity on councils would potentially contribute to more informed, better decision making. While many factors might have influenced women in their decisions to stand – or not stand – for local government roles, or to continue in such roles, that may be beyond the control of local government to influence, there are some factors within its control. For example, the training of potential and elected candidates, is an area where there is scope for improvement. Other factors which can support women include timing of meetings and support for childcare. (National Council of Women of New Zealand, sub. DR234, p. 2)

Some submitters commented that councils tend to be risk averse in their decision making. Environment Canterbury explained the implications of this for innovation in local government.

Local government is often risk averse (not least because of the limitations of its sources of funding and its obligations to consult) and thus innovative change can be slow. Innovation requires adequate funding mechanisms to underwrite and being prepared to fail. The appetite for local government initiative failure is arguably lower than in the private sector (where one is often risking one's own money and earning returns that reflect that risk) and coupled with limited capacity to sustain failure from a financial perspective, means the costs of this can be perceived to be too great. (Environment Canterbury, sub. 111, pp. 8-9)

This mirrors the Commission's inquiry into *Improving state sector productivity*, which found that closed and risk-averse cultures in many core public service agencies are stifling innovation.

Based on this evidence, the Commission has concluded that the elected member governance model does not consistently deliver a mix of councillors who collectively possess the full range of skills required for effective governance, and many councils lack the necessary expertise for effective decision making.

The discussion below explores ways to improve council capability. This is followed by an examination of the checks and balances to help incentivise good decisions and militate against poor decisions.

F5.1

The elected member governance model does not consistently deliver a mix of councillors who collectively possess the full range of skills required for effective governance, and evidence shows that many councils lack the necessary expertise for effective decision making.

Improving governance and financial capability

It is essential that councillors receive appropriate induction, as well as ongoing training and support. External expertise is also likely to be required. The Commission has considered two main ways to improve councils' financial governance and decision making. These are:

- strengthening councils' understanding and use of assurance and risk management, through the use of Audit and Risk Committees and co-opting of relevant experts; and
- building the governance and financial skills of elected members.

Strengthening the use of Audit and Risk Committees

Audit and Risk Committees play a valuable role in improving the governance, performance and accountability of an organisation. The OAG states that such committees can be

a powerful advisory group to help the entity manage its risk. By applying external, independent perspectives to the risks, issues, and challenges facing an entity, the committee can help the entity to manage the variability of its delivery of its outputs, impacts and outcomes. (OAG, n.d.)

No centralised information is held about the number of councils that have some type of assurance committee. The New Zealand Society of Local Government Managers (SOLGM) undertook a survey of all territorial authorities, asking them whether they had an Audit and Risk Committee, and, if so, whether it had independent members and/or an independent Chair. Sixty-three councils responded to this survey; information for the remaining 15 councils was sourced from their websites.

Fifty-nine councils have a committee or other governance body explicitly set up to perform audit and risk functions. A further 13 identify audit and risk in the title of a committee with a wider brief (such as "Finance, Audit and Risk"). Six councils have neither, though assurance functions may be undertaken within the remit of another committee, such as a Finance committee. Of the 72 council committees with an explicit audit and risk function, 58 have one or more independent members (8 have two or more), and 30 of these have an independent Chair. The committee of one other council has an independent advisor with no voting rights.

CouncilMARK™ assessments show that many of these committees have been established recently (in the last year or two), while some are longstanding (for example Waimakariri District Council's Audit and Risk Committee has been operating for 20 years). Some appear to have been established (in one case reinstated) since the council received its CouncilMARK™ assessment.

The Commission considers that all councils must have an Audit and Risk Committee. This requirement is consistent with guidance published by Local Government New Zealand (LGNZ), which states that such committees are a necessary part of ensuring a council has effective controls in place to meet its legislative requirements (including for prudent stewardship) and community expectations (Jones, n.d., p. 1).

LGNZ submitted that the legislative requirement should be flexible enough to accommodate the diversity across councils and not impose a one-size-fits-all model (LGNZ, sub. DR263).

Audit and Risk Committees should follow the good practice guidance around scope, membership and practices, including for risk management. This includes having at least one external member, to help ensure its membership spans the full range of requisite skills and experience, and acts independently and objectively. Having an independent Chair can further promote free and frank debate.

The Commission notes a range of existing resources are available to support such committees, including those provided by the OAG, the Institute of Directors, LGNZ and Deloitte (much of which is freely available), and recommends that councils draw on this when developing and running their committees.

Given that most councils already have some form of Audit and Risk Committee in place, the additional costs to the sector should be relatively small. While some councils would face the additional costs of remunerating independent members, the intention is that they would also benefit from better investment decisions, including the avoided costs of poor decisions and poorly managed risks.

Building the governance and financial skills of elected members

A wide range of resources, and training and development opportunities, are already available to local authorities, including through LGNZ and SOLGM, and provided by agencies such as the OAG. Support for governance and the financial capability of elected members includes induction and other courses run by EquiP (LGNZ's Centre of Excellence), and governance training by the Institute of Directors (including a module about financial governance, and a short course about Audit and Risk Committees).

Some councils actively support the induction and professional development of their councillors. For example, Hauraki District Council holds a thorough induction programme, including a three-day retreat for its elected members and Executive Leadership Team immediately following local body elections, and ongoing training for elected members (CouncilMARK, 2019a). And New Plymouth District Council provides training and mentoring of councillors, as well as encouraging membership and participation in the Institute of Directors (CouncilMARK, 2019b).

However, a general theme from the CouncilMARK™ assessments, submissions and the Commission's case studies is that the uptake of training and supports across councils is patchy. This echoes a finding in the report of the Shand Review, which reported that "it appears many elected members do not utilise training opportunities" and recommended a more comprehensive and formal training programme (Shand Report, 2007, pp. 257–258). The Commission was told, via submissions and case studies, that disincentives to taking part in professional development include:

- reluctance to travel (including the opportunity cost of time away);
- dissatisfaction with training received in the past;
- the scrutiny on travel and training expenses;
- a perception that participating in training implies a lack of competence; and
- lack of personal awareness of the need for such training.

SOLGM's submission suggested that online courses, or enabling delivery by local authority staff (including an element of "training the trainers"), could help overcome these barriers (SOLGM, sub. 24, p. 96). The Commission agrees that greater use of alternative delivery platforms are worth exploring, including the likes of webinars and online collaboration tools. Other models of capability development could also be considered, such as institutional links between councils ("sister council" arrangements), through which one council mentors and supports another.

There may also be scope to improve the content of existing training. SOLGM submitted that the induction training for new Mayors and Regional Council Chairs run by EquiP focuses "largely on the rating system, and that there is little on the basics of financial governance" (SOLGM, sub. 24, p. 95).

The Commission notes the importance of ongoing monitoring and independent evaluation of training and development to ensure both are fit for purpose and meeting their objectives. In addition to identifying any gaps in the available training, it would be helpful for such evaluation to also canvass the views of councillors who do not take up professional development supports, and to explore the reasons for this (eg, identify any gaps or shortcomings in content or delivery methods).

F5.2

A wide range of training, resources and supports is available for elected members. However, the uptake of these is patchy. Reported barriers include reluctance to travel, public scrutiny of travel and training expenses, dissatisfaction with the training provided, perceptions that training implies a lack of competence, and lack of personal awareness of the need for capability development.

R5.1

The Department of Internal Affairs, Local Government New Zealand (LGNZ) and the New Zealand Society of Local Government Managers should work together to improve basic governance, including financial governance, skills and knowledge across elected members. In undertaking this work, they should consider:

- a range of formal and informal mechanisms, such as training, peer support, mentoring (eg, via “sister council” links), and networking; and sharing of resources and best practice; and
- a variety of delivery platforms, including online media and collaboration tools.

LGNZ should ensure that resources and programmes are independently evaluated.

R5.2

Local Government New Zealand should work to achieve greater participation in ongoing professional development by elected members, including new and existing members, to ensure skills and knowledge are built and periodically refreshed.

R5.3

The Local Government Act 2002 should be amended to require all local authorities to have an Audit and Risk Committee.

Councils should draw on the good practice guidance and resources that are available to develop and run their committees. Good practice suggests that Audit and Risk Committees should have at least one independent member, to ensure they span the full range of necessary skills and experience. Independent members should be external to the Council, and appropriately skilled and qualified.

Better information to support decision makers

CouncilMARK™ assessments have found that the quality of information provided to councillors varies in comprehensiveness, structure and appropriate level of detail. A common theme was the lack of a consistent use of business cases to inform major investment decisions. Where business cases are prepared to support decisions, they typically lack analytical rigour. A bottom-up engineering perspective often dominates, and financial analysis may be inadequate or absent.

A common recommendation in these assessments was for councils to stress test their underlying assumptions (particularly around population growth) and to undertake sensitivity analysis (eg, high and low scenarios). Projections around economic structure and land-use change are also important.

An important part of assumption testing is interrogation by councillors. To do this, they need to know what questions to ask. As discussed above, failure to ask the right questions was a key problem with the management of the Mangawhai wastewater scheme. A range of guidance and support exists to help councillors. For example, the OAG publishes reports and guidance on governance for public sector entities, including local authorities. It also convenes a Public Sector Audit Committees group.

A strong theme from submissions, and the Commission’s engagement and case studies, is that councils of all sizes are struggling to attract and retain the necessary capacity and capability across the range of necessary skills, including the expertise required to provide high-quality advice to decision makers. For example, many councils lack the internal resource and capability to prepare adequate business cases.

The Terms of Reference for this inquiry preclude the Commission from recommending council amalgamations. Yet it is clear that the small size of many councils makes it difficult to recruit and retain the range and quality of skills, experience and expertise required to perform to a suitable standard. With such competition for analytical resources, combined with lack of scale, the Commission sees scope for greater use of capability and resource sharing (eg, via shared services arrangements, centres of excellence, and

collaborative knowledge sharing and problem-solving). One submitter also suggested that strategic workforce planning would assist in this regard (Tracey O’Callaghan, sub. DR180, p. 3).

Box 5.3 Incentivising the use of shared services

Shared services arrangements can offer councils access to a wider range of skills and resources, as well as cost savings through economies of scale. Appropriate use of shared services can therefore provide councils with a way of better managing cost pressures, within the existing funding and financing framework.

The LGA provides councils with considerable freedom to participate in shared services arrangements, through a variety of structures including CCOs. CouncilMARK™ assessments show that some councils are making good use of alternative and innovative service delivery models, including regional collaborations and shared services. Regional collaborations include the Bay of Plenty and the Waikato Local Authority Shared Services, which are both incorporated as CCOs.

A primary barrier to the use of shared services is resistance within councils. At the councillor level, this includes the political desire to protect local autonomy. Within the executive, it includes the desire to protect individual careers and staff numbers. Another barrier is friction among councils, due to differing personalities, conditions, characteristics, priorities and objectives (Aulich et al., 2011; Drew, 2011).

Section 17A of the LGA requires councils to regularly review the cost-effectiveness of its service delivery arrangements. These reviews must consider “options for the governance, funding, and delivery of infrastructure, services and regulatory functions”. CouncilMARK™ assessments have found that while many councils do reviews under section 17A, these reviews typically lack good quality analysis. This suggests a lack of genuine and robust consideration of other arrangements for service delivery.

Experience from overseas and New Zealand has shown that significant adoption of shared services arrangements has been slow in the absence of mandating or strong incentives, such as the threat of forced amalgamation or funding reductions (Aulich et al., 2011; Drew, 2011).

Shared services arrangements do not necessarily deliver cost savings. Overseas experience has shown “significant success stories” as well as initiatives that have been “spectacularly unsuccessful” (Aulich et al., 2011, p. 21). This is consistent with the evidence presented to the Commission through submissions and case studies, which illustrated mixed experiences with shared services. Councils should therefore carefully analyse the costs and benefits of options before entering such arrangements and monitor the realisation of benefits over time.

But overall, the Commission sees scope for greater use of shared services. The economies of scale, access to specialist skills, and in some cases cost savings through standardisation of processes or equipment, can be of particular benefit for smaller councils that struggle with high fixed costs and find it hard to attract and retain skilled staff.

F5.3

Significant scope exists for greater collaboration across councils, including through the use of shared services. The benefits of collaboration can include economies of scale and access to specialist skills, which can be particularly helpful for small, rural councils.

5.4 Incentives and accountability

Accountability mechanisms

Accountability describes the complementary checks and balances that exist in a system to incentivise the making and implementation of good decisions and to highlight weaknesses or failure.

Local authorities have responsibilities to a range of stakeholders, including local residents and businesses, the courts, central government institutions and ministers, and Parliament. Under the LGA and Resource Management Act 1991 (RMA), councils also have specific responsibilities to local iwi, including obligations to facilitate and support Māori participation in decision making.

The two main types of formal mechanisms available for communities to hold local authorities to account for their expenditure and funding decisions are:

- **Decision review** – judicial review and decision appeal rights.
- **Local democracy** – through local body elections, and the consultation requirements set out in the LGA.

The LTP and annual plan consultation processes are the main mechanisms for communities to express their views on council proposals for expenditure, and the associated funding and financing, including the implications for rates. Ultimately, councillors are held to account through the local election process. Underpinning the effectiveness of these formal accountability mechanisms are **transparency** (including reporting) and **effective participation** in democratic processes.

Decision review

The LGA provides the **power to object** to the assessed amount of a development contribution (s 199C), which must be reviewed by independent commissioners. Further, under the Rating Valuations Act 1998 ratepayers may object to the assessment of rateable value. The valuation is referred to a registered valuer for review (ss 33–34), and the Land Valuation Tribunal hears any objections to the review outcome.

Otherwise, apart from the RMA (which has relatively broad decision review and appeal rights), the options to review council planning and funding decisions are mostly limited to **judicial review**. The scope for judicial review is limited to matters such as failure to follow statutory procedures and processes, and the reasonableness of decisions – with a very high threshold for what can constitute “unreasonable”. Courts rarely intervene in political decision making, as overriding the decisions of elected representatives would risk undermining local democracy.

An **Ombudsman** can investigate decisions made by a committee or employee of a local authority, relating to matters of administration (s 13(1) of the Ombudsmen Act 1975). The **New Zealand Police** is responsible for investigating possible criminal offences and the **Serious Fraud Office** is responsible for investigating serious or complex fraud.

Legislation provides a spectrum of **options for central government to intervene** when there is a “significant problem” in relation to a local authority. “Problem” is defined broadly in the LGA and includes failure by the local authority to demonstrate prudent management of its finances. “Significant” is defined to mean that the problem will have actual or probable adverse consequences for residents and ratepayers.

The ministerial powers to intervene are set out in Part 10 of the LGA. They range from requesting information, to appointing a Ministerial body (Crown Observer, Crown Manager or Commissioners). Examples of how these powers have been used include the following.

- A Commissioner was appointed to Rodney District Council in 2000, to “re-build community trust in local democracy by providing an effective form of decision making and resolving the issues that led to the dysfunction” of the Council (Minister of Local Government (Hon. Sandra Lee), 2000).
- Commissioners were appointed to Environment Canterbury in 2010 to tackle problems with the council’s freshwater management.

- As discussed in Box 5.1, Commissioners were appointed to Kaipara District Council in 2012 following its management of a wastewater reticulation scheme. This was followed by the appointment of a Crown Observer to assist with transition and a Crown Manager to focus on the outstanding issues around rates litigation.
- In 2013, a Crown Manager was appointed to Christchurch City Council to tackle serious problems with the council's building consents performance, following the withdrawal of its International Accreditation New Zealand and Building Consent Authority accreditation.
- More recently, the Minister of Local Government requested information from Westland District Council, following a March 2019 report by the OAG into its procurement of work to construct a stopbank. The report found "numerous examples of poor decision-making and poor procurement practices", prompting the Department of Internal Affairs (DIA) to recommend Ministerial intervention (DIA, 2019f; OAG, 2019a, p. 5).

The LGA gives the Minister significant discretion as to when and how to intervene. There is no check on the exercise of that discretion by, for example, an independent agency. However, the Act requires that the intervention must ensure, as far as is practicable, that a local authority's existing organisational capacity is not diminished. As obliged by the Act, the Minister has published in the *New Zealand Gazette* a list of matters that will be relevant to the use of the intervention powers (Minister of Local Government (Hon. Nanaia Mahuta), 2018). That list identifies guiding principles that the Minister must consider when determining what action, if any, to take.

Oversight

No single agency is responsible for oversight of all the work of local authorities. This is consistent with the constitutional status of local government. However, a number of agencies have some role in scrutinising the activities and financial management of local authorities.

- **DIA** is responsible for administering the legislation governing local authorities, including providing policy advice to the Minister of Local Government and leading central government's relationship with local government.
- Some regulatory frameworks specifically provide that a local authority is accountable for its operational performance to the relevant minister or government department, directly or indirectly. For example, under the building regulatory framework, the **Minister for Building and Construction** has powers of intervention if the Minister believes that the territorial authority is not fulfilling its statutory functions (s 277 of the Building Act 2004). The Chief Executive of the **Ministry of Business, Innovation and Employment** also has powers to review the performance of local authorities in exercising their statutory functions and powers under the Building Act (ss 204 and 276 of the Building Act 2004). However, in the absence of explicit statutory recognition of a line of accountability, a local authority is not accountable to the relevant minister or department for the exercise of its statutory powers.
- A number of councils choose to apply for an **independent credit rating** or to be a member of the **LGFA**. Councils that do so are subject to scrutiny as part of their application. For example, the LGFA undertakes a credit analysis of councils who apply to be members. Any local authority that borrows from a bank will also be under scrutiny and will have to comply with its own banking covenants.
- The **OAG** is responsible for auditing all local authorities. LTPs must include a report from the Auditor-General, providing an opinion on whether the plan provides a reasonable basis for fulfilling its legislative purpose (as described in s 93(6) of the LGA) and whether the information and assumptions underlying the forecasts are reasonable (s 94 of the LGA). Similar requirements apply to LTP consultation documents. The LTP must also provide an opinion on whether the disclosures made are complete (to fulfil the requirements of the financial prudence regulations). The audit opinion neither guarantees the accuracy of the information nor takes a view on the merits of any policy content.

The Auditor-General also has the discretion to carry out other work, including performance audits to consider matters of effectiveness and efficiency, probity and waste; as well as inquiries into any other matter

concerning a public agency’s use of its resources. Examples of such inquiries include the 2013 inquiry into the Mangawhai wastewater scheme overseen by Kaipara District Council, and (as also mentioned above) a 2019 inquiry into the procurement of work by Westland District Council to construct a stopbank.

The OAG has undertaken reviews of councils’ LTP consultation documents (discussed below) and of councils’ approaches to managing infrastructure assets (OAG, 2014b). The OAG also issues guidance on matters such as governance and reporting.

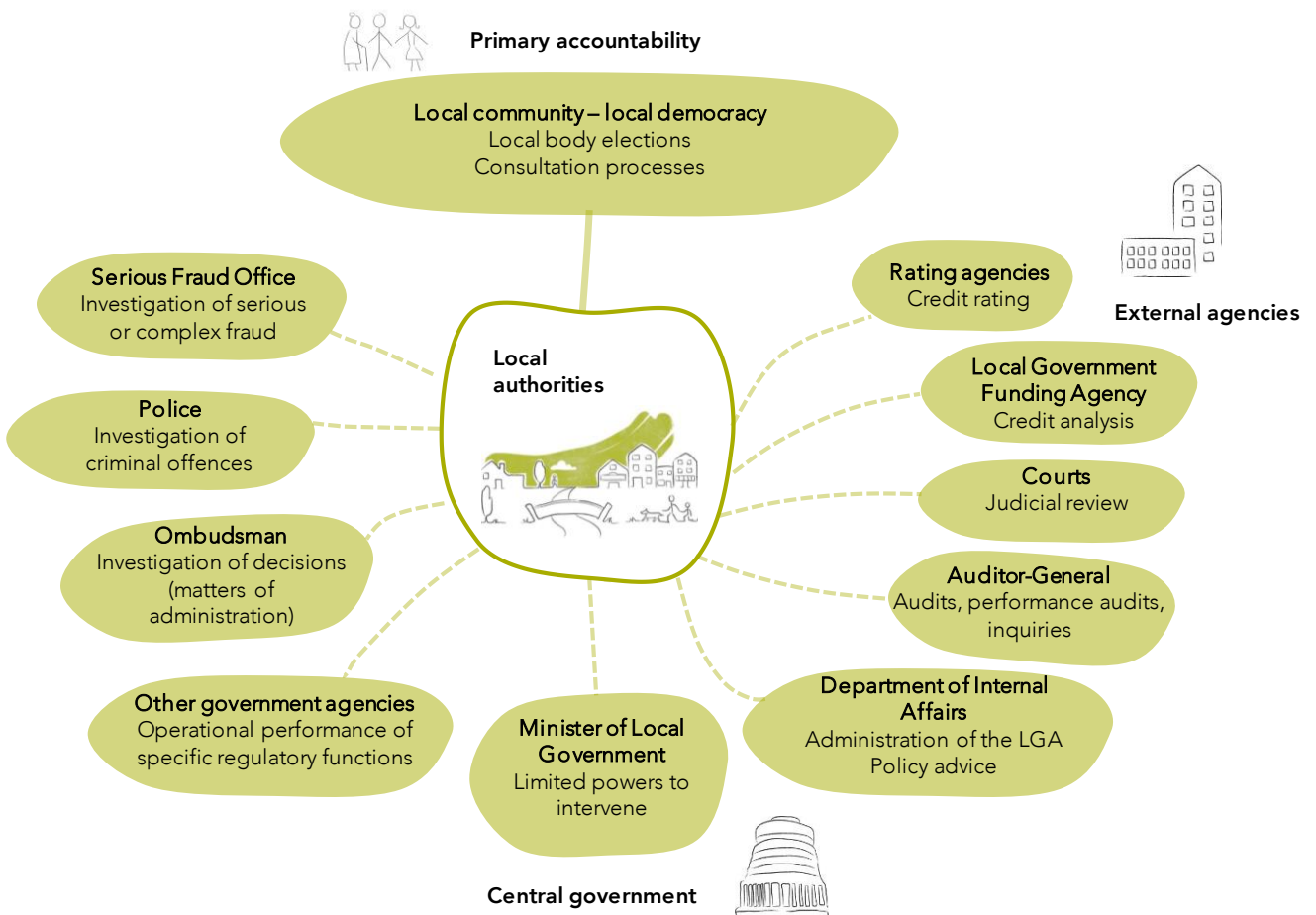
Appeal rights

The appeal rights in relation to councils’ rating and long-term planning decisions (primarily judicial review, and investigations by the Ombudsmen) are limited. Meridian’s submission made this point, raising the option of creating appeal rights in respect of LTPs (Meridian, sub. 73, p. 7).

Strengthening the appeal rights on decisions relating to councils’ long-term planning and rating decisions could help improve the incentives on councils to undertake good quality engagement and be transparent in their decision making. Yet it could also have drawbacks similar to those raised by submitters to the Commission’s *Housing affordability* inquiry. These include the potential to delay the adoption of LTPs (and therefore rating) and strengthen the voice of minority interests. And as noted earlier, the courts are generally reluctant to intervene in what are essentially political decisions – it would be a radical move to change this and would substantially undermine local government autonomy. For these reasons, and those outlined above, the Commission favours a transparency-based approach to improving the accountability of council decision making.

Figure 5-3, below, summarises the range of oversight and accountability mechanisms that apply to local authorities.

Figure 5-3 Local government oversight and accountability mechanisms



5.5 Transparency of decision making

The importance of transparency in local government

Transparency is important for enabling effective participatory democratic processes, and assisting communities to hold their local authorities to account for using devolved powers.

In the local government context, transparency is the process by which information is made available to the community about how council rates and charges are set, revenues spent, spending decisions made (including trade-offs), and value and outcomes delivered.

Public accountability enables citizens to see how their taxes and rates have been used. It should also provide an insight into what has been achieved by the public sector. Those responsible for governance need to be accountable for the decisions they make and the basis on which they are made. Their decision-making processes need to be legitimate and be seen to be so. (OAG, 2016, p. 6)

To meet its accountability purpose, information on options for council activities needs to be readily available and easily understood. The importance of transparency in local government is amplified because some of the key accountability mechanisms are weakened by lack of public understanding and participation.

- There is widespread public misunderstanding of how rates are set. Many people assume that increasing property values translates to increased rates. But, as explained in Chapter 2, this is not correct.
- More generally, the public lacks an understanding of local government roles and decision-making processes, and public participation in the consultation processes of local government is low. This is discussed further below.
- Councils are ultimately held to account via the election process. However, as discussed later in this chapter, public participation in local government elections is much lower than for general elections. Participation is also not representative of the wider community.

The combination of these factors makes it difficult for councils to assess the range of community preferences, and limits the extent to which they can view feedback from formal processes (such as submissions) as an accurate indicator of community sentiment. This suggests the accountability of local government relies highly on the transparency of local government's processes, decision making, and performance.

F5.4

The transparency of local government's processes, decision making and performance is the cornerstone of its accountability to local communities.

Measuring and reporting service delivery and financial performance

Local authorities in New Zealand are not currently subject to mandatory performance benchmarking. However, councils' annual reports must include an audited statement that compares service levels for groups of activities against the associated performance target or targets, explaining the reasons for any variation between the actual and intended level of service. Mandatory performance measures for service delivery from core infrastructure are specified in a rule made under section 261B of the LGA.

As described in Chapter 2, local authorities are required to report their financial performance against a set of benchmarks specified in the Local Government (Financial Reporting and Prudence) Regulations 2014. In addition, the LGA requires councils to set their own quantified limits on rates increases and borrowing as part of their Financial Strategy.

Voluntary performance assessment and benchmarking

While performance benchmarking is not mandatory, a number of councils participate in voluntary performance assessment or benchmarking initiatives, as part of their efforts to continually improve.

The CouncilMARK™ programme is a voluntary initiative that is part of LGNZ's Local Government Excellence Programme. It is designed to "improve the public's knowledge of the work councils are doing in their communities and to support individual councils to further improve the value they provide to all New Zealanders" (LGNZ, 2018a). The programme is intended to be part of a continuous improvement cycle, rather than a one-off assessment.

The programme includes an independent assessment system that is overseen by an independent assessment board and delivered by a small team of independent assessors. Assessors provide gradings against four priority areas as well as an overall grading, along with commentary and advice for improvement, in a published report. The four areas are:

- excellence in governance, leadership and strategy;
- excellence and transparency in financial decision making;
- excellence in service delivery and asset management; and
- strong engagement with the public and businesses.

The assessments consider the processes and capability a council has in place to deliver customer value, as well as the outcomes being achieved. Aspects assessed include, for example, infrastructure service performance, financial performance, customer satisfaction, and the effectiveness of stakeholder relationships (including with iwi).

The reports from the assessment are published online, providing transparency to the general public about the assessment and its results. However, it is not a benchmarking scheme and it is not designed to enable the public to compare council performance across quantitative metrics (eg, of efficiency).

At the time of writing, assessment reports had been published for 27 councils, with a further four due for release. Overall grades to date range from CCC (Wairoa District) to AA (Greater Wellington Regional and Waimakariri District) (the lowest available grade is C and the highest is AAA).

Some councils participate in voluntary benchmarking through the Australasian Local Government Performance Excellence Program. This Program is run by SOLGM's sister organisation Local Government Professionals Australia (LG Professionals, NSW). It carries out a yearly survey that collects, compares and benchmarks information from over 100 councils across Australia and New Zealand. Unlike CouncilMARK™, reports are confidential to each participating council, though councils may choose to distribute their own report. Aggregated results are available only to SOLGM and LG Professionals, NSW and to council survey participants. This initiative therefore does not primarily serve as an accountability mechanism, but rather as an organisational performance measurement and improvement tool.

Another voluntary benchmarking initiative is the National Performance Review (NPR), which has been conducted by Water New Zealand since 2008 (Water New Zealand is the principal industry organisation for water services in New Zealand). The NPR is a yearly review that collates performance metrics for drinking water, wastewater and stormwater service provision. Forty-six councils and two CCOs participated in the 2017-2018 review (Water New Zealand, 2019). In *Using land for housing*, the Commission recognised the NPR as good practice and recommended that LGNZ support it by encouraging all councils to participate and by working with councils to improve their data quality (NZPC, 2015, p. 266).

A number of councils also participate in other voluntary initiatives. For example:

- Waikato Regional Council submitted that in addition to the above two programmes, it undertakes benchmarking with Environment Canterbury and Bay of Plenty Regional Council about trends in human resource and financial metrics, and is a member of the Regional Human Resources Special Interest Group that gathers human resource metrics across regional and unitary authorities (Waikato Regional Council, sub. 125, p. 13).
- Queenstown Lakes District Council has adapted and used the Investor Confidence Rating (ICR) methodology, to inform improvements in its approach to investment management and improve

community confidence in its infrastructure management (Queenstown Lakes District Council, 2018, pp. 25, Vol. 2). The ICR is a tool that Treasury uses to assess the investment management performance of investment-intensive state sector agencies (The Treasury, n.d.).

Problems with the existing performance reporting framework

A number of submitters were of the view that the current accountability framework should be further strengthened, with some calling for greater monitoring and oversight of local authorities.

The current mix of rating and voting systems creates strong incentives for councils to push costs onto sectors that are poorly represented at the ballot box.... Central government has adopted institutions and frameworks which provide appropriate checks and balances against the powers vested in Government.... Local Government has none of these checks and balances. Some ongoing independent monitoring of the sector would provide impetus for performance improvement and enhance local government accountability. (Foodstuffs NZ, sub. 23, p. 4)

We need a robust audit and control body with real teeth and powers to rein in errant TLAs [Territorial Local Authorities] and keep them honest. This body would also listen to appeals from ratepayers who at present are brushed off by TLAs when they raise genuine concerns. (Stewart and Raewyn Webster, sub. DR143, p. 2)

A lot of communities or parts of communities have just given up on [local government] as a lost cause. This is possibly reflected by the low voter turnout at election time, but it is to some extent the result of the inability for anyone to hold local government elected members or staff accountable in any meaningful or timely manner. (Stuart Bell, sub. DR255, p. 3)

In its recent audits of the 2018–2028 LTPs, the OAG raised concerns about the effectiveness of the mandatory financial disclosures. An area of particular difficulty is the expression of the limits to rates increases, which differs across councils and can:

- exclude growth in the rating base;
- exclude both rating units and valuation movement impacts; or
- be restricted to reflecting increases in general rates rather than all rates.

In its submission, Federated Farmers of New Zealand expressed similar concern about the explanation and comparability of rating policies in LTP consultation processes.

As experienced submitters we are finding the coverage [in LTP consultation processes] of rating impacts, rating policy and sources of funding has declined in quality in recent years.... A re-vamp of the consultation provisions in the Local Government Act overall is needed to strengthen accountability and set requirements on transparency as to the allocation of rates to various property owner groups. (Federated Farmers of New Zealand, sub. 75, pp. 21-22)

The variation in approaches restricts both the transparency and comparability of this measure across councils.

The Commission engaged Professor Ian Ball (Public Sector Performance (NZ) Ltd) to provide an expert review of, and advice about, the financial and non-financial performance disclosure requirements on local authorities (Public Sector Performance (NZ) Ltd, 2019). Ball assessed the reporting regime against the statutory principles (as noted in section 0) and the following criteria:

- relevance to the needs of the report's users;
- quantity and complexity of reporting;
- consistency of reporting; and
- cost of reporting.

With respect to the first criterion, Ball distinguished between the information needs of two types of users:

- *owners*, who are interested in matters such as financial performance, efficiency of asset use and investment funding requirements; and
- *customers*, who are interested in information on outputs or services delivered, such as quantity, quality, and cost, as well as the outcomes to which the outputs contribute.

Ball found both gaps and overlaps in the reporting requirements from these two perspectives. For instance, the Funding Impact Statement (FIS) lacks needed information about the ownership perspective, while the service performance benchmarks lack information about the full cost of services.

In relation to the financial disclosure requirements (including the financial prudence benchmarks and the FIS), Ball concluded that these are not fit for purpose:

The present financial disclosure regime has certain elements which are excessively detailed, have an inappropriate focus, or are confusing in the context of the wider reporting framework. The FIS component of the disclosure regime suffers from all three of these limitations.

At the whole of council level, it is very difficult to see the presence of both the FIS and the Cash Flow Statement as anything other than highly confusing.

The disclosure regime in relation to groups of activities is somewhat incoherent, not being based on a recognition of the different perspectives of “performance” – “ownership” and “customer” – that would assist in structuring information requirements to better meet user needs. (Public Sector Performance (NZ) Ltd, 2019, p. 21)

In relation to the non-financial benchmarks, he queried the appropriateness of a number of the measures. For instance, some councils’ level of borrowing is so far below the debt servicing benchmark that reporting on this metric is of limited use to decision makers.

Ball advised that significantly improving and simplifying the reporting scheme is possible by having a single authoritative source for service performance reporting. This would include financial and non-financial information related to groups of activities, and would reflect the two perspectives on performance. Ball recommended that the local government performance reporting framework should undergo a fundamental, first principles review.

F5.5

The current performance-reporting requirements on local authorities, including the financial and non-financial information disclosures, are excessively detailed, inappropriately focused and not fit for purpose.

Improving the transparency of council performance

Successive reforms since 2002 have sought to improve transparency and accountability by using more plain English for financial reporting. They have also sought to use standardised financial reporting and non-financial performance measures to improve comparisons between councils.

The OAG recently reiterated its previous caution against further prescription of the disclosure requirements for financial strategies, as this “could lead the sector to address the requirements in a mechanistic way” (OAG, 2019b, p. 28). Similarly, the Local Government Think Tank²⁶ observed that

[t]he main developments since the Shand report have been additional fine tuning of council reporting and accountability requirements, often increasing the complexity and lack of transparency needed to build trust and understanding. (Local Government Think Tank, sub. 105, p. 3)

Based on this experience, and the advice from Professor Ball, the Commission is of the view that the local government performance reporting framework requires a fundamental review, with a mind to significantly simplifying the required disclosures and improving their overall coherence and fitness for purpose.

²⁶ The Local Government Think Tank is “a small group of councils seeking to understand and apply new approaches to the role and function of local government including innovation in how councils work with their communities” (sub. 105, p. 1).

The Porirua Economic Development Group (PEDG) submitted that a revised set of performance measures for local authorities should be provided in a standard reporting template (ideally within a simple document of three to five pages). PEDG also submitted that local authorities should be required to provide reporting data on a monthly basis to a monitoring body (such as an independent entity or Office of Parliament), which would publish relevant data, with the aim of enhancing public comparison of council performance. PEDG's submission included initial suggestions for a set of measures (PEDG, sub. DR161, Attachment Two).

The Commission is keen to avoid the perverse incentives created by the increasingly prescriptive reporting requirements imposed on local government to date. It agrees with the PEDG that the mandatory performance measures for local authorities should be simple and concise, focusing on a small number of key measures. The proposed review of the financial and non-financial disclosures should also inform the recommended streamlining of the LTP requirements discussed below.

To support greater transparency, the review should cover reporting of total rates revenue by category of rateable property (eg, residential, business and rural), to give effect to recommendation 7.9 (Chapter 7).

The review should also consider how to effect centralised publication of the mandatory performance measures for all local authorities, to assist greater public transparency and comparison of council performance. Questions around the frequency of publication, and which entity would be responsible for collating and publishing the data, would be matters for the review to determine. To minimise compliance costs on councils, the review should also consider the most cost-effective way for councils to provide the information (eg, using digital filing).

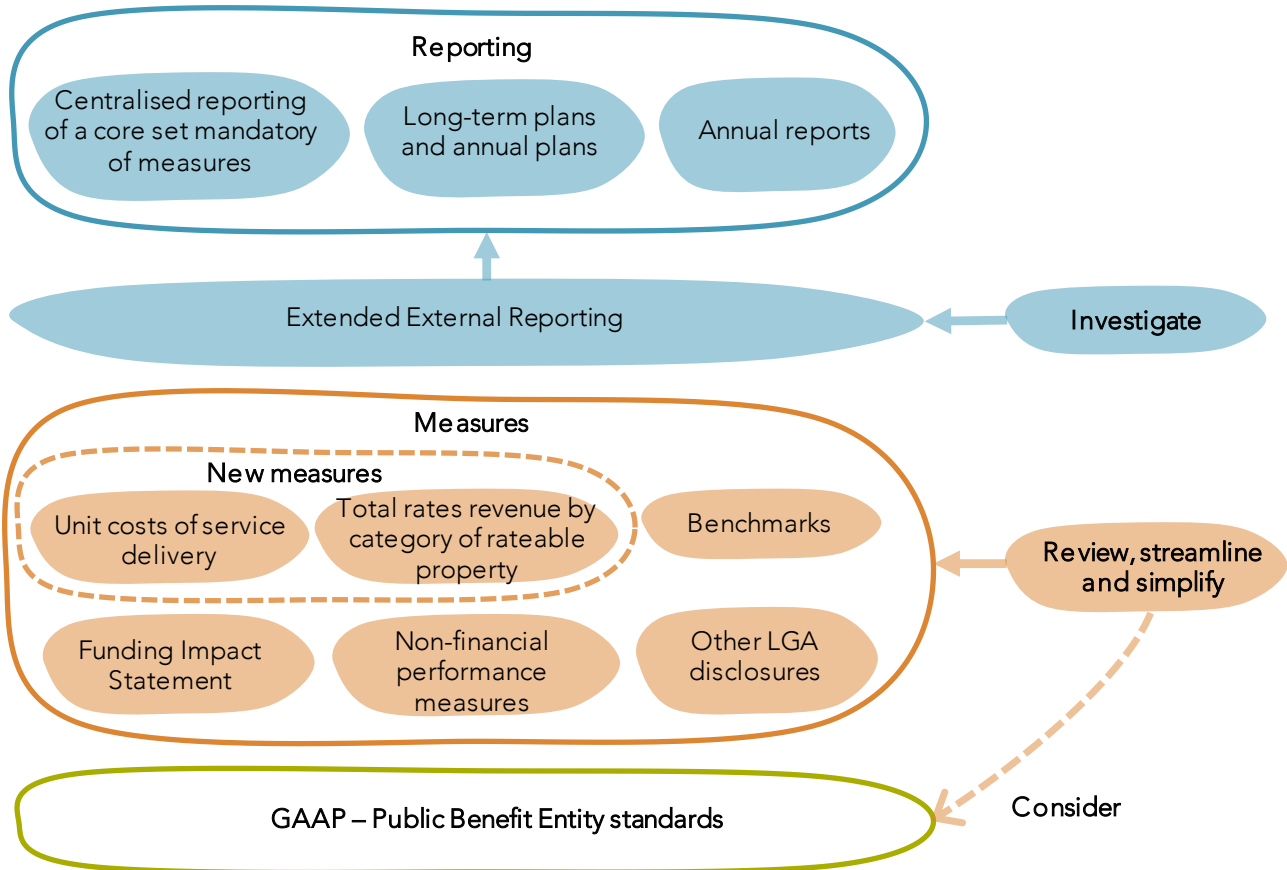
Ball suggested such a review should consider the potential for new forms of extended external reporting, including integrated reporting, to shape changes in the reporting framework. Integrated reporting is one of the developments taking place internationally in corporate reporting. It emphasises concise communication of the factors contributing to an organisation's value.

One of the advantages of integrated reporting is that it encourages organisations to use a very open framework to consider how best they can "tell their story", making for better communication and transparency. (Public Sector Performance (NZ) Ltd, 2019, pp. 37–38)

Such an approach would provide local authorities with flexibility to explain their local circumstances and reasons behind their results as shown in the mandatory measures, as well as highlight activities and outcomes of particular interest to their communities.

Figure 5-4, below, illustrates the intended scope of this proposed review. It includes reference to the requirements under generally accepted accounting practice (GAAP), including the Public Benefit Entity (PBE) financial reporting standards, as the purpose of the review is to develop a single, coherent framework. The set of measures to be reviewed and rebuilt includes the new measures of rates by category of rateable property (recommendation 7.9), as well as proposed new measures for the unit costs of service delivery discussed below (recommendation 5.7). The required reporting outputs include a core set of mandatory measures that would be provided to a central entity for collation and publication. They also include the requirements for annual reports, annual plans and LTPs, with those for LTPs feeding into the proposed review of LTP requirements (discussed below).

Figure 5-4 Local government’s performance reporting framework – scope of review



Given the growing participation in existing performance review and improvement programmes, the Commission does not see a case for creating new programmes or initiatives. The Commission therefore recommends building on the existing performance review and improvement mechanisms, such as CouncilMARK™ and industry-run benchmarking programmes. With respect to CouncilMARK™, the Commission notes the assessment framework is continuing to evolve. As with any such initiative, it should be subject to ongoing monitoring and independent evaluation, of both the framework and the independent review processes.

The Commission favours a voluntary approach to increasing participation, to help ensure that councils participate because they see value in performance review, and focus on learning for continuous improvement, rather than taking a compliance-based approach.

F5.6 Successive legislative reforms aimed at increasing the transparency of council performance through prescriptive reporting requirements have been counterproductive. The performance reporting framework of local government requires fundamental review, with a mind to significantly simplifying the required disclosures, and improving their overall coherence and fitness for purpose.

R5.4

The performance reporting framework of local government (including the financial disclosures, Funding Impact Statement and performance measures) should undergo a fundamental, first principles review. This review would:

- identify financial disclosures of low value to users of financial statements;
- examine the mix of financial and non-financial disclosures, and recommend a revised framework that provides the most efficient, coherent and accessible way of reporting the range of information sought by users, whether in relation to financial performance or service delivery performance;
- consider the interaction between the financial reporting requirements under generally accepted accounting practice (GAAP) and other requirements under local government legislation and regulation;
- develop new measures for rates by category of rateable property (recommendation 7.10) and the unit costs of service delivery (Recommendation 5.7);
- consider the potential for new forms of extended external reporting, such as integrated reporting, to shape changes in the reporting framework;
- ensure that the conclusions of the review are appropriately taken into account in the proposed review of the legislative requirements for Long-Term Plans (recommendation 5.5);
- determine how to best implement centralised publication of a set of mandatory disclosures across all councils, to support greater accessibility, transparency and comparability (eg, by using digital filing); and
- be undertaken by a working group including the Department of Internal Affairs, the External Reporting Board and representatives of the local government sector and information users. The Office of the Auditor-General would be consulted.

Box 5.4 **Local government reporting on community wellbeing outcomes**

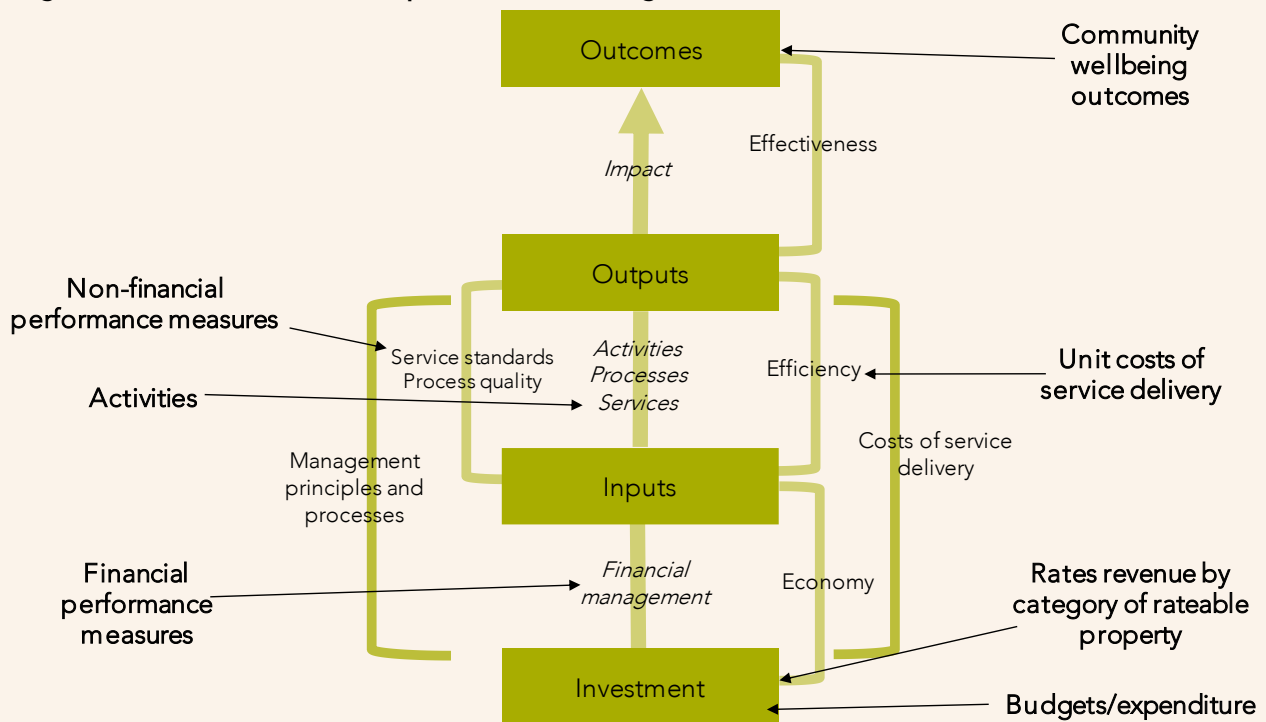
As explained in Chapter 4, recent changes to the LGA have restored the promotion of the four wellbeings (social, economic, environmental and cultural wellbeing) to the statutory purpose of local government. LTPs must, to the extent the local authority determines is appropriate, describe the community outcomes for the district or region, identify how groups of council activities contribute to community outcomes, and identify any significant negative impact an activity would have on wellbeing. Annual reports must report on the results of any measurement undertaken of progress towards achieving those outcomes; and describe any identified effects that activities have on community wellbeing (Schedule 10 of the LGA).

Consistent with good practice, outcomes reporting should focus on a small number of meaningful metrics that meet well-established criteria for good indicators. An important consideration is the cost-benefit of gathering and analysing the data (measures that are so expensive to generate they do not provide a net benefit should not be pursued).

Another consideration is the overall coherence of the reporting framework. Reporting measures should strategically align – linking the inputs, outputs, outcomes and costs for each activity (or group of activities). They should also not duplicate across these dimensions. Figure 5.5 (below) illustrates how the revised reporting framework for local government would map to the outcome-based performance management model presented by the OAG in their 2011 advice for central government agencies on annual reports.

The Commission does not envisage that the review of the reporting framework would generate mandatory requirements for outcomes reporting. Local authorities should continue to determine the outcomes that are most relevant and important for their community, based on local preferences and circumstances, and use these to drive prioritisation of their activities. Outcomes-reporting should be sufficiently flexible as to allow councils to tell their performance story in a way that is relevant and meaningful to their communities as well as their management and decision-making stakeholders. Central government could assist by providing guidance on developing robust wellbeing metrics, and supporting the use of consistent data sources (both across councils, and between central and local government), where appropriate.

Figure 5-5 Outcomes-based performance management model



Adapted from: OAG (2011, p. 14).

5.6 Ascertaining and balancing community preferences

Consultation requirements

Both the RMA and LGA place a heavy weight on public consultation (NZPC, 2015). Krupp (2016) underscored the importance of transparency and good quality information in local government consultation processes.

If the level of local government accountability is to be meaningfully improved, communities need to know what options are available to them, the trade-offs associated with each, and the consequences of their choices. (J. Krupp, 2016, p. 45)

The LGA imposes general obligations on councils to consider the views of all their communities, reflecting the RMA's goal of promoting "the accountability of local authorities to their communities" (s 3(c)). Section 78 of the LGA requires councils to consider the views and preferences of people likely to be affected by, or to have an interest in, the decisions being made. Guidance published by the DIA explains that full consultative and analytical processes are only expected for significant decisions. These decisions are defined as being highly important to community wellbeing, or to the people likely to be affected by a decision; or that affect the ability of the council to perform its role and the costs of doing so (DIA, 2011).

Each council must develop their own **significance and engagement policy**. That policy sets out the council's approach to determining significance and includes a list of assets that it considers are of strategic

importance. The purpose of that policy is to provide the community with clarity about when and how the community can expect to be engaged in decisions on particular matters. Councils are required to consult on certain matters regardless of their significance policy. These include the LTP and the annual plan, and adopting or amending funding and financial policies.

Consultation on decisions must follow statutory principles (s 82), provide opportunities for Māori to contribute to decision-making processes (s 14) and establish and maintain processes for Māori to contribute to decision making (s 81(1)(a)).

The LGA lays down particular requirements for consultation on LTPs, including the preparation of a public **consultation document**. Section 93B explains the purpose of this document.

The purpose of the consultation document is to provide an effective basis for public participation in local authority decision-making processes relating to the content of a long-term plan by—

- a) providing a fair representation of the matters that are proposed for inclusion in the long-term plan, and presenting these in a way that—
 - i. explains the overall objectives of the proposals, and how rates, debt, and levels of service might be affected; and
 - ii. can be readily understood by interested or affected people; and
- b) identifying and explaining to the people of the district or region, significant and other important issues and choices facing the local authority and district or region, and the consequences of those choices; and
- c) informing discussions between the local authority and its communities about the matters in paragraphs (a) and (b).

Section 93C explains the required content, which includes, for each of the key issues identified:

- the principal options for addressing the issue;
- the financial and non-financial implications of each of these options;
- the local authority's proposal for addressing the issue (ie, preferred option), if it has one; and
- the likely consequences of proceeding with the proposal on rates, debt and level of service.

With respect to the consultation document for the annual plan, this must identify "significant or material differences between the proposed annual plan and the content of the long-term plan" (s 95A).

The requirement for councils to prepare a consultation document before adopting their LTP was introduced in 2014. As LTPs are prepared every three years, consultation documents have so far been prepared in 2015 and 2018. The OAG has published reviews of its observations on the two tranches of consultation documents prepared to date. While both reviews found examples of good practice, they also identified room for improvement. For example, the 2015 review found that many councils missed an opportunity for effective engagement. Shortcomings in consultation documents included poor discussion of the infrastructure and financial strategies, and poorly drafted consultation questions (OAG, 2015a, p. 4).

The OAG's 2018 review reiterated many of the findings of its first review. It also found that information about funding and financial strategies, including the council's approach to debt and the rates implications for an individual ratepayer, was often difficult to understand or even find in the documents (OAG, 2018b, p. 11). The report reviewed the types of issues presented for consultation. The most common issues related to "community facilities", with most of these concerned with proposals to enhance existing amenities. Funding and rating issues mostly related to affordability.

Box 5.5 Concerns with the consultation processes for LTPs

The Commission received a number of submissions, particularly from business organisations, that expressed similar concerns with councils' consultation processes, including the presentation of alternative options, the framing of consultation questions and the quality of supporting information.

Our experience across New Zealand also shows that consultation by local authorities has become a simplistic tick box exercise. (Millennium & Copthorne Hotels New Zealand Ltd, sub. 26, p. 7)

The surveys and consultation processes are set-up in such a way as to provide a pre-determined outcome.... The LTP process is just a rubber stamp. (The Employers and Manufacturers Association, sub. 94, p. 5)

[I]n most cases the LTP process arrives at a foregone conclusion, there being little time for robust debate either orally or through the formal submission processes. In BusinessNZ's experience, it is very much a rubber stamp process with marginal tweaks here and there and therefore likely to deter groups from spending time and effort making submissions. (BusinessNZ, sub. 54, p. 19)

Public consultation processes do not always present all the relevant information on which to base an objective decision. (Foodstuffs NZ, sub. 23, p. 4)

Trade-offs are not clearly articulated, and counterfactual scenarios are not laid out for stakeholders to consider. (Wellington Chamber of Commerce and Business Central, sub. 72, p. 7)

Too often Councils do not support resource decisions with competent assessments of their net benefits to affected members of the community.... Nor do current complex consultation processes adequately facilitate community oversight of public expenses. (The New Zealand Initiative, sub. 96, p. 17)

The public consultation component of the Ten Year Plan is a very expensive waste of time. The documents are large, technical, and poorly written. The financial information is presented in a nonintuitive way. Even after years of helping construct these plans I cannot pick up a random TYP and understand what is going on financially in an activity. And, in fact, councils don't use them internally. They are effectively a document produced purely for compliance reasons. (Donald Ellis, sub. 89, p. 11)

Facilitating effective community engagement

Some councils submitted that greater flexibility in statute would help councils achieve meaningful and more representative community participation in long-term planning.

We agree participation in Annual/Long Term planning processes can be low and lack representation from all sectors of society. We consider more flexibility in these processes is required, which would enable councils to design the consultation (and supporting documents) to be fit for local circumstances. (Northland Regional Council, sub. 32, p. 9)

There is no one right answer to how councils can better interact and connect with their communities through the LTP process. The issues facing councils are varied because their geography, infrastructure, natural and physical resources, growth profiles and communities of interest are very different. This diversity of environmental, social, economic and cultural context means councils need legislative flexibility that promotes innovative and creative approaches to achieve meaningful connection and engagement with their communities through the LTP process. (Palmerston North City Council, sub. 124, p. 4)

While the purpose and content of LTP consultation documents is specified in legislation, its form and manner are not. Further, councils face no legislative impediment to undertaking a wide variety of additional engagement techniques and tools, such as pop-up Q&A shops/drop-in sessions, community barbecues, roadshows, hui at local marae, interacting via social media, and other web-based tools (such as apps and surveys), and indeed many do use such engagement tools. As Hurunui District Council submitted:

Engaging with the community is important and in the Hurunui District we have pre engagement sessions with the community ahead of preparing budgets. Whilst this requires a significant increase in preparatory work it results in better engagement through the LTP process (Hurunui District Council, sub. 110, p. 8)

Examples of good practice consultation documents and engagement techniques also exist. The OAG's 2018 review of consultation documents highlighted those from Hauraki, Waimate, Gisborne and Horowhenua District Councils as particularly effective, in terms of their use of plain English and presentation style. They also observed a number of other councils using a variety of approaches (in addition to the formal consultation document), to help make the process more accessible and improve community participation in the LTP process. These included using videos, online rates calculators, informal meetings, and advertising campaigns to raise awareness and encourage feedback.

In addition, pre-engagement processes, including the questions asked, are not constrained, and some councils are undertaking innovative and open-ended engagement before preparing their consultation document.

Horowhenua District Council elected to prepare a 20-year LTP (rather than the required minimum of 10 years) in light of expected strong future growth in the district. The pre-engagement process for this involved seeking community feedback on the desired future focus. Mayor Michael Feyen explained that "[b]efore the plan can be written, we first need to find out from everyone what is important to them, what should be included in the plan, and if our vision is right or needs altering" (Horowhenua District Council, 2017).

Horowhenua District Council's pre-engagement saw 2 680 people engage in various ways, including sending in postcards, completing surveys, attending meetings, interacting via social media, talking to council staff and elected members, and playing the "LTP Priorities Game" (Horowhenua District Council, 2018).

Gisborne's early engagement campaign – "WTF Tairāwhiti" (What's the Future Tairāwhiti) involved a roadshow of 35 events including hui at a local marae, an interactive website, bilingual radio advertising, digital and newspaper advertising and social media. The campaign won the Excellence in Public Sector Engagement category of the Deloitte IPANZ Public Sector Excellence Awards 2018 and was also a finalist in the 2018 LGNZ EXCELLENCE Award for Community Engagement. LGNZ reported the feedback from the judges for their award.



Judges praised the project for its innovative, edgy engagement, widening the participation from different communities and demographics, including youth and Māori.

Judges said 'This project showed innovative, edgy engagement for consultation of the Council's Long Term Plan reaching new community segments. The project widened the participation from different communities and demographics, including youth and Māori, resulting in increased face to face engagement by 700 per cent'. (LGNZ, 2018c)

While attracting face-to-face interactions, alternative engagement techniques do not necessarily translate into formal written submissions. For example, while the Tairāwhiti campaign engaged with around 2 800 people, the council received 347 formal submissions on its LTP consultation document, compared to 308 for the previous LTP (an increase of 13%). This is not surprising, given that the campaign aimed to garner feedback from a wider range of people than typically engage in formal consultation processes. In addition, guidance from SOLGM explains that

[c]hanges to the special consultative procedure have deemphasised the formal reliance on a "written submission and hearing" approach to engagement. In particular, written submissions are no longer the only means for making feedback....

Your local authority cannot rely solely on written comments or submissions. The practical implication is that thought must be given to engagement method or methods, and the practicalities of engaging in those ways, at an early point in the process. (SOLGM, 2016b, pp. 24–25)

It is therefore important that community feedback from all engagement methods is incorporated into the decision-making process (eg, included in the summary material presented to councillors for their LTP deliberations).

Box 5.6 A wide range of community engagement techniques

In addition to traditional consultation methods, local authorities can use a wide range of other techniques to elicit the views of their communities and gain their input into decision making.

- **Polling and surveys** canvass views on issues. Under the Local Electoral Act 2001, a local authority can hold **referenda** (a type of polling) on any of its existing or potential services, policies or proposals (s 9). Various New Zealand councils have held local referenda on issues such as water fluoridation and the development of recreational facilities. Whanganui District Council ran yearly referenda from 2005 to 2010 on the options for rates increases, and the associated spending implications, to inform the LTP process (LGNZ, 2019b).
- **Citizen juries** involve a randomly selected and demographically balanced group of citizens meeting over several days to provide structured deliberation on a specific issue. Members are presented with impartial background information and expert speakers, and participate in facilitated discussions and voting to arrive at recommendations (Jefferson Centre, 2019).
- Other ways of debating specific issues include “town hall” meetings, and online and in person debates and discussion forums (Department of Prime Minister and Cabinet, 2017).
- **Public participation** involves the public helping to design and develop policies and services. Methods include co-design/human-centred design (where end users are directly involved in the design of services), and participatory budgeting (a process in which citizens are directly involved in deciding how to spend public money). Participatory techniques have been used in the Christchurch recovery and regeneration programme. From 2011 to 2016 the Christchurch Community Forum provided advice to the Canterbury Earthquake Recovery Authority and the Minister for Canterbury Earthquake recovery. Since then, Regenerate Christchurch has provided advice to Christchurch City Council and the Minister supporting Greater Christchurch Regeneration. It has used methods ranging from traditional consultation techniques, to “design jams” (Department of Prime Minister and Cabinet, 2017).

The benefits of more participatory methods of community engagement can include more effective design of services (through accessing local resident/user knowledge), more representative engagement and better buy-in to decisions. Participatory budgeting techniques have been shown to also increase citizen understanding of, and confidence and engagement in, local political processes (Williams, St. Denny, & Bristow, 2017). However, participatory methods can require significant time input from community participants, which may militate against representative participation.

The Commission’s assessment is that local authorities are not unduly constrained by the legislative requirements surrounding LTP consultation documents and engagement processes. The problems that submitters raised focus more on how councils are implementing the requirements. In relation to this, and to submitters’ concerns about the quality of information on the impacts of the identified options, the Commission notes that SOLGM offers guidance on this matter, which includes examples of good practice (SOLGM, 2016b).

Good examples observed by the Commission provide information on the implications for rates and service levels of the identified options, presented simply and at a high level. Including this information has the following advantages.

- Information on the service levels associated with the identified main options will help the community understand the marginal benefits they offer, compared to the preferred option. (Service levels could relate to changes in capacity, quality or some other dimension).
- Information on the financial implications of options will help people assess their willingness to pay for different options. The community’s demands for activities may change when confronted with the costs of

their choices – for example, they may prefer to accept the lower levels of service of a cheaper option. This in turn could assist councils in their prioritisation process.

F5.7

While the purpose and content of the consultation documents for Long-Term Plans are prescribed in legislation, the form and manner of engagement are not. Councils are free to undertake early engagement to ask open-ended questions, and use a wide range of techniques tailored to their local communities. Some councils are doing this effectively.

Balancing preferences and making trade-offs

The public has longstanding concerns about the level of rigour and transparency around how councils consider community views when planning and making decisions. In its 1998 report on public consultation and decision making by local government, the OAG found a common perception that consultation processes are a “sham”. It cited concerns that councils are unwilling to listen, do not provide feedback about final decisions, have vested interests and avoid making decisions. It also reported concerns expressed by both councils and the public that particular interest groups can dominate or capture public consultation processes, leading to a reluctance to voice opinions and the “squeaky wheel syndrome” (The Controller and Auditor-General, 1998, p. 9). This was echoed in the 2007 report of the Shand Review, which found that “those who make submissions or participate in other consultative processes often feel that their views are ignored” as they do not receive meaningful feedback about their input (Shand Report, 2007, p. 247).

The OAG’s 2018 review of consultation documents noted the challenge for councils in giving due consideration to all community feedback, received from different parts of the community and via different approaches. The report states that “[c]ouncils have processes to ensure that elected members are aware of the channels through which feedback has been provided and this information assists elected members to evaluate the relative weight of community opinion” (p. 23). However, it acknowledges concerns raised by Grey Power Auckland that “it can be difficult for the community to understand the value placed on their feedback by the elected members during their deliberations” (p. 23).

Lack of transparency around the consideration and weighting of community views was again a common theme in submissions to this inquiry. Hospitality New Zealand submitted:

On occasion our members have felt that genuine consultation was not undertaken but rather council appeared to be paying lip-service to any consultation.

Once the consultation process was completed, in many instances it was not evident from subsequent documents produced by councils as to whether points in the submissions made had even been actually, or fairly, considered.

In our view, the Long-Term planning process needs to be made easy for the average person to understand.... Councils should undertake proper consultation with those who will be affected by their decisions and be transparent in their decision-making. (Hospitality New Zealand, sub. 78, pp. 11-12)

Grey Power New Zealand Federation Inc. submitted:

The current LTP process is opaque so far as most citizens are concerned. It is also largely a ‘mock consultation’ since the ability of either public submission or councillor opinion to effect more than minor changes is very limited. Attempts to improve citizen engagement by singling out specific items of expenditure together with costs and rating implications, whilst welcome, often merely diverts attention to projects several orders of magnitude smaller in cost terms than the business as usual expenditure and financing associated with major infrastructure. (Grey Power New Zealand Federation Inc., sub. 113, p. 4)

And D. Hewison submitted that

[the LTP and annual plan consultation processes are] better described as an opportunity with little likelihood of elected members listening with an open mind... My experience is that the dominant elected members will just ignore what has been said and do what they want to do with no accountability. (D. Hewison, sub. DR163, p. 12)

The Commission also heard concerns from business that submissions to council from peak bodies and umbrella agencies are given the same weight as submissions from individuals. Submissions from peak

bodies represent numerous entities and may relate to systemic issues, whereas submissions from individuals may be about very localised matters (such as suburban amenities).

These concerns reflect the incentives on councils as a sole supplier of many local services, including essential infrastructure such as the three waters and roading. A key difference between a situation with multiple suppliers and a single supplier is the power of customer choice. In the absence of customer choice, the voice of local residents and businesses are an important feedback mechanism about preferences.

A problem with relying on voice is that it favours groups of well-educated, middle-class people and their interests at the expense of groups of people who are not as well-educated or on lower incomes. In contrast, with choice, all customers are valued²⁷ (competing suppliers want to attract and retain customers). This bias in voice is reflected in the demographics of those who participate in local democratic processes (discussed below).

Table 5.1 compares the different impacts that customer choice and customer voice have on supplier incentives. For example, the concerns around the weighting of submissions reflect the discretion of councils in how they aggregate views from across their local communities.

Table 5.1 The disciplining power of choice over voice

Customer choice	Customer voice
Consumers have no reason to misrepresent their views in the hope of private advantage	Consumers may have incentives to misrepresent their views (called “gaming”), and their responses can depend on how survey questions are framed
The intensity of customer views is revealed	Difficult to truthfully measure intensity of customer views
Views are easily aggregated as they show up in the form of “lost business”, and are measured financially	Often multiple options exist for aggregating views that, in turn, produce different headline results
Accounting processes automatically record and report customer choices to decision makers	Bespoke processes are often adopted for recording and reporting feedback; the timing and veracity of reports to decision makers can be manipulated
Significant financial consequences tend to attract the attention of senior managers and boards	The implications for customer value are inferred and not explicit. This makes it easier for boards and senior managers to defer action as the financial position of their firm is not greatly affected
The financial consequences of customer choice often provide a helpful counterfactual for building a business case for taking costly action	Management finds it hard to motivate a business case for action. The costs of action are highly visible, but the benefits are largely intangible to the firm

Source: CSA (2019).

The Commission reviewed a sample of minutes from LTP deliberations and found wide variation in how the nature of debate was formally recorded. The minutes of some councils’ deliberations on their LTP detailed the issues raised (and by whom); others only recorded the final decisions, and sometimes voting patterns. Where the discussion was recorded, this showed that councillors are very aware of the impact of their spending decisions on total (average) rates increases and of the need to be fiscally prudent. However, the recorded discussion also showed a focus on incremental spending proposals (typically charismatic, discretionary projects), and a lack of explicit policy rationale around individual projects.

Minutes from LTP deliberations also showed that it was often unclear how feedback from submitters was weighted in the decision making. Discussion of the impact of funding and rating decisions on the various financial prudence benchmarks (against which councils must report) was minimal. Debate mostly focused on the level of rates increases that councillors thought the community would tolerate. This is consistent with the findings of the Shand review, and with feedback received by the Commission through submissions and

²⁷ Some exceptions do exist, such as customers with bad debts or who pay late.

engagement meetings for this inquiry. It suggests that political economy is a primary discipline on setting rates. Indeed, Manawatu District Council submitted that

[o]ne of the traditional methods of seeking election is to propose lower rates and one of the most reliable means of staying elected is keeping rates down... This pressure can even extend to Council officers, whose jobs may be under threat from current or aspiring politicians if rates rise too much. (Manawatu District Council, sub. DR170, p. 1)

Councils that successfully balance preferences and achieve community buy-in to decisions and trade-offs do so in a variety of ways. The Commission heard through its engagement meetings and case studies that communities tend to accept targeted rates well because of their transparency (ie, appearing as separate line items in rates invoices). Early engagement, and engagement that links options to their costs and funding implications, can assist community conversations about priorities and trade-offs. In engagement meetings, one council told the Commission that having a clear fiscal envelope helps them say “no” to some discretionary funding proposals. Another council explained that having a clear strategic vision and set of priorities assists them when selecting and staging investments.

CouncilMARK™ assessments have identified some examples of good practice in eliciting and balancing community preferences, including those below.

- Upper Hutt City Council has invested heavily in understanding the needs and preferences of the community. The council received strong community engagement about its LTP and has produced a “realistic” plan.
- The survey that Central Hawke’s Bay District Council sent to its residents was identified as providing a comprehensive representation of community preferences, which the council has analysed and prioritised.
- Ruapehu District Council sought community input on major infrastructure issues at an early stage, allowing better informed and prioritised decision making. The review identified that the council communicates well with its community about the trade-offs between expenditure and environmental impact; and around agreeing on service levels.

While there are examples of well documented and transparent decision processes (such as comprehensive minutes that record the detail of debate, as well as feedback to the community), the level of documentation and transparency is not even across the sector.

F5.8

There is scope for councils to be more transparent about how they have considered and balanced the range of community views in their decision making.

Box 5.7 The Local Government Official Information and Meetings Act 1987

The purpose of the Local Government Official Information and Meetings Act 1987 (LGOIMA) is to make information held by local authorities more available and to promote the open and public transaction of business at meetings. The aim is to:

- enable more effective public participation in the actions and decisions of local authorities; and
- ensure people can hold local authority members and officials to account for their decisions (s 4).

Anyone can request information from a local authority. Their request does not need to be in writing and they do not need to cite the LGOIMA. Councils must respond to requests for information within 20 working days. If a council refuses a request, they must provide the requestor with the reason for refusal and inform them of their right to seek a review of this decision from the Ombudsman.

Some submitters raised concerns with councils' responses to requests for information (subs. 35, DR150, DR163, DR217). The number of LGOIMA complaints received by the Ombudsman each year has varied between 240 and 400 over the last 10 years, with 299 received in 2017–18 (Office of the Ombudsman, 2018). These include complaints about the timeliness of response, the adequacy or completeness of information provided, and refusals.

The Chief Ombudsman's role includes monitoring the official information practices, resources and systems of agencies. Since 2015, he has investigated and reported on compliance in a number of central government agencies. In 2019, he initiated a targeted investigation into the LGOIMA practices of local government. This involved investigations of a sample of councils. Reports for five councils have been published.²⁸

The investigation reports show mixed practices across these five councils. Some have a strong culture of transparency, and most perform well on timeliness of responses. However, areas where practices are more variable include the adequacy of LGOIMA policies and guidance, staff training, record-keeping and information management. Some councils found it difficult to deal with requests for information from elected members – which are subject to the LGOIMA in the same way as anyone else. Other councils found managing the politics around official information difficult. This includes dealing with the release of information on controversial topics or political matters, and ensuring elected members do not have a role in LGOIMA decisions (which rest with the Chief Executive or their delegate) (Office of the Ombudsman, 2019).

5.7 Strategic planning and prioritisation

Concerns about the required content of Long-Term Plans

A primary purpose of the LTP is to provide “integrated decision-making and coordination across the resources of the local authority” (s 93(6)(c) of the LGA). Another purpose is to “describe the community outcomes of the local authority's district or region” (s 93(6)(b)). The second purpose was merged into the LTP in the 2010 reforms, having previously been a separate required process. Part of the intent of this and other legislative changes was to give LTPs a more strategic focus; to focus on the community outcomes sought by the council, and provide clearer links between these outcomes and how the council proposes to achieve and pay for them (Minister of Local Government (Hon. Rodney Hide), 2010).

In its recent audits of the 2018–2028 LTPs, the OAG raised concerns about the content of LTPs.

LTPs, and the strategies they contain, remain long and complex. It is timely for the Department of Internal Affairs and the local government sector to discuss and review the required content for LTPs to ensure that they remain fit for purpose as planning and accountability documents. (OAG, 2019b, p. 5)

²⁸ A sixth report, for Christchurch City Council, was published after this report content was finalised, and has not been reflected in this box story.

Particularly, we recommend that any review consider whether all the content required for LTPs is actually needed, such as some of the mandatory disclosures in the financial strategies and the duplication in the Act in the area of assumptions. (p. 9)

The OAG noted that they have “not yet seen a financial strategy that we consider to be an overall good example” (p. 29). They challenged councils to “present a financial strategy in a clear and concise way, in no more than five pages”, in their next LTPs (p. 29).

Level of prescription contributing to the expense of long-term planning

LTPs cover a rolling ten-year period, and are required to be reviewed every three years. A strong theme from submissions, case studies and the Commission’s engagement with the sector was that the LTP review process is time-consuming, expensive and resource-intensive. Yet some councils do consider the process valuable.

The long term plan process provides a thorough decision-making process for councils to work through to identify what cost pressures it is facing, how it will manage them and keep council services affordable.... It enabled our Council to have a clear conversation with our communities about the trade-offs between costs and services and the results of this have been a clear directive to the subsequent annual planning process, as legislation intended. (Hauraki District Council, sub. 43, p. 13)

Overall, the Long Term plan is a good process to address the issues and to have a strategic look at what has happened in the previous three years and the following three years as well as looking forward to the next ten years. (Hurunui District Council, sub. 110, p. 7)

However, many feel it is inefficient and ineffective, with the level of prescription acting to constrain effectiveness.

The long term plan consultation process every three years creates a huge expense in both time and money. Council has to ask the community about every decision we make. Very prescriptive compliance removes our ability to be flexible. (Manawatu District Council, sub. 57, p. 10)

Consultation Documents on Long Term Plans are generally effective, but the legislative constraint around limiting content to consultation matters makes it harder for local authorities to provide a coherent explanation of their plans to their communities.... Flexibility of content to reflect local issues, local language, and local personalities would help engagement. (Selwyn District Council, sub. 84, pp. 2-3)

The LTP process is long and tortuous, and should be reviewed for effectiveness. Small local authorities struggle to resource the LTP and it does take valuable resource away from day to day business. Our LTP costs in the order of 2% of our rates to prepare and have audited, and that is without the internal staff costs. (South Wairarapa District Council, sub. 104, p. 6)

Several councils submitted on the associated cost of audits (of LTP consultation documents, annual reports and LTPs), which they consider are excessive (Mackenzie District Council, sub. 27; Ashburton District Council, sub. 92; Hurunui District Council, sub. 110; Tauranga City Council, sub. 119; and Ōpōtiki District Council, sub. 126).

Scope to streamline the required content

Successive reforms to the LTP requirements have sought to streamline the planning process. For example, legislative changes in 2010 aimed to simplify LTPs and reduce compliance costs for councils (Minister of Local Government (Hon. Rodney Hide), 2010).

The Commission reviewed a sample of LTPs and found them to be very long and detailed, with much duplicate information. The duplication in LTPs is partly a feature of the current legislated requirements, which are disjointed and still require a level of detail that works against the strategic intent of LTPs.

The Commission sees scope to further streamline the required content, to help reduce duplication and therefore the length of LTPs, and encourage a more integrated approach. This could present a problem for councils who choose to publish components of the LTP separately as self-contained documents (such as the Financial Strategy, Infrastructure Strategy and so on). One option is for councils to have greater flexibility in how they present the required content in their LTP. This would be consistent with recent developments in

Extended External Reporting, which the Commission recommends is considered as part of a fundamental review of the performance reporting requirements on local authorities (recommendation 5.4).

F5.9

Long-Term Plans (LTPs) are long, complex and contain duplication. This is partly a function of the legislative requirements, which are disjointed and require an unnecessary level of detail. This works against the strategic intent of LTPs.

R5.5

The Local Government Act 2002 should be revised to clarify, streamline and reduce the required content of Long-Term Plans so as to avoid duplication, ease the compliance costs on councils, and help make them more accessible documents. This review should incorporate the conclusions of the proposed review of performance reporting (recommendation 5.4).

Value in retaining current audit requirements

In relation to audit costs, one of the Cabinet Committee papers for the 2010 LGA reforms noted that

[t]he only way to significantly lower the cost of auditing LTCCPs [Long-Term Council Community Plan (now called Long-Term Plan)] would be to abandon the audit. However, this year 13 of the 85 draft LTCCPs received a non-standard audit opinion. In addition there were councils that amended their original proposals before publication to achieve an unqualified opinion. Overall, the performance of the sector has not reached a level where the benefits of the audit process are outweighed by the cost. (Minister of Local Government (Hon. Rodney Hide), 2009, p. 10)

The audit results from later years show that the number of non-standard audit reports has declined over time. However, a number of changes have occurred over this period, including changes to the requirements for audited documents and the matters on which the OAG provides opinion. This makes it hard to infer too much from this trend. In addition, a positive final opinion may partly reflect work undertaken by auditors through the process, to help a council meet the requirements.

In an engagement meeting, one council suggested an “audit-lite” track, on which councils meeting certain requirements (such as a history of unqualified audits) would only have to undertake the full audit process every three years. The aim of this track would be to reduce audit costs for those councils who are low risk and performing well, and provide an incentive for others to lift their game. However, an independent expert advised the Commission that reducing the frequency of audits would not necessarily reduce either audit fees or council staff time and resources. The same amount of work would be required to provide the necessary assurances (indeed possibly more, given the time between full audits).

SOLGM’s submission suggested simplifying the audit mandate for consultation documents by removing the requirement for the auditor to consider whether the document gives effect to its statutory purpose (SOLGM, sub. DR176).

The Commission believes that the current prospective audit requirements provide an important discipline on planning and funding processes. However, it is important that audit processes are not taken as a substitute for internal quality assurance, peer review and (where appropriate) expert input and review (such as for highly technical or complex matters, or large and/or risky projects). The example from Kaipara District Council illustrates the risks of over-reliance on external audits as an assurance mechanism, and the need for adequate in-house processes, commensurate with the size and risk of particular decisions (see Box 5.1). Individual councils are responsible for deciding when and how to apply quality assurance and review procedures. These processes are fundamental aspects of good organisational practice, and particularly important when making significant decisions. SOLGM guidance on long-term planning states:

Quality assurance is a vital part of developing an LTP and needs to be incorporated formally into your process.... Quality assurance is an on-going process, and not just a task that gets done towards the end....

The external audit process can sometimes become a de facto quality assurance process. This will add to the time and cost it takes to produce your LTP and should be avoided. (SOLGM, 2016a, pp. 27–28)

In addition to the scrutiny of individual LTPs and their associated consultation documents, the Commission also sees value in the reports prepared by the OAG that summarise the findings from the OAG’s reviews across all councils. These review reports include recommendations for improving current practice, and examples of good practice. They provide a useful resource for councils and transparency for wider stakeholders, including ratepayers and central government.

LGNZ submitted that the audit requirements are an important part of the accountability framework for local government funding and financing, which is “internationally regarded and works well”. Its submission stated:

The audit of annual reports and OAG’s annual report to parliament is not only a mechanism for highlighting individual councils that may be facing financial risks, but highly symbolic. (LGNZ, sub. 112, p. 26)

The Commission is therefore not convinced that a net benefit would result from reducing the current LTP audit requirements. Further, given the findings of the latest round of auditing on consultation documents (as discussed above), relaxing the audit requirements could lead to a decline in the quality of LTPs, and fewer LTPs complying with the legislative requirements.

F5.10

The benefits associated with auditing Long-Term Plans and their consultation documents currently still exceed the costs. These benefits include assurance and transparency for the general public, as well as recommendations and advice for councils about good practice.

R5.6

The scrutiny on long-term planning provided by the audit requirements should not be considered a substitute for internal quality-assurance processes. Councils should have robust quality-assurance procedures across their long-term planning process, including the use of expert review where appropriate (such as for highly technical or complex matters, or large and/or high-risk projects).

Long-term planning processes are part of continually improving performance

Several submissions suggested reducing the frequency of the LTP process (Paul Elwell-Sutton, sub. 48; Manawatu District Council, sub. 57; Ruapehu District Council, sub. 85; and Southland District Council, sub. 106).

Long-term planning is part of a wider performance management cycle. SOLGM guidance explains that performance management is an ongoing cycle that includes the disclosures in the LTP, as well as monitoring of other performance measures, to maintain and continuously improve performance over time (SOLGM, 2016d). This is consistent with the notion of adaptive management, which supports innovation through ongoing experimentation, learning and adaptation.

The SOLGM guidance cites the performance management framework for state and local government developed by the US National Performance Management Advisory Commission, which describes performance management as a dynamic and continuous process. Planning is an integral part of this framework, alongside budgeting, operational management and evaluation. Planning may happen over the medium term or long term (covering two, three, five or more years), while budgeting happens over a shorter term (yearly or every two years) (National Performance Management Advisory Commission, 2010, p. 21).

While auditing processes provide assurance around probity and legislative compliance, performance management is focused on the internal systems and culture for delivering improved results.

Traditional government processes and practices have too often emphasized a process-compliance definition of results rather than an outcomes-based definition. Compliance with prescribed processes

may help to assure fairness, fiscal probity, or adherence to the law, but often results in less emphasis on achieving actual substantive benefits for the public. Performance management principles and practices work to assure that the organization's strategies, processes, and the culture itself are aligned with the results the organization aims to achieve, while still ensuring fairness, proper stewardship, and adherence to the law. (National Performance Management Advisory Commission, 2010, pp. 8–9)

The timing of the current cycle of LTPs was structured around the three-year election cycle, allowing time for a new council to come up to speed before preparing and then adopting its LTP. The benefits of reducing the frequency of LTPs could include reduced costs for councils, in terms of consultation processes, LTP development and audit fees. Reducing the frequency could also help depoliticise the LTP process, by de-linking it from the local election cycle. However, drawbacks could include reduced community engagement and loss of in-house expertise in preparing LTPs. Reducing the frequency could also lead to more substantive amendments between LTPs, due to changing circumstances. In addition, a frequency other than three-yearly (or six-yearly) would mean that the revised LTP cycle would eventually coincide with an election year.

In its draft report, the Commission asked for feedback on the advantages and disadvantages of reducing the frequency of LTPs. Most submissions on this matter were opposed to the idea. The most common reasons given were the likelihood of increased amendments between LTPs (negating the cost savings) and the desire to allow each new council to set their own strategic direction.

The Commission has considered the equivalent requirements on central government agencies. Of particular relevance are the requirements on investment-intensive state services agencies. Each of these agencies is required to have a Long-Term Investment Plan that covers a period of at least 10 years, and to update its plan at least once every two years (The Treasury, 2017).

The Commission's view is to keep the current requirement to review LTPs every three years. Ongoing planning is a normal part of good business practice and should be considered in the context of broader performance management.

Prioritisation and strategic alignment

CouncilMARK™ assessments have identified a need for some councils to prioritise their resource allocation more carefully and deliberately. This prioritisation may be hindered by a lack of integration between the council's strategy (embodied in the LTP) and the suite of planning and accountability documents, and with the council's decision making. As discussed above, some councils have achieved good strategic integration. Yet CouncilMARK™ assessments have found that others lack a clear strategy and vision to guide policies and actions. In addition, several councils lack a regulatory enforcement strategy to guide the prioritisation and targeting of enforcement resources, meaning compliance monitoring and enforcement occurs without a sound basis for assessing risks, outcomes or alternative approaches. This has implications for both the efficiency and effectiveness of regulatory enforcement activity.

While the legislative requirements do impose parameters around the content of LTPs, they do not preclude the preparation of a strategic framework, and alignment of the LTP and other accountability and planning documents within this framework. A number of councils have done both successfully.

For example, Palmerston North City Council was the 2018 winner of the LGNZ EXCELLENCE Award for Best Practice in Governance, Leadership and Strategy, for its strategic framework development "Framing the Big Picture". Councillors led the development of a strategic framework to inform the preparation of the LTP.

Judges said the project "showed a clear vision and strategy operationalised by measurable success indicators and was able to be endorsed by external organisations. It also demonstrates strong links between the Council's strategy, financial decisions and public engagement..."

Overall the judges felt that the strongest entries demonstrated a strong strategic focus, clear outcomes, measured results, cost benefit analysis and engagement with external organisations – particularly a collaborative approach with stakeholders, and meaningful engagement with iwi and Māori." (LGNZ, 2018d)

CouncilMARK™ assessors praised Hauraki District Council for its coherent strategic framework, in which its strategies and plans are closely aligned with its vision and goals, and reflected in the Chief Executive's

performance agreement. The review report commented that “[t]he Council formally reviews its vision, goals and other strategic documents every three years, and effectively allocates resources on the basis of urgency and importance, taking care to balance effective governance, management and administration/compliance” (CouncilMARK, 2019a, p. 6).

As a matter of best practice, all local authorities should have a strategic framework that:

- sets out their vision and goals;
- provides clear links between the strategic goals and desired community outcomes, the planned activities to deliver the goals and outcomes, and measures of results against these outcomes;
- aligns all supporting strategies, plans (including asset management plans) and policies within the strategic framework; and
- is actively used to guide prioritisation and decision making.

F5.11

A clear strategic framework is an important mechanism for guiding councils’ decisions about both prioritisation and resource allocation. While the current legislative requirements impose parameters around the content of Long-Term Plans (LTPs), they do not preclude the preparation of a strategic framework, and alignment of the LTPs and other accountability and planning documents within this framework. A number of councils have done both successfully; others lack a coherent framework to guide their strategic planning.

The value of a spatial approach to long-term planning

“Spatial planning” has various definitions. In its *Better urban planning* inquiry, the Commission saw value in regional-level spatial plans. These would be high-level, strategic and direction-setting documents that lay out a vision for development over time. They would:

- be led by regional councils, yet owned by all councils in a region;
- focus on issues closely related to land use; in particular the corridors for water and transport infrastructure, land for community facilities (eg, schools, hospitals, recreational spaces, and conservation areas), protection of high-value ecological and cultural sites, and natural hazard management;
- enable all key stakeholders to participate and share information, including iwi, central agencies, developers, and infrastructure providers and operators; and
- be the platform for a suite of plans in a region covering both land use regulation (district and unitary plans) and operational and budgeting plans (eg, council long-term, annual and infrastructure plans) (NZPC, 2017, p. 294).

A number of councils have used the LGA to establish spatial or growth management plans, which act as linchpins to guide RMA and LGA decisions as well as Land Transport Management Act decisions. Councils use the LGA plans to set the strategic goals for their cities, and then use the RMA to set regulatory controls aimed at achieving these goals.

In its review of 2018–2028 LTPs, the OAG examined the approach of two councils to develop their LTPs. The OAG reported that both councils found benefit in a spatial planning approach.

The [Palmerston North] City Council felt that a spatial planning approach was an easy way to engage with the community and would allow it to reach a broader range of people. (OAG, 2019b, p. 46)

A key comment made by [Gisborne] District Council staff we spoke to was the need for an integrated planning approach across the Resource Management Act 1991, the Local Government Act 2002, and the Land Transport Management Act, which could result in a spatial plan. They described spatial planning as

the “why” for the approaches included in the infrastructure and financial strategies, and noted that this is particularly the case for regional councils. (OAG, 2019b, p. 48)

Waipa District Council’s submission echoed this finding.

We see a future planning system centered on integrated spatial planning with input from all layers of government. This would provide the mechanisms to generate better outcomes, including better use of public funds. (Waipa District Council, sub. 88, p. 1)

In *Better urban planning*, the Commission recommended that spatial plans or strategies become a standard and mandatory part of the planning hierarchy, with a statutory basis (NZPC, 2017). To the extent that councils engage in spatial planning as recommended by the Commission, they will have a stronger basis for making and prioritising investment decisions.

F5.12

Undertaking long-term planning within a spatial planning approach promotes a more coordinated and integrated approach to strategic planning as well as investment decision making.

Incentives to manage cost pressures through productivity improvements

Chapter 3 explored trends and drivers in the prices faced by local government. It explained that councils commonly set rates by adjusting the previous year’s rates by the forecast Local Government Cost Index (LGCI), with additional adjustments for anticipated population growth.

This raises the question as to whether it is appropriate for a council to include anticipated price inflation in its budgeting process. Central government does not include provision for inflation in its budgeting. In fact, the government’s fiscal strategy has involved fixed nominal baselines since 2003. This means that government agencies do not receive an automatic increase each year in their baseline funding to account for inflation (exceptions do exist – such as funding for services that are price-indexed and demand-driven, such as welfare payments). The annual budget allocation for new spending is tightly focused on the government’s key priorities. Agencies are expected to manage within their baselines by reprioritising as well as improving productivity (The Treasury, 2018b).

A similar discipline could be applied to local authorities, to encourage a focus on productivity improvements in the first instance (rather than rates increases), to meet cost and price pressures. In its draft report, the Commission sought views on whether and how to implement such a discipline, and the benefits and drawbacks of doing so.

A number of councils, as well as SOLGM, submitted that it is common practice to remove inflation from operational budgets before preparing detailed annual budgets. Councils then add the inflation to future periods as part of preparing their LTP, in line with GAAP, and to ensure an unmodified audit opinion.

To clarify, both central and local government prepare their prospective financial statements in line with the Public Benefit Entity Financial Reporting Standard 42: Prospective Financial Statements. This standard does not prescribe the budgeting process councils must use, but sets out some general principles they must follow. Taken together, these principles mean that councils must disclose in their LTP financial statements their best estimates, at the time those statements are prepared, of what the ex post (actual) financial statements will, in due course, report.

Each process for an annual plan is distinct, with different modifiers based on volumes, resourcing and other variables. Council managers must then operate within the nominal budgets set out in the annual plan. To set out financial forecasts for the subsequent years, the LTP uses various assumptions (disclosed separately) to determine the expected year-on-year nominal increases. As such, the financial forecasts, including those in the annual plan, should only report on the fixed nominal baseline if this is the level of expenditure the council expects to actually incur.

However, the common practice of taking current outturns as a starting point for budgeting can help emphasise the need to be more productive, and to look for efficiencies in service delivery. Auckland Council

submitted that “[t]he council separately sets out efficiency savings targets, either centrally or by service area, to ensure productivity improvements and the best use of ratepayer funds” (Auckland Council, sub. DR185, p. 2).

Another way of improving the incentives for productivity improvements could be to require local authorities to publish information on the unit cost of services (by some standardised grouping). A measure of cost could be annual operating expenditure for each high-level category. If depreciation expenses were included, this would capture the operational impacts of capital expenditure. Excluding interest costs would mean the measure was neutral as to source of capital funds (ie, whether funded from external debt or internal reserves). Standard denominators would be needed for each category (such as kilometres of roading renewed or cubic metres of wastewater treated). The Commission recommends that the review of local government performance reporting requirements considers how to include measures of the aggregate unit cost of service delivery for a small number of essential infrastructure categories.

R5.7

The review of local government performance reporting requirements should consider how to include measures of the aggregate unit costs of service delivery for a small number of essential infrastructure categories (roading, water supply, wastewater, stormwater and solid waste).

The importance of good asset management practices

The task of managing, maintaining and investing in infrastructure assets dominates local government’s activities and expenditure. Effective asset management is therefore critical to ensuring local government uses funds efficiently, makes good decisions about how services are delivered and how any trade-offs are made, and achieves good quality outcomes.

The National Infrastructure Unit identified three key areas for improvement in asset management:

- **appropriate institutional incentives** – in particular, alignment between strategic asset management functions and financial management functions;
- **effective use of asset management capability** (given the limited pool of specialist expertise in New Zealand); and
- **collection of the right kind of data using shared data standards**, so that infrastructure condition and performance can be meaningfully compared and benchmarked across infrastructure providers (National Infrastructure Unit, 2015, p. 48).

The OAG has emphasised the need for alignment between asset and financial management, and the importance of good quality data.

Overall, 30-year [infrastructure] strategies will be a useful planning tool for local authorities only if they are supported by robust information about asset performance.... Local authorities will need to match their revenue and financing policies, and their choice of funding tools, to their asset management and service intentions. Linking the infrastructure policy to the financial strategy is therefore critical. (OAG, 2014b, p. 9)

To help ensure the collection of consistent and comparable data across infrastructure providers, Land Information New Zealand is leading work on developing metadata standards for three asset types (roads, water infrastructure and built assets). The standards for water infrastructure were released in August 2017.²⁹

The task of maintaining drinking water, wastewater and stormwater assets takes up a significant proportion of local government expenditure. However, there is a lack of comprehensive data on the performance and condition of councils’ water assets and services. Good information on asset condition is essential for making sound decisions about infrastructure investments, and LGNZ is leading a project to rectify this lack of

²⁹ The water infrastructure standards are available from NZ Asset Metadata Standards at <https://standards.meta-connect.com>

information. The first part of this project was a National Information Survey, which was conducted in 2014 and gathered data from 70 councils. It found that “large sections of the three waters networks remain ungraded... [and] some councils have entire networks that have not been graded by their condition” (LGNZ, 2014, p. 14). Future work aims to develop a common set of key performance indicators for water service providers and benchmark relative performance levels.

Regional collaboration is important for making more effective use of limited asset management expertise. Ways to incentivise greater collaboration between councils in the management of water infrastructure are explored in Chapter 11.

The management and delivery of capital projects was a common area for development identified in CouncilMARK™ assessments, with several councils experiencing low completion rates and therefore underspends. Issues identified in assessment reports include planning and prioritisation, project management, reporting and governance. This suggests that better project management and governance are important aspects of improving the efficiency of asset management, and ensuring investment decisions are aligned with strategic priorities.

The Investor Confidence Rating (ICR) is one of a number of tools that could assist councils in assessing and improving their approach to asset management, and investment management more broadly. Should the local government sector see benefit in promoting this tool to councils, the Commission suggests that LGNZ leads the establishment of an independent governance body to oversee use of the ICR, to ensure the integrity and credibility of ICR ratings.

A number of submitters raised the potential benefits of asset recycling – when funds from a partial or total asset sale are recycled into new council assets (subs. 75, 94, 96, DR177, DR189, DR249). It is sensible for councils to regularly review their asset portfolio to assess whether their present return from assets is better than alternative approaches. As part of this assessment, councils should explore their options for asset recycling, including through the preparation of business cases. The potential for greater use of asset recycling to create funding capacity is discussed further in Chapter 7 (section 7.3).

5.8 Participation in local democratic processes

One main way that people can hold councils to account for the expenditure and funding decisions is through local body elections. However, voter turnout in local body elections is notoriously low, and has been steadily declining since the late 1980s.

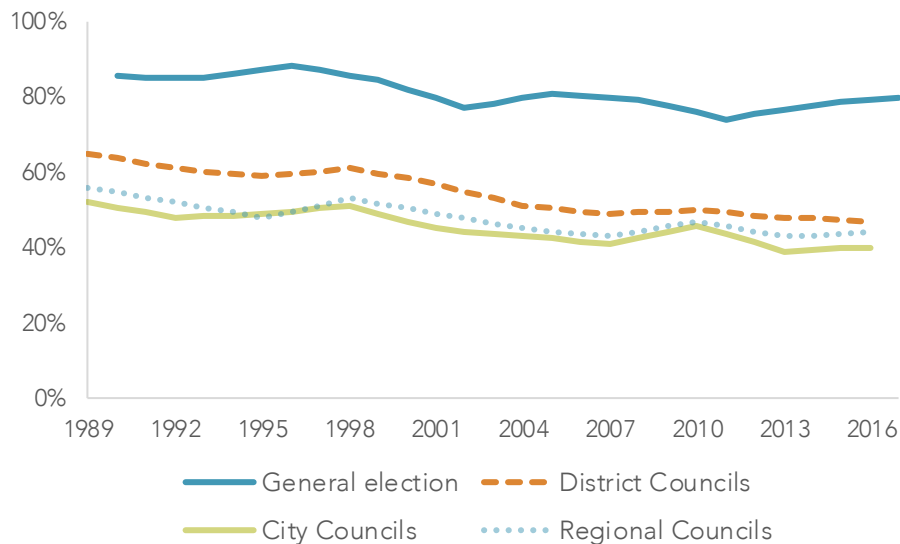
Voter turnout for the general Parliamentary election has also been declining overall (though the last election saw an increase). However, as shown in the chart in Figure 5-6, the rate is substantially higher than for local body elections. The total voter turnout for the most recent³⁰ general election was 79%, compared to 47% for district councils, 44% for regional councils and 40% for city councils.³¹

Voting behaviour is correlated with a number of factors, including age, level of education, property ownership, ethnicity and length of time lived at the same property (LGNZ, 2019a; Zhang, 2015). For example, older people are much more likely to both vote and be homeowners (and therefore ratepayers).

A range of theories explain why people do not vote. Analysis for Auckland Council found that reasons for not voting included lack of political knowledge and civic literacy, political apathy and administrative barriers to voting (Zhang, 2015).

³⁰ The percentages for the most recent voter turnout are 2017 for the general election and 2016 for local authority elections. At the time of writing, final figures for turnout at the 2019 local elections were not yet available by council type.

³¹ The higher turnout at the 2010 elections was partly due to increased local voting for the first Auckland “super city” election and increased voting in Christchurch following the 2010 Canterbury earthquake (Department of Internal Affairs, 2016a).

Figure 5-6 Voter turnout in general and local authority elections

Source: Electoral Commission (2018); DIA (2016a).

The low participation in local elections is mirrored in the low rates of community engagement in council engagement processes, such as submissions on annual plans and LTPs. For example, Rangitikei District Council submitted that community participation in their latest LTP was 0.82% (Rangitikei District Council, sub. 115, p. 4). And as with voter turnout, feedback on LTPs tends to come from a non-representative cross-section of the community. For example, an analysis of feedback on Auckland Council's 2015 LTP showed that males and older people (particularly those aged 55 and above) were over-represented in submitters; younger people (particularly those aged under 25), Māori, Pasifika and Asian people were all significantly underrepresented (Nunns, 2015).

In its 2018 review of consultation documents, the OAG noted that Auckland Council had created partnerships with community groups to target diverse audiences, and that "this resulted in consultation responses coming from a more representative profile of Aucklanders" (OAG, 2018b, p. 20). However, the overall low rates of engagement across the sector, combined with non-representative participation, mean that using community feedback on LTPs as a barometer of community sentiment and buy-in is generally problematic.

Public understanding of what councils do varies widely

LGNZ's New Zealand Local Government Survey has found that people's understanding of local government's roles varies widely across its services and functions. While most people are aware that councils provide infrastructure and core services such as solid waste management (average of 80% awareness), the awareness for functions such as natural resource and hazard management (average of 57%) and economic development (average of 54%) is lower (LGNZ, 2017b).

People's understanding of council decision-making processes is also low. The Quality of Life Survey measures the perceptions of New Zealanders across a suite of domains, including council processes. The 2016 survey found that 32% of people agreed that they understood how their council makes decisions (Colmar Brunton, 2016).

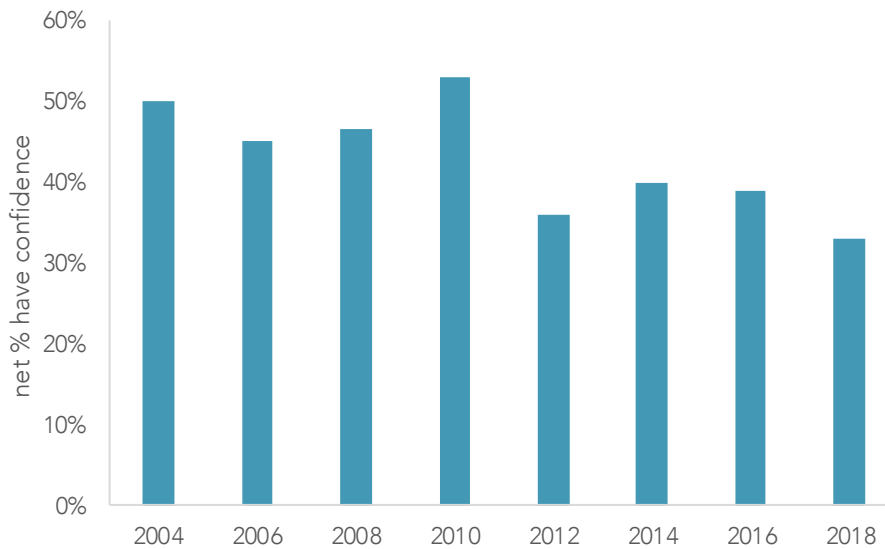
People's perceptions of local government

LGNZ's New Zealand Local Government survey asks a sample of people from the general public and business about their perceptions of local government. The survey produces a number of measures, including a reputation index, which is a weighted summary of people's ratings across the dimensions of leadership, service performance and communication. The 2018 survey found that the overall reputation of local government only rated 28 out of 100 (LGNZ, 2017b). This result was consistent with the 2014 score, and was the impetus for developing the CouncilMARK™ programme (discussed earlier).

The 2017 survey found that among the general public, net satisfaction with local government was 17% (up from 12% in 2014). Business satisfaction was net -6% (a slight improvement on -7% in 2014).³²

The Quality of Life survey asks people whether they are confident that their local council makes decisions in the best interests of their city or area. In 2018, 33% of respondents either agreed or strongly agreed that they did. As the cities included in the sample differ between surveys, it is not possible to directly compare results over time. Mindful of this limitation, scores for this question have generally reduced over time (Figure 5-7).

Figure 5-7 Confidence in council decision making



Source: The Quality of Life Project (2019).

Notes:

1. Results not directly comparable across time. The surveys carried out in 2004, 2006 and 2008 included 12 cities. The surveys in 2010 and 2016 included 7 cities; and the surveys in 2012 and 2014 included 6 cities. The 2018 survey included 8 cities, but results are shown for 6 cities to make comparisons easier.

Scope to improve participation in local democratic processes

The effectiveness of procedures in the decision making of local government hinges on the public understanding and taking part in local democratic processes, including engaging in councils' LTP and other consultation processes. Previous reviews, including the Shand review, pointed to the need for greater civic education. SOLGM's submission to this inquiry reinforced this conclusion, advocating for work by DIA, SOLGM and LGNZ to "enhance the breadth and availability of the public resources on local government" (SOLGM, sub. 24, p. 11).

The Commission notes the campaigns by LGNZ and SOLGM in 2016 and 2019 to encourage greater participation in local body elections. In addition, changes to the LGA in 2019 included an amendment to the role of council Chief Executives to include facilitating and fostering representative and substantive elector participation in elections and polls held under the Local Electoral Act 2001 (s 42(2)(da)). However, the accompanying Regulatory Impact Statement included no analysis of the costs or benefits of this proposal, as the DIA considered its impact to be too minor (DIA, 2016b). The Commission considers that the impact will depend on how councils choose to give effect to this requirement. Given the flexibility and discretion entailed, and the variety of local circumstances, this will vary across the sector.

The Commission sees scope for further concerted efforts to lift the public's understanding of the role and procedures of local government and how they can engage in its decision-making processes (not just the local elections).

³² Net satisfaction is the proportion of those who are satisfied minus the proportion of those who are dissatisfied.

F5.13

The effectiveness of the decision-making procedures by local government depends on the public understanding, and taking part in, local democratic processes – both of which are notoriously low. This deficiency weakens the incentives that those processes provide for local governments to be accountable for the quality of their decisions.

5.9 Conclusion

Governance and financial capability across the local government sector is patchy, with a number of councils lacking the necessary systems and skill-mix to make effective decisions. However, some councils, including those with challenging external circumstances, are managing their decision making better than others, and making good use of the flexibility provided in the LGA. Based on evidence from case studies, submissions, the CouncilMARK™ assessments and other literature, the Commission identified the following success factors that support good decision making.

- **Effective working relationships**, based on high trust and good understanding of the respective roles of management and councillors, particularly between councillors, and between the Mayor/Chair and Chief Executive, which then filters down through the organisation.
- **Strong and capable leadership**, encompassing the requisite skill mix and experience across the Mayor/Chair, Chief Executive and senior management.
- **Good information to support decision makers**, including high-quality, comprehensive and transparent financial and risk reporting to councillors, and the use of business cases to inform investment decisions.
- **Use of independent, external governance expertise** to strengthen internal capability and support robust governance and decision making (such as asking the right questions). Including external experts on Audit and Risk Committees appears to be particularly beneficial.
- **Effective community engagement** that generates productive conversation and buy-in around service levels, willingness to pay and trade-offs.

The effectiveness of decision making by local government largely depends on the public understanding, and taking part in, local democratic processes – both of which are notoriously low. This deficiency weakens the mechanisms by which councils understand and match community preferences.

Councils need to get better at explaining what they do, what the big decisions are, and why it matters. People need to know what the genuine options are and how much they will cost – so they can choose and prioritise what they ask their councils to do. Councils also need to make it easier for a more diverse range of people to have their say, so they can get a better gauge of community preferences. A need also exists for more transparency around council decision making, including how councils make trade-offs.

The recommendations in this chapter aim to foster the success factors outlined above, to improve the disciplines and incentives on councils to make effective decisions, and to increase the transparency of council performance. Improvements in governance and financial capability will enable councils to make better use of their existing resources within the current funding and financing framework. New requirements for Audit and Risk Committees will also strengthen the monitoring and management of costs and emergent risks. This, in turn, will reduce the likelihood of, and costs from, making poor decisions. And better engagement and greater transparency of decision making will help build community understanding and buy-in, taking some of the political heat out of decision making.

Improvements to the knowledge and incentives of decision makers are also important enablers of ongoing innovation and adaptation. As such, they become enablers of productivity growth and better outcomes from local government.

6 Evaluation of current funding and financing arrangements

Key points

- Local government's role is to enhance community wellbeing primarily through regulating land use, choosing and funding local amenities and investing in essential infrastructure for transport, water, wastewater and stormwater.
- Local government's role sits alongside that of central government and they both draw on the same populations of citizens and businesses to fund these roles. Central government takes the lead on macroeconomic stabilisation and redistribution across citizens, including by providing a social safety net for the least well off. Even so, local government may legitimately consider ability to pay alongside the benefit principle and efficiency principles as its main guides to allocate the costs of its services.
- The current main funding tools of local government in New Zealand – property rates, charges and the ability to borrow – measure up well against the principles of efficiency, fairness and the stability and predictability of revenue. Yet scope exists for many councils to improve the transparency of their funding decisions and make better use of their funding tools.
- Funding transfers from central government are a significant source of revenue for local government, but are modest compared to most other countries. It is important that transfer programmes have a clear purpose, provide predictable revenue, preserve local government autonomy and accountability as far as possible, and are transparent.
- Among current transfer programmes, the system of grants from the National Land Transport Fund for local roads and other forms of land transport is an example of good design.
- Given the modest scope of local government in New Zealand and the absence of a clearly superior alternative, rating land and property should continue as local government's main taxing power. Overall, the Commission did not find any major alternative funding system that meets requirements markedly better than the current system. Fundamental change would be disruptive, expensive and risk unintended consequences.
- Despite the apparently greater taxing powers and revenues of local governments in countries such as Sweden, the reality of what is decided nationally against what is decided locally, and who pays for it, is not very different in Sweden compared with New Zealand.
- Rates revenue per person, council expenditure per person and income per person have grown, in aggregate, at similar rates since the early 1990s. This suggests that the current funding system has proved adequate and sustainable in the past. Yet four areas of funding pressure – infrastructure in high-growth cities, local government's increasing responsibilities devolved from central government, adapting to climate change, and the growth of tourism – indicate the need for some additional funding sources to provide fiscal adequacy and sustainability.
- The Commission favours targeted solutions to these diverse and uneven pressures on councils, while retaining the local autonomy and accountability that are cornerstones of New Zealand's system of local government.
- Some smaller, rural, lower-income local authorities are under additional strain because, to raise enough revenue, they have needed to increase rates to a high level as a percentage of income.

This chapter examines the fitness for purpose of New Zealand’s system of local government funding and financing and assesses the need for new tools and funding sources. It begins with principles for the design and operation of local government funding and financing and then assesses current arrangements against those principles.

6.1 Design principles for funding and financing instruments

Several past reviews of funding local government in New Zealand have set out principles for revenue-raising instruments. The reviews include *Alternative tax bases for local government* (Local Authority Funding Project Team, 2006), *Funding local government* (Shand Report, 2007) and *Alternatives to rates: a review of revenue mechanisms to supplement local authority rates* (NZIER, 2007). Bailey (1999) is a UK example. Reviews of taxation at a national level have also listed principles for good taxation (*Future of tax: interim report* (Tax Working Group, 2018); *A tax system for New Zealand’s future* (Victoria University of Wellington Tax Working Group, 2010)). These sets of principles have a strikingly common core of features, including economic efficiency, fairness, revenue adequacy and low compliance and administrative costs. Additional principles relevant to revenue-raising by local authorities include local autonomy and accountability.

The Commission’s view is that a set of principles with these sorts of features remains valid and suitable for this inquiry. The Commission has distilled the following set to evaluate the funding and financing tools that local governments in New Zealand currently have the power to use.

Funding and financing instruments for local government should be:

- **Appropriate for local government use** – given the role of local government and the need for local autonomy (ie, the flexibility to align with local preferences and other circumstances) and accountability.
- **Coherent within national policies and institutions.**
- **Efficient** – instruments should minimise harmful incentive effects on resource allocation, investment and innovation, and should minimise compliance and administration costs (these last two properties need instruments to be reasonably simple).
- **Fair**, taking account of who benefits from local government services; and horizontal equity, vertical equity, affordability and inter-generational equity.
- **Sustainable** through minimising avoidance and providing enough revenue, and stable and predictable revenue over time.
- **Transparent** – the reasons for funding and financing decisions are clear to those who are paying and to the community as a whole on behalf of whom councils make decisions.

Treaty of Waitangi

References to the Treaty of Waitangi in legislation require councils to actively facilitate Māori participation in council decision making. As a result, the Treaty is an important frame for the design of local government funding and financing. As Ngāi Tahu submitted:

In relation to principles of a funding and financing framework (p48 [of the issues paper]) Te Rūnanga note that Treaty partnership integrity is a relevant principle. This certainly has links to the equity and fairness principle, and to fiscal adequacy, but is also a distinct and significant element that should be considered in design. (sub. 53, pp. 6-7)

Chapter 2 outlined how local government decisions have a strong impact on Māori interests, which are explicitly recognised in legislation. Chapter 5 sets out how the Local Government Act 2002 (LGA) places requirements on councils to facilitate Māori participation in council processes and decision making. The Resource Management Act 1991 (RMA) similarly sets out responsibilities to engage Māori in resource management decisions including through joint-governance arrangements. Treaty settlements have progressively given increased weight to councils partnering with iwi and hapū in the joint management and governance of natural resources important to Māori as tangata whenua (Chapter 4).

The following sections explain each of the funding and financing principles listed above and how they relate to local government.

Appropriate for local government use

Regulating land use, providing local public and “club” goods (eg, public parks, street lights, streetscapes, recreation and cultural facilities), and providing essential infrastructure such as roads, footpaths and drainage are natural tasks for local government because they are specific to a community. Further, community wellbeing is enhanced when the community can make the choices about these amenities that suit it best.

The amount of choice and control depends critically on the extent that funding for the amenities comes from the community, rather than from external sources not under the community’s control (such as central government). The more local government depends on funding from central government, the greater the risk its *autonomy* will suffer. In addition, local choice, control and funding have the benefit of making elected local councillors more *accountable* for how well they spend the funds raised from the community.

The main possible downside of local autonomy and choice is that the production of many goods and services could be more efficient at a scale larger than the size of a local authority. This can create a tension between autonomy and efficiency. Collaborating or contracting with others can sometimes achieve scale without sacrificing autonomy, but in other cases the community may have to strike a balance between them.

Coherent within national policies and institutions

Local government sits within national policies and institutions. Its powers and mechanisms need to be coherent with the national system of laws and responsibilities. Standard public finance texts argue that, of the three basic fiscal functions – stabilisation, economic efficiency and redistribution – the first and the third functions should be the primary responsibility of central government, while central and local government should share the second function (Oates, 1999). The reason for this separation is that fiscal stabilisation and redistribution outcomes could be undermined and achieve no-one’s intended objective if two levels of government follow inconsistent policies. In addition, income transfers are better undertaken at a national level because:

- central government has better information on personal incomes and indicators of household status such as unemployment, single-parenthood and disability; and
- significant differences in regional or local welfare policies can encourage “benefit shopping” where people move to live in areas that offer generous welfare benefits. If such movements were significant, they would likely create instability and be harmful to desirable redistribution goals.³³

Oates (1999, p. 1134) summarised this natural division of roles and responsibilities between levels of government:

Central government plays the major role in macroeconomic stabilization policies, takes the lead in redistributive measures for support of the poor, and provides a set of national public goods. Decentralized levels of government focus their efforts of providing public goods whose consumption is limited primarily to their own constituencies. In this way they can adapt outputs of such services to the particular tastes, costs, and other circumstances that characterize their own jurisdictions.

Without careful coordination, different levels of government that share the same tax base can impair coherence. For example, each level could set its tax rate without considering the rate set by the other levels – which could result in a damagingly high combined rate.

³³ In contrast, a national welfare system largely avoids this risk because it can draw on the much larger and more stable national population as the insurance pool to cover risks that will affect some people, for example the risks of falling sick, being injured, suffering unemployment or living with a disability.

Efficient funding and financing

As noted, economic efficiency is a responsibility of both central and local government. Since costs and preferences for local public goods differ across communities, efficiency can be enhanced by leaving choice and control to those communities. However, economies of scale, if present, enhance efficiency by going in the opposite direction – through joint provision across two or more communities.

Efficient funding and financing is a huge topic. It relates not only to taxes but any form of revenue raising to cover the costs of goods and services (eg, user charges).

It is clearly desirable to minimise the costs for taxpayers of having to *comply* with a tax system (ie, the costs of time and effort as well as paying for expert advice). Minimising these costs depends largely on the simplicity of the system and how much it is automated. *Administrative costs* are those incurred by the tax authority in assessing what people owe, collecting the funds and enforcing the rules. Clearly also, the lower these costs the better.

Taxes can interfere with *productive* and *allocative efficiency*. They can do so by distorting people's decisions about consuming, working and saving relative to what would be most economically efficient. Careful choice of taxes and tax design can reduce these harms (called the "deadweight costs" of taxation). but do not usually eliminate them. In general, taxes cause less inefficiency when producers and consumers are less inclined (or less capable) to reduce their tax bills by switching from more highly taxed goods and services to more lightly taxed goods and services.³⁴

Dynamic efficiency is about improving economic efficiency over time. An important characteristic is that innovators have optimal incentives to create and introduce new or better products and methods that raise productivity and wellbeing over time. Innovation is the major source of increases in living standards. Funding methods and sources can have a significant bearing on dynamic efficiency because innovators need access to funding and financing to enable them to develop their ideas and try them out. Innovators also need to be rewarded for the new ideas they generate that spill over and benefit others. Tax credits for research and development and strong profits are examples of rewards.

Efficient funding for council-supplied local services

Council-supplied local services range from pure public goods to pure private goods. Many have elements of each such as libraries, clean water, and waste services. Box 6.1 describes the distinction between public and private goods. The type of service determines which funding method and institutional arrangements are conducive to economic efficiency. As a result, there is a need to tailor funding methods to a service's characteristics as described below.

- **Council services that have private-good characteristics** (ie, the services are rival and excludable). Unit charges (ie, the price paid by users for each unit they purchase) are the usual means to fund these services. Kerbside rubbish collection with a unit charge per bag of rubbish is an example. Unit charges are efficient if councils set them at the marginal cost of providing the service and the council uses efficient means to produce the service.³⁵ In some cases, charging marginal cost will not generate enough revenue to cover a council's costs because the marginal cost will be lower than the average cost of production (average cost includes upfront fixed costs of providing a service while marginal costs only include costs that vary with the services actually supplied). Determining the efficient way to make up this revenue so that the council can cover all its costs is complex. The next two points deal with infrastructure services where this problem is common.
- For **infrastructure services** with identifiable consumers whose access can be controlled, such as drinking and wastewater services, the price that consumers should be charged (to achieve economic efficiency) depends on whether overall demand for the service is comfortably within, close to, or above the capacity of the existing system:

³⁴ This lack of response to a tax (or inelasticity) is efficient when the purpose of a tax is to raise revenue. But when the purpose of a tax is to make a person or business face the costs they are imposing on others, and they respond in a way that reduces this cost, this is the aim of the tax and is a good thing.

³⁵ Chapter 5 covers the factors that influence a council's productive efficiency.

- *Demand within existing capacity* – once an additional customer is connected, the operational cost to supply them is likely to be very low. This is the short-run marginal cost (SRMC) and the efficient price is the SRMC.
 - *Demand close to existing capacity* – SRMC will now be higher because additional use will likely cause the quality of the service to other users to deteriorate. So the efficient price is the SRMC, but it will be higher to reflect this additional “congestion” cost. This is the rationale for charging vehicles for access to congested roads – it obliges an additional driver to consider the extra cost they impose on other road users because they slightly worsen congestion for everyone. Pricing congested roads or water when capacity is stretched can have the large benefit of postponing the need to build expensive new infrastructure. The price signal incentivises customers to economise on their use of the good or service.
 - *Demand above existing capacity* – the efficient price will be higher again. It will be whatever price reduces demand to the available capacity.
- The different efficient prices described in the previous bullet point could worry household consumers who do not wish to face **short-term price uncertainty**. Such price uncertainty could arise if demand fluctuates between peak times and off-peak times. In these situations, a wholesale purchaser of the service will usually be willing to offer households price certainty for an appropriate margin.
 - With **infrastructure services that require expensive upfront investments** such as roads, water and wastewater, charging SRMC will not fully cover costs (ie, a situation of high fixed costs and low marginal costs). The efficient solution will be either to raise prices above SRMC, adopt some form of multi-part pricing, treat the service as a “club good”, or cover the deficit with revenue raised from taxation. For further details, see the Commission’s report *Better urban planning* (2017, pp. 307–311) and Kahn (1988).
 - **Council goods and services with public-good characteristics** should be funded by local taxes, at least for the local benefit component. Councils cannot charge directly for such goods and services because it is not possible to exclude users who do not pay (or at least it would be very costly to do so). Elected councils make decisions on behalf of their communities to determine the types, quantities, locations and funding/financing of local public goods and services. Typical local public goods are uncongested local roads and street lighting, public parks and reserves, enhanced streetscapes and waterfronts. A council decision to supply and fund a new local public good, or extend an existing one, will be efficient if the total community benefit it generates exceeds its total costs, but not otherwise. Of course, this is not easy to determine and requires tools such as cost–benefit analysis. Final decisions often contain an element of judgement.

Box 6.1 Definitions of “public goods”, “private goods” and “club goods”, and how they differ

“Public goods” are goods or services with two specific characteristics:

1. the good or service is *non-rival*, which means that many people can “consume” it and benefit from it without diminishing the benefit to others (eg, well-lit city streets, or the public-health benefits of wastewater systems); and
2. the good or service is *non-excludable*, which means that it is impossible (or at least highly impractical) to exclude people from using and benefiting from it (eg, a city’s stormwater system).

If a good or service is non-excludable, it is not practical to charge users. As a result, private businesses will choose not to supply a non-excludable good or service (except in rare cases).³⁶ Given this, either central or local government supply most public goods.

The geographical reach of public goods varies – at one end of the spectrum, national defence simultaneously benefits all citizens of a country; at the other end, street lights in a suburban cul-de-sac benefit only the street’s residents. As such, *local public goods* are those with a relatively local effect across a region, city or town.

“Private goods” are goods or services with opposite characteristics to public goods:

3. the good or service is *rival*, which means that if one person or household consumes it then other people or households cannot do so (eg, a loaf of bread, an armchair); and
4. the good or service is *excludable*, which means that it is possible to exclude people from using and benefiting from it (eg, withholding the bread or armchair). This characteristic enables private businesses to charge for the supply of private goods and services.

Yet governments may still wish to provide services that are excludable (such as many health services) for no or little charge for equity reasons or because of wider social benefits.

“Club goods” are excludable but non-rival up to the point they become congested. A swimming pool is an example. Excludability means that users can easily be charged, but this may not be efficient when the pool has few users. When the number of users is close to or at capacity, it will be efficient to charge to limit demand to capacity. Even in quiet times, a charge contributes to covering costs, but efficiency would suggest setting it at a lower off-peak rate to encourage people to visit.

Source: NZPC (2017, p. 6).

Fair funding and financing

Councils have a lot of flexibility in deciding from whom they collect local taxes and charges. Councils and ratepayers are typically very concerned to achieve fairness in who ends up paying for what. Indeed, many complaints that people express about funding tools, such as rates or charges, come down to people’s dissatisfaction with having to pay for goods and services they either do not value or think someone else should pay for.³⁷

But what is fair? Tax scholars have developed several concepts and categories to aid thinking about fairness. Inevitably, fairness involves value judgements – objectively correct answers to what is fair are not possible.

Fairness concepts relevant to local government funding decisions include:

³⁶ Ronald Coase (1974) drew attention to one example that is consequently well-known among economists. Before public lighthouses were put into service, some British private insurance companies built lighthouses. It was in their interest to do so because it reduced shipwrecks among the ships of their clients, even though ships not insured with the companies were able to free-ride and gain the benefit of the lighthouse service as well.

³⁷ Even when the argument is that central government should fund and provide a service, this is essentially saying that taxpayers across the country ought to be paying rather than local residents.

- **Benefit principle** – services should be funded by those who benefit from them.
 - User charges (where such charges are feasible) result in users funding the cost of services. If the charge is a uniform price, then the more a user consumes and benefits the more they pay. While the amount a user pays is positively related to the benefit they receive, it is significantly smaller than the benefit because people typically value what they buy more than what they pay (the difference being the user's "consumer surplus").
 - A targeted rate on a specific group of residents who benefit from a service is another way to apply the benefit principle.
 - The benefit principle also implies that the overall cost of local services should be funded from local government revenues (ie, drawn from residents). Services benefiting the nation (ie, that contribute to the national interest or national policy objectives) should be funded by central government. Some local assets and their associated services could benefit both local residents *and* national interests. In these instances, the benefit principle points to shared funding (Figure 6-2).
 - While the benefit principle has a natural appeal, it can be difficult to determine which people benefit from a service and how much, and to separate local from national benefits. These challenges limit but do not nullify the principle's practicality.
- **Exacerbator principle** – the exacerbator principle is, in a sense, the opposite of the benefit principle. It says that whoever causes a need for the use of costly resources (eg, for a clean-up, a preventative activity, or extra time spent in traffic congestion) should pay for it. Imposing costs on those who cause them embodies not only fairness but also efficiency. For example, unless polluters are faced with the costs they impose on the environment, there is likely to be too much pollution and not enough incentive for firms to find and implement cleaner methods. To achieve efficient outcomes, exacerbators should face charges equal to additional costs they cause.
- **Horizontal equity** – a tax principle that citizens with the same characteristics should pay the same tax. The relevant characteristic on which "sameness" is based depends on the type of tax. It could mean the same income (for an income tax), the same consumption spending (for a consumption tax) or the same property value (for a property tax).
- **Vertical equity** – a tax principle that citizens with greater ability to pay should pay more tax than those with less ability to pay. The degree to which someone on a higher income pays proportionately more tax is termed the "progressivity" of the tax system. Ability to pay can be assessed in different ways, such as current income, current consumption, wealth, or property value.
- **Intergenerational equity** – a principle that seeks fairness across generations. Intergenerational transfers – where one generation pays for a benefit enjoyed by another generation or imposes a cost on the other generation – often lack intergenerational equity. For example, emissions of greenhouse gases by past and current generations will impose costs on future generations through destructive climate change. Applying the benefit principle to intergenerational transfers implies that such transfers should be minimised because each generation should pay for the costs of the benefits that it enjoys. Generations should not shift the costs onto future generations; neither should they have to incur the entire costs of building long-lived assets from which future generations will also derive benefits.
- **Tax incidence** – tax incidence refers to who ultimately pays taxes or rates. It is not itself a fairness concept but is an important consideration in applying the concepts. Tax incidence differentiates "nominal incidence" from "economic incidence". The first type refers to who is legally obliged to pay the tax; the second refers to who is actually worse off from the tax payment. For example, retailers are legally obliged to pay Goods and Services Tax (GST) on their sales of goods to consumers. Yet because they pass the GST on as part of the retail price, the consumer ends up paying the GST. A relevant example for local government is that while landlords are legally responsible for paying property rates, and because all landlords in a location are similarly obliged, the cost of rates will get factored into market rents. Therefore, the tenants will end up paying a substantial portion of the rates on a property through their rent payments.

The different fairness concepts can conflict with each other. For example, the benefit principle may conflict with vertical equity (ie, ability to pay). It follows that the designer of a funding system will have to choose which fairness concept to follow and, where necessary, strike a balance between them.

In the Commission's view, councils should consider all five fairness concepts, as well as tax incidence, when determining who should pay for council-supplied goods and services. Doing so is consistent with the main statutory authority for council funding – section 101 of the LGA. Councils should be transparent about which concepts they are applying in their rating, fees and borrowing policies (see more below). They also need to bear in mind that redistribution (ie, vertical equity) is the primary responsibility of central government. A system in which two levels of government practised significant redistribution would lack coherence.

Even so, councils may be well placed to seek what they see as better outcomes for their communities by shifting some of the funding burden of some council-supplied services from those who benefit to those with greater ability to pay. Providing such shifts are modest, councils can express community preferences and improve wellbeing without undermining national redistributive goals.

Sustainable funding and financing

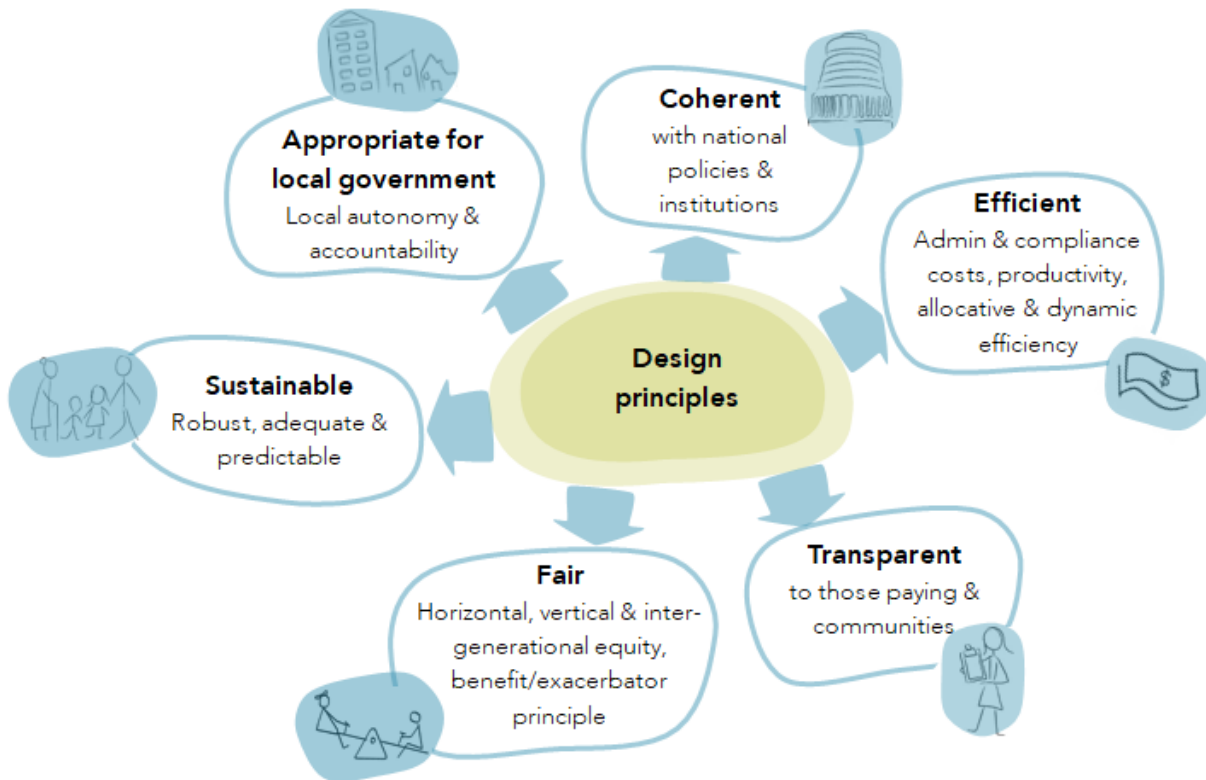
A funding and financing system for local government will not be sustainable unless it has three key attributes:

- **Robust against avoidance** – taxpayers paying for collectively funded goods and services, and even consumers of private goods and services, will quickly undermine sustainability if they can avoid making payments. Revenues will fall short of costs, and greater burdens will fall on those who act honestly by paying. Financing a major piece of infrastructure by borrowing will not be sustainable without an assured and secure future revenue stream to repay the debt over time.
- **Fiscal adequacy** – the tax system and other revenue sources must be capable of providing the amount of revenue that a government requires. A tax base could be too small or suffer other limitations so that even high rates of tax will not raise enough revenue or do so only at the cost of severe distortions or hardship. Another dimension of adequacy is having a flexible menu of taxes and revenue sources. This is important for local governments so they can select a mix that fits local circumstances and preferences.
- **Stable and predictable revenue** – councils must make long-term plans and investments. For each, stable and predictable revenue streams over time are highly desirable. A sudden fall in revenues, particularly when it happens unexpectedly, can precipitate a fiscal crisis. For example, national tax revenues in Ireland fell sharply when the Global Financial Crisis broke in 2008 because a large portion of its revenue was based on the value of property transactions.

Transparent funding and financing

The accountability of local government to local communities is highly reliant on the transparency of its processes, decision making, and performance (Chapter 5). Funding and financing decisions are keenly followed by those who pay and vote; with competing views of what is fair. To maintain support for, and confidence in, their decisions, councils need to explain clearly how they have applied and weighed relevant funding and financing principles.

Figure 6-1 summarises the desirable design principles for local government funding and financing tools.

Figure 6-1 Design principles for local government funding and financing tools

Using the principles to evaluate funding and financing instruments

Sections 6.3 to 6.8 use the above principles to evaluate the funding and financing instruments available to local government under New Zealand's current system. Chapter 7 will use the principles to assess proposals for improvements. Designing a system that satisfies all the principles is probably impossible. Tensions could emerge between the principles, such as:

- between efficiency and fairness (particularly when using ability to pay as the fairness concept); and
- between funding instruments that closely reflect benefits (which are complex to measure and determine), and the simplicity needed to keep administrative and compliance costs low.

6.2 Design principles for intergovernmental transfers

In addition to the principles for the design of funding instruments for local government, a separate set of principles is useful for the design of intergovernmental transfers. Such transfers – typically from a central government to local levels of government – are ubiquitous around the world.

Regardless of the political or constitutional definition of the nation, subnational governments are almost never self-sufficient financially. Their revenue-raising responsibilities fall short of their expenditure responsibilities, forcing them to rely on financial transfers from national government. (Boadway & Shah, 2007, p. xxvii)

New Zealand is no exception. The main example of such transfers is the extensive co-funding of local roads from the National Land Transport Fund (NLTF).

Objectives for central government transfers to local government

Several policy objectives for transfers from central to local governments are possible.

- **Vertical fiscal gap** – essentially when local government's expenditure responsibilities are greater than its revenue-raising capacity (eg, when small, low-income communities struggle to pay). This can arise from unfunded mandates passed down from central government, or excessive concentration of taxation powers at central government level.

- **Horizontal fiscal equalisation** – redistribution across districts to redress imbalances both in varying fiscal capacity (revenue-raising ability) and expenditure needs (eg, where districts face different costs in delivering services). Transfers to balance fiscal capacities sometimes also fulfil a **risk-sharing** or stabilisation function (driven by social solidarity values), when districts are subject to damaging shocks.³⁸
- **Benefit spillovers/externalities** – as noted under the benefit and exacerbator principles, it is important to account for cross-jurisdictional and/or national-level positive or negative spillovers. Variations of this include:
 - **National minimum standards** – when central government wishes to achieve certain standards of service delivery and national consistency (can be for equity, and/or efficiency reasons).
 - **Influencing local priorities** – when central and local government priorities differ, and central government seeks to induce local spending in line with its priorities.
- **Administrative efficiency** – when it is more administratively efficient for a tax to be collected through a centralised system and then distributed to local governments.

Figure 6-2 illustrates the first three policy objectives for central to local government transfers in New Zealand. It also shows examples of funding responsibilities that are clearly the sole responsibility of each level of government. Given the limited scope of local government in New Zealand, the Commission's view is that transfers from central to local government should be limited to situations set out in recommendation 6.1.

If central government makes significant payments outside these situations, it risks weakening the separation of roles and responsibilities between central and local government and, with that, undermining the autonomy and accountability of local authorities – a great strength of the New Zealand system.

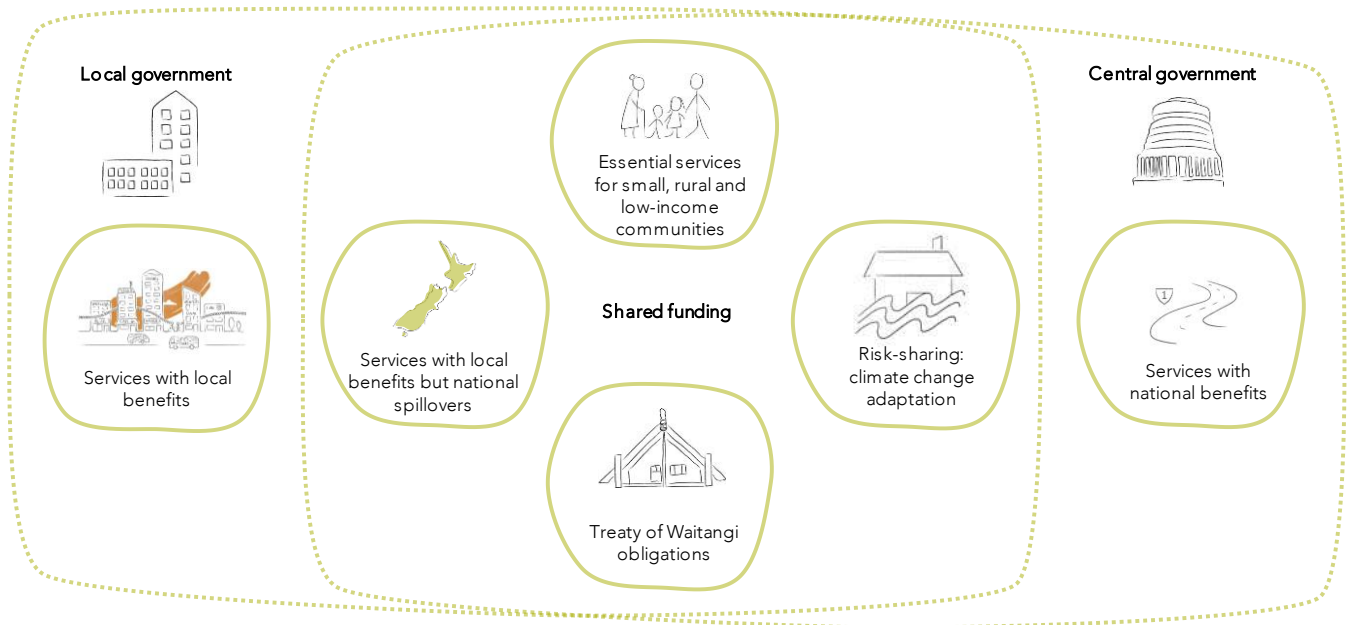
R6.1

Given the limited scope of local government in New Zealand, central government transfers to local government should be restricted to the following situations:

- when local government activities have national-level benefit spillovers;
- sharing risks across all taxpayers, when some communities are subject to damaging shocks (such as natural disasters);
- helping low-income communities whose councils are struggling to fund essential services; and
- recycling revenue collected centrally (for administrative efficiency) to cover costs incurred locally.

Central government payments to local government that do not have one of these principled justifications, or similar, risk undermining the autonomy and accountability of local government.

³⁸ The literature focuses on economic shocks, but shocks could also be due, for example, to natural disasters.

Figure 6-2 Should local or central government pay for publicly funded local services?

Conditional transfers

Conditions can be imposed on central government transfers to local government in several ways.

- **Co-funding requirements**, where local governments must contribute a proportion of funding. Co-funding brings an element of local financial accountability and ownership (as local government has some “skin in the game”), but also curtails local accountability to some extent. Transfers with no co-funding are more suitable for when central government is seeking to influence local priorities.

Co-funding requirements can reflect local fiscal capacity and expenditure (eg, lower co-funding requirements for districts with lower fiscal capacity or higher costs of services).

- **Inputs/process or outputs-based conditions.** Outputs-based conditions are better because they leave room for local autonomy and innovation in achieving the desired objectives (eg, meeting national standards). They also support results-based accountability to citizens.
- Both **carrots and sticks** may be applied to encourage adherence to conditions. For example, **financial penalties** (by way of lower central government funding contributions) may be applied for failing to meet conditions.

Design principles

Shah (2007) sets out a number of principles for guiding the design of intergovernmental transfers:

- **Simplicity** – “rough justice may be better than full justice” – to achieve acceptability and sustainability.
- **Singular focus** – each transfer programme should have a single and clear objective.
- **Autonomy** – transfer programmes should undermine the autonomy of local government as little as possible.
- **Fairness** – funds should vary directly with expenditure needs and inversely with the fiscal capacity of each jurisdiction.
- **Predictability** – funding should be assured over several years and avoid sharp changes from year to year, so local governments can plan ahead. This can be done through publishing five-year projections of funding availability, as well as ceilings and floors on yearly fluctuations.
- **Transparency** – in both the formulae and the allocations.

- **Efficiency** – grant design should be neutral to local governments’ choices of resource allocation (eg, not specify particular inputs).
- **Accountability** – local governments should be accountable to their citizens and to central government for financial integrity in the use of transfers and the delivery of results.
- **Affordability** – recognising central government’s budget constraint and desire for control over its budgets.
- **Review** – transfer programmes should be periodically reviewed (and renewed/adjusted as appropriate). Programmes should not be altered in the intervening years, to provide budgeting certainty for local government.

Policy makers will need to make trade-offs across these principles – a major one will be to strike a balance between advancing national priorities and allowing local autonomy. The trade-offs will depend on the objective of the transfer and the relative weighting accorded to different principles. Some value judgements are inevitable. Different design features can help manage these trade-offs.

For example, high priority given to achieving national minimum standards may see greater conditions imposed, implying lower local autonomy. But autonomy can be supported by imposing conditions on outputs (rather than on process or inputs). Doing this also assists efficiency by allowing local governments some choice in how they allocate resources. Conditions on outputs can therefore help strike a balance between achieving national objectives and preserving local autonomy.

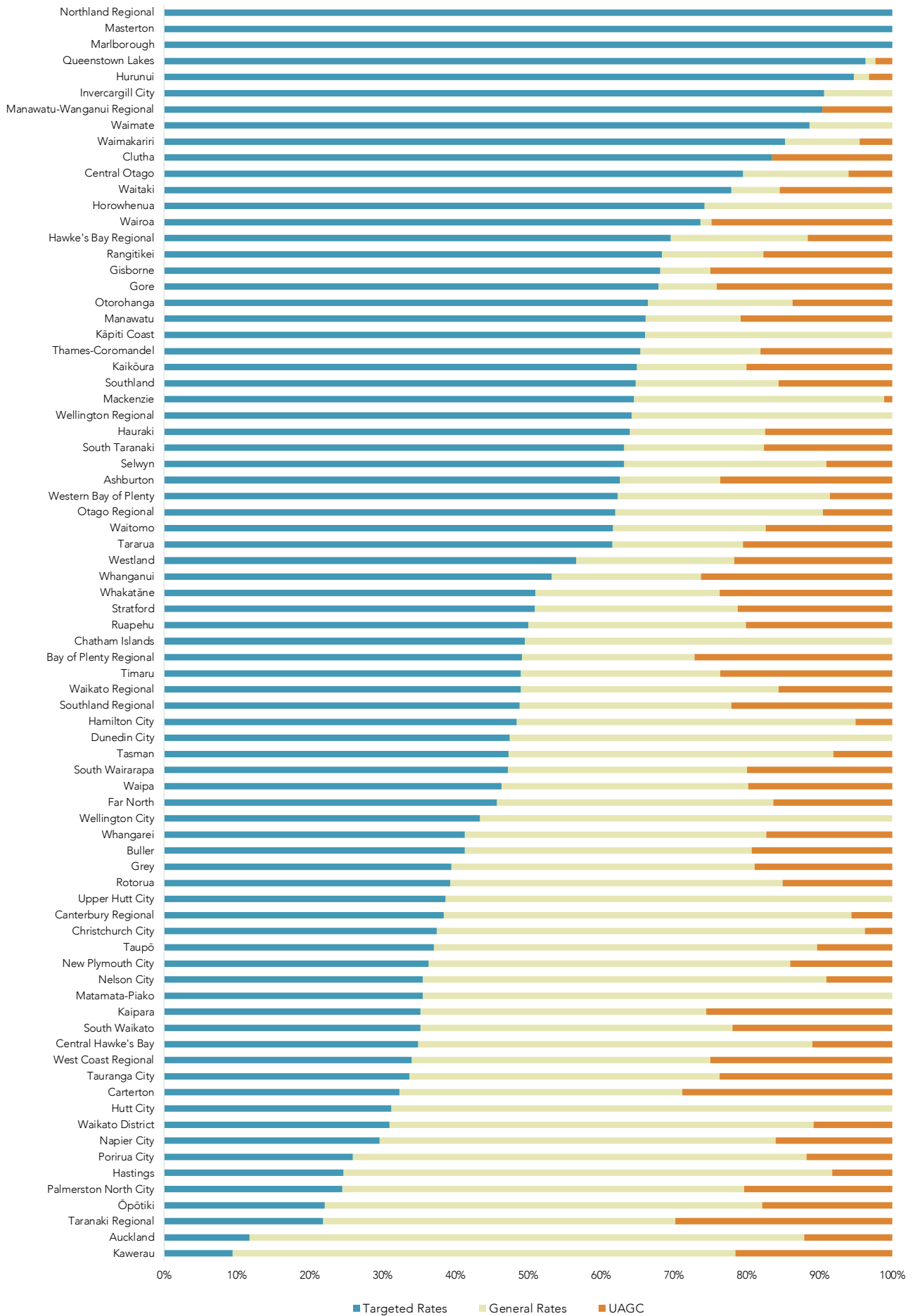
6.3 How do current arrangements measure up against the principles?

Section 2.5 described the features of New Zealand’s current system of funding and financing local government. Without repeating the description, the main sources of funding (with approximate percentages of total revenue) across all councils in 2018 were:

- taxes on property (about 47%, in the form of general rates, targeted rates and uniform annual general charges (UAGCs));
- user charges for services (about 13%);
- regulatory income (about 5%);
- development contributions (DCs) and vested assets (about 11%);
- investment income (about 5%); and
- grants from central government (about 19%, mostly for roading and transportation).

The current system gives councils a lot of flexibility. For example, within the rates category, councils can vary their mix of general rates, targeted rates and UAGCs; apply rating differentials for different classes of taxpayers (residential, business and rural); and choose whether to base property-value rates on land value or capital value. Figure 6-3 illustrates how councils can and do use this flexibility.

Figure 6-3 Composition of council rates revenue in 2019



Source: Insight Economics (2019a).

The two biggest concerns that submitters raised about the current system were:

- sustainability, especially fiscal adequacy, to meet rising spending pressures on local government; and
- fairness, assessed on one or more of the fairness concepts, especially vertical equity (ie, ability to pay).

These concerns echo the inquiry's Terms of Reference, which ask the Commission to investigate, among other questions:

- the ability of the current funding and financing model to deliver on community expectations and local authority obligations, now and into the future; and
- rates affordability now and into the future.

The Commission's evaluation of New Zealand's current system will focus on these concerns.

6.4 How appropriate and coherent are current funding and financing arrangements?

Current arrangements are appropriate for local government use

Local governments in New Zealand raised 68% of their total revenues from local residents and businesses in 2016 through their powers to tax and charge (OECD & UCLG, 2019b). This is a high proportion by international standards and among OECD countries in particular. This feature gives the current system two important benefits:

- the community, through the council, has the autonomy to choose the quantities and types of services that suit local tastes, costs and other circumstances to maximise wellbeing, subject to what the community is prepared to fund; and
- the council is accountable to its community because it has autonomy and control in what it chooses and achieves – this will limit how much it can credibly blame other parties (eg, central government) for failures (Bailey, 1999; OECD & Korea Institute of Public Finance, 2018).

In some circumstances, the supply of local services by a local provider can have disadvantages. For example, economies of scale in some services may favour their production at a higher level of government and/or on a greater scale than is feasible at the local level. As set out in Chapter 11, the Commission finds this is the case for drinking and wastewater services in some small (and not so small) local authorities.

Even so, local autonomy and accountability are important benefits of New Zealand's current system of funding local government.

Current arrangements are coherent within national policies and institutions

There is wide agreement in New Zealand that central government is in charge of fiscal stabilisation and the redistribution of resources from those well-off to those in need. To achieve these outcomes, central government holds and controls the levers of fiscal policy, monetary policy, tax and benefit policy and taxpayer-funded health and education. Coherence requires that local government has at most only a modest influence in these policy areas. This is true under current arrangements.

The tax tools of local government – mostly rates based on property values or property units – are separate from the main tax tools of central government – income tax and GST. This separation of tax bases helps the two sets of funding mechanisms to work coherently together. But strict separation is not necessary. In OECD economies such as Sweden, the income tax base is shared between the central, regional and local levels of government.

In allocating resources to satisfy needs and preferences for public goods and infrastructure, central and local government efforts in New Zealand largely focus on separate goods and services. As a result, conflicts are infrequent. Central government funds and oversees national public goods such as defence and law and order; local government funds and oversees local public goods and local infrastructure such as street

lighting, public parks and water supply. Some areas such as roading, conservation, civil defence and public health do overlap, but clear lines of demarcation, or a good system of cooperation, usually avoid conflict.

Exceptions occur. For example, the Commission heard about the NZTA's recent re-prioritisation of a long-promised upgrade of an important section of state highway suffering from high traffic volumes and accidents. This re-prioritisation created a conflict because it dashed the plans of a district council – and the significant resources it had already committed – for a major housing development in an area with a serious housing shortage. The development depended on the highway upgrade for the new residents to commute to work in the nearby large urban area.

As noted, difficulties can emerge when benefits or costs spill over to the national level (or even affect another local authority) and the funding system does not consider this. For example, residents of districts popular with tourists are feeling increasingly aggrieved at bearing the cost of services to tourists (Chapter 10). Another example is the problem of “unfunded mandates” when central government requires local authorities to take on regulatory tasks (aimed at least partly at national benefits) yet provides no funding to help meet the costs of the regulation (Chapter 7).

F6.1

The funding tools of local government in New Zealand are appropriate for local government's role, and coherent with the responsibilities of central government to stabilise the macro economy and redistribute from those well-off to those in need. Responsibilities for making choices about public goods and infrastructure are mostly well demarcated across the two levels of government.

Some areas of tension between central and local government have emerged. These tend to be where local government services have national-level benefit spillovers, yet current funding arrangements do not consider this.

While New Zealand's system of funding local government has a high degree of coherence within national policies and institutions, this could change should local government take on more or fewer responsibilities. For example, local government in some countries such as the United Kingdom and Sweden plays a much greater role in areas such as social services, health and education. This greatly expands the scope and funding of local government. This draft report assumes that the scope of local government in New Zealand (ie, what it does) remains like it is today.

6.5 How efficient are current funding and financing arrangements?

This section's evaluation of the efficiency of New Zealand's current funding and financing arrangements for local government looks separately at administration costs, compliance costs, and efficiency (allocative, productive and dynamic efficiency).

Administration costs

Once set up, property rating systems generally have low compliance and administration costs. New Zealand's is no exception. The main reason is that land and buildings have defined locations that do not move, and the ownership of these assets is clear. An effective rating system requires a good property register. An up-to-date, digitised and computerised register exists in New Zealand. The register has other purposes. The main one is to register titles to the ownership of property and changes of ownership from property sales and purchases. The register would have to exist even if local government raised its revenue in a different way. As such, most of the costs of the register would remain even if rates were replaced with a different funding system.

The rating system also depends on a valuation system that maintains reasonably accurate property values associated with each title. This is a significant administrative expense of the rating system.

Collection and enforcement costs are relatively low. Property is visible and cannot disappear or move and it is straightforward to track legal ownership from the property register and serve rates notices (Collier, Glaeser, Venables, Blake, & Manwaring, 2018). Councils have strong powers to enforce payment.

Compliance costs

It is easy and costs little in time or money to comply with paying rates. Property owners each year receive a rates demand from their council which they then pay in instalments (eg, quarterly or more frequently). They do not have to fill in a return.

In his international overview of tax compliance and administrative costs, C. Evans (2008) notes that studies of the main central government taxes (eg, income tax and GST) “suggest that compliance costs of such taxes are typically anywhere between two and ten percent of the revenue yield from those taxes In contrast, compliance costs of property taxes are low in absolute and relative terms ... The studies also suggest that administrative costs are absolutely and relatively less burdensome than compliance costs.” (pp. 457-458)

Rates payments do not have a cashflow automatically available to pay them in the way that PAYE income tax and GST do. This can cause difficulties for ratepayers who have wealth (ie, property ownership) but a low cash income. They may need to act, at some cost, to acquire liquidity to pay their rates bills. Chapter 8 examines rates affordability for households.

Economic efficiency – allocative and productive

Taxes on **land value** – the unimproved value of the land on which a property sits (whether the property is vacant or has a building or other improvements) – are among the most efficient taxes. Landowners cannot do anything to change the unimproved value of their land or, therefore, change the amount of tax owed. For this reason, taxes on unimproved land value do not distort the economic choices of taxpayers.

Taxes on **capital value** create a disincentive at the margin to owners to invest in property improvements and put land to its highest value use (NZPC, 2017). The disincentive is because the improvements will raise capital values and increase the amount of tax payable. As shown in Chapter 3, many local authorities have shifted from land value to capital value for their rating base in recent years. This is likely to have reduced economic efficiency. However, the Commission is not aware of any empirical estimates of the size of this reduction in efficiency.

An important exception to rates on capital value reducing efficiency is when capital value is a good indicator of benefits received. For example, the capital value of a property could be a proxy for the number of people living or working in it which, in turn, could be a proxy for services such as street cleaning, drinking water or wastewater. In this situation, the decision of an owner to improve the property is effectively a decision to use more services and, to the extent that the supply of these services is a cost to the council, it is efficient that this is signalled to the property owner and they pay more in rates.

Outside of the situation where business rates are a good proxy for benefits received from council services, **rates on the capital value of business property** risk greater inefficiency than rates on the capital value of residential property. If rates on the capital value of a business are simply a tax to raise revenue for the council, they risk creating productive inefficiency that is avoidable.³⁹ This adverse outcome is an important result in tax economics and tax design (Diamond & Mirrlees, 1971).⁴⁰

An example of rates on the capital value of businesses causing productive inefficiency is when councils apply a high differential to rates on electricity generators. Meridian Energy, for instance, told the Commission that its wind farms in Wellington were subject to the same 2.8 times commercial differential applying in the city itself, despite their rural location and the fact that they made few demands on council services (sub. 73). A

³⁹ An economy is production efficient when it is on its “production-efficiency” frontier. This means that it is impossible to use available resources to increase the output of any one good or service without reducing the output of another. Broadly speaking, production efficiency is about using resources to make the size of the economic pie as large as possible.

⁴⁰ The explanation for this result is as follows. Business rates on capital value make an important business input (the use of physical premises) more expensive. This distorts business choices about which inputs to use and creates production inefficiency. In addition, the business will tend to shift the cost of the rate onto other parties such as its customers or employees. As a result, another party ends up paying the rate indirectly. It would be more efficient to tax that other party directly and avoid the production inefficiency within the business.

commercial differential on electricity generation in rural locations likely means generators' rates are significantly out of proportion to benefits received from council services – remembering also that generators' assets typically have high capital values.

Apart from these high rates possibly distorting generators' decisions, the generators will tend to pass them on in higher electricity prices. As a result, electricity is more expensive than its true resource cost to the many hundreds of thousands of businesses that use electricity. This is likely to cause them to make decisions about electricity use that are inefficient. For example, businesses could decide not to decarbonise as much as they would do if electricity were cheaper. Meridian Energy's submission described its experience and that of other generators:

Meridian and other electricity generators have high capital value assets on their land and therefore pay extraordinarily high rates, while consuming very little local government services. Rates bills are an input cost for electricity generation and ultimately capital value rates increase the cost of electricity for New Zealand consumers. (sub. 73, p. 6)

The Commission recommends that councils should levy rates for business properties only in proportion to the cost of council services that benefit those properties (see Chapter 7).

Use of **targeted rates** gives councils flexibility to charge ratepayers in line with the costs that arise from ratepayers' use of council services. The ability to base targeted rates on land value, capital value, uniformly across dwellings or on some other basis provides this flexibility. In general, the better a rate is targeted on ratepayers according to the costs they create, the more it will support efficient choices.

Use of "user pays" among New Zealand councils appears to have decreased. Revenues from sales and user charges declined as a percentage of total revenue from about 20% in the 1990s to 13% in 2018. User-pay charges are efficient, providing that the charges correspond to guidelines described in section 6.1.

Development contributions

Councils often recoup a portion of their infrastructure capital costs from users (usually developers) at the point of new residential or non-residential development by levying development contributions (DCs). If well implemented, these levies support efficiency. Where new property developments cause the need for new or extended local infrastructure (such as the three waters or roads), making the new residents and businesses bear the costs is efficient (as well as fair).

When those who create the need for new infrastructure pay the capital costs (either through DCs, connection charges or targeted rates), they automatically consider these costs when deciding what and where to build. Effectively, the infrastructure capital costs are the marginal costs of adding capacity to the local network (Kahn, 1988, p. 75). Since these costs are avoidable, benefits need to exceed these costs to justify investment. If developers and buyers of the newly developed properties do not face these costs, they will find locating away from the existing network artificially cheap. This can bias development towards greenfield areas and away from land already serviced by network infrastructure. It can also impose the cost burden on existing ratepayers.

The LGA established DCs as a cost-recovery tool for local governments in 2002. Following some criticisms⁴¹ and a review of DCs in 2012, the Government amended the LGA in 2014 to include a clear purpose and set of principles for DCs that councils are obliged to follow (Box 6.2). Developers also gained a right to appeal against DCs if they feel that they are unfair or incorrect. These amendments significantly clarified and improved the understanding and use of DCs.

Several aspects of implementing DCs are complex.

- A new council infrastructure project can be a mix of a renewal, filling a backlog, or building greater capacity to cater for growth. Of these, councils are entitled to charge DCs only for greater capacity to cater for growth.

⁴¹ The Commission's inquiry into Housing Affordability (NZPC, 2012) reviewed DCs and made several recommendations to improve them. Some of these recommendations were included among the 2014 amendments to the LGA.

- This cost of growth must be allocated over multiple developments in line with how much each development has caused the need for the infrastructure. Councils estimate what costs a standard new house will cause. This impact is known as a Housing Unit Equivalent (HUE). Each other type of development (eg, a new supermarket or warehouse) is assigned a number of HUEs which gives the estimated impact of that type of development as a multiple of a standard house.
- HUEs vary not only by type of development but also by the area or catchment in which the development is located.

Some councils have online calculators to help deal with this complexity. These give developers an early, rough indication of the likely DCs that they will be required to pay for any project they have in mind. Even so, developers of non-residential properties continue to complain either that councils fail to explain the basis for their DC charges or that the charges are unreasonable or contain errors (eg, Foodstuffs, sub. 23; Property Council New Zealand, sub. 117).

Box 6.2 Development contributions principles in the LGA

A 2014 amendment to the Local Government Act 2002 sets out (in section 197AB) the following principles for development contributions:

- (a) development contributions should only be required if the effects or cumulative effects of developments will create or have created a requirement for the territorial authority to provide or to have provided new or additional assets or assets of increased capacity;
- (b) development contributions should be determined in a manner that is generally consistent with the capacity life of the assets for which they are intended to be used and in a way that avoids over-recovery of costs allocated to development contribution funding;
- (c) cost allocations used to establish development contributions should be determined according to, and be proportional to, the persons who will benefit from the assets to be provided (including the community as a whole) as well as those who create the need for those assets;
- (d) development contributions must be used:
 - (i) for or towards the purpose of the activity or the group of activities for which the contributions were required; and
 - (ii) for the benefit of the district or the part of the district that is identified in the development contributions policy in which the development contributions were required;
- (e) territorial authorities should make sufficient information available to demonstrate what development contributions are being used for and why they are being used;
- (f) development contributions should be predictable and be consistent with the methodology and schedules of the territorial authority's development contributions policy under sections 106, 201, and 202;
- (g) when calculating and requiring development contributions, territorial authorities may group together certain developments by geographic area or categories of land use, provided that:
 - (i) the grouping is done in a manner that balances practical and administrative efficiencies with considerations of fairness and equity; and
 - (ii) grouping by geographic area avoids grouping across an entire district wherever practical.

Source: Local Government Act 2002.

Councils experiencing rapid population growth have been making greater use of DCs to help fund infrastructure needed to service new developments. From when councils acquired the power to levy DCs in

the early 2000s, DC revenues increased until the Global Financial Crisis in 2008–09 when they dipped with construction activity. From about 2015, DC revenues have grown strongly again (Insight Economics, 2019b).

While DCs are a desirable funding tool, some developers, as noted, raise concerns about how councils are using them. Property Council New Zealand is concerned that councils place “a heavy reliance on development contributions which are often used to supplement rates, rather than undertaking the due analysis required to collect them”. It “has significant concerns with the analysis that councils use to justify the use and proportionality of development contributions” (sub. 117, p. 13).

In its submission, Foodstuffs notes it is not against the principle of DCs but is critical about how some councils operate their DC policies:

While we consider the use of DCs as justified, Foodstuffs has had occasion to question the reasonableness of individual charges and believes some councils are using their statutory powers to charge developers a disproportionate share of infrastructural development costs. (sub. 23, p. 4)

Foodstuffs’ submission was accompanied by an assessment of DCs by TDB Advisory (sub. 23, Appendix). Foodstuffs is a major developer of properties for supermarket purposes and has had a variety of experiences at various sites throughout New Zealand. TDB Advisory assessed these cases against the principles for DCs in the LGA (Box 6.2). The main issues that they identified were:

- significant recent increases in DC revenues could suggest policy misuse by councils;
- disproportionate charging in excess of the costs imposed by developments;
- variation in charging across DC policies (from one year to the next and across catchments);
- lack of transparency in councils’ charging methodologies for DCs and in how councils calculate HUEs for specific developments; and
- system unreliability evidenced by errors, and a lack of integrated and up-to-date data.

To help it understand councils’ use of DCs and assess the above issues, the Commission asked Insight Economics to conduct a review of the DC policies of four high-growth councils – Auckland, Hamilton, Tauranga and Queenstown Lakes (Insight Economics, 2019b).

DC revenues do not appear to have grown unreasonably since 2007. This is because revenues have closely tracked consents for new dwellings – as one might expect. Figure 6-4 plots DC and financial-contribution revenues for those four high-growth councils against building consents (with a lag of one year).⁴² The fall in revenues since 2007 mirrors the fall in development activity following the Global Financial Crisis, just as the rise from 2012 mirrors the subsequent increase in development activity.

DC charges in some of the Foodstuffs’ cases did seem disproportionate. Yet whether they were excessive often came down to whether councils gave enough HUE credits for work undertaken and paid for by the developer (eg, for roading works, stormwater works or water supply tanks) and the extent to which the development placed an added load on councils’ infrastructure. Initial DC assessments can certainly be coarse and neglect site-specific factors. Councils mostly appear willing to consider these factors once developers provide the site-specific information. However, council systems may also be at fault because data is not integrated across different council departments. As a result, the DC database may not contain all relevant council information for properties to enable accurate assessments.

TDB Advisory and Foodstuffs’ last two criticisms of lack of transparency and system unreliability also raise concerns. It is important that councils explain their DC policies and methodologies well and make it clear in each instance how they arrive at the DCs they charge to developers. Methodologies should be available online, with supporting information such as the list of council infrastructure projects that feed into each DC charge.

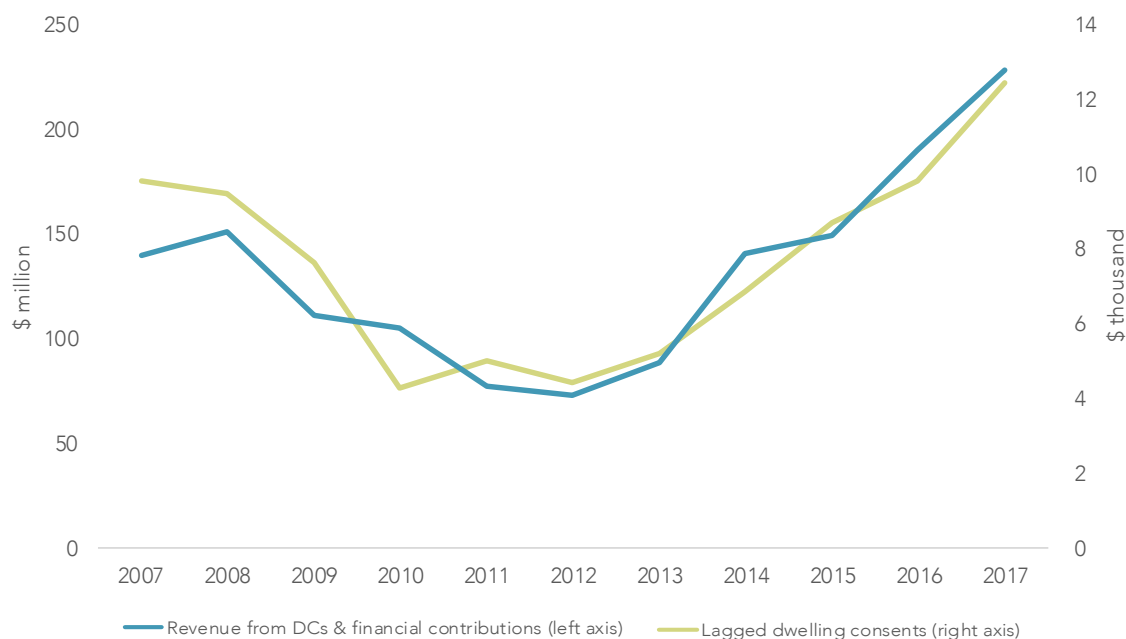
The Insight Economics (2019b) review of the DC policies of the four high-growth councils since the 2014 amendments found much that is sound and in line with the LGA purpose and principles for DCs. It reviewed each council’s DC policy under the headings of “cost allocation methodology”, “funding areas” (ie, the catchments within which developments are linked to council infrastructure required for growth), “cost

⁴² Financial Contribution revenues are included because official data series report them jointly with DC revenues. Financial Contributions are like DCs but are levied under the RMA instead of the LGA.

recovery methodology”, “development types and conversion ratios”, “policy content, transparency and overall usability” and “policy strengths and weaknesses”. The review concluded that, overall,

certain policy features have evolved over the last five years, such as greater use of localised funding areas, and the identification of more development types. Both help forge closer links between the infrastructure demands of specific developments (in certain locations) and the suite of capital works that they are required to help fund via DCs. Accordingly, both help give effect to the DC principles....We believe that the DC policies reviewed in this report generally reflect the DC principles to the greatest extent practicable, and thus provide a transparent and reliable platform for setting DC charges. (p. 29)

Figure 6-4 Revenues from DCs and Financial Contributions versus lagged dwelling consents, 2007-2017



Source: Insight Economics (2019b).

F6.2

The rating tools of New Zealand local governments have low compliance and administration costs. The complexity of development contributions (DCs) causes them to have higher administration and compliance costs.

Rates based on (unimproved) land values cause little or no economic distortion and therefore are a highly efficient way to raise revenue.

Rates on capital value are relatively less efficient because they can disincentivise land and building development. Rates on the capital value of business property can, in addition, cause unnecessary productive inefficiency.

Even so, when rates, user charges, DCs and connection charges reflect costs to the council of providing services, these are efficient ways to raise revenue.

F6.3

Development contribution (DC) policy and implementation are inherently complex. Good examples exist of council DC policies. Councils appear to have been refining and improving them over time. Yet the DC policies of some councils still fall short of best practice. The good policies provide a transparent and reliable platform for setting DC charges in line with the purpose and principles of DCs in the Local Government Act 2002.

Chapter 7 has a recommendation for improving the clarity of councils' DC policies and their assessments of what developers must pay in DCs.

Dynamic efficiency

Dynamic efficiency is about decision makers making the right investment decisions at the right time, managing assets well and having a system that encourages disciplined experimentation and innovation. Dynamic efficiency is a major driver of productivity growth and improved outcomes over time. The way local governments are funded and financed is seldom conducive to disciplined experimentation and innovation leading to higher-quality, value-for-money services. One problem is that potential innovators in councils rarely have the resources, decision rights and incentives to trial new ways of doing things.

The reform that led to the enlarged Auckland City in 2010 created Watercare, an Auckland City “Council Controlled Organisation”. Watercare can levy volumetric charges for water and wastewater, and connection charges for new customers. This ability is likely to have improved dynamic efficiency and productivity. The charges give Watercare an independent source of revenue, and through that a greater incentive and clearer decision rights to introduce new, innovative ways of doing things to better serve customers over the long term.

Councils need access to debt finance for their needed infrastructure investments both for replacement and new infrastructure to keep pace with growth. The creation of the Local Government Funding Agency in 2011 has given councils easier access to debt at favourable rates. This has improved councils’ ability to invest in needed infrastructure and spread the cost of it over the successive generations of ratepayers who benefit from it.

Unfortunately, debt limits have hampered the ability of some high-growth councils to invest in infrastructure fast enough to meet the demand for new development. Chapter 7 examines potential solutions to this significant problem.

Chapter 5 examined deficiencies in information, incentives and other aspects of the operating environments of councils that can hamper the quality of their decision making. Chapter 11 investigates how these things within local government can hinder innovation, dynamic efficiency and customer outcomes for drinking-water and wastewater services.

6.6 Are current funding and financing arrangements fair?

The fairness of who pays rates, charges, DCs and connection charges to local governments in New Zealand is a key question. Box 6.3 has examples of submitters’ concerns about fairness and affordability.

Box 6.3 Submitters’ views on whether councils allocate rates fairly

Many submitters thought that rates were allocated unfairly, though they had differing reasons for thinking this.

Rates levels on farmland are simply too high to make a serious case for trust and value. There is no connection between rates and services rendered, in terms of general rates, and no credible relationship with incomes...

The concern for many farmers is that much of their rates contribution is for services located many kilometres from the farm, such as parks, stormwater, streetlights and other amenities. (Federated Farmers of New Zealand, sub. 75, pp. 1 & 25)

There are numerous examples of rating differentials and targeted rates imposed with little evidence of rigorous, objective analysis, particularly of access to service and benefits derived. These include increased business differentials and imposition of new targeted rates. A particularly egregious example is Greater Wellington Regional Council’s targeted rate for funding public transport where Wellington CBD businesses were considered the primary beneficiaries (rather than the commuters) and a 7 to 1 differential was imposed on those businesses. (Local Government Business Forum, sub. 54, p. 8)

[T]he level of rates paid is often entirely disproportionate to the level of services received. The situation is exacerbated by the widespread use of business/commercial rating differentials despite strong evidence supporting their removal. Where councils have agreed to reduce the differentials,

they have often been tardy in doing so, tending to incremental change due to 'expenditure pressures'. (BusinessNZ, sub. 54, p. 3)

We strongly oppose rating differentials and endorse the Shand report's recommendations that they should be abolished and replaced with targeted rates. There is no economic rationale that supports business rates differentials. For example, Tauranga City Council recently introduced a business differential in their recent Long-term Plan, although reducing it to a 1.2 differential from their proposed 1.6 differential. Its main rationale is: other councils had differentials; and that it needed to raise more money than they thought they could from residential rate payers. The rationale for greater benefits to the business community was shaky at best. (Property Council New Zealand, sub. 117, p. 7)

For decades now, Horowhenua Grey Power has made detailed assessments of the unaffordability of the district's rating model for low to middle income householders, and has unsuccessfully resisted incremental transfer of inherent rating costs from rural and urban business to the disadvantage of householders... Councillors have simply set our representations aside, apparently preferring, by some unspoken policy, to relentlessly prioritise commercial interest over the wellbeing of low-income recipients. (Horowhenua Grey Power Association Inc., sub. 21, p. 9)

Rating differentials must relate to genuine differences in the level of services provided. Cross subsidisation between business and residential ratepayers, rural and urban ratepayers, should be eliminated or minimised. Differentials to deal with affordability concerns are inappropriate. (Foodstuffs, sub. 23, p. 6)

The fairness of the current system and how councils use it need to be assessed against the benefit principle, the exacerbator principle, and the principles of vertical, horizontal and intergenerational equity.

Three aspects are worth noting:

- The most important principles for councils in deciding who should pay rates are the benefit principle and ability to pay (ie, vertical equity). Generally, councils across New Zealand use a mixture of these two principles, although the balance between them varies across councils. This is a legitimate local democratic choice about what is considered fair, but councils should be transparent about their decisions. The usual means to charge according to benefits received are user pays, targeted rates, rating differentials and UAGCs. The usual means to charge according to ability to pay are general rates based on either land value or capital value. Many submitters thought that rates are allocated unfairly, though they had differing reasons for thinking this (Box 6.3).
- Applying the benefit principle by charging citizens directly for local government services, or levying rates that reflect benefits, is not only fair under the benefit principle; it can also promote efficiency. The same is true of applying the exacerbator principle. The efficiency comes about when the charge or the rate indicates the cost of the service or facility, and citizens can then decide whether the benefit they will receive is greater than this cost. For example, suppose a new bridge could improve access for the residents of an isolated settlement but generates neither benefits nor costs to anyone else. If the bridge is to be funded by a targeted rate on the properties in the settlement, then the residents are likely to make a rational collective decision about whether the bridge should go ahead based on overall benefits and costs.
- Fairness in the sense of inter-generational equity demands that the cost of a large investment in a long-lived infrastructure asset should be spread over time so that all who benefit from the asset pay for it, not just the ratepayers at the time of the investment. Spreading the cost with a loan avoids having to impose a large rates rise on these ratepayers. Otherwise, these ratepayers are likely to block the investment even though it produces overall net benefits. This would be inefficient. Councils vary significantly in their use of debt to finance investment in infrastructure. Many use it sensibly while others eschew debt at the cost of creating infrastructure backlogs and poor quality services.

6.7 Are current funding and financing arrangements sustainable?

Local government rates and other main funding tools are robust against avoidance. Few rates demands go unpaid and councils have strong powers of enforcement. The revenue streams that rates and charges deliver to councils are generally stable and predictable. The way that rates are set each year (by deciding the total revenue required and then setting rates and charges to achieve that) enables councils to be precise about how much revenue they will receive.

Whether the current system of local government rates and charges delivers a fiscally adequate amount of revenue for the needs of councils is a central question of this inquiry. The inquiry's approach to answering the question is to evaluate the pressures on local government (as described in Chapter 4) to see if those pressures are putting demands on local government that they cannot reasonably meet, or should not be expected to meet, from the current funding and financing tools.

Box 6.4 has examples of submitters' concerns about the sustainability of current funding and financing arrangements.

Box 6.4 Submissions on the sustainability of current funding and financing arrangements

[T]here is a growing sense in the sector that current arrangements – which have a significant over-reliance on property taxes to deliver services – are not sustainable in the long-term, and that if local government is to play a broader role in community wellbeing as envisaged by central government, it needs the tools and access to resources to be able to deliver on that objective. (Wellington City Council, sub. 61, p. 2)

Ultimately, these challenges...lead Council to the conclusion that the funding and financing system for local government is fundamentally broken, and unsustainable heading into the future. It is appropriate therefore that central government, with the assistance of the Commission, assess the drivers of cost and price escalation and recommend appropriate funding and financing solutions. (Timaru District Council, sub. 25, p. 2)

The ability of local government to fine tune and apply the existing powers of land rating and borrowing are limited, and are unlikely to provide any enduring solution to the matters raised by the Minister in the referral to the Productivity Commission. (Ken Palmer, sub. 10, p. 12)

Property Council believes the current system is broken. We have had twenty years (sometimes much longer) of under-investment and it's only getting worse. We recognise that some good initiatives have been undertaken by some councils to make improvements, however we suggest these are isolated.

Successive governments have amended the Local Government Act 2002 (LGA) to try and get territorial authorities to better manage their funding and finances, although nothing appears to rectify the on-going issues. This shows there is something fundamentally wrong with the system. (Property Council New Zealand, sub. 117, p. 4)

Several submitters want councils to have a more flexible set of funding tools to tailor solutions to local circumstances.

Councils represent different communities and many of these communities face quite different challenges. The critical issue is that councils have access to a menu of funding tools (or the authority to develop appropriate tools) so that they can apply the relevant tool to whatever the local issue happens to be. (LGNZ, sub. 112, p. 25)

There is considerable variation in the need for tools – this depends on the type of council (e.g. district vs regional), its priorities, social/demographic make-up, community needs and economic pressures (which also change over time). We consider the important thing is that there is an expanded tool-box available to address this diverse range of issues. (Northland Regional Council, sub. 32, p. 15)

Two areas where new pressures exist and are on a rising trend are:

- **the fast growth of tourism.** Chapter 10 identifies the nature of the funding problem created by tourism and proposes solutions; and
- **adapting to climate change.** This pressure will grow inexorably over time. The Commission's analysis of its implications for local government funding, with findings and recommendations, is in Chapter 9.

Both pressures are unevenly distributed across local authorities. For those affected, the adequacy of current tools needs to be investigated.

Two other areas stand out as ongoing problems for local government:

- **infrastructure funding for high-growth councils.** A key question is whether growth can pay for itself in the eyes of councils and their existing residents. Analysis of this and the potential barrier of council debt limits, together with findings and recommendations, are in Chapter 7.
- **councils' accumulation of responsibilities** placed on them by central government – so-called “unfunded mandates”. Analysis of this funding challenge is in Chapter 4, with recommendations in Chapter 7.

Looking back, the historical picture of trends in rates revenues, council expenditures and various measures of national economic growth and income suggests that local government revenues have been sustained and therefore ought to be sustainable at similar levels into the future. Yet sustainability at these levels is not evidence of adequacy, particularly given the four pressures just described.

Even putting these pressures aside, some councils may have exercised fiscal constraint to keep rates from growing faster but at the cost of running down service quality, neglecting maintenance and failing to invest in new or replacement infrastructure. Western Bay of Plenty District Council submitted (sub. DR155, p. 5):

Our Council's financial record demonstrates that for the most part the current local government funding tools can work. The main problem is that elected members are aware that putting up rates will mean affordability issues for many. This can result in sub-optimal decision-making where funding and investment decisions are based on the most deprived households' ability to pay. This can lead to too little being collected in rates, and consequent under-investment in community assets, postponement of necessary asset replacement and the gradual decline of public assets, services and amenities.

Affordability is another lens to judge adequacy of the current funding system. If rates are increasing faster than incomes, then not only are rates likely to be putting strain on the household budgets of the less well off; the outpacing could also indicate that councils are struggling to raise the revenue they need.

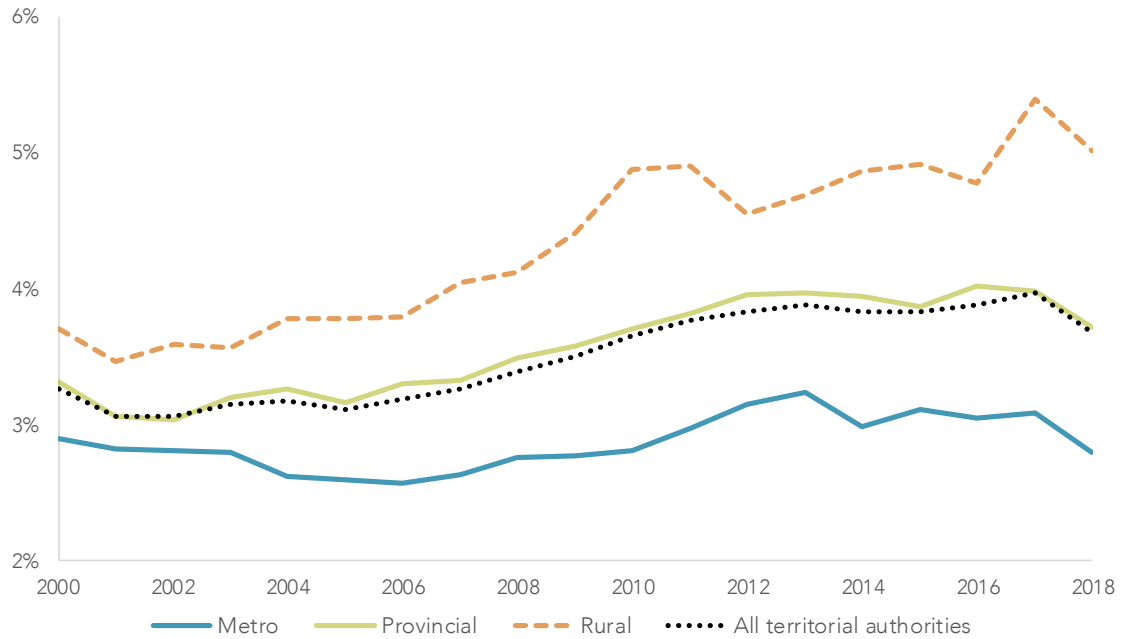
Rates increases have roughly matched increases in income on average over many decades...

Revenue from rates has remained generally stable as a proportion of Gross Domestic Product (GDP) since the mid-1940s, varying between 2% and 2.5% of GDP (Jason Krupp & Wilkinson, 2015). Rates revenue as a percentage of GDP in 2018 was 2.1%.

Figure 3.1 shows the tracks of rates revenue as a proportion of Gross National Income (GNI) and other similar measures from 1993 to 2018. Between 1993 and 2018, council operating income per person, rates per person, and GNI per person grew respectively at average rates of 1.8%, 1.9% and 2% a year (after adjusting for inflation) (Stats NZ, 2018a, 2019e, 2019b). This shows that rates per person have gone up over time but not faster on average than people's incomes. It is not surprising that council expenditure increases as people's incomes increase. As their incomes rise, people are likely to demand more and better goods and services, including the goods and services they receive from local government.

...yet rating capacity has fallen in many small, rural and poor local authority districts

Even so, new Commission analysis has revealed that rates as a proportion of median personal incomes show marked differences across territorial authorities in both levels and growth rates. While in many of the more populous local authorities, rates have remained stable at between 2% to 3% of median adult personal incomes, in some smaller, mostly rural, lower-income authorities, rates have grown to as high as 5% to 6% of median incomes over the period 2000 to 2018 (Figure 6-5).

Figure 6-5 Rates per person as a percentage of median adult personal incomes, 2000-2018

Source: Stats NZ Household Labour Force Survey and Stats NZ (2019d).

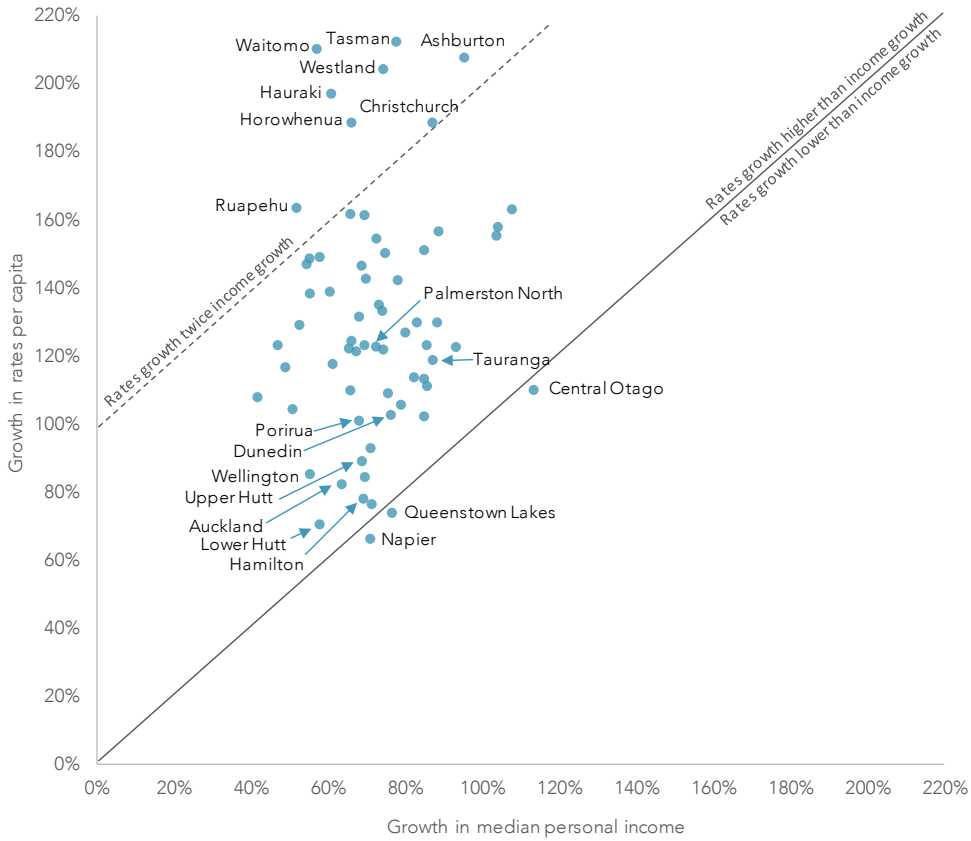
Notes:

1. Incomes are measured as the median for the population aged 15 years or older.

Figure 6-6 shows the effects of rates rises against median incomes across individual territorial authorities between 2001 and 2018. Rates had reached an historic low as a proportion of median incomes in 2001, so a large majority of councils experienced an increase in the ratio of rates to income between 2001 and 2018. Even so, councils serving most of the large metropolitan areas (with the exception of Christchurch) experienced relatively modest increases. Increases were much more marked for a group of largely rural councils.

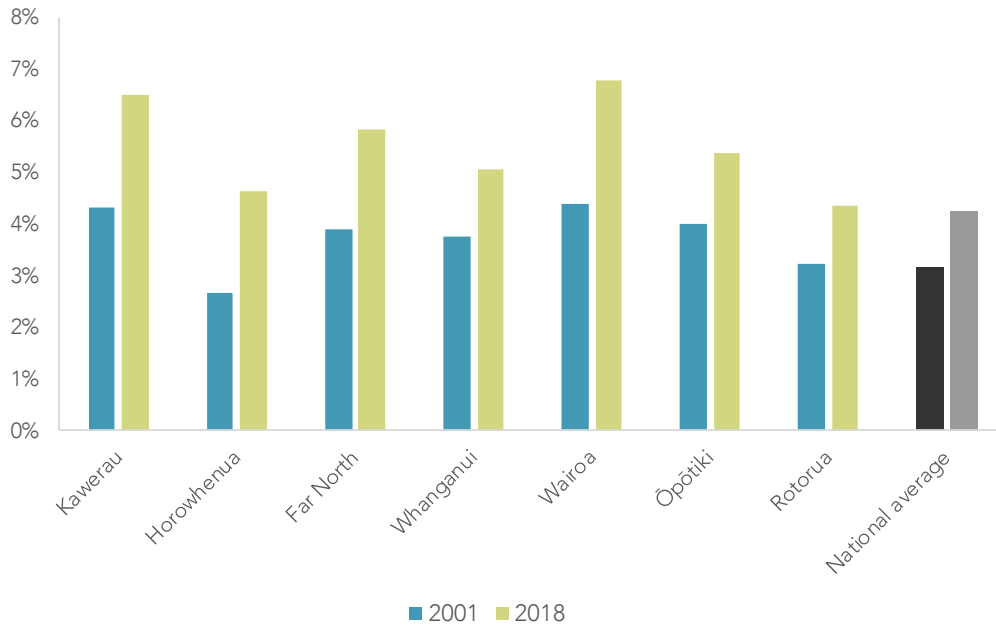
The main drivers of rates rising faster as a proportion of incomes in rural councils are likely to be a combination of faster growth in costs (Chapter 3) and lower-than-average growth in incomes. Many of the districts with high rates as a proportion of incomes have experienced low income growth over the period 2001 to 2018. Some also have experienced relatively high rates of benefit receipt (Figure 4.2). Councils with high rates of receipt of the accommodation supplement now have some of the highest proportions of rates to income (Figure 6-7). Some districts (eg, Buller and Horowhenua) with high rates of accommodation supplement receipt also have a high proportion of the population aged 65 or older (see Figure 4.1 in Chapter 4). Even so, many districts with such older populations (eg, Thames-Coromandel, Tasman, Central Otago) do not have high rates of accommodation supplement receipt, indicating a weak relationship between older populations and difficulty in meeting housing-related costs (Chapter 8).

Figure 6-6 Growth in rates per person and median incomes across councils, 2001-2018



Source: Stats NZ census 2001 & 2018; Stats NZ (2019d, 2019e).

Figure 6-7 Rates as a proportion of incomes, high-deprivation districts, 2001 and 2018



Source: Stats NZ Census 2001 and Census 2018; Ministry of Social Development.

Notes:

1. Deprivation is proxied by the proportion of the population receiving the Accommodation Supplement. The seven councils depicted had the highest rates of receipt of the accommodation supplement in 2018 (see Chapter 4).
2. The national average is an unweighted average across all territorial authorities. So it reflects the experience of the many smaller councils rather than the few large metropolitan councils.

Several councils submitted that residents in their deprived communities were having trouble with rates affordability (Hauraki District Council, sub. DR210; Whangarei District Council, sub. DR203; Whakatāne District Council, sub. DR121; Hawkes Bay Regional Council, sub. DR248; West Coast Regional Council, sub. DR220; Ōpōtiki District Council, sub. DR261). Other rural councils and their residents made similar points about the effects of rising rates on affordability (Buller District Council, sub. DR149; Ruapehu District Council, sub. DR204; Northland Regional Council, sub. DR158; Tracey O’Callaghan, sub. DR180; Porirua Economic Development Group, sub. DR161).

For these poorer, mostly rural local authorities, this growth in their rates as a proportion of income to a high level historically is a source of strain and an indicator of potential revenue inadequacy. Some councils in this situation have told the Commission that they need to make greater use of ability to pay rather than the benefit principle to raise enough revenue. This is understandable.

Past adequacy and sustainability is not necessarily a reliable guide to future sustainability and adequacy. The two new pressures and the continuing effects of the two ongoing problems as well as the increasing pressures on smaller, mostly rural, lower-income territorial authorities may well require new funding tools and other changes.

F6.4

The fiscal adequacy of local government funding is under strain in the areas of adaptation to climate change, tourism, growth infrastructure, and unfunded mandates from central government. Pressures in these areas are mostly uneven across councils, and in the first two areas are set to continue rising.

Since the early 1990s, rates revenue per person, council expenditure per person and income per person have grown at similar rates. While this suggests that the current funding system has proved adequate and sustainable in the past, the new and growing pressures may require new sources of funding for the future.

Also, some smaller, lower-income and mostly rural local authorities are under additional strain because, to raise enough revenue, they have needed to increase rates to an historically high level as a percentage of income.

6.8 Are current funding and financing arrangements transparent?

The Commission and many submitters find that councils’ rating practices are too often not transparent. Councils often do not make clear how the general rates, rating differentials and UAGCs that they set relate to benefits received, ability to pay and efficiency. Targeted rates are more transparent because they relate to a particular benefit and group of ratepayers. User charges, connection charges and development contributions (if well implemented) are inherently transparent.

It is important that ratepayers understand the choices that councils make when setting rates and charges. If ratepayers can see and understand that rates and charges are being set in line with desirable principles and it is clear what the rates and charges are funding, then they are more likely either to accept rating and other bills they receive from their councils, or make an active choice to participate in local democracy.

Rates are councils’ major source of revenue. As noted, councils have great flexibility in setting rates.

Different types of councils use rating tools differently...

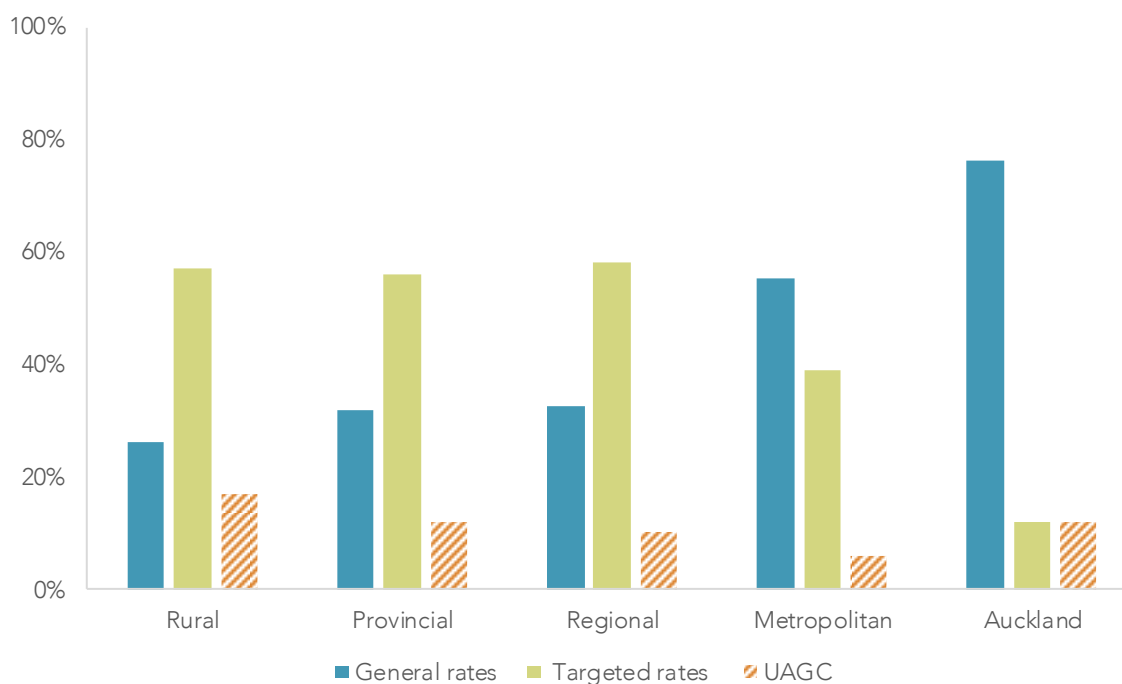
Councils use their flexibility in setting rates very differently (Figure 6-3). Some of this variation is explained by the different types of councils – rural, provincial, regional, metropolitan and Auckland. (Figure 6-8). Regional councils are more likely than other councils to set targeted rates (and to set a greater number of targeted rates), reflecting their responsibilities for activities like drainage and flood protection that relate to particular locations (Insight Economics, 2019a). Metropolitan councils, and particularly Auckland, get a much larger share of their rates revenue than other councils from general rates. Rural councils get a greater share of

revenue than other councils from UAGCs (which may reflect an intention to reduce the relative rates burden on farms). Metropolitan councils are more likely than others to use rural differentials for this purpose.

...but variation often simply reflects local choices

Much of the variation in the use of rating tools seems to reflect idiosyncratic local choices. For instance, Selwyn and Waimakariri District Councils serve similarly located communities, but Selwyn makes substantially greater use of general rates and less use of targeted rates than Waimakariri. Some district councils have no general rates; others make little use of targeted rates; yet others, again, have no UAGCs. This variation in the use of rating tools likely shows that councils can use different means, as desired by their communities, to achieve much the same rating outcomes.

Figure 6-8 Rating-tool share of rates revenue by type of council in 2019



Source: Insight Economics (2019a).

Councils' rating decisions often lack transparency

Local variation in rates setting is appropriate given differences in circumstances and preferences. Even so, the rationale for councils' rating decisions is often unclear. Councils are ever mindful of the need to consider ability to pay when they apply the benefit principle and they often do not clearly distinguish between the two principles.

Lack of clarity also results from councils making most adjustments to rates incrementally rather than from first principles. These adjustments are (appropriately) political choices mainly designed to raise enough revenue to meet spending plans while taking account of affordability and the willingness of ratepayers to pay.

For example, Federated Farmers of New Zealand argued that when councils are under pressure from growth, decline or an ageing population they turn to increasing rates revenue from farmland as a solution. Councils often do this by reducing the percentage of rates taken from a UAGC or replacing targeted rates for community facilities with district-wide rating (sub. 75, p. 15) The Horowhenua Grey Power Association supports the increased use of differentials precisely because they will relieve the rates burden on residential ratepayers (sub. 21). Concerns about lack of transparency in setting differentials and UAGCs have been longstanding (LGNZ, 2015; Shand Report, 2007).

When councils do apply the benefit principle they necessarily apply “rules of thumb” to do so.⁴³ Yet council staff and elected members do not usually have the skills in economic analysis required to identify robust rules (Chapter 5). As a result, it is easy for specious considerations to influence judgements (Box 6.5).

Box 6.5 Does the tax status of businesses justify a rates differential?

A common argument for business differentials is that businesses, unlike households, can claim back GST paid on rates and claim rates as an expense to reduce their income tax liability. Colegrave (2007) noted that many councils use this argument “to justify their business differentials” (p. 40). For example, Wellington City Council had taken this approach in working out one version of the benefit shares that informed their business differentials. This was contested in *Woolworths v Wellington City* ([1996] 2 NZLR 537). The High Court Judge and the presiding Judge in the Court of Appeal saw this as a “pragmatic assumption” that was within the competence of elected representatives (pp. 551-552).

BusinessNZ submitted against taking tax status into account when setting business differentials.

These claims have been discredited by reputable economists for the following reasons. First, a firm can only claim a tax deduction for rates because its income is subject to tax and nobody could seriously argue it is an advantage to be subject to income tax. Second, a GST registered person or firm can claim a credit for GST paid on inputs because supplies (outputs) are subject to GST. But as the net GST collected is paid to Inland Revenue, businesses get no advantage. (sub. 54, p. 27)

The Shand Inquiry also thought tax status was irrelevant in setting differentials.

The Panel does not support a higher differential on businesses to compensate for the tax deductibility of rates for business income tax. The tax status of a residential ratepayer is not considered when setting rates, and many owners of residential investment properties also have an ability to claim rates as a tax expense. More importantly, other taxes and goods and services are not set on the basis that businesses should pay more because of their tax status. The Panel considers that the tax status of a business or individual is not a relevant factor in deciding the incidence of rates. (Shand Report, 2007, p. 131)

Section 101 of the LGA sets out matters that councils must consider when they make funding and rating decisions. Section 103 requires them to show, in their Revenue and Financing policies, how they have done this. The Society of Local Government Managers (SOLGM) submitted (based on its review of policies) that councils are “not usually clear” in how they do this and, in particular, how they fulfil the requirement to consider the overall impact on community wellbeing (sub. DR176, p. 12). The Commission recommends how councils could better explain their funding and rating decisions (see Chapter 7).

F6.5

Councils often make rating decisions in a non-transparent manner that fails to explain the basis for setting rates and suggests a confused consideration of benefits, affordability and willingness to pay.

6.9 How well are current intergovernmental transfers working?

Transfers from central government currently comprise around 19% of the total revenues of local government in New Zealand. By international standards, this figure is modest. A main reason is that the scope of local government in New Zealand is smaller than in other countries. Yet the modest proportion is also a strength because it means that local government in New Zealand retains a lot of autonomy. And this substantial autonomy supports local authorities’ accountability to their communities.

⁴³ For example, Wellington City Council staff used such “rules of thumb” to help determine commercial differentials in the early 1990s (as described in *Wellington City Council v Woolworths New Zealand Ltd* [1996] 2 NZLR 537).

This section briefly assesses some of the main intergovernmental transfers in New Zealand against the design principles outlined in section 6.2.

Transfers for local roads from the National Land Transport Fund

This programme makes the largest transfers from central to local government in New Zealand. The transfers amounts to around 12% of total local-government revenues, or around \$1 428 million in 2018 (NZTA, 2018b). Contributions from the NLTF⁴⁴ cover around 53% of the cost of local roads. The programme is closed-ended because it must fit within the overall budget of the National Land Transport Programme (NLTP), which in turn reflects priorities in central government's three-year Government Policy Statement (GPS). Each region agrees a Regional Land Transport Plan with the NZTA to reflect regional priorities in the light of the GPS and the NLTP.

The programme ticks several boxes for good design in that it:

- has a clear purpose that justifies some central government funding to local government;
- gives local government reasonable predictability;
- requires councils to be accountable to both the funding agency and their citizens;
- is administered by an arms-length agency (the NZTA); and
- involves co-funding and pays attention to equity. Once the quantum of funding for local roads and other forms of land transport is decided for each region, the co-funding shares are determined by a transparent formula – the Funding Assistance Rate which makes allowance both for the need and fiscal capacity of each territorial local authority.

Even so, the system is not perfect for local government. Councils are required to have 10-year Long-Term Plans and 30-year infrastructure plans, yet NZTA funding is assured for only 3 years. As Auckland Council said in its submission, "Our infrastructure planning could ... be improved by greater certainty around NZTA funding which could be achieved at no cost to the government" (sub. DR185, p. 4).

Transfers for city-shaping infrastructure

The Auckland Transport Alignment Project (ATAP) began in 2015.⁴⁵ An update in 2018 reflected the new government's priorities. ATAP is a collaboration of central government and Auckland Council in recognition that Auckland is New Zealand's major city and its success is a matter of national economic interest (NZPC, 2017). That success depends on Auckland having a transport system that works – one that supports connectivity, safety, new housing, environmental quality, economic growth and productivity. Yet transport in Auckland had been heading in the opposite direction, with projections of increasing transport demand and worsening congestion.

ATAP has a governance structure within which officials from the Ministry of Transport, Auckland Council, Auckland Transport, the NZTA, the Treasury and the State Services Commission work together to improve alignment between the parties about the way to develop Auckland's transport system. This includes an agreement on cost sharing. ATAP plans to invest \$28 billion over the 10 years from 2018–28, shared between central government and Auckland Council. This investment includes funding from the new Auckland Regional Fuel Tax (Ministry of Transport, 2018).

ATAP has developed to become an effective institutional innovation to enable the council of a leading city and central government to work together and implement a national funding contribution for a major programme of urban infrastructure with national spillover benefits.

⁴⁴ The NLTF receives funding from petrol excise tax, road user charges and a portion of vehicle registration and licensing fees. It is a key component of New Zealand's pay-as-you-go, user-pays funding system for land transport.

⁴⁵ A precursor to ATAP, the Auckland Transport Strategic Alignment Project, began about 9 years earlier.

Yet ATAP took many years to develop, which created policy uncertainty and delay. Similar delays and uncertainties are apparent in a joint project between central government and the Wellington region – the “Let’s Get Wellington Moving” project.

The Provincial Growth Fund and tourism funds

The Provincial Growth Fund (PGF) is a \$3 billion fund, providing \$1 billion a year over three years to projects that will “lift the productivity potential of the regions”. The PGF funds a combination of “bottom-up” initiatives prioritised by the regions, and “top-down” initiatives prioritised by the Government to address social and infrastructure deficits at a regional level.

The PGF is in its early phases and so is difficult to assess against the principles of good design of intergovernmental transfers. It has a very high-level and broad purpose that militates against it having a single, clear objective. Since it is a contestable fund, the revenue is unpredictable for local government. The fund is large and is attracting a lot of attention and effort by local governments to win grants. As a result, a risk exists that it will undermine local government autonomy and accountability. It is not clear that allocations are based on objective factors or whether the allocations consider the need for ongoing operating expenditure.

As described in Chapter 10, governments over recent years have created several funds to help local authorities cope with pressures from rapidly growing tourism. These funds include the Tourism Infrastructure Fund and the Responsible Camping Initiative. While councils have been thankful for grants under these programmes, they cite problems with them such as lack of predictability (because grants are contestable), the bias against small councils who lack resources to fulfil application requirements, and restrictions to capital funding only.

F6.6

Programmes of central-government transfers to local government are ubiquitous globally but play a smaller role in New Zealand than in many countries. This smaller role is good for local government autonomy and accountability. It is important that programmes have a clear purpose, provide predictable revenue, preserve local government autonomy and accountability as far as possible, and are fair, efficient and transparent.

Among current transfer programmes, the system of grants from the National Land Transport Fund for local roads and other forms of land transport is an example of good design.

6.10 Rating land and property should continue as the main tax revenue source for local government

Despite the growing pressures on local government funding in the areas mentioned, the current suite of funding tools generally measures up well against the principles of a good system. Given that these tools have served local government and New Zealand well historically, they should not be lightly discarded. Providing satisfactory solutions exist to deal with the pressures, it will be preferable to retain a known and successful existing system to incurring the disruption and costs of transferring to another system that is not substantially superior.

Further, as detailed below, the main alternative funding systems of a local GST or income tax would fail to address the fiscal shortfalls of councils facing pressures from adaptation to climate change, a heavy burden of unfunded mandates, or a combination of high needs and low incomes. Allowing councils to tap into local income or spending streams would not relieve these pressures. Arguably, the other two pressures of high levels of tourism and infrastructure for growth could be relieved by more direct access to local spending and income streams.

Several councils, Local Government New Zealand and SOLGM agreed that the current system is generally sound and should be retained (Horizons Regional Council, sub. DR153; Rangitikei District Council,

sub. DR247; Tasman District Council, sub. DR236; Whangarei District Council, sub. DR203; LGNZ, sub. DR263; SOLGM, sub. DR176).

The Commission's view is that acceptable solutions are possible for each of the areas under strain. As noted, its analysis and recommendations on these are covered in later chapters. The additional concern, voiced by some councils and many submitters, is that rates are becoming increasingly unaffordable for some ratepayers. As noted, affordability pressures are most likely in small, rural districts with low average levels of income. Districts with small populations start with the disadvantage of having to share the fixed costs of infrastructure and local public goods across fewer ratepayers. When these ratepayers are also, on average, relatively poor, the rates burden as a percentage of income shoots up.

One solution to this structural problem would be to redraw boundaries to nest these small districts within larger ones. The Commission does not further investigate this solution since it cannot recommend it under the inquiry's Terms of Reference. Even so, the Commission recommends collaboration across councils where that would achieve efficiency gains (Chapter 5), and it analyses a structural solution for drinking water and wastewater services that would not involve re-drawing district boundaries (Chapter 11).

Alternative models of local government funding

To test whether any radically different approaches to raising local government revenue would be superior in terms of local government use, coherence, efficiency, equity, sustainability and transparency, the Commission examined the main alternatives. It looked at systems in use around the world including several in Europe where local governments have larger scope and access to significant income tax revenues (Crawford & Shafiee, 2019).

A major finding was that despite the apparently greater taxing powers and revenues of regions and districts in countries such as Sweden, the underlying reality of what is determined nationally against what is determined locally, and who pays for it, is not very different to New Zealand's arrangements. For example, in Sweden health is a responsibility of regional governments and education is a responsibility of the smaller municipalities. Yet both areas are subject to considerable national oversight and standards. In New Zealand, health and education are also devolved to an extent – but through District Health Boards and schools rather than through local government.

Overall, the Commission found no major alternative funding system that meets requirements markedly better than the current system. Besides, fundamental change would be disruptive, expensive and risk unintended consequences. Table 6.1 lists the main alternative funding systems and their chief advantages and disadvantages.

Table 6.1 Potential alternatives to rates on land and property

Alternative to rating land and property	Advantages	Disadvantages	Location of further analysis
Local income or sales taxes	<ul style="list-style-type: none"> Revenue more responsive to economic activity Income tax more aligned to ability to pay 	<ul style="list-style-type: none"> High administration and compliance costs 	Section 7.2 and Crawford & Shafiee (2019)
Some share of national GST or income tax	<ul style="list-style-type: none"> Revenue more responsive to economic activity Low administrative and compliance costs 	<ul style="list-style-type: none"> Risk of undermining local autonomy and accountability Determining shares would be controversial Low transparency 	Section 7.2 and Crawford & Shafiee (2019)
Property tax based on a percentage of the property value	<ul style="list-style-type: none"> Revenue generated without having to set rates each year Revenue more responsive to economic activity 	<ul style="list-style-type: none"> Potential loss of fiscal discipline Risk of volatile revenue because of volatile property prices 	Section 7.2 and OliverShaw (2019)
Value capture	<ul style="list-style-type: none"> Revenue raised efficiently on windfall gains in property prices caused by city development Fair 	<ul style="list-style-type: none"> Not suitable for raising the bulk of revenue Complex 	Section 7.2; Chapter 11 in NZPC (2017), and Oliver (2016)
Tax on vacant land	<ul style="list-style-type: none"> Intended to incentivise productive use of land (eg, by discouraging land banking). Yet this is hard to achieve and risks unintended consequences (see disadvantages) 	<ul style="list-style-type: none"> Taxing economically efficient vacant land is hard to avoid Risk of harmful tax on development High administrative costs per dollar of revenue 	Section 7.4 and CSA (2019c)
Poll tax (a per person uniform charge)	<ul style="list-style-type: none"> High economic efficiency 	<ul style="list-style-type: none"> Hard to enforce Regressive and unfair Unpopular 	No further analysis

As noted in Chapter 1, the Commission received a request from the Minister of Finance after this inquiry had begun to consider whether a tax on vacant residential land would be a useful mechanism to improve the supply of available housing for New Zealanders. This is not a tool whose primary purpose is to raise revenue. In response to the Minister's request, the Commission asked Capital Strategic Advisors to investigate this potential tool. Its report, CSA (2019c), is on the Commission's website. The Commission's advice on taxing vacant land is in Chapter 7.

F6.7

The current main funding tools of local government in New Zealand measure up well against the principles of appropriateness for local government use, coherence within national policies and institutions, efficiency, enforceability, and the stability and predictability of revenue. Yet scope exists for many councils to make better and more transparent use of their funding tools and this would help relieve funding pressures.

R6.2

Given the modest scope of local government in New Zealand, the benefits of a property-tax-based system, and the absence of a clearly superior alternative, rating land and property should continue as local government's main taxing power.

To help relieve funding pressures, councils should make better and more transparent use of their rating and other funding tools.

6.11 Conclusion

Overall, the Commission finds that the current system of rates on property and user charging performs reasonably well against the principles of a good system of local government funding, and should be retained.

This conclusion takes into account the Commission's investigations of the areas where funding is under strain (Chapters 7, 9, 10 and 11).

Further, significant opportunities exist for many councils to make better and more transparent use of current funding tools (Chapter 7), and to further relieve funding pressures through better organisational performance and decision making (Chapter 5). Opportunities also exist for councils to innovate more and more effectively, leading to higher productivity (Chapters 5 and 11).

Programmes of central government transfers to local government are ubiquitous globally but play a smaller role in New Zealand than in many countries. This smaller role is good for local government autonomy and accountability. It is important that transfer programmes have a clear purpose, provide predictable revenue, preserve local government autonomy and accountability as far as possible, and are fair, efficient and transparent.

7 Future funding and financing

Key points

- Funding pressures on local government have been growing, but not evenly across councils. The first steps to deal with these pressures are improved council governance, decision making, asset management and financial management (Chapter 5), and better use of existing funding tools such as rates, user charges, development contributions, asset recycling and borrowing.
- Four areas of funding pressure indicate the need for some changes. The pressure areas are (i) supplying enough infrastructure for urban growth; (ii) coping with the growth of tourism; (iii) central government's growing list of responsibilities and standards for local government; and (iv) adapting to climate change.
- The failure of high-growth councils to supply enough infrastructure to meet housing demand is a serious problem. Councils have funding and financing tools to make growth pay for itself over time, but debt limits and the perception that growth is not self-supporting are significant barriers.
- Innovations such as using targeted rates to capture a portion of rising property values and the Milldale Special Purpose Vehicle debt model (and its proposed extension) would help high-growth councils deal with these problems.
- Imposing taxes on vacant land and dwellings would suffer definitional problems, have high administrative costs and be ineffective in improving the supply of available housing for New Zealanders. Other approaches to improve housing supply are preferable.
- Councils must be transparent in explaining to their communities and individual ratepayers what their rates and charges are for, and how costs are being shared. This will help build accountability and understanding and, in turn, a greater willingness to fund projects and services that are needed and give value for money.
- Central government transfers to help fund local government activities can be desirable and justified in certain cases: (i) when council activities have national-benefit spillovers; (ii) risk sharing across communities that experience damaging shocks (such as natural disasters); (iii) helping low-income communities struggling with essential services; and (iv) recycling revenue collected centrally (for administrative efficiency) to cover costs incurred locally.
- Payments beyond such cases could undermine local-government autonomy and accountability. Transfer mechanisms need to be carefully designed for efficiency, equity, predictability and to prevent the emergence of "transfer dependence".
- A reset of the relationship between central and local government to one of partnership would improve regulatory design and outcomes. It would help alleviate the problem of "unfunded mandates" where central government places extra responsibilities on local governments without adequate consideration of funding.
- The Government should pay development contributions on its projects in line with the development-contributions policies of the local authorities in which the projects are located.
- Maintaining services in small, rural, low-income districts, often with static or falling populations, requires openness to new scalable technologies, collaboration with others, and some co-funding from central government.
- The funding pressures from the need to adapt to climate change and from tourism are dealt with in Chapters 9 and 10 respectively.

While in broad terms current funding and financing arrangements in New Zealand perform well and are fit for purpose, new and growing expenditure pressures on local government described in Chapters 4 and 6 justify some new approaches, including new tools to augment existing tools.

This chapter recommends some new tools and mechanisms to deal with expenditure pressures from population growth and central government's growing list of responsibilities and standards for local government. Later chapters will deal with the affordability of rates for households (Chapter 8), the funding challenges of adaptation to climate change (Chapter 9), responding to tourism pressures (Chapter 10) and the funding and financing of three-waters services (Chapter 11).

This chapter also examines how councils can make better use of existing tools and whether introducing a tax on vacant land could be an effective way to boost the supply of developed land to alleviate the serious problem of unaffordable housing.

7.1 A decision framework to guide the use of funding tools

In *Better Urban Planning*, the Commission put forward a decision framework laying out a sequence of questions that would guide decision makers to choose the best instrument for funding infrastructure (NZPC, 2017; Oliver, 2016). With some modifications, this decision framework can be used as a guide to the broader question of what funding tools are best for services as well as infrastructure (bearing in mind that the two are closely related because the delivery of most local government services relies on underpinning infrastructure).

The decision framework is shown in Figure 7-1 and is based on important distinctions explained in section 6.1 (under the "Efficient funding and financing" subheading) between public and private goods and whether a set of beneficiaries can be identified and charged. The choice of funding tool is dictated by what scores best on a combination of efficiency (marginal cost pricing and the exacerbator principle) and a fair allocation of the cost (based on a balance between the benefit principle and ability to pay).

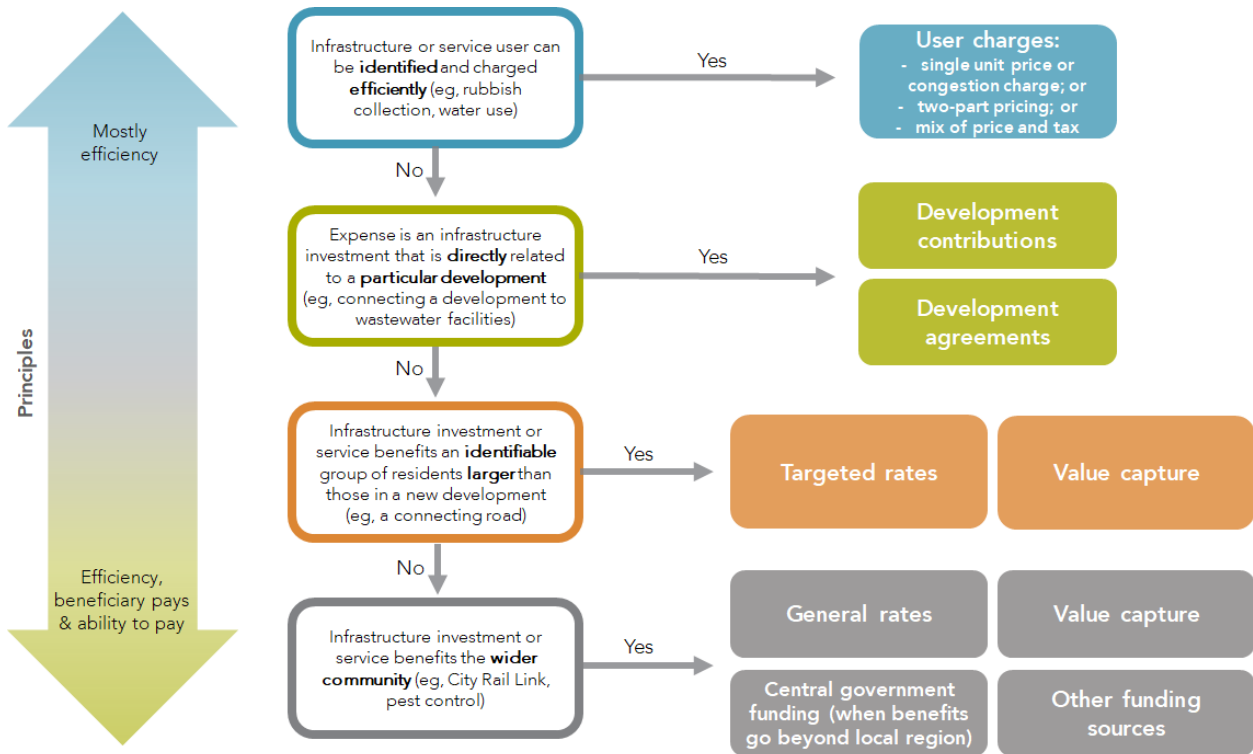
In the upper part of Figure 7-1, where councils can easily identify and charge individual service users, efficiency considerations should dominate. In the lower parts of Figure 7-1, where councils can less easily identify and charge individual service users, they should consider ability to pay in addition to efficiency and who benefits from the service. How much weight to place on ability to pay and how to give effect to it are largely political judgements of democratically elected councils. Yet it is vital that, in making these judgements, councils are transparent so that they may be held to account by their citizens (section 7.5).

A further consideration is to balance economic efficiency with keeping compliance and administration costs low. In some cases, keeping funding instruments simpler may sacrifice economic efficiency. Yet the simplicity avoids higher compliance and administration costs to an extent that the trade-off is a net benefit.

Local authorities can be monopoly suppliers of some services to citizens. The lack of competition creates risks that the services will be supplied inefficiently, or below an acceptable quality, and/or they could be overpriced. Two forms of protection against these risks are democratic accountability and transparency, but these vary in effectiveness (Chapter 5). Another mechanism often used to mitigate risks with private monopolies is regulation. Chapter 11 examines the use of regulation to improve water and wastewater services.

The decision framework includes value capture. The legal ability of councils to use value capture tools is limited. This is further described in section 7.2. Central government funding is dealt with in section 7.6.

Figure 7-1 Decision-making framework for choosing funding tools for local government services and investments



Local authorities are not legally able to use congestion charges or environmental taxes to discourage environmental “bads” such as road congestion or the discharge of pollutants into the air or water bodies or onto land.⁴⁶ Environmental taxes can be an efficient means to modify behaviour and improve environmental quality. They are not primarily a means to raise revenue. The recent Tax Working Group (TWG) developed a “Framework for taxing negative environmental externalities” and stated that significant scope exists for New Zealand to make greater use of environmental taxes (Tax Working Group, 2019). Regional councils in particular could be well placed to make use of environmental taxes to help carry out their environmental stewardship responsibilities.

R7.1

In choosing among funding tools, rating bases and whether to charge rates as a percentage of property values or as uniform charges or some other targeted feature, councils should give close and explicit consideration to:

- promoting economic efficiency;
- fairness in who pays; and
- keeping compliance and administration costs low.

Sometimes these three goals will conflict, in which case councils must be clear and transparent about the reasons for their choices.

Regarding fairness in who pays, councils must strike a balance between charging in line with who benefits from the service and basing payments on ability to pay. Again, it is important for councils to be transparent about their reasons for striking the balance they choose.

⁴⁶ In the case of waste disposal, a Waste Disposal Levy is payable by landfill operators (many of whom are councils) who pass it on to customers. The revenue goes to central government and it is then partly returned to territorial authorities for waste minimisation activities.

User charges and cost recovery from regulated parties

A strong efficiency case exists for councils to impose user charges on regulated parties where the benefits from the regulated activity are private. In a sense, the regulated party causes the need for a permit or resource consent and can be regarded as the “exacerbator”. This will be the case for many regulated activities. The costs involved are the processing costs for the consent as well as the costs of compliance, monitoring and enforcement (CME) associated with the regulation. If councils do not charge fees that reflect the costs, they not only fail to signal the cost to the exacerbator, but also pass the cost to the general ratepayer causing some increase in funding pressure. Another risk is that rather than use either source of funding, councils will fail to undertake CME activities and undermine regulatory effectiveness.

As section 4.3 notes, councils suffer from legislative uncertainty about whether they can charge for the CME of permitted activities (ie, activities that do not require a resource consent under a relevant district or regional plan). Indeed, guidance from the Ministry for the Environment (MfE) states that councils cannot charge for monitoring permitted activities except when they are empowered to do so under a National Environmental Standard (NES). But only one NES to date (the Plantation Forestry NES) allows for such charges.

Most councils do little or no monitoring of permitted activities. CME activities more generally are under-resourced, and practices vary significantly across councils (particularly between regional and district councils) (Brown, 2017; MfE, 2016).

Councils’ weak resourcing of CME stems partly from the confusion/uncertainty around the legislative authority for cost recovery, and partly from self-imposed constraints arising from:

- councils’ dual economic development and environmental protection roles (and in the case of unitary authorities, dual roles of regulator and regulated party);
- lack of appropriate separation of governance and operations for CME functions;
- elected members’ lack of understanding of their role; and
- following from the above points, political pressures that lead to categorising more activities as permitted activities (to reduce compliance costs for resource users and to keep fees low).

The combination of limited budgets and modest fees means ratepayers shoulder the burden of what tends to be a largely private good. This is inconsistent with the Commission’s advice that councils should make greater use of user pays, through applying the benefit and exacerbator principles and recovering costs from users where it is efficient to do so.

The Government should resolve the legislative ambiguity about councils’ ability to charge for their work on CME (including incident response and investigation) of non-consented activities. Non-consented activities include permitted activities as defined under the Resource Management Act 1991 (RMA). The resolution could be through clear national guidance and/or a legislative amendment that explicitly provides for cost recovery. This work should be done in partnership with Local Government New Zealand (LGNZ), the New Zealand Society of Local Government Managers (SOLGM) and local government practitioners.

R7.2

The Government should resolve the legislative ambiguity about councils’ ability to charge for their work on compliance, monitoring and enforcement (including incident response and investigation) of non-consented activities.

The resolution could be through clear national guidance and/or a legislative amendment that explicitly provides for cost recovery. This work should be done in partnership with Local Government New Zealand, the New Zealand Society of Local Government Managers and local government practitioners.

What are “reasonable” costs that councils can charge?

Another source of difficulty for councils in trying to recover the cost of their regulatory activities through user charges is unclear guidance about what constitute “reasonable” charges.

Charges imposed under section 36 of the RMA must meet the criteria set out in section 36AAA:

- (2) The sole purpose of a charge is to recover the **reasonable costs** incurred by the local authority in respect of the activity to which the charge relates. [emphasis added]
- (3) A particular person or particular persons should be required to pay a charge only—
 - (a) to the extent that the benefit of the local authority’s actions to which the charge relates is obtained by those persons as distinct from the community of the local authority as a whole; or
 - (b) where the need for the local authority’s actions to which the charge relates results from the actions of those persons; or
 - (c) in a case where the charge is in respect of the local authority’s monitoring functions under section 35(2) (a) (which relates to monitoring the state of the whole or part of the environment)... .

Consistent with s36AAA(2) of the RMA, section 150(4) of the Local Government Act 2002 (LGA) states that the fees prescribed

must not provide for the local authority to recover more than the **reasonable costs** incurred by the local authority for the matter for which the fee is charged. [emphasis added]

SOLGM has developed guidance for councils on setting prices, both for cost recovery and other purposes (SOLGM, 2017b). This guidance is unclear on what constitute “reasonable” costs for an activity. In particular, it is not clear what types of indirect costs could be considered reasonable. Furthermore, the guidance is peppered with warnings about the threat of judicial or Parliamentary review for pricing that goes beyond the reasonable cost of the legitimate purpose of legislation.

The Quality Planning guidance provides practical advice on setting charges for consent processing and monitoring, based on economic principles and case law (Quality Planning, 2017). The guidance contains a table setting out the proportion of charges that could reasonably be recovered for each category of activity according to the estimated split of public to private benefit. For example, “routine consent supervision, compliance monitoring, inspections and auditing” is categorised as 100% cost recoverable. The funding/benefit splits in the table draw on case law, which has shown (for example) that councils are not expected to absorb any of the costs of consent processing as part of their general overheads (p. 7).

The guidance notes that some councils fund their monitoring of compliance with consents largely or entirely from general rates, on the basis that it is a public good. The guidance states that it may not be appropriate for the wider community to bear these costs, since if there were no consent there would be no need for any compliance monitoring.

To assist councils, SOLGM should review and revise its guidance on setting fees in local government, to more clearly explain how to apply the benefit and exacerbator principles and how to set fees that meet the legal test of “reasonable”. The Quality Planning guidance on setting fees for consented activities would be a good model for the revised guidance to follow.

R7.3

The New Zealand Society of Local Government Managers should review and revise its guidance on setting fees in local government, to more clearly explain how to apply the benefit and exacerbator principles and how to set fees that meet the legal test of “reasonable”. The Quality Planning guidance on setting fees for consented activities would be a good model for the revised guidance to follow.

7.2 Funding and financing growth

This section investigates the extent to which funding and financing barriers lie behind the failure of some high-growth councils to supply enough infrastructure to meet housing and business demand. It examines the nature of any barriers and how they might best be overcome.

Conclusions from past inquiries about how councils can fund growth

In three past inquiries, the Commission has investigated housing affordability, the supply of land for housing and better urban planning (NZPC, 2012, 2015, 2017). These topics are closely related to each other and to this section.

A recurring question in all three inquiries has been, from a council's perspective, "does growth pay for itself?" More precisely, as the population of a district grows, are the revenues that accrue to the council from the new residents and their properties enough to cover the costs that the growth places on the council (eg, the costs of new water, wastewater, roading and community infrastructure)?

If growth does not pay for itself, some of the costs of growth will fall on existing residents. In all three previous inquiries, and in this one (as noted in Chapter 4), the Commission heard from many councils and others that growth does not pay for itself. Perhaps more importantly, many residents of growing cities or towns *perceive* this, and that growth puts a financial burden on them. Naturally, these residents put pressure on councils to resist growth because it will hit them in the pocket. This lack of enthusiasm for growth (either expansion beyond the existing urban boundary or intensification within it) has been a significant contributor to the undersupply of housing in fast-growing urban areas. In turn, this supply-demand deficit has been a major driver of rapid and harmful house-price increases in New Zealand since around the turn of the century.

In its report on *Better urban planning*, the Commission concluded that a council's additional revenues from growth *can* cover the costs of the infrastructure needed for growth. Yet this conclusion was subject to several caveats.

- Councils' growth expenses will tend to arrive early in the growth cycle (eg, for large, lumpy pieces of infrastructure) while revenues (eg, additional rates and charges) will be spread over many subsequent years. Councils will need to finance these timing gaps by borrowing if costs are not to be a burden on existing residents.
- Councils must bear the risk of making their large, upfront investments in infrastructure based on forecasts of demand growth that are uncertain. If the forecasts turn out to be overly optimistic, councils are locked into their expenditure and may face high borrowing costs and underused assets at the same time as facing a rating-revenue shortfall relative to expectations. In other words, councils face significant risks in trying to service growth in their districts.
- Lenders and credit-rating agencies place debt limits on councils which, if exceeded, would lead to a downgrading of a council's credit rating and higher interest costs. The limit fast-growing councils are most likely to find binding is that the ratio of total debt to revenue must stay under 270%. This limit is close to binding on some fast-growth councils, such as Auckland and Tauranga, and prevents them from investing as much as they need to keep up with growth (despite the prospect of strong council revenue increases that would pay for the additional borrowing over time).
- The political economy is difficult because, even if evidence indicates that growth can pay for itself, existing residents do not perceive it this way. They resist change and the council taking on more debt (which means that growth would indeed need to be funded in large part by current residents). The high visibility of rates compared to GST and PAYE tax also contributes to political resistance.

A value-capture tool

Because of these concerns, and considerations of fairness, the Commission recommended a new funding tool for councils. The tool would raise revenue by "value capture". Property owners who enjoyed windfall gains in the value of their property because of nearby infrastructure that the public has funded, would be

required to pay a portion of this gain to the council. In turn, revenue raised would help the council fund future growth. In its report on *Better urban planning*, the Commission made the following recommendation:

A future planning system should include a value-capture tool for councils' optional use to help fund infrastructure projects that benefit broad parts or the whole of a city. One way of applying value capture that would be feasible, efficient and fair is to enable councils to levy targeted rates on changes in land values. This would require a change in legislation. (NZPC, 2017, p. 334)

The Government has so far not responded to the Commission's recommendation. A value-capture tool of this type or some other type (still based on targeted rates) would yield additional revenue from growth. Increases in the value of urban property are a natural part of urban development as public and private investment makes nearby land more valuable.

Several overseas jurisdictions have forms of value capture that target properties benefiting from infrastructure investments, using tools such as targeted rates that are already available to local government in New Zealand. These tools avoid problems with pure forms of value uplift – such as determining the base period for measuring the increase in value; and unpredictable and potentially large levies on some property owners. Property owners can easily understand the rationale for such targeted rates and predict what they will have to pay (Terrill & Emslie, 2017). Even so, New Zealand councils will need to be confident that targeted rates of this type will not be vulnerable to legal challenge. Legislative clarity to avoid this would help.

Making more use of currently available tools

As explained in *Better Urban Planning*, the tools that a council can currently use to raise funds for investment in growth from those who benefit from growth (rather than existing residents) are:

- resource-consent fees;
- development contributions (DCs) and infrastructure that developers typically pay for and install within subdivisions and then vest with councils;
- infrastructure growth charges (IGCs) (Auckland only, paid to Watercare by property owners or developers for connections to Watercare's water and wastewater networks. The charge contributes to the capital cost of new or enlarged treatment plants and pipe networks to meet growth in demand);
- targeted rates on new properties that benefit from any new infrastructure not already paid for by DCs or IGCs (eg, for roads, stormwater, sports facilities, parks and reserves);
- water charges (which could be targeted rates, fixed charges, volumetric charges or a combination of these);
- wastewater charges (only Watercare in Auckland can charge volumetrically, but other councils can use targeted rates);
- solid waste management charges; and
- regional fuel levy (currently Auckland only, revenue will increase as regional traffic increases with growth).

Volumetric charges for wastewater

The Commission has recommended in past inquiries that the Government should give councils the power to levy volumetric wastewater charges and road-congestion charges. It concluded that adding these powers and the value-capture tool to existing funding tools would likely be enough to give councils the means to fund growth without placing a financial burden on existing residents (providing large, upfront costs can be financed with additional debt). These means would be fair because the costs would fall on those who benefit – the new residents. They would also be efficient given the efficiency of user charges, DCs, congestion charges, and the reasonable efficiency of rates – particularly when based on land values.

F7.1

Councils have a portfolio of charging and rating tools to recover the costs of their growth-related infrastructure. Yet cost recovery may take many years, councils face investment risks (eg, over-investment or investing in the wrong location) and some councils face debt limits. Councils also face political pressure to not support growth. The result is that some councils in fast-growing cities are either not willing, or not able, to invest in growth-related infrastructure at levels that match demand.

F7.2

Giving councils powers to levy a value-capture rate, road congestion charges and volumetric wastewater charges would give them additional means to recover the costs of growth from those who benefit from growth.

R7.4

The Government should give councils powers to levy:

- some form of value capture using targeted rates;
- road congestion charges; and
- volumetric wastewater charges.

These would give councils additional means to recover the costs of growth from those who benefit from growth.

Despite available funding tools, the perception still exists that growth harms existing residents

Land-use planning and investing in infrastructure to meet the demand for housing and other amenities in fast-growing cities has very high social returns (NZPC, 2017). Yet, as noted, the returns to councils and existing residents sometimes appear to them to be negative; or, even when councils see the investments as desirable, limits on debt stop those investments. The high social returns mean that it is very important to lower the barriers to these investments.

Concerns about the negative attitudes of existing ratepayers towards growth have been echoed by the former Minister of Housing and Urban Development, Hon Phil Twyford. In a speech to the New Zealand Initiative on 22 March 2019, he stated:

[T]o a large extent, local government politicians have been unable to convince their ratepayers to invest in growth, leaving a burgeoning infrastructure deficit for the next generation.

The unwillingness or inability to invest in the infrastructure to support development stops cities growing. When a city cannot grow in response to demand, a pressure cooker effect is created, which is what has given Auckland some of the most expensive urban land and housing in the world relative to local incomes. (Minister of Housing and Urban Development (Hon. Phil Twyford), 2019)

One barrier that submitters and others often mention is that the rating system does not automatically generate more revenue when economic activity in a council district grows. They draw a contrast between the funding tools of local government with those of central government. The central government's set of tools includes income tax and GST, which generate more revenue for central government as the volume of economic activity grows. This does not happen under the rates system. Councils do not set the equivalent of the rate of GST or the rate schedule for income tax and then see what revenue those rates (combined with economic activity) will bring in. Rather, councils are obliged to decide on their expenditure needs and then set rates yearly to generate enough revenue (after considering receipts from user charges, DCs and other sources).

In addition, most people find income tax and GST less painful taxes because money gets taken either before it gets into their pockets (income tax) or in the act of spending (GST). In each case, the tax is deducted automatically while rates require property owners to make explicit payments to councils from their existing

funds. The different perception is partly irrational, but it is also understandable. Because of the way PAYE tax and GST deductions work, taxpayers have a cashflow out of which to pay these taxes. But ratepayers do not necessarily have cash on hand when rates are due.

The Government recognised in 2017 the importance of investing in urban infrastructure to keep up with the growth in residential and business demand by issuing a National Policy Statement (NPS) for Urban Development Capacity. This NPS acts as a regulatory instrument that requires councils to make enough land available for development and service it with infrastructure. This is a “stick” approach to incentivising councils. There may be merit in considering a “carrot” incentive to complement it.

F7.3

Many councils and ratepayers still perceive that council revenue from local growth does not fully cover related costs, and that therefore growth is financially disadvantageous. This perception is exacerbated by the:

- highly visible way that property owners are billed for and pay rates;
- much less visible way that most people pay income tax and GST; and
- the automatic link between economic activity and revenue from income tax and GST, which does not exist for rates.

Property taxes and other tools that link revenue to growth

Some organisations and individuals have called for an additional funding tool or a modification of the current rates system that, like income tax and GST, would have an automatic link between growth and revenue. Such a tool could create an incentive for councils to embrace growth and alleviate concerns of existing residents that growth is a burden on local government finances and will disadvantage them. Suggestions for such a funding tool include:

- a local property tax;
- local income or sales taxes; or
- a portion of national GST or income tax.

A local property tax

Some local authorities in the United States and elsewhere draw significant funding from local property taxes and set property tax rates as a fixed percentage of the value of property in its jurisdiction.⁴⁷ If property values generally increase across a jurisdiction, then the authority would automatically gather more revenue. New houses and businesses in an area, as its population grows, would also increase revenue automatically.

The two automatic and transparent links – between the growth in property values and council revenue, and between the number of properties and council revenue – would mean that the level of revenue determines the amount a council can spend, rather than councils having to set expenditure at step one and then set rates to cover this expenditure at step two, as under the current system in New Zealand (and in some US states such as Illinois). The argument is that linking the growth in property values to council revenue would align the incentives of councils and existing residents to favour what is good for the whole community – that the growth in the quantity and quality of property matches demand.

However, property tax revenue could be neither stable nor predictable. Property taxes risk generating either too much or too little revenue because property prices can grow strongly over extended periods for reasons unrelated to the quality and quantity of local amenities, and sometimes they can drop quite sharply. Several submitters expressed this concern. For example, Waikato Regional Council submitted:

A disadvantage of this approach is that Council’s revenue is dependent on the property values of its area. In a growing area, the tax revenue would likely grow with expenditure. However, in a declining area, if property values are falling this could create serious difficulties for councils as their revenues fall

⁴⁷ Across the 50 US states in 2007, residential property tax rates varied between 0.14% in Louisiana and 1.84% in Texas (Tax Foundation, 2009).

too. Similarly, if property values are over-valued for a sustained period, a bursting of the bubble may create a cash-flow crisis for a council. The thinking behind the rating system is that revenue can only be raised for the things that the community wants and has collectively agreed to pay for. This acts as a kind of discipline on local government. This would not be the case for a local property tax which is a disadvantage. (sub. 125, p. 17)

Glaeser et al. (2005) have presented strong evidence that the strictness of planning regulations largely explains shortages of land for housing (and therefore housing affordability) rather than the method of local taxation. The Commission agrees that this evidence is convincing.

For this reason, and the caveats of volatility of revenue and lack of fiscal discipline, a property tax (levied as a percentage of the value of properties) would cause significant concerns in the New Zealand context. The Commission agrees with OliverShaw that a property tax is not the answer to the problem of councils lacking enough incentive to embrace growth. OliverShaw concludes:

What sort of changes to the rating framework would be required to better align incentives? A move to a property tax along the lines considered in this paper would require a relaxation of the existing fiscal constraints on councils, closer government micro-management of council expenditure forecasts or imposition of market driven fiscal constraints as per USA. Such options do not seem viable or justified in the New Zealand context.

Overall the preferred approach seems to be to retain the existing rating framework and encourage councils to utilise the tools they have in order to align the costs of growth with the benefits from growth. This might include some relaxation in revenue raising rules (such as allowing for value capture along the lines of previous Productivity Commission Reports.) This seems to be the preferred option. (OliverShaw, 2019, p. 14)

Despite this conclusion, a perception problem may remain because of how rates are set in the current rating framework. The way they are set provides fiscal discipline, yet it can fail to incentivise councils and voters to support growth.

F7.4

While local property taxes as a fixed percentage of property values are used in other parts of the world, they are not a panacea for aligning the incentives of existing voters and property owners with socially desirable growth in dwellings. Given that property prices in New Zealand have been neither stable nor predictable, property tax revenues would not be either, and this would be undesirable.

The highly transparent system of rating in New Zealand provides a healthy fiscal discipline on councils.

Local income or sales taxes

A local income or sales tax could be another way to provide revenues in line with growth and incentivise councils and existing residents to favour growth. While revenue from these taxes would increase with local economic activity, implementing such tools in New Zealand would be complex. The New Zealand tax system is not set up to determine income or sales by local authority district. A system that could do this would have high administrative and compliance costs. Revenue from these taxes would be more volatile than from rates and they would make it more difficult for low-income districts with static or falling populations to maintain existing service levels.

In his report for the Commission for its inquiry into *Better urban planning*, Oliver (2016) gave an example of the complexity in determining in which local authority a company's income is earned and tax is payable.

Local authority income tax could be implemented as a surcharge on the existing income tax with the surcharge set by each region. However this form of tax would require complex rules to allocate the revenue to each local authority – an internal web equivalent to our international tax treaties... These rules would need to decide, for instance, where to allocate the tax on a company with a Christchurch Head Office, owned by shareholders in Dunedin, manufacturing in Wellington and selling in Auckland.

Given that allocating company income and tax would be complex, a practical local income tax could be one in which local taxable income is defined as each person's income for national income taxation. Inland

Revenue could then simply apply a local-income surcharge on each person's taxable income. Yet this system would require each person to have an authentic address that fairly reflected their use of local services. The system could also be open to people "sheltering" their income in companies that they control so they can avoid the tax surcharge on local income.

Designing and implementing a local GST would also be complex and problematic. A sales tax on final goods and services within a local authority would be simpler, but would face the difficult task of determining goods and services that are for final consumption rather than for sale to another business, and collecting and enforcing the local tax on those sales.

Even so, the Commission is aware that local income and sales taxes exist in other countries (Bailey, 1999; Crawford & Shafiee, 2019; OECD & UCLG, 2019a).

The options of local income and local sales taxes received mixed support in submissions. Some submitters drew attention to the benefit of revenue being more buoyant and reflective of local economic activity and the incentive effects of this on councils to support growth (Ruapehu District Council, sub. 85; New Zealand Initiative, sub. 96; LGNZ, sub. 112; Infrastructure NZ, sub. 128). Yet some of these same submitters and others also drew attention to the downsides of complexity and volatility (Wellington Chamber of Commerce, sub. 72; Rangitikei District Council, sub. 115; Ruapehu District Council, sub. 85; New Zealand Initiative, sub. 96; Waikato Regional Council, sub. 125).

A portion of national GST or income tax

Several submitters argued that local government should have access to a portion of national GST or income tax to solve the failure of rates to provide enough revenue for councils to fund growth (eg, Youth Hostel Association of New Zealand, sub. 64; Selwyn District Council, sub. 84; Whakatane District Council, sub. 121; Hamilton City Council, sub. 130). Like a local income or expenditure tax, revenue from such access would increase automatically with economic activity. Submitters argued that, unlike with a true local GST or income tax, the administrative and compliance costs of such access would be low. The tool would require only a formula that allocates across local authorities the portion of national GST or income tax that central government has agreed to give up.

This proposal has several problems.

- A fair allocation formula is likely to prove elusive if by "fair" is meant an allocation reflecting how much income or spending has occurred in each local authority. As noted for local income or sales taxes, it would be complex to determine these shares. Even a formula based on where people live would confront some problems – given the infrequency of census counts, the frequency with which many people move, and the uncertainty about the location of some people's main residence (eg, tertiary students).
- If the formula is based on where people live, the government would have to decide whether the division among local authorities is based on headcounts, or on the total personal income or spending of people in each local authority. These would give very different allocations and so the choice would be controversial.
- The approach would risk undermining local autonomy and accountability to some extent by putting more of a local authority's revenue outside its control. Local politicians would be able to blame central government for setting the portion too low or for unfairness in the allocation formula, rather than conducting a more honest discussion with the local community about how much local people are prepared to pay for additional services.

Submissions on the Commission's draft report contained almost no support for the above options. The Commission's conclusion is that none of the above options is satisfactory because they do not meet one or more important criteria for a good local tax.

F7.5

None of the options of a local property tax, a local income or sales tax, or a portion of national GST or income tax is a fully satisfactory solution to the problem of councils and existing property owners and voters failing to embrace growth.

These options could provide more direct links between growth and council revenue, but each one fails to meet at least one important criterion for a good local tax. The revenue from local property tax would be neither stable nor predictable, local income and sales taxes would be complex and likely to have high administrative and compliance costs, and a portion of national GST or income tax would risk undermining to some extent local autonomy and accountability.

Payments to territorial authorities based on new building work put in place

Another possible way to provide a direct link between local growth (that puts pressure on council infrastructure spending) and council revenue would be a system of central-government payments to territorial local authorities based directly on the amount of new building work put in place in each territorial authority's district. The payment would be available to all territorial authorities. Such a tool would seem to:

- be largely consistent with local autonomy and accountability;
- link council revenue directly to local growth and development; and
- be transparent and relatively low cost to administer – the payment would be proportional to a simple measure of construction and development in a territorial local authority's area (eg, based on the value of building work put in place, or new construction measured by floor area).

The direct link between new building work in a district and council revenue would incentivise councils to facilitate development and construction – two activities over which they have a considerable influence through land-use planning and infrastructure investment.

This option has similarities to schemes that operate in some European countries such as Germany where local politicians have strong incentives to support development. As Evans and Hartwich (2005, p. 27) note:

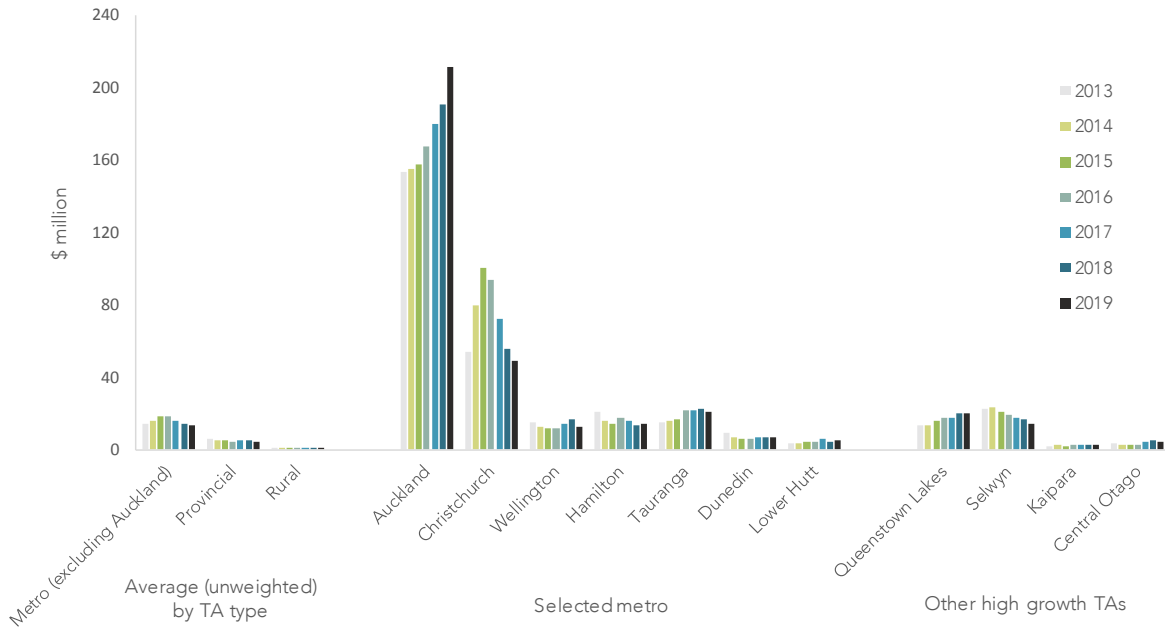
They [the councils] have very clear incentives to provide land for residential and commercial uses as they receive state grants based on the number of inhabitants and are required to finance their local infrastructure with tax revenue created at the local level.

In addition, a scheme of central government grants to territorial authorities directly linked to new building can be justified under the benefit principle because of the strong national interest in an adequate supply of infrastructure-serviced land and new houses to meet demand. As noted, the sluggish supply of these in council areas with high population growth has been the major driver of the very socially and economically damaging rise in house prices in New Zealand over the last two decades.

The level of the payments and what they would be based on would be choices for central government. It would be important that factors determining the size of the payments are clear and stable to maximise the incentive effect on councils. Relatively modest payments (as a percentage of total rates revenues) could have quite strong incentive effects. Total rates revenue of all councils in 2018 was about \$5.8 billion. Ten per cent of this, for example, would amount to a yearly fiscal cost for central government of about \$580 million. The total value of building work put in place in 2018 was \$22.76 billion (Stats NZ, 2018e).

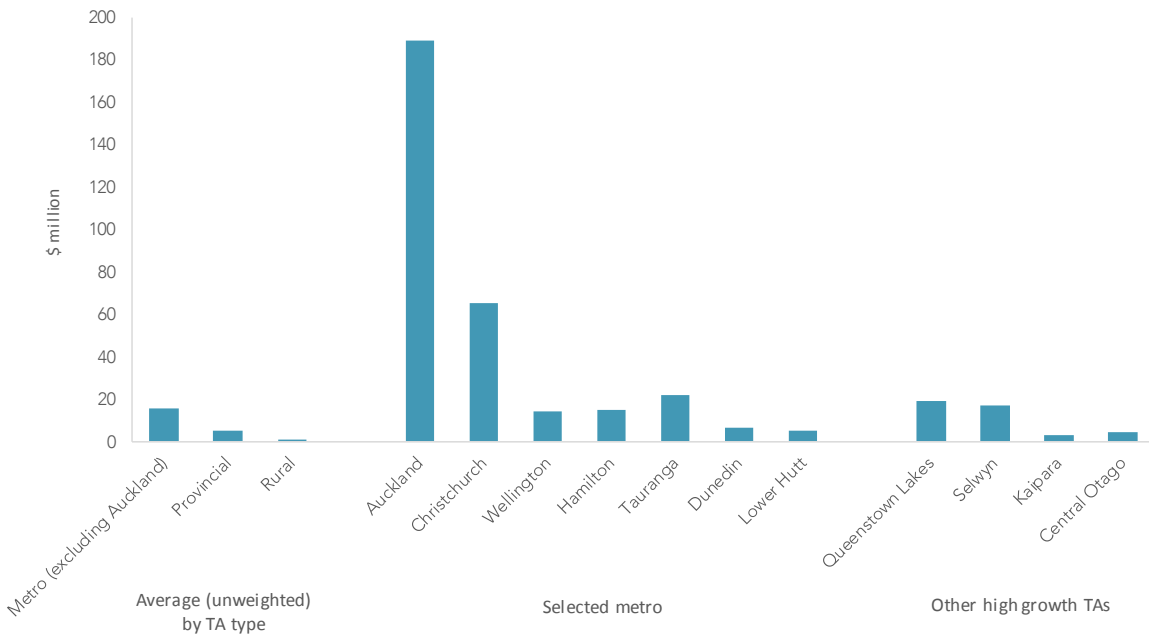
Figure 7-2 shows how incentive payments – in proportion to new building work – would have been allocated across types of, and selected individual, territorial authorities if a total of \$500 million had been disbursed each year between 2013 and 2019. The figures are based on the official statistics for building work put in place. Figure 7-3 shows the average payments over 2016–19.

Figure 7-2 Value of annual incentive payments, 2013–19



Source: Stats NZ, based on official statistics for building work put in place.

Figure 7-3 Value of annual incentive payments, average 2016–19



Source: Stats NZ, based on official statistics for building work put in place.

Possible rules for allocating the revenue are (i) the floor area of completed new buildings, (ii) the value of building consents or (iii) the value of building work completed in each year in each territorial local authority area. The relative size of the chosen measure across local authorities would determine the division of the total payment across councils.

The total payment could be fixed in dollars, adjusted each year with a price-level index, or be a percentage of total rates or other suitable variable. SOLGM proposed that the system use a three to five year rolling average of the value of building work put in place, to promote stability and certainty in funding for territorial authorities (sub. DR176). While the rules would remain stable over time in normal circumstances, it would be important for the Government to retain ultimate control over the rules to ensure national fiscal management.

The incentive payment would be in addition to and not instead of DCs received from developers. Some council submitters misunderstood or queried this and consequently had reservations about the scheme (subs. DR144, DR186, DR203 and DR236).

Many councils, Federated Farmers of New Zealand, SOLGM, and LGNZ supported a system of central government payments to territorial authorities based on new building work in place. LGNZ submitted:

LGNZ supports this recommendation in principle and supports the concept of a piloted and evaluated model before wider application since councils themselves have a limited impact on demand for infrastructure serviced land. Such an approach would go some way to assisting councils address the short term costs associated with growth. (sub. DR263, p. 8)

Tasman District Council submitted that a system of incentive payments from central government would be some compensation for the loss of funding arising from the rating exemption for the Crown (sub. DR236).

The Commission has considered the potential benefits of payments to territorial authorities based on new building work against the cost to central government. The potential national benefit is through a better functioning housing market that reduces the fiscal costs of housing assistance, and makes it easier for workers to locate where they will be most productive (Chapter 4; NZPC, 2017).

On balance, the Commission has concluded that the effectiveness of such payments to incentivise councils to stimulate development is too uncertain, given currently available evidence, to justify recommending them.

F7.6

A system of payments from central government to councils based on new building work in territorial local authorities could offer local government an additional funding source. The system would provide a direct link between council revenue and a council's effectiveness in keeping land supply and infrastructure responsive to demand. The payments could be effective in incentivising councils and their existing ratepayers to support growth.

The effectiveness of such payments to incentivise councils to facilitate development is too uncertain, given currently available evidence, to justify recommending them. Even so, given the very strong national public interest in stimulating housing supply, further consideration of incentive mechanisms to achieve that end is warranted.

Reducing the barrier to local growth from council debt limits

In its *Better urban planning* inquiry, the Commission found that fast-growth councils who were close to reaching their borrowing limits faced a problem. The limits contribute significantly to these councils failing to supply enough infrastructure (to service new property development) to keep pace with demand for development. The Commission commented:

Such limits have high social costs – the large foregone net benefits from preventing highly-valued development (well in excess of its opportunity costs) going ahead. Further, capital is not in short supply. Particularly now, with the world awash with cheap capital looking for secure and reasonable returns, this is a large system failure. It is damaging the wellbeing of many thousands of New Zealanders because, for example, housing is unaffordable for them. (NZPC, 2017, p. 338)

It is not surprising that fast-growth councils need to borrow large amounts if they are to spread the costs of growth across the future residents who will be beneficiaries of the new growth infrastructure. This avoids imposing growth costs on current residents. Instead, the beneficiaries – the future residents – will provide the payments (eg, by means of a targeted rate) to service the loan and meet the cost of the growth infrastructure.

The debt limit used most often is that the ratio of total debt to revenue must stay under 270%. Fast-growth councils that are close to this limit, or that likely might be in the future, include Auckland, Tauranga, Hamilton, and Kāpiti Coast. This limit comes primarily from rating agencies such as Standard & Poor's and Moody's, but the LGFA (the main lender to councils), and the Local Government (Financial Reporting and Prudence) 2014 regulations also impose limits. In its submission, Auckland Council explained the implications for borrowing costs should it exceed its debt limit.

Borrowing beyond our debt ceiling – which the council is very close to – would risk a downgrade to [our] credit rating, meaning higher interest costs across all our borrowing and a reduced ability to access

capital markets. A downgrade in Auckland Council's credit rating would also impact on the credit rating of the Local Government Funding Agency (LGFA) thus also impacting the borrowing costs of all other councils that raise funds through the LGFA. (sub. 120, p. 6)

Property Council New Zealand pointed to the debt limit's impact on the failure to fund much needed infrastructure:

In developing the [Future Urban Land Supply Strategy], Auckland Council recognised its significant barriers to financing and funding all the necessary infrastructure within the timeframes needed to meet projected demand. ...the strategy attempts to help manage these financial issues by sequencing land release over time, [but] it has not resolved how and when the necessary infrastructure investment can be funded. (sub. 117, p. 4)

Despite the importance of solving the council's debt-limit problem, the Commission found it difficult in its *Better urban planning* inquiry to come up with a fully satisfactory solution. It recommended that a debt-constrained council such as Auckland should tackle the problem by some combination of:

- raising more revenue so it can borrow more within prescribed debt-to-revenue limits;
- financing more infrastructure by putting debt on the balance sheets of others, such as private homeowners and body-corporate entities in large new subdivisions;
- negotiating central-government capital grants or some form of debt guarantee when a national interest exists; and
- working with central government and finance experts to make the case to credit-rating agencies to impose less stringent limits in return for assurances on creditworthiness and fiscal prudence.

Since the 2016 *Better urban planning* inquiry, progress has occurred on the first three of these options.

- Parliament passed regional fuel tax legislation in 2018 that allowed Auckland to introduce a tax of \$0.10 a litre (the maximum rate allowed in the legislation) to support transport projects that would otherwise be delayed or not funded. The New Zealand Transport Agency (NZTA) collects the tax directly from fuel distributors and passes it back to Auckland Council (less a service cost and less any rebates paid). This additional revenue increases Auckland Council's borrowing capacity. Under the legislation, the Minister of Finance and another Minister have "complete discretion" to approve or decline proposals from regional councils to introduce a regional fuel tax from 2021.⁴⁸ Even so, on 24 October 2018, the Prime Minister stated in Parliament, "I can give this guarantee to this House and to consumers: there will be no other regional fuel taxes while I'm Prime Minister" (Prime Minister (Rt Hon Jacinda Ardern), 2018).
- The Treasury, Crown Infrastructure Partners, the developer Fulton Hogan and Auckland Council have worked together and established a Special Purpose Vehicle (SPV) that has raised nearly \$50 million in long-term finance that will not sit as debt on the balance sheet of either Auckland Council or the Crown. The SPV will finance the cost of five bulk roading and wastewater infrastructure projects to connect a large new residential development – Milldale at Wainui, 25 minutes north of Auckland – into Auckland's existing networks and provide for future growth. Crown Infrastructure Partners ran a competitive process to secure the finance. As a result, the Accident Compensation Corporation became the main investor. The loan is secured by a charge on the titles of the Milldale properties so that the property owners fund the projects through sharing loan repayments and interest over the 35-year term.
- The Government and Auckland Council have continued to work together on the Auckland Transport Alignment Project and the City Rail Link. These are very large city-shaping, transport projects that involve a significant national interest because they are critical to the successful development of New Zealand's major city. The Government and Auckland Council are sharing capital costs.

The Milldale SPV model is a contractual model to finance the connecting infrastructure for major new greenfield developments. The developer is responsible for building the bulk infrastructure, to the specifications of Auckland Transport and Watercare. These two Council Controlled Organisations will

⁴⁸ Land Transport Management (Regional Fuel Tax) Amendment Bill, Sub-part 3, Section 65J.

become the owners once the infrastructure is completed. The model entails property purchasers committing voluntarily to a charge over their properties. It could be used elsewhere in similar circumstances. Even so, it is not suitable to finance major infrastructure upgrades and new infrastructure relating to urban development and regeneration in existing (ie, brownfield) areas where the beneficiaries are existing property owners as well as the owners of new properties. To work in that type of situation, a scheme would need to make the loan-servicing charges compulsory for existing property owners. That would be a significant additional step.

The Government and officials are investigating whether it is possible to extend the SPV model in this way. While more challenging to design, and requiring legislation, these investigations promise to provide a valuable extension to the SPV model that will further reduce the barrier of debt limits for fast-growth councils.

It is notable that debt limits are a problem for only a few fast-growth urban authorities. Most councils have adequate capacity on their balance sheets to finance investment in infrastructure. Even fast-growing Queenstown Lakes District has this capacity and intends over the next five years to make substantially more use of it to tackle its infrastructure deficits (Queenstown Lakes District Council, 2018).

Some councils face a lack of funding, not financing. The capacity to pay for the infrastructure, even over a long time, may not exist because of limited income and/or wealth. This could be the situation for some councils in small, low-income districts. This problem is examined in section 7.7.

In other councils, the problem could be one of political economy: a voting bloc of current residents who are reluctant to see council debt increase will elect councillors who stand on that platform. Ways to address this problem include greater transparency in setting rates, more effective public engagement and consultation, and councillors having better financial knowledge and understanding, leading to better decision making. Chapters 5 and 6 examine these issues.

F7.7

Councils vary widely in their use of debt. Debt can spread the cost of long-lived infrastructure assets fairly over the people and properties that benefit from these assets. Most councils have adequate capacity on their balance sheets to finance their infrastructure development. A few high-growth councils face debt limits that seriously hinder their infrastructure investment from keeping pace with demand for new development.

F7.8

Special Purpose Vehicles (SPVs) are an effective way to reduce the harm caused when debt limits hinder the ability of high-growth councils to invest in infrastructure to serve new greenfield developments. The SPVs raise finance for infrastructure investment in a way that puts debt on the balance sheets of new property owners who benefit from the infrastructure, rather than on the balance sheets of councils or the Crown.

F7.9

The Government and officials are working on ways to expand the use of Special Purpose Vehicles (SPVs) to finance different types of infrastructure investments, including ones that will benefit both new and existing residents. While more challenging to design, and requiring legislation, these expanded SPVs promise to deliver a further valuable means to reduce the barrier of debt limits for fast-growth councils.

R7.5

The Government should expand the use of Special Purpose Vehicles to finance investment in growth infrastructure in fast-growth local authorities that face debt limits. If needed, the Government should promote legislation in Parliament to enable the placement of debt-servicing obligations on existing as well as new residents who will benefit from the infrastructure.

DCs are a desirable funding tool, but scope exists to improve their implementation

Chapter 6 described how councils generally make good use of DCs to help fund infrastructure investment needed for growth. This is desirable because DCs are an efficient means to fund and finance growth. Councils close to their debt limits should make maximum use of DCs because every dollar of DCs is a dollar that councils do not have to borrow.

Yet DCs are understandably not popular because they add to development costs, including the prices of residential sections. So, it is important that councils explain their DC policies well and present developers with clear and understandable DC assessments. Two economic consultants, TDB Advisory and Insight Economics, suggested that councils follow a template to standardise the structure and format of their DC policies to make them easier to understand and use (Insight Economics, 2019b; TDB Advisory, 2018). A second template could standardise the structure and format of the DC assessments that councils send out to notify developers of their DCs. The Commission agrees with this suggestion. The DC policy template would not prescribe content, simply structure and form. It would still allow councils to differentiate their policies according to local circumstances. Use of the templates would:

- act as a guide to councils to reflect the principles for DCs laid down in the LGA;
- make the policies and the assessments easier to read, understand and use because they would follow a standard structure and format; and
- help to hold councils to account for having DC policies and assessments that reflect the legislation.

Several submissions from councils indicated support for further guidance on the use of DCs and for “commonality and consistency” but not a compulsory template (subs. DR168, DR170, DR179, DR186, DR210, DR232, DR236, DR245, DR262). However, the Commission believes most of these responses were based on the misunderstanding that the template would prescribe content rather than simply structure and form.

R7.6

The Government, Local Government New Zealand and the New Zealand Society of Local Government Managers should work together to develop templates to standardise the structure and format (but not the content) of:

- councils’ development contribution (DC) policies; and
- council assessments of DC charges for individual property developments.

Councils should be strongly encouraged to use the templates.

Some Crown projects are exempt from the obligation to pay DCs to councils. The Commission examines the case for removing this exemption in section 7.6.

7.3 Managing depreciation and recycling assets

Depreciation and managing “depreciation funding”

Depreciation is a significant expense for most councils and has been growing as a proportion of total council operating expenditure (opex) (Figure 3.7). This partly reflects that councils own increasing quantities of valuable physical assets. Depreciation spreads the initial investment cost of purchasing or constructing assets over their useful lives. The general approach of local authorities to depreciating their infrastructure assets is satisfactory (Public Sector Performance (NZ) Ltd, 2019).

Even so, several issues relating to depreciation impinge on local government funding and financing. First is managing “depreciation funding” – the large amounts of cash that can become available to councils when they take in revenue to cover depreciation cost. Second is the accurate estimation of asset lives and what impact it has on estimating depreciation. Third is the lack of merit in one of the financial prudence benchmarks that councils are required to report on – the Essential Services Benchmark.

Managing depreciation funding

Depreciation is a large expenditure item, and councils normally must balance their budgets in accrual terms. While the depreciation component of opex is a non-cash item, revenues to pay for depreciation are largely realised in cash. As such, depreciation funding can generate large amounts of cash. How should councils manage these large cash balances?

Were a council to put all its depreciation cash into a reserve account and invest it in safe low-yielding financial assets, the funds would be likely to build up to levels great enough to cover the cost of replacing the asset at the end of its useful life. But this may not be the best use of the funds. To determine the best use, a council should treat the decision as part of its wider financial and infrastructure strategies. The Commission consulted Professor Ian Ball, a public-sector accounting expert, who commented:

“Depreciation funding” should be seen as simply one element of a number of factors that need to be considered in developing financial and infrastructure strategies. These include factors related to the condition and future life of major assets, projected growth in the demand for services, levels of rates and charges relative to community income and wealth, external economic factors such as interest rates, risks such as climate change and natural events, and the community and council’s attitude to risk and resilience. Also relevant is how councils view intergenerational equity, and the desirability of spreading the cost of infrastructure assets over their economic life. (Public Sector Performance (NZ) Ltd, 2019, p. 26)

Monitoring the condition of assets and estimating asset lives

The Auditor-General has expressed concern in his report on matters arising from audits of council 2018-2028 Long-Term Plans (LTPs) that lack of knowledge of the condition of council assets could be leading councils to be overly conservative in their estimations of asset lives. This in turn could lead to the front loading of depreciation expenses. Several submitters, including councils, agreed with the need for improved knowledge about the condition of assets (eg, Ruapehu District Council, sub. 85; Tararua District Council, sub. 18; Water New Zealand, sub. 19; Whangarei District Council, sub. 46).

The consequence of over expensing depreciation in the early life of an asset is that, given the balanced-budget requirement, ratepayers could be paying their council more than they should to use services, and rates could be higher than they should be. This could also be placing more of the cost burden of assets on the current generation.

Section 5.7 describes other benefits from councils’ improving their asset knowledge. The Auditor-General called on councils to continue to work on improving their knowledge about the condition and performance of their assets and “should prioritise work on confirming whether the asset lives they have assigned to their assets are accurate” (OAG, 2019b, p. 23).

The Essential Services Benchmark is not sensibly framed

The Essential Services Benchmark is one of several financial prudence benchmarks in the Local Government (Financial Reporting and Prudence) Regulations 2014 that councils must disclose in their LTPs, Annual Plans and Annual Reports. The benchmark is that “[a] local authority meets the essential services benchmark for a year if its capital expenditure on network services for the year equals or is greater than depreciation on network services for the year” (Local Government (Financial Reporting and Prudence) Regulations 2014, 20 (1)).

The aim of this benchmark is to monitor the extent to which councils are investing adequately in renewing their infrastructure. The Auditor-General has expressed concern that councils appear not to be doing so for their core assets. He examined forecast renewals expenditure as a proportion of forecast depreciation across councils over 2019 to 2028 (as reported in LTPs) and found average ratios less than 100% for all core asset classes except flood protection and control works. The average figures over the period for other classes were roading (83%), water supply (82%), wastewater (67%) and stormwater (52%).

These figures certainly raise a concern that the investment intentions across all councils, and over a horizon of 10 years, are too low. But the Essential Services Benchmark does not measure renewals over many councils and years – it suggests that each council should be investing in renewals each year at least as much as its depreciation expense. But as Ian Ball points out,

[w]hile depreciation is allocated in a relatively smooth pattern over the life of an asset, the cost of asset acquisition is inherently lumpy. Other things being equal, the larger the number of assets owned by a council, the smoother would be the pattern of capital expenditure. A council with fewer significant assets would tend to have a lumpier capital expenditure pattern associated with the replacement of those assets, than would a council with a larger portfolio of significant assets.

To a degree, this calls into question the appropriateness of the Essential Services Benchmark that capital expenditure in a year is equal to or greater than the depreciation expense. The relationship between depreciation expense and capital expenditure should be viewed over a longer time period than a year. (Public Sector Performance (NZ) Ltd, 2019, p. 26)

Several submitters also made the point about the lumpiness of asset-renewal expenditure (eg, Greater Wellington Regional Council, sub. 68; and Selwyn District Council, sub. 84).

R7.7

While the general approach of local authorities to depreciating their infrastructure assets is satisfactory, three issues are of concern and may require action:

- councils' decisions about the best use of the large amounts of cash that depreciation funding can give rise to should be part of formulating their wider financial and infrastructure strategies;
- councils should prioritise improving their knowledge of the condition and performance of their assets to, among other benefits, avoid the risk of under-estimating asset lives and over-estimating depreciation expense; and
- the Essential Services Benchmark should be reviewed as part of the wider review of the performance reporting framework of local government referred to in Recommendation 5.4. Any reframing should avoid the implication that individual councils must invest in as much asset renewal each year as their depreciation expense.

Asset recycling to create funding capacity

As section 5.6 mentions, several submitters from the business community are keen for councils with significant commercial assets to consider asset recycling as a potential source of funding for needed new investment (subs. 75, 94, 96, DR177, DR189, DR249). This is a valid suggestion, particularly for councils that either do not want to increase their debt or cannot do so because they are close to their debt limits.

Councils and residents often resist selling assets because it could mean going without a future stream of dividends that can hold rates lower in the future than otherwise. The strength of this argument depends on how successful the council is as the owner of a commercial business, and the net benefits of realising sale proceeds and re-deploying them. Councils need to examine each case on its merits and consider several aspects including:

- the size and riskiness of the current and expected future returns on the existing asset;
- the expected sale price of a partial or full asset sale given that it could include a premium that private investors are prepared to pay;
- the opportunity cost of not selling as measured by the interest cost of additional debt, or community wellbeing losses from not proceeding with new investment;
- the future capital needs of the business that the council, as owner, would need to finance and which could put a strain on the council's balance sheet.

The last three of these points are relevant to the recent decision of Hawke's Bay Regional Council (HBRC) to sell a 45% stake in Napier Port and retain ownership of the remaining 55% (Box 7.1).

Box 7.1 Hawke's Bay Regional Council's partial sale of Napier Port in August 2019

The port needed to invest \$180 million in a new wharf. This triggered the council's decision. HBRC could have financed the investment itself, but this would have meant going without port dividends for 10 years alongside rising needs to finance other investments (such as investing to meet freshwater standards) and implement a coastal-hazards strategy. HBRC consulted with its community before the sale decision, and gave priority in the share sale to residents, iwi and employees. These helped achieve political support.

The council has ring-fenced the sale proceeds (net of \$110 million for the wharf investment) in a fund from which it can withdraw money only to the extent that investment returns exceed inflation. Even so, because of the share price rise, the book value of the council's 55% holding is now higher than the 100% of its value less than a year ago, and the port dividends from the council's remaining 55% stake, plus returns from the fund, exceed the dividends the council used to get from the port.

The outcome can be seen as a win-win from a several angles. HBRC is better off financially while retaining a controlling interest in a strategic asset. The port has gained capital to invest and, arguably, a stepped-up board. The community still has the commercial benefits of its port while local iwi and many employees and residents have greater ownership. Nationally, a portion of the rising savings from Kiwisaver and other funds has benefited from a solid, domestic investment opportunity rather than needing to go offshore.

Source: NZPC meeting with James Palmer, Chief Executive, Hawke's Bay Regional Council.

F7.10

The partial or full sale of a commercial asset can provide a council with opportunities to improve ratepayer value and finance investments in other assets. Each case needs to be considered on its merits based on maximising net benefit for the district or region.

R7.8

Councils should consider the partial or full sale of commercial assets as an alternative to borrowing so they can finance needed new investment. Councils should consider each case on its merits based on maximising net current and future benefit for the district or region.

7.4 Could taxes on vacant land boost housing supply?

The Commission has examined whether vacant-land taxes would be a useful mechanism to improve the supply of available housing in New Zealand. This responds to a request from the Minister of Finance in April 2019, following a recommendation from the 2019 the TWG for the Commission to look at whether local councils should be empowered to introduce local vacant-land taxes.

The Commission included the Minister's letter in its draft report and sought submissions from interested parties. Out of 134 submissions on the report, 15 discussed the vacant-land tax issue, with 13 presenting arguments or concerns about it. Two submitters expressed the view that vacant land was a significant problem for housing supply and affordability.

The Commission contracted Capital Strategic Advisors (CSA) to help it analyse vacant land taxes. Its detailed report informed the Commission's view and can be found on the Commission's website (CSA, 2019c).

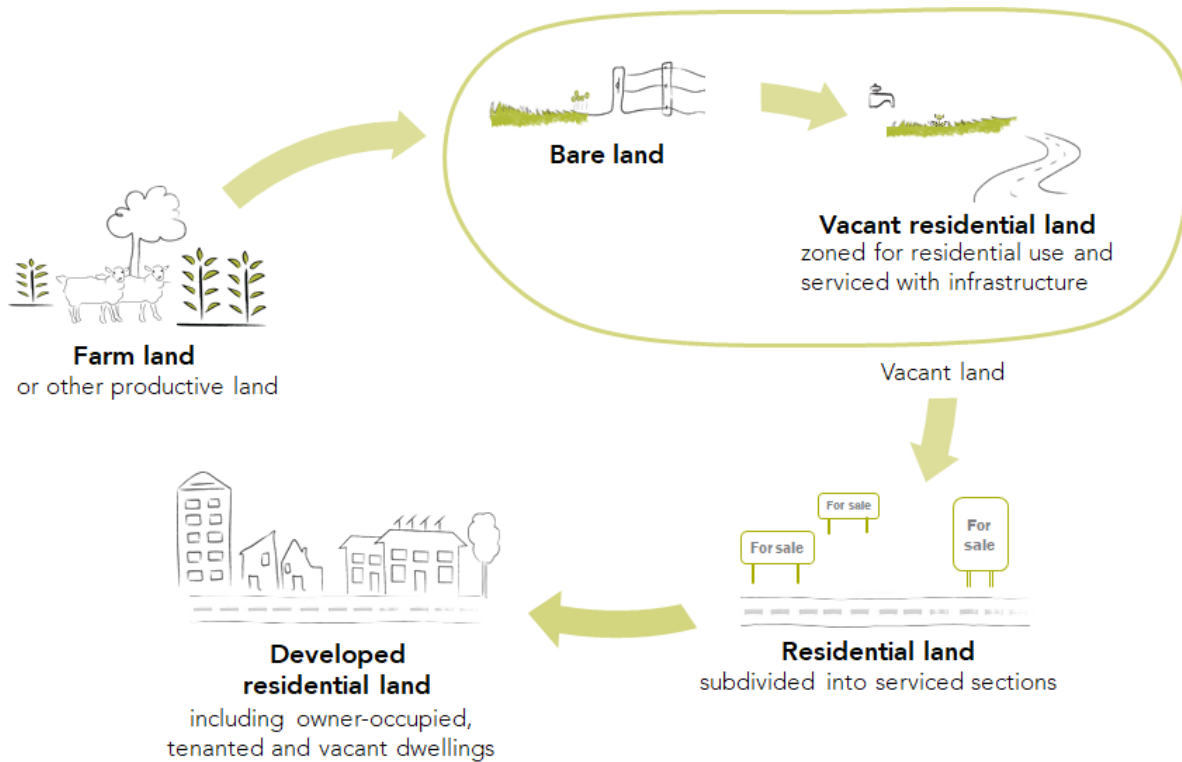
On the surface, taxing vacant properties may seem appealing, especially to address inefficiencies and inequities arising from land banking. If the tax were to prompt land bankers to reduce their holdings, this would seem to increase the supply of land for housing. However, the Commission's research and analysis has led it to conclude that while vacant-land taxes could help reduce land banking and increase housing supply in the near term, these effects are likely to be small and transitory. Indeed, over several years, such taxes

would likely prove to be taxes on the development of new housing and have harmful effects. They would likely reduce housing-supply responsiveness by reducing developer flexibility and risk-taking, which is the opposite of what is needed in New Zealand.

The property development process

An appreciation of the development process is critical to understand the Commission's conclusion that a vacant-land tax is not a good idea. Figure 7-4 illustrates the main stages in the process.

Figure 7-4 The property development process



Housing development is a flow process that progresses through stages. The supply of land for housing typically involves converting farmland (or other productive land) to vacant land, and then converting vacant land to developed land. Progress through the stages will not always be smooth and regular because of demand uncertainties (about the number of people who want to purchase houses and live in that area). Vacant land is an intermediate stage in the process and serves a useful role in providing an inventory of land (ready to be developed) that helps deal with this uncertainty. Impediments to the flow at any stage of the process risk causing it to work less well as a whole. A vacant-land tax is likely to prove such an impediment.

The main effect of imposing the tax is to raise the cost of holding vacant land for developers (or other landowners) who would therefore reduce the amount they choose to hold. Selling off the vacant land they no longer wish to hold would give a small and transitory boost to housing supply, but it would not solve the undersupply of housing relative to demand in New Zealand.

- The first-round impact is likely to be small because much vacant land is likely to be excluded from the tax to minimise the economic costs of taxing “legitimate” vacant land (see below). CSA estimated that 70 – 90% of vacant residential land in Auckland could be excluded from the tax.
- The first-round impact is likely to be transitory because increases in land supply would largely occur only for the period that stocks of vacant land are being reduced to their new (after-tax) chosen levels. That adjustment would likely occur quite quickly over two to three years.

Beyond the first-round effect, vacant-land taxes would likely reduce the responsiveness of housing supply to changes in housing demand, exacerbating the underlying problem with New Zealand's housing market. The taxes would likely shift the scale and timing of steps in the development process from their before-tax chosen settings – choices that are likely to be efficient. For example, a smaller stock of vacant land after-tax

might entail converting farmland in inefficiently small chunks and holding inefficiently small inventories of vacant land to cope with demand fluctuations. These inefficiencies will raise risks and costs for developers with knock-on adverse effects for residential development and house buyers.

Land banking and land price bubbles

Vacant-land taxes are unlikely to significantly reduce speculation and land price bubbles, for two reasons. The first is that the vacant-land tax rate would need to be set high to be effective. For example, the rate would probably need to exceed 5% of land value (one jurisdiction has adopted a 30% rate). Yet historically, a 5% rate is very high – 10 to 20 times higher than typical property rates in New Zealand. Even so, if speculators were expecting land prices to rise by 12%, they would still perceive an attractive net return of 7%.

The second reason is that high vacant-land tax rates would make it imperative to define taxable land narrowly, and to provide lengthy grace periods for property developers – to minimise the serious risk of harming development and increasing development costs. But a narrow definition would mean speculators would:

- avoid paying vacant-land taxes if they own vacant land during the grace period; and
- have strong incentives to compete with genuine developers for vacant land not subject to the tax (eg, land zoned for non-residential uses or vacant land that has not been zoned and serviced with infrastructure).

In short, a narrow definition will enable speculators easily to switch to un-taxed types of land. A broad definition would better constrain speculative investment, but it would increase risks and costs for developers and, as a result, harm the development process.

Land price bubbles cause speculation in land and can, in turn, be sustained or made worse by speculation. A vacant-land tax at a fixed rate would make it less likely bubbles would occur and more likely they would end earlier. Yet once a strong bubble is underway, the speculation and land price rises would simply continue “over the top” of the fixed tax rate. To tackle land price bubbles effectively, councils would need to be prepared to ramp up their vacant-land tax rates in response to market conditions. Even if councils could do this well, it would likely increase investor uncertainty with negative effects on housing development.

Problems of definition and costly administration

As noted, some level of vacant land is desirable for efficient and effective housing development. This presents designers of vacant-land taxes with the difficult task of identifying legitimate vacant land and exempting it from the tax. One consequence of a narrow definition is low tax yields and high administration costs for the revenue collected.

For example, Vancouver recently imposed a vacant-dwelling tax. In its first year of operation, 2017, it spent C\$2.5m administering the regime, which amounted to 12% of the C\$20.6m revenue collected (City of Vancouver & Housing Vancouver, 2019, pp. 5, 7)⁴⁹. In addition, it spent C\$7.5m implementing the new regime. By comparison, the cost of administering the overall New Zealand tax system is less than 1% of revenue collected (Inland Revenue, 2017, p. 13).

As also noted, broader definitions of vacant-land taxes, with few exemptions for “legitimate” vacant land, would risk reducing development activity and increasing development costs.

Few jurisdictions charge vacant-land taxes, perhaps because of the definitional problems. The Commission has found isolated examples among cities in Chile, Columbia, India, South Korea, Taiwan, the Philippines and the United States. Little information exists to date about their effects on behaviour.

⁴⁹ The Vancouver City regime raised an assessed amount of C\$38m of revenue but C\$17.4m remained outstanding. Presumably additional costs, including legal and debt collector fees, will be incurred to collect the outstanding amounts. If no additional costs are incurred, and all outstanding amounts are paid, then administration costs will be 6.6% of revenue collected and total costs for the first year will be 26% of revenue collected.

Is concentrated ownership of suitable land a problem?

Concerns are sometimes raised that most suitable or zoned land for development on the outskirts of some cities is in the hands of a very small number of owners. Owners of this land then exercise monopoly or market power by restricting supply and driving up prices.

New Zealand data on the concentration of ownership of undeveloped land zoned for urban residential development do not bear out these concerns. Private ownership is widely distributed in all New Zealand's urban land markets included in the data (Dunedin is the only major city not included). Hamilton and Porirua each has a private owner with about a 26% market share, but many other private owners with very modest shares make up the balance in each case.

Based on the data, it is unlikely that landowners could exercise significant market power. Even so, if they could exercise market power, a vacant-land tax would not be a good way to discourage such landowners for three reasons.

- It would provide only a weak incentive not to exercise market power because landowners could easily switch their vacant land to some form of productive use to avoid the vacant-land tax.
- To provide a significant disincentive, the vacant-land tax rate would need to be set high, for example it would probably need to exceed 5% of the land value (one jurisdiction has adopted a 30% rate). A 5% rate would mean vacant land would be subject to local-government tax rates 10 to 20 times higher than typical property rates in New Zealand.
- It is not practical to target vacant-land taxes just to landowners exercising market power. As a result, other owners of vacant land would also incur the tax. This would be likely to increase the costs and risks of property development and reduce the supply responsive to increases in housing demand.

A more effective approach to any concerns about concentrated ownership and market power would be to change land use regulations to free up land supply (Box 7.2). This would undermine any market power and reduce the costs of property development and housing.

Taking a broader view

The property development process and how it interacts with demographics, the construction sector, other economic forces and the market in existing dwellings is a complex, evolving system. If housing supply is not responding to housing demand and this is causing harmful land and house price inflation, then that may be caused by any number of variables in the system. The Commission's investigation strongly suggests that the problem will not be cured with vacant-land taxes.

More likely causes include poor land-use regulations or slow infrastructure provision. These can restrict the ongoing supply of usable land, push up land prices and increase development costs. Imposing additional taxes on development through vacant-land taxes is not going to counteract these effects and will likely exacerbate them. As BusinessNZ observes:

Housing provision's fundamental problems must be addressed – current demand and supply-side constraints; owners of vacant land should not be randomly picked on for a special land tax.

Introducing a tax on vacant residential property is likely to defeat the principles of a good tax system, quite apart from having significant unintended consequences for good economic management and efficient resource use. (sub. DR189, p. 13)

The Commission has, in previous enquiries into *Housing affordability*, *Land for housing* and *Better urban planning*, recommended policies to improve the supply of infrastructure for development (section 7.2); and to overcome regulatory barriers to development (Box 7.2).

Box 7.2 Overcoming regulatory barriers to development

In previous inquiries, the Commission has investigated and proposed solutions to reduce regulatory barriers to development.

Overly restrictive land use regulations have been a key cause of escalating house prices in Auckland. For many decades, Auckland local authorities limited greenfield growth on the urban boundary while preventing intensification of housing in inner-city suburbs and along transport corridors. Other fast-growing centres have experienced similar restrictions with resulting pressure on housing affordability.

The Commission has made several recommendations to reduce these regulatory barriers:

- Using statutory Independent Hearing Panels (IHPs) to simplify the process of putting in place district plans. IHPs would be guided by statutory principles that recognise the value of development for wellbeing, and provide for efficient, proportionate and fair planning processes and regulation. The Auckland IHP process in 2016, guided by such principles, proved effective in improving the supply of development capacity in Auckland – enabling four times the city’s previous housing capacity. There was an immediate fall in house prices. IHPs would consider all district and regional plans as a package and in the context of statutory regional spatial planning (Chapters 5 and 12).
- Improving the operation of competitive urban land markets, by:
 - allowing private investors to build and finance trunk infrastructure to support “out-of-sequence” development beyond current city footprints;
 - giving local urban development authorities special powers and land use rules to undertake certain developments designated by Order in Council as having the potential to deliver significant numbers of dwellings; and
 - giving councils the power to sell development rights to achieve a controlled amount of greater density in growing cities. The revenue raised would be used to provide additional amenities to communities in which more intensive development was undertaken.
- Mandating the release by councils of further development-ready land for housing when specified thresholds for price differentials between developable and undevelopable land are exceeded.

Source: NZPC (2012,2015 & 2017); Norman (2019).

It is worth noting that 71% of councils levy their general rates on capital value rather than land value. This is not helpful to encouraging property development. This is because rates based on capital value tax development. By switching to land value rating (which is possible under current law except for Auckland Council), these councils would increase the tax burden on vacant relative to developed land without causing any distortion. Indeed, such a switch to land value taxation would improve productivity and economic efficiency more generally.

F7.11

Vacant land is a necessary intermediate stage in a complex process that starts with rural or brownfield land and ends with new occupied houses on developed land. Taxing vacant land would impose an additional tax on this process and would likely impair developer flexibility and risk-taking. It would probably increase costs and slow housing supply. This is the opposite of what New Zealand needs.

F7.12

Vacant-land taxes present severe definitional challenges because it is difficult to distinguish legitimate from harmful holdings of vacant land. Mainly for this reason, the administrative costs of vacant-land taxes are likely to be a high percentage of the revenue raised.

F7.13

Evidence indicates that ownership of vacant land suitable for development is not concentrated enough on the outskirts of New Zealand cities to cause problems from the owners using market power to restrict supply and push up prices.

R7.9

The Government should not further advance the idea of implementing a vacant-land tax. Councils should tackle the problem of lack of housing supply by reducing regulatory and infrastructure barriers to development.

7.5 Improving transparency in setting rates

Current rating tools give councils great flexibility in distributing the burden of rates across different classes of property. Councils vary greatly in how they do this in practice, but clarity about the principles they follow is often lacking (Chapter 6). Many ratepayers find the basis for their assessed rates is far from transparent. Organisations representing the interests of particular ratepayer groups, such as farmers and business, express frustration at the lack of clarity in setting differentials and Uniform Annual General Charges (UAGCs) and their difficulty in getting information from councils about the way that rates are allocated overall (Federated Farmers of New Zealand, sub. DR217; Local Government Business Forum, sub. DR177).

Local decisions on the allocation of rates provide an opportunity to reflect local-service choices and preferences. While acknowledging that this opportunity is desirable, the Commission believes that scope exists for councils to improve transparency around how they set rates.

Improving reporting on the allocation of rates across classes of ratepayers

Federated Farmers (sub. DR217), the Porirua Economic Development Group (PEDG) (pers. comm. 25 September 2019), and Clive Thorp (sub. DR219) proposed that councils should be required to report on total rates revenue received from different category of ratepayer (eg, residential, business and rural). PEDG suggested that, as part of a broader reporting framework, councils should show this total revenue for each category of ratepayer as a proportion of the rateable value in each category and as a share of all council income. The Shand report recommended that councils adopt such reporting as part of a voluntary reporting template on rates that would allow comparisons between councils (Shand Report, 2007).

Reporting in this way would provide interested ratepayers with a clear picture of how the burden of rates is shared across different classes of ratepayers, of how their council's practices compared with other councils. Comparisons and ratepayer scrutiny would provide incentives for councils to clearly explain their decisions. To help comparisons, it would be useful for councils to report on the number of rating units in each category of rateable property, the total value of all property and total rates revenue in that category, and average and median rates in that category.

A potential difficulty in implementing this proposal is that councils use varying ways of classifying properties for rating purposes. Judgement would be required to consolidate these into a small number of categories that could be used for comparisons. The reporting framework could provide guidance on how to do this in a reasonably straightforward and robust way. For instance, in their work for the Commission on how councils use their rating tools, Insight Economics categorised rateable properties (and so all rates revenue across the country) into six types (Insight Economics, 2019a).

The Commission has recommended a fundamental first-principles review of the local government reporting framework, including a review of performance measures (Chapter 5). This review would provide an

opportunity to work out how to implement a requirement that councils publish information on rates revenue by category of rateable property.

R7.10

The Commission has recommended (Recommendation 5.4) a fundamental first-principles review of the local government reporting framework, including a review of performance measures. This first-principles review should consider how to implement a requirement that councils publish information on rates revenue by category of rateable property (eg, residential, business and rural), the number of rating units in each category and average and median rates per unit in each category.

Improving information for ratepayers on how their rates are spent

Another way in which councils can improve the transparency of rates is to provide ratepayers with itemised rates assessments (Federated Farmers of New Zealand, sub. DR217; Taranaki District Council, sub. DR240; Clive Thorp, sub. DR219). Itemisation will increase ratepayer awareness of how their rates are spent, without having to go to the trouble of locating and interpreting information in council LTPs. As a result of increased awareness, more ratepayers will want to participate in local democratic decision making. The Shand report recommended such itemisation, though few councils currently do so (Shand Report, 2007; Federated Farmers of New Zealand, sub. DR217).

Federated Farmers provided the Commission with a sample of several such itemised rates assessments. These assessments break down funding for activities into dollar amounts that sum to the total rates assessment. In these assessments, general rates and UAGCs were itemised, as well as targeted rates. SOLGM provided the Commission with feedback from an anonymous council that warned of the risk that itemisation would require councils to account strictly for the spending according to the itemised categories. The feedback suggested instead that it would be better to show a summary of where the rates dollars are intended to go.

Even so, the fact that some councils already produce such itemised rates assessments suggests that this can be done in a way that does not require “hypothecation” of the revenues. Some councils, for instance, already provide a breakdown of “indicative contributions” in this way (either on rates assessments or as a table in their LTPs). These examples demonstrate that indicative itemised assessments can be generated simply by prorating (ie, in proportion to) total expenditure for each activity from the category of rates used to fund that activity.

Rules for rates assessments are set out in Part 3 of the Local Government (Rating) Act 2002. Section 45 (1)(f) and (1)(g) require that assessments set out “the amount and a description of each rate” and “the activities or groups of activities of the local authority that will be funded from each rate”. Section 45 should be amended to provide for a more (indicative) itemised rates assessment, while avoiding the need for hypothecation.

R7.11

Section 45 of the Local Government (Rating) Act 2002 should be amended to require councils to provide indicative itemised rates assessments that show ratepayers the dollar amounts they are contributing to each activity funded from each rate. Even so, councils should retain their current budgeting flexibility and should not, as a result of the amendment, be required to hypothecate the dollar amounts for particular activities.

Guidance to improve councils’ explanations of their revenue and financing policies

Legislation requires councils to explain their revenue and financing policies in their LTPs. While there is a great variety of practice, councils’ explanations are often unclear. More guidance on meeting the legislative requirements would help.

Section 101(3) of the LGA sets out the matters that councils must consider when determining their rates and other revenue.

The funding needs of the local authority must be met from those sources that the local authority determines to be appropriate, following consideration of,—

- (a) in relation to each activity to be funded,—
 - (i) the community outcomes to which the activity primarily contributes; and
 - (ii) the distribution of benefits between the community as a whole, any identifiable part of the community, and individuals; and
 - (iii) the period in or over which those benefits are expected to occur; and
 - (iv) the extent to which the actions or inaction of particular individuals or a group contribute to the need to undertake the activity; and
 - (v) the costs and benefits, including consequences for transparency and accountability, of funding the activity distinctly from other activities; and
- (b) the overall impact of any allocation of liability for revenue needs on the current and future social, economic, environmental, and cultural well-being of the community.

Section 103(3) requires councils to explain how they have reflected the requirements of section 101 in their revenue-raising decisions. Submitters told the Commission that councils' explanations of their revenue and financing policies are often far from clear (Chapter 6).

SOLGM submitted that councils' explanation of whether and how they consider overall impacts of funding decisions on community wellbeing is "not usually clear" (sub. DR176, p. 12). This step (s. 101(3)(b)) could obviously involve a wide range of considerations and varying approaches. SOLGM, for instance, argued that this step was likely to be where councils could best consider "affordability".

Even so, councils typically devote considerable effort and space in their LTPs to explaining their funding policies. Auckland Council, for example, derives a set of 12 principles from section 101 to guide its Revenue and Financing Policy (five of which are benefits received, transparency, affordability, efficiency and practicality). Auckland Council then applies these principles, in broad terms, to explain its funding policies for each activity. The Council (perhaps for reasons of practicality and economy of space) does not provide in its LTP details of how the application of the principles produces the final allocation of rates. The Council reports a decision to adjust the business differential over a 20-year period to reduce the proportion of general rates taken from business properties; but it does not provide details of the basis for this decision (Auckland Council, 2018).

Ōpōtiki District Council's LTP sets out transparently and, in detail, how the council applies the benefit principle to each of its activities. The Council, for example, attributes proportions of total benefit to national, regional, district, community, commercial and user groups and determines revenue sources accordingly (Ōpōtiki District Council, 2018).

Applying the benefit principle is not straightforward

Many submitters commented on the difficulty and uncertainty in applying the benefit principle.

- Councils of necessity use "rules of thumb" to apply the principle. These rules will necessarily be approximations of the true incidence of benefits and taxes (Chapter 6). Even so, the rules of thumb must be able to stand up to the scrutiny of affected parties so that the reasons behind rating decisions are clear and supportable. Authoritative guidance that commands the support of the local government sector as a whole would give each council more confidence in applying the principle.
- There are trade-offs between accuracy and transparency in reflecting benefits on the one hand; and administrative complexity and ease of communicating ratings policy on the other. The trade-offs will be different for each council (eg, depending on its size, the dispersion of its population into separate communities, the mix of services it provides, and the types of properties that form its rating base). More guidance on how to make these trade-offs when applying the benefit principle would help each council work out an approach that is both robust and suitable for its circumstances.
- There is also a trade-off between applying the benefit principle and the ability-to-pay principle (Chapter 6). Councils need to be able to explain this trade-off clearly to their ratepayers and community.

Chapter 6 found that, for efficiency reasons, councils should take special care when applying rates to businesses. If business rates do not reflect the relative benefits of council services, then this is likely to distort businesses' choices. Excessive taxes on businesses to raise revenue will also be passed on to other businesses and consumers. This in turn will distort production and consumption choices (and could also raise affordability concerns).

R7.12

Councils should assess rates for business properties in proportion to the cost of the council services that benefit those properties. If business rates are set simply to raise revenue without reflecting benefits, they are likely to cause productive inefficiency that is avoidable.

SOLGM submitted that applying the benefit principle was not a matter of "paint[ing] by the numbers" (sub. DR176, p. 12).

Guidance on explaining funding policies would help

SOLGM and LGNZ have provided a guide to the rating system (SOLGM & LGNZ, 2013) and more recently SOLGM has developed comprehensive advice for councils on rating reviews (SOLGM, 2017a). Even so, ratepayer submissions show that councils' explanations of their funding policies often lack transparency. As a result, ratepayers and the community more generally are not in a good position to understand funding policy and to engage in shaping that policy.

F7.14

Section 103(3) of the Local Government Act 2002 requires councils to show how they have complied with section 101(3). Section 101(3) sets out the matters that councils must consider when determining the sources of funding to meet their funding needs. Councils' explanations of their revenue and financing policies are often not transparent in showing how they have met the requirements of the Act.

R7.13

Local Government New Zealand and the New Zealand Society of Local Government Managers should develop advice for councils on transparently showing how their revenue and financing policies meet the requirements of the Local Government Act 2002, including consideration of the benefit principle, the exacerbator principle and ability to pay.

7.6 Central government funding for local government infrastructure and services

When should central government contribute to local government funding? Should there be more or fewer transfers from central government to local government? And when they do take place, is there scope to improve their design and delivery?

The answer to the first question, based on local-government funding principles, is that central government should contribute funds to local government only when principled reasons exist to do so. In line with Recommendation 6.1, contributions may be justified in the following situations:

- when local government activities have national-level benefit spillovers;
- sharing risks across all taxpayers, when some communities are subject to damaging shocks (such as natural disasters);
- helping low-income communities whose councils are struggling to fund essential services; and
- recycling revenue collected centrally (for administrative efficiency) to cover costs incurred locally.

Examples of council activities which create benefits that spill over its boundaries to a wider area and possibly to the whole country are (i) meeting NESs and (ii) helping the Crown to meet its Treaty obligations.

An example where recycling of revenue from central to local government should arguably occur but does not is where the NZTA collects Road User Charges (RUCs) from heavy vehicles for the damage they cause to local roads. This revenue is not directly recycled back to local authorities; they bear significant costs from this damage.

When central government payments to local government are justified, the institutional design of the delivery system for the funding should follow the principles described in Chapter 6.

A straightforward application of the benefit and exacerbator principles justifies payments by the Crown to local authorities when the Crown, as owner of property within a district, benefits directly from council services, or imposes costs on councils. In this case, the Crown should cover the cost of those services. Examples of this, but where payments currently do not happen, are where legal exemptions exist for the Crown from paying DCs on many of its projects, and from paying rates on its land.

F7.15

Significant examples exist of where central government payments to local government are justified yet not paid. If the Government were to recognise these situations and act on them, it would help to relieve funding pressures for local authorities.

However, central government payments to local government – where no principled justification is present – risk undermining the autonomy and accountability of local government.

Development contributions for Crown developments

Since DCs are an efficient form of user pays, and are consistent with the benefit principle, exempting the Crown from an obligation to pay DCs on some of its projects is an anomaly and should be rectified. The exemption deprives councils (some more than others) of a legitimate source of income. SOLGM made this point in its submissions to the inquiry.

[W]e particularly want to remind the Commission of ... the Crown exemption [for DCs] – which if anything appears likely to be broadened to include developments undertaken by Kāinga Ora Homes and Communities as the Bill that establishes this entity currently stands. A development such as the so-called Carrington development in Auckland is expected to have some 4,000 homes when that development is at full capacity – a community the size of Te Awamutu. It is unclear why the rest of the community is (or should be) expected to subsidise the community. We remind the Commission that development contributions are not a tax – they are more of a targeted charge for a service. (sub. DR176, p. 14)

The Commission agrees with SOLGM that the Government should pay DCs on all developments it undertakes in line with the DC policies of the local authorities in which the developments are located. The DC principles and rules are robust enough to prevent unfair charging of the Crown by councils.

R7.14

The Government should pay development contributions on all projects it undertakes, in line with the development-contributions policies of the local authorities in which the projects are located.

Payments for council services to Crown properties

Most Crown land is currently exempt from general rates. This includes land occupied by institutions such as schools, universities and hospitals, as well as the conservation estate.⁵⁰ In previous inquiries, the Commission has recommended that central government should pay rates on its properties. The Terms of Reference

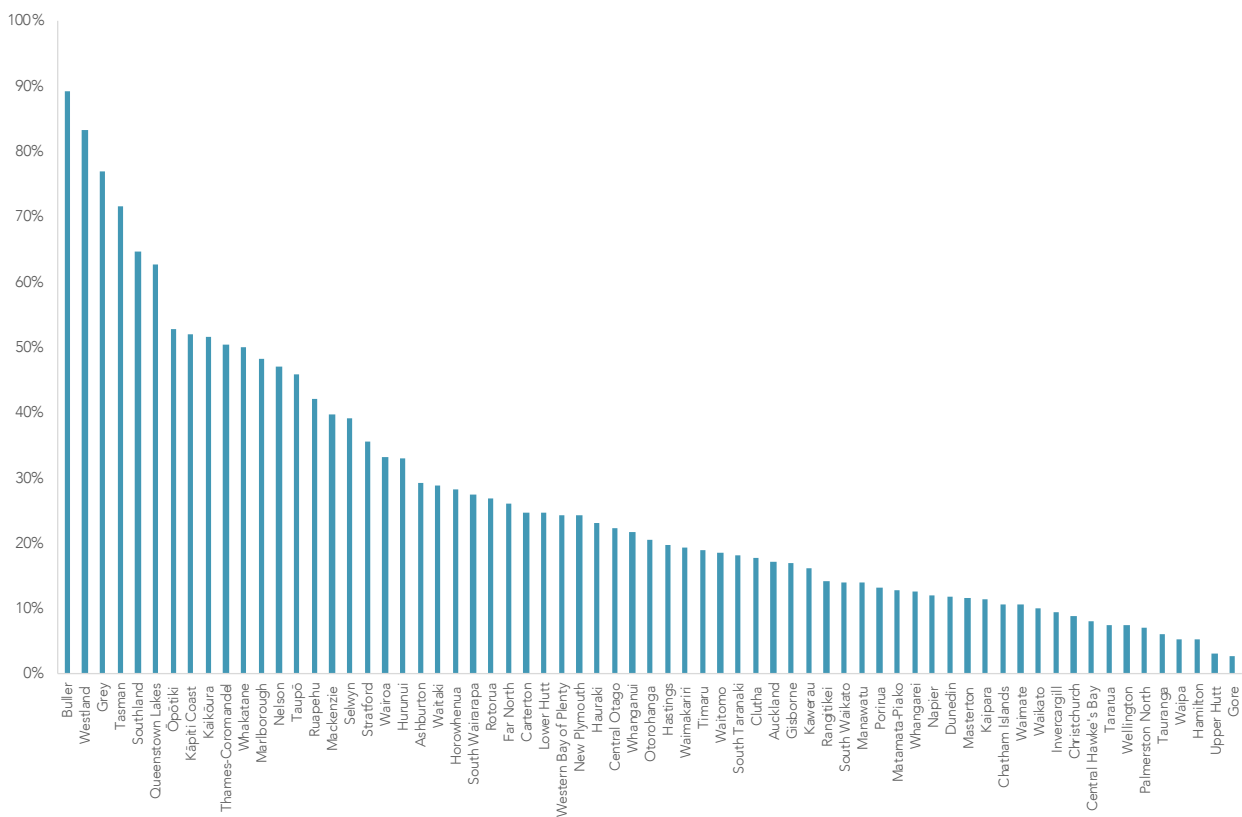
⁵⁰ Exemptions from rates also include land used for airports, railways and ports, some of which may be owned by the Crown and some by other entities such as regional councils.

(TOR) for the current inquiry direct the Commission to make no recommendations on the “particular mechanisms for rating crown land”. Even so, the Commission takes the view that if the Crown benefits directly from council services to property it owns in a district, then it should pay the cost of those services.

Councils may set targeted rates to cover the cost of water supply, sewage disposal or refuse collection to Crown land that is otherwise exempt from rates (s. 9 of the Local Government Rating Act 2002). Yet this provision still leaves councils missing out on payments for a range of other services to Crown properties. Crown properties, for instance, are served by the local road network, benefit from the development of central business districts, and are protected by flood-control infrastructure. Councils must provide roads and bridges to access the conservation estate, often in sparsely populated parts of their districts where few residents benefit from the provision.

Crown-owned land accounts for 39% of New Zealand’s total land area. This is distributed very unevenly across territorial authorities. Almost 90% of the land area in Buller district is Crown-owned, compared to 2.6% in Gore (Figure 7-5).

Figure 7-5 Crown land as a proportion of Territorial Authority land area



Source: Land Information New Zealand (LINZ), Central Record of State Land (CRoSL).

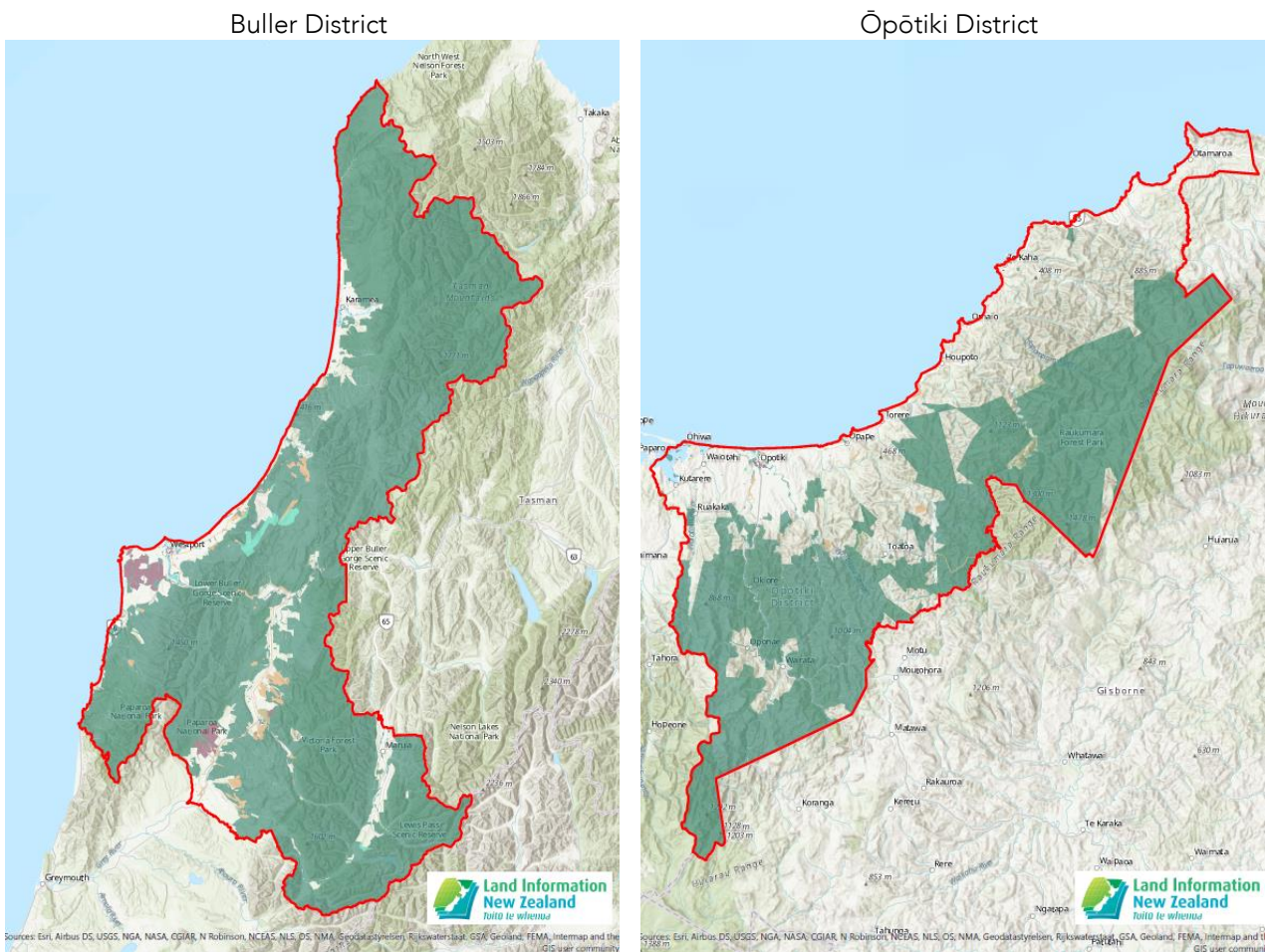
Conservation land accounts for 85% of all Crown-owned land, so districts with a high-proportion of Crown land are also predominantly rural councils. Many of these districts also have small, low-income communities, which have experienced the greatest pressure on rates affordability (Chapter 8). While much conservation land will require little in the way of council services, it also means that significant tracts of a district are unavailable for housing or other development. Conservation land therefore acts as a permanent constraint on the size of a council’s rating base.

Figure 7-6 provides two illustrations. Conservation land comprises almost 87% of the land in Buller district, and over 52% in Ōpōtiki. In both districts, rates as a proportion of median incomes have grown strongly, reaching 5.9% in Buller and 5.4% in Ōpōtiki in 2018.

R7.15

The Government should pay more than it currently pays (because of the Crown rating exemption) for the services that councils provide to Crown properties.

Figure 7-6 Department of Conservation land: Buller and Ōpōtiki Districts



Source: LINZ, Central Record of State Land (CRoSL).

Notes: Department of Conservation land shown in dark green. Red line indicates Territorial Authority boundary.

Damage to local roads from heavy vehicles

Chapter 4 describes the concern of some councils – such as Whanganui District Council (sub. 93, p. 2), Rangitikei District Council (sub. DR247, p. 2), and Waikato Regional Council (sub. DR229, p. 6) – as well as SOLGM (sub. 24, p. 38) about costs falling on councils from damage to local roads from heavy vehicles (and logging trucks in particular). These submitters anticipate that the problem will become worse as forestry becomes more extensive as part of the effort to lower net emissions of greenhouse gases.

Councils have no means of charging the owners of heavy vehicles directly for this damage. They can impose targeted rates on those, such as foresters and farmers, who cause the need for heavy vehicles on the roads, but such rates are very unpopular. Also, and importantly, imposing a targeted rate for this purpose would be double charging because the heavy vehicles already pay for the damage they cause to roads through their RUCs. The problem is that RUCs go into the National Land Transport Fund and no effective mechanism exists to channel them back to the councils that must meet a large proportion of the cost of the damage.

The Commission sees this as a case of the central government efficiently collecting funding from the exacerbator – the heavy vehicles – but not recycling it to the local government that incurs the costs locally. The Government should find an efficient and effective means to fund councils for the cost of this damage to local roads caused by heavy vehicles such as logging trucks and milk tankers.

R7.16

The Government should find an efficient and effective means to fund councils for the cost of damage to local roads caused by heavy vehicles such as logging trucks. While the vehicles pay for their damage through Road User Charges, no effective mechanism currently exists to channel these funds to councils to cover the cost of the damage that councils bear.

Contested territory – increasing responsibilities and unfunded mandates

Section 4.3 of this report draws attention to the rising funding pressures on local governments from the accumulation of tasks and responsibilities that central government has passed to councils over the years. Sometimes these additional tasks and responsibilities fit the description of “unfunded mandates” that central government imposes on local governments. Many local authorities see this passing of tasks and responsibilities as a case of central government shifting costs from its budget to theirs (see the quotes from council submissions in section 4.3).

Two key situations typify unfunded mandates (as described in Chapter 4):

- Central government sets national standards and local governments are responsible for meeting those standards. For example, the various NPSs, NESs and higher standards for drinking water.
- Central government requires local governments to act as regulators (eg, administering problem gambling levies under the Gambling Act, licensing food premises, licensing liquor outlets, licensing the sex industry, and licensing dog control).

In both cases, arguments can go either way as to who should fund the tasks involved. For example, regulating food premises and liquor licensing are both intensely local issues and a matter of national benefit given the fallout for the health system or visitor reputation in the event of a serious incident arising from lax standards. Yet, it is possible to conclude three things:

- the default in the event of central government assigning a regulatory role to local authorities is that the regulator should be given a means to adequately fund its operations – either from the regulated parties, or through government payments;
- if significant national-benefit spillovers are involved, a good case exists for a contribution from national funds; and
- even in the absence of national spillovers, central government should undertake thorough regulatory impact analysis that takes full account of the costs that new regulations are likely to impose on local authorities.

Section 4.3 points out a few remaining areas of local regulation where legislation limits the fees that councils can charge to recover their regulatory costs. These areas are:

- Amusement Devices Regulations 1978, which sets the fees to pay when applying for a permit;
- Land Transport (Certification and Other Fees) Regulations 2014, which sets the fees to pay to obtain a permit to exceed mass limits; and
- Sale and Supply of Alcohol (Fees) Regulations 2013, which sets the fees (within different fee categories) that premises must pay to obtain a licence.

These restrictions are anomalous and ought to be removed, with appropriate safeguards to limit councils to charging reasonable costs only.

R7.17

The Government should remove the few remaining legislative limits on the fees that councils can charge to recover their regulatory costs. Consistent with provisions in the Resource Management Act 1991 and the Local Government Act 2002, it should constrain councils to charging reasonable costs only.

Towards a true partnership between the levels of government

A major contributor of the problem of unfunded mandates is the poor state of relations between central and local government. There needs to be a shift from treating local government as an agent of central government to a relationship of genuine partnership. If that were to happen, regulatory regimes would be co-designed and jointly implemented with the needs and circumstances of local government kept front of mind.

The need for partnership between central government and local government is clear in the case of fulfilling obligations under the Treaty of Waitangi. As noted in Chapter 4, the primary obligations under the Treaty lie with the Crown; yet, often local governments fulfil responsibilities with respect to local iwi. Central government must ensure that local government has the funding to carry out these responsibilities to an acceptable standard. For its part, local government would then need to deliver to this standard.

A recurring theme of the Commission's *Local government regulation* inquiry was "the poor state of the relationship and interface between central and local government, across all aspects of the regulatory system" (NZPC, 2013, p. 6). In that inquiry, the Commission concluded that central government's involvement in regulatory regimes managed locally needed to improve, particularly in the following areas:

- the interface between central and local government needs to improve, with local authorities recognised as "co-producers" of regulatory outcomes;
- central government agencies need to enhance their knowledge of the local government sector and increase their capability to undertake robust implementation analysis; and
- meaningful engagement and effective dialogue with local government needs to occur early in the policy process.

The Commission has continued to hear from inquiry participants that, despite some examples of successful collaboration (such as the Auckland Transport Alignment Project), the interaction between central and local government on regulatory and planning matters remains unsatisfactory. Also, a 2016 Colmar Brunton survey of councils indicated that communication between central and local government was poor.

Central-government agencies are currently not fulfilling at least some of their regulatory stewardship responsibilities. A more productive relationship and interface between central and local government on regulation are possible, and desirable, in helping to fulfil these obligations. They should feature:

- central and local government providing input (formally or informally) into each other's relevant policy-making processes, and that this process is governed by an agreed set of principles;
- meaningful engagement and effective dialogue with local government occurring early in the policy process;
- cooperative approaches to tackling potential problems with implementing relevant new legislation, regulations, NPSs or NESs;
- central government explicitly considering the costs to local government of relevant new regulations in its Regulatory Impact Assessments;
- the creation of formal and informal feedback loops to identify problems, when they first appear, with delegated regulations; and
- the spread of information through the system and the sharing of expertise and knowledge.

To make progress, both central and local government need to foster a more open and productive relationship. A hopeful sign is that in May 2019 the Government released new guidance for engaging with local government, laying out the key elements of good practice for central government agencies to follow. The aim of this guidance is to "make central government engagement practices with local government more timely, effective and consistent across central government" (Department of Prime Minister and Cabinet, 2019).

The Commission sees significant value in building on this guidance. It has previously recommended that central and local government work together to develop a “Partners in Regulation” protocol (NZPC, 2013). The protocol would articulate an agreed set of behaviours and expectations when developing and implementing local regulation and, more generally, would promote a constructive interface between central and local government (Box 7.3).

Box 7.3 Partners in regulation protocol

The protocol would aim to promote a constructive interface between central and local government by:

- developing a common understanding of, and respect for, the roles, duties and accountabilities of both spheres of government; and
- articulating an agreed set of principles to govern the development of regulations, with implications for the local government sector.

The protocol would be a jointly created document signed by the Government and representatives from the local government sector. To signal strong commitment, the Prime Minister and the Minister of Local Government could sign it. This would increase the protocol’s status as a “whole-of-government” document. It is equally important that local government illustrates ownership and commitment to the protocol. For this to occur, the sector must see the signatories to the protocol as legitimate representatives with the authority to “speak for councils”.

The Commission does not envisage that the protocol would be a legally binding document. However, the requirements of the protocol should be set out in a Cabinet Circular with a directive that the principles are to be complied with when formulating local regulation in all but exceptional circumstances. At the same time, performance assessments of relevant central government agencies should include progress towards implementing the protocol. Likewise, the protocol should include a provision that local authorities include a “statement of intent to comply” in their annual reports.

The protocol could include a principle that central government will make payments to local government (or enable other means of cost recovery) when it places additional regulatory or other responsibilities on local government. It is notable that at least two other jurisdictions formally recognise this sort of principle.

- The US enacted an Unfunded Mandates Reform Act in 1995, the purpose of which is to curb the practice of imposing unfunded Federal mandates on States and local governments; to strengthen the partnership between the Federal Government and State, local and tribal governments; to end the imposition ... of Federal mandates on State, local, and tribal governments without adequate funding ...; and to ensure that the Federal Government pays the costs incurred by those governments in complying with certain requirements under Federal statutes and regulations, and for other purposes.
- In Sweden, the central government has agreed to a “financing principle” to ensure that local government has financial capacity to provide the services delegated to them, and curb the practice of imposing unfunded mandates. According to the Organisation for Economic Co-operation and Development (OECD) and United Cities and Local Governments (UCLG):

[I]f the central government decides to delegate a new task to subnational government, the central government must increase grants or provide other revenues to the subnational governments in question in order to finance the new service. If, however, an existing subnational task is centralised or abandoned, the subnational grants may be reduced. The financing principle is applied only to those central government decisions that affect subnational service costs directly... While the principle is not legally binding, it is agreed upon by all political parties and routinely used by the government. The principle is applied only to new tasks. (OECD & UCLG, 2019a)

Source: Crawford & Shafiee (2019); NZPC (2013).

R7.18

Central and local government should strive to achieve a more constructive relationship and effective interface through:

- central and local government providing input (formally or informally) into each other's relevant policymaking processes, under an agreed set of principles or a protocol;
- central government engaging in a meaningful dialogue with local government early in the process of developing relevant new regulations;
- central government explicitly and consistently considering the costs to local government of relevant new regulations, and the funding of the costs, in its Regulatory Impact Assessments;
- cooperative approaches to tackling problems with implementing relevant new legislation, regulations or environmental standards;
- the creation of formal and informal feedback loops to identify problems with delegated regulations when they first appear; and
- the spread of information through the system and the sharing of expertise and knowledge.

Spatial planning as a platform for more effective collaboration between central government and local government

Chapter 5 pointed out the merits of spatial planning to help councils collaborate in long-term planning and infrastructure decisions. In *Better urban planning*, the Commission described how central government should participate in regional spatial planning to help it coordinate and collaborate with local governments in each region in various areas including:

- transport infrastructure planning;
- urban and regional growth and population planning;
- health and education infrastructure planning; and
- preserving and enhancing the natural environment.

These are all areas with national, regional and local dimensions and interests. Regional spatial planning also seems a suitable platform to act as a bridge between a national climate-change adaptation plan and regional adaptation plans, given that locating and relocating infrastructure and communities in sensible places will be key to successful adaptation (Chapters 9 and 12).

7.7 Funding for councils facing sustained pressure on rating capacity

Chapter 6 found that councils in small, rural and low-income districts have been experiencing sustained pressure on their rating capacities. Over the last two decades, the ratio of rates to income in these councils has increased significantly faster than in other councils. Rates are now much more burdensome for ratepayers in these districts than for ratepayers in metropolitan centres.

These low-income districts also often have static or falling populations. In its 2018–38 population projections, Stats NZ estimated that 15 of the 26 rural districts would have falling populations, most already having small populations. No metropolitan or provincial authority is projected to have significantly negative population growth. Several councils pointed out to the Commission that their recent experiences were contrary to the projections and that their population growth rates had turned from negative to positive. Common drivers

cited for this turnaround included rising tourism and the attraction of cheaper house prices. Time is needed to tell if the recent growth is a turning point or a blip.

As noted in Chapter 4, councils in areas with static or falling and low-income populations must continue to fund services and the supporting infrastructure from a smaller rating base, and from ratepayers with less ability to pay. Many of these services such as drinking water, wastewater and roading are subject to economies of scale. This means that the costs of a pipe network or road network, or the fixed costs of a wastewater treatment plant must be spread over fewer ratepayers, or ratepayers with low fixed incomes. Many of these councils will also face significant costs to adapt their infrastructure to meet the challenges of climate change (Chapter 9).

Meeting the funding challenges

The increased pressure on rating capacity in small, low-income rural districts creates difficulties for them in funding essential infrastructure such as roads (a high proportion of costs in rural districts) and the three waters. These are areas where central government has an interest. For example, central government support for roading reflects the national benefits of the local roading network (section 7.6). The amount of support from the NZTA already takes account of local rating capacity (Chapter 6).

Similarly, central government has an interest in the quality of drinking water and has set minimum standards to reflect this. Chapter 11 sets out a way forward on water reform that could deal with the challenges of small low-income communities struggling to fund safe, cost-effective drinking-water and wastewater services. While this way forward would encourage scale and specialisation, financial assistance from central government to help these communities make the transition may also be needed.

Chapter 9 recommends that the Government should extend the NZTA's role in co-funding local land-transport infrastructure to include assistance to councils facing significant threats to the viability of roading infrastructure from climate-change events. Chapter 9 also recommends a similar approach to assisting local government in the redesigning, and possible relocation and rebuilding of three-waters infrastructure when it becomes no longer viable as a result of climate change.

Other countries where local government has a much wider scope than in New Zealand typically use extensive fiscal equalisation systems as a way of addressing disparities in fiscal capacity across local government units (Crawford & Shafiee, 2019). The narrow scope of local government in New Zealand, and concentration of its major costs in essential infrastructure, suggests purpose-designed funding arrangements for particular types of infrastructure would be more efficient and transparent. Funding assistance can then be more readily matched to assistance with local infrastructure design; and to local funding to achieve effective outcomes (consistent with the design principles for intergovernmental transfers set out in Chapter 6). The Commission recommended such an approach in its *Better urban planning* inquiry (NZPC, 2017).

Small councils facing funding difficulties need to be innovative in finding new ways to deliver essential services. For example, new modular technologies for water treatment can deliver safe drinking water, and small-scale, modern, local and effective wastewater treatment options exist (as an alternative to centralised, reticulated systems). Yet, some small councils may lack the specialist knowledge and capabilities to know about and implement new technologies. A further problem may be unwillingness to collaborate. For example, Wellington Water proposed a coordinated rollout of standardised modular drinking-water treatment plants that would upgrade 105 existing plants and bring safe drinking water to 520 000 additional people across central New Zealand (Wellington Water, 2018b). Yet, the Commission understands few councils were interested in the proposal.

Further north, Hauraki District Council makes the valid point that becoming more efficient in water services is not simply a matter of applying *physical* scale to the network (although that should be done when existing small networks are geographically close).

The major benefits of scale are achieved where multiple small water/wastewater supplies are able to be amalgamated. In Hauraki this has already been done, and seven water supplies have been amalgamated to form three supplies. This is only economically efficient where the supplies are geographically close.

With the exception of the amalgamation of separate water supplies, Council does not believe there is strong evidence that scale necessarily results in cheaper three waters outcomes. Hauraki supplies water

that is compliant with drinking water standards at a lower cost per unit than Watercare. Hauraki also treats wastewater to a high quality at a lower cost per residential ratepayer compared to Watercare. Hauraki's water and wastewater activities are fully funded from water by meter charges and wastewater targeted rates. (sub. DR210, p. 13)

Inability to fund and secure specialised management and technical expertise is a challenge for small, low-income rural councils. Amalgamation is one way to share the funding of expertise across a larger population but is outside the inquiry's TOR. Another solution for small councils struggling to maintain or upgrade their water infrastructure would be to contract an existing provider to take over its water services and apply its scale and specialised knowledge to raise quality and bring down costs (Chapter 11).

R7.19

The Government should, in providing funding to local government for essential infrastructure (such as roading or drinking water infrastructure), take account of the rating capacity of councils in determining the level of support.

Government funding should also be conditional on sensible infrastructure design and local co-funding. The Government should favour designs with the scale and specialisation best suited to help small communities upgrade and then maintain their essential infrastructure.

7.8 A future funding and financing system

The conclusion of this chapter is that a fit-for-purpose future funding and financing system for local government would look substantially like the present system but with some significant new tools, improved council practice and performance, and some new and improved funding transfers from central government.

That the foundations of the system should remain largely the same reflects the soundness of land and property rating as the main revenue-raising tool for local government. Property rating is an efficient and effective tax that generally yields a stable, predictable and adequate stream of revenue for councils while supporting local autonomy and accountability.

The appropriate use of rates (including targeted rates), along with user charges, development contributions and connection charges is efficient and can also yield fair outcomes in the sense of satisfying the benefit principle (that those who benefit from a service should pay) or the exacerbator principle (that those who cause a cost or the need to prevent or mitigate a harm should pay). Yet questions remain about the ability of some property owners to afford to pay rates. This concern relates mostly to smaller, remote local authorities with higher-than-average levels of deprivation.

Councils must be transparent in explaining to their communities and individual ratepayers what their rates and charges are for, and how costs are being shared. This will help build accountability and understanding and, in turn, a greater willingness to fund projects and services that are needed and give value for money.

In two areas where funding pressures have called into question whether current funding tools can generate enough revenue or enough incentive, the chapter has recommended solutions.

For **funding and financing growth**, the recommendations are to:

- give councils the ability to levy some form of value capture using targeted rates on property values associated with growth and infrastructure investment. This has the potential to be a significant additional revenue source for high-growth urban councils;
- enhance councils' ability to charge for road congestion, and wastewater (by volume); and
- complete policy work on and implement an enhanced version of Special Purpose Vehicles to help high-growth councils nearing or at their debt limit to finance investment in infrastructure to meet demand for growth.

To substantially ease the funding pressure that local government feels from increasing **central government regulatory requirements**, the recommendations are as follows.

- The benefit principle should be used to test whether a funding contribution from central government is justified. If benefits from local government activities yield significant national benefits, then central government should fund a share proportionate to those benefits.
- When the Crown owns property within a district and benefits directly from council services, or imposes costs on councils, then it should cover the cost of those services.
- If the Government collects taxes or charges from third-party beneficiaries of council services (where the council cannot charge for these services directly) then a case may exist for the Government to pay a portion of that revenue to the council to help cover its costs.
- The two levels of government should seek a regulatory partnership based on mutual respect and an agreed protocol. The protocol would articulate an agreed set of behaviours and expectations when developing and implementing local regulation and, more generally, would promote a constructive interface between central and local government.
- Integral to the partnership, central government should explicitly consider the costs to local government of relevant new regulations, and how they will be funded, in its Regulatory Impact Assessments.

These recommended changes can happen broadly within the current system. Given this, while the changes are significant, the Commission does not see that implementing the recommended changes would be unduly disruptive.

In following chapters, the Commission explores some other areas where local government funding is under pressure. Chapter 8 examines affordability of rates for households. Chapter 9 examines and makes recommendations about the funding pressures that some local authorities will increasingly feel because of the imperative to adapt to climate change. Chapter 10 examines the pressures from high and growing levels of tourism and makes recommendations for affected councils and the Government. Chapter 11 explores the future funding and financing of the three waters, including the challenge to make these important services both higher quality and more innovative yet still universally available.

8 Affordability for households

Key points

- The burden of rates is shared by all households either directly, or indirectly through rents and through purchasing goods and services from businesses. At a national level, rates per person have remained at a fairly stable proportion of the incomes of low-income households for many decades. Even so, small, rural and low-income councils have experienced increasing pressure on rating capacity over the last two decades (Chapter 6).
- Central government is best placed to tackle pressures on low-income households facing high housing costs. Central government agencies hold detailed information on household circumstances relevant to providing equitable assistance. It has access to an efficient and comprehensive tax base from which to fund large income support programmes.
- Concerns about the affordability of rates typically focus on low-income (particularly elderly) households who own their own homes, usually without a mortgage. Yet such households generally have much lower housing costs than other low-income New Zealand households who rent or who have a mortgage.
- The Rates Rebate Scheme (RRS) is targeted to low-income homeownership households. The RRS is inequitable (because renting households in otherwise similar circumstances do not qualify), administratively cumbersome and modest (the maximum payment amounts to a little over \$12 a week, or \$630 a year).
- The Accommodation Supplement (AS) is the Government's principal form of assistance for accommodation costs to low-income households living in private residences. Most recipients of the RRS would not qualify for the AS because their housing costs are too low (as they usually own their own homes without a mortgage).
- A national scheme for postponing rates would better fulfil the purposes that the RRS is designed to address. The Government should collaborate with local government and interested financial institutions to design, implement and promote such a scheme. Once a successful scheme is in place, the RRS should be phased out.
- If the Government wishes to retain the RRS it should improve its administrative efficiency, by shifting to fully online application and processing capabilities. This could be achieved by extending the current trials undertaken by the Department of Internal Affairs, or by moving administration to the Ministry of Social Development or Inland Revenue.
- The 30% cap on uniform charges (under the Local Government (Rating) Act 2002) is not necessary to prevent rates being overly regressive. The Local Government Act 2002 provides sufficient guidance for councils to consider wellbeing in setting rates, and councils are keenly aware of ability to pay in making decisions. The cap is inconsistent with local government autonomy to set rates according to local preferences. It should be removed.

Chapter 6 assessed the current fairness of local government funding and financing and the transparency with which councils apply the “benefit” and “ability to pay” principles. That chapter also identified the types of councils which are experiencing sustained increases in rates as a proportion of incomes. Chapter 7 made recommendations on how central government should consider these pressures when deciding on the extent of grants and subsidies in areas where there is a significant national interest in service outcomes.

This chapter focuses on the affordability of rates for households. It looks at the affordability of rates within the broader framework of central government's assistance for those facing hardship in meeting housing-

related expenses. The chapter identifies weaknesses in the current policies to address affordability for specific groups of ratepayers and recommends changes.

8.1 Housing costs and rates affordability

While this inquiry is primarily about local government cost drivers and the funding and financing framework, a further consideration is affordability, particularly the affordability of rates. Concerns about the affordability of rates are not new. In 2007, “concerns about the impacts of rates increases for low-income groups and other sectors of society and the economy” were factors leading to the establishment of the Shand Inquiry (Shand Report, 2007, p. 22).

The Shand Inquiry provided a useful broad definition of affordability: “[Affordability] means the ability to pay without serious economic difficulty” (Shand Report, 2007, p. 185). Shand then considered the affordability of rates in a relatively narrow context:

Ability to pay rates requires consideration of

- the cost of rates relative to income and also relative to wealth, to the extent that wealth can be converted to income
- having sufficient income to pay for rates without crowding out other critical expenditure
- ratepayers earning greater income as a result of council investment in infrastructure and services. (p. 185)

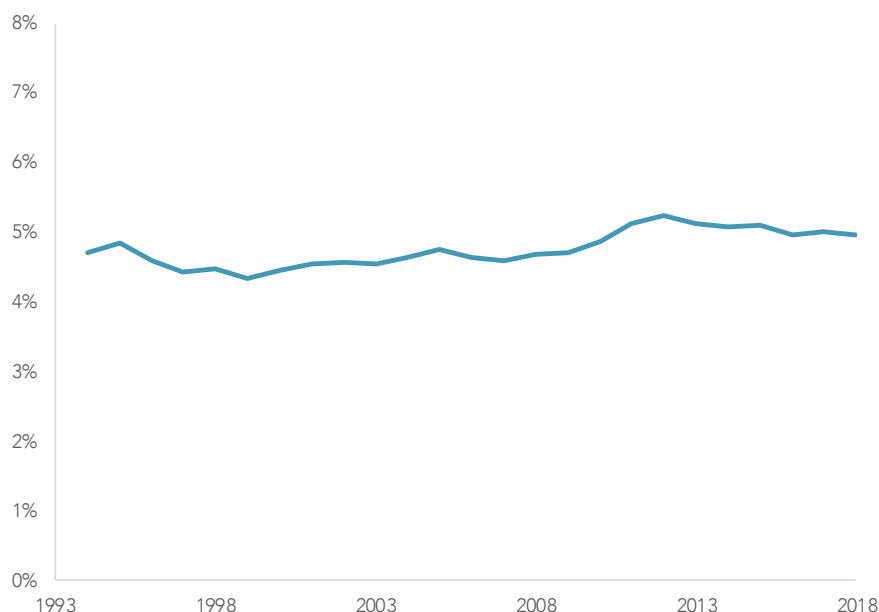
This chapter takes a broader approach by looking at rates as a component of housing costs. Much better and more reliable data and analysis is available about housing costs (rather than rates alone) as a proportion of income, and the effects on material hardship (especially Perry (2018a) and Perry (2018b)). In addition, as discussed below, rates paid by landlords are likely largely passed on to tenants. As a result, the economic position of tenants is as relevant to the question of rates affordability as the economic position of residential ratepayers.

Central government is best placed to tackle pressures on low-income households facing high housing costs. Central government agencies hold detailed information on household circumstances relevant to providing equitable assistance. It has access to an efficient and comprehensive tax base from which to fund large income-support programmes.

The largest central government income-support programme to address housing costs is the Accommodation Supplement (AS). Central government also provides much more limited support through the Rates Rebate Scheme (RRS). This section examines the limited coherency of these two instruments.

Rates affordability for low-income households over time

Chapter 3 showed that rates increases have broadly matched income increases over the last 25 years for the typical household. Even so, rates affordability may still be a concern for many lower-income households and households on fixed incomes (eg, for people who rely on superannuation). Rate revenue as a proportion of the 20th percentile of household disposable income remained within a fairly narrow band over the last 25 years and stayed almost constant around 5% for the last decade (Figure 8-1).

Figure 8-1 Rates per person as a proportion of low-income household disposable income

Source: Perry (2018a), Stats NZ (2019e), (2019d).

Notes:

1. Household disposable income is equivalised disposable income (before housing costs are paid) reported in Perry (2018a) and derived from the Stats NZ Household Economic Survey. Disposable income refers to income after tax and transfers; equivalised income is income adjusted for household composition. The income data used in the figure are for the 20th percentile of people by equivalised household disposable income.

Chapter 6 showed that in some (mostly small, rural and low-income) districts, rates have been growing much faster than incomes since 2000. This partly reflects the fact that rates had reached an historic low point as a proportion of incomes around 2000. More importantly, it reflects faster growth in cost pressures and slower growth in incomes in those parts of the country. This means that councils in those districts have been facing a sustained challenge to their rating capacity. Chapter 7 proposes policy approaches to address those challenges. Even so, households in those districts are paying a significantly higher proportion of their income on rates (either directly or indirectly) than in larger, wealthier and mostly metropolitan districts – and the gap continues to grow. Central government income support programmes are the main instruments available to address any resulting affordability concerns (see section 8.2).

The incidence of rates on renting households

Most of the discussion of the affordability of rates for particular households focuses on ratepayers (owners of residential property). Yet the economically most vulnerable households are largely renting households (Perry, 2018a). Renting households, in effect, pay rates on the properties they occupy, through rent. It is not possible to accurately quantify the extent to which rates are passed on to renters because housing supply, housing tenure, employment and location decisions interact in complex ways (England, 2016). Even so, while landlords have choices about whether to continue to own and rent their properties, renters on average are less able to make choices that find them paying no rent. This suggests that rates are mostly passed on to renters.

Also, rates on business properties eventually get passed on to consumers through the cost of goods and services the business provides. In most but not all cases, these costs fall locally. Meridian Energy pointed out that the costs of rates on its power-generating properties gets passed on to electricity consumers around the country (sub. 73). Farmers, on the other hand, likely have to absorb some of the costs of rates through reduced profits, as they are supplying commodities into international markets where they are price takers.

Households facing material hardship are mostly young, renting and on low incomes

Housing costs can have a significant influence on whether households experience poverty or material hardship. Perry (2018a) looked at the percentages of individuals, by age and housing tenure, who live in low-income households after accounting for housing costs.⁵¹ Renters are much more likely to live in low-income households than those who own their own house (and so pay rates directly). Younger people are three times more likely to live in low-income households than older people.

Table 8.1 Proportion of individuals in low-income households by tenure and age, 2015

	Aged under 65	Aged over 65
Owned, no mortgage	5%	1%
Owned with mortgage	8%	9%
Rented – private (no AS)	7%	
Rented – private (AS)	32%	
Rented – public housing	32%	
Rented		12%
Total proportion in low income households	13%	4%

Source: Perry (2018a, p. 141), Tables G 8A & G 8B.

Notes:

1. The data in the table show the percentage of individuals of each age and tenure type who are in low-income households.
2. Low income is defined as being below 50% of 2007 median equivalised household disposable income after housing costs.
3. Data are derived from the Stats NZ's Household Economic Survey.
4. "AS" refers to the Accommodation Supplement administered by the Ministry of Social Development.
5. "Owned" includes owned through a family trust.

Perry (2018b) looked at various measures of material hardship and found that the relationship between experiencing material hardship and living in low-income households is inexact.⁵² Owning a home without a mortgage makes a significant difference. While 35% of those aged over 65 have before-housing-cost incomes in the lowest income quintile, this falls to 13% after accounting for housing costs, and only 7% on an index of material wellbeing (p. 11). One reason is that (in 2015) 72% of those over 65 lived in their own house without a mortgage.

Across a range of measures, older people consistently have much lower rates of hardship than younger people (and especially younger people in sole parent families and households dependent on benefits as their main source of income). Māori families were also significantly more likely to experience hardship than European families (Perry, 2018b).

Central government assistance

Any local government rating policy tackling "ability to pay" should complement relevant central government policies (Chapter 6). The main forms of central government assistance for housing costs are the AS and, to a much lesser extent, the RRS. The government also helps families in social housing through a large income-related rents subsidy programme (Ministry of Social Development, 2019). Some households receiving the AS require additional assistance to meet their essential housing costs. Temporary Additional Support (TAS) provides such assistance for a maximum of 13 weeks, after which recipients must reapply. More than 20% of recipients of the AS also receive TAS at any one time (Welfare Expert Advisory Group, 2018).

⁵¹ "Housing costs include all mortgage outgoings (principal and interest) together with rent and rates for all household members. Repairs and maintenance and dwelling insurance are not included [though insurance will be in future reports]" (Perry, 2018a, p. 18).

⁵² Non-income measures of material wellbeing are derived from responses to surveys about "actual day-to-day living conditions of households in terms of the basics of food, clothing, accommodation, heating, and transport, and more widely in terms of their ability to maintain or replace broken household appliances, purchase desirable non-essentials, cope with unexpected demands on the household budget and so on" (Perry, 2018b, p. 3).

The Accommodation Supplement is the primary programme to help low-income households meet housing costs

The AS is central government's most important programme to assist low-income families meet housing costs. The AS is a very substantial programme with a total annual appropriation in the 2019 budget of almost \$1.7 billion. Almost 303 000 people (in most cases each representing one household) were receiving the AS in December 2018.

The AS is a non-taxable weekly payment that helps people with their rent, board or the cost of owning a home. Importantly, as the AS is available both to renters and to people who own their own home, it addresses the effects of rates on costs whether direct or passed on through rents. Section 65(2) of the Social Security Act 2018 (SSA) defines eligible "accommodation costs". For homeowners, these costs include rates and mortgage payments, house insurance premiums and "essential repairs and maintenance".

Eligibility for the AS depends on factors such as accommodation costs, location, income and cash assets, and family circumstances. The amount of AS is determined by the following factors.

- The Social Security Regulations 2018 (clause 17) sets the relevant main benefit rates (including the maximum Family Tax Credit rate for the eldest child, if applicable) as a "base rate". The rates vary by household composition and relationship status.
- The AS is paid at 70% of actual housing costs that exceed 25% of the base rate (30% for homeowners). The payment is subject to a maximum depending on which of four areas the recipient lives in. The current maximum payment is \$305 a week for households with three or more people living in the most expensive housing area. The maximum for two-person households is \$220 a week (SSA, Schedule 4, Part 7). The maxima are not indexed for inflation.
- If the recipient is a non-beneficiary, the AS is reduced by 25 cents for every \$1 of income of the recipient and their partner.⁵³ If the recipient is a beneficiary (including New Zealand Superannuation), the AS is not abated against income. Instead:
 - the main benefit is abated for working age beneficiaries; and
 - a person receiving New Zealand Superannuation is not eligible for the AS if the combined income before tax of that person and their partner exceeds \$835.04 a week (SSA, s 67(e) & Part 2 of Schedule 5).
- Recipients may hold cash assets of up to \$16 200 if they are in a relationship or with a dependent child, or \$8 100 otherwise (Social Security Regulations 2018, clause 15).

The current combined before-tax rate of New Zealand Superannuation for a couple is \$724.85 a week. That couple could earn around \$110 a week on top of their superannuation payments before losing eligibility for the AS. Yet a couple living in their own home without a mortgage will likely not qualify because their housing costs (rates and insurance) would fail to meet the 30% of their before-tax superannuation income threshold (just over \$13 000 a year).⁵⁴ More generally, it is most likely that only homeowners (including those living alone) who are making mortgage payments or who have significant essential repairs would meet the cost thresholds for AS.

The distribution of AS beneficiaries by tenure and benefit status reflects the groups for whom housing costs are the greatest challenge (Table 8.2). Homeowners are only 11% of the total, while homeowners who receive New Zealand Superannuation are only 2% of the total.

The Welfare Expert Advisory Group considered the AS as part of its review of the welfare system (Welfare Expert Advisory Group, 2018, 2019). It noted some well-known problems, including the different accommodation costs threshold for renters and homeowners, the fact that the asset test has not been adjusted for inflation since 1989, and that the maximum payments are not indexed for inflation. The Group

⁵³ Every \$100 of cash assets held over specified values are treated as \$1 of income for the purpose of this income test (SSA, s 423(3)). Non-beneficiaries may be receiving the Working For Families tax credit.

⁵⁴ The costs of "essential repairs" might temporarily exceed the threshold.

also pointed to the suspected low uptake among non-beneficiaries (people who are neither on a main benefit nor receiving New Zealand Superannuation). The Group made recommendations to the Government to address these issues.

Table 8.2 Accommodation supplement proportion of total by tenure and beneficiary status, December 2018

Tenure	Beneficiary	NZ Super	Non-beneficiary	Total
Renting	42%	10%	14%	67%
Boarding	20%	1%	1%	22%
Own home	5%	2%	4%	11%
Total	67%	14%	19%	100%

Source: Ministry of Social Development.

Notes:

1. NZ Super includes recipients of the Veteran's Pension.
2. The NZ Super column 2 totals 14% instead of 13% because of rounding.

More broadly, expenditure on the AS has been increasing rapidly in recent years as house prices and rentals have been rising. This points to deeper problems in the housing market which require a suite of solutions that have been canvassed in earlier Commission inquiries (NZPC, 2012, 2015, 2017). The AS has struggled, by itself, to provide enough assistance to some low-income households, especially those who rent their homes, to meet these rising costs. As a result, many recipients also need TAS payments to meet their essential housing costs (Welfare Expert Advisory Group, 2018).

F8.1

Concern about rates affordability typically focuses on low-income (particularly elderly) households who own their own homes. Yet such households generally have much lower housing costs than other low-income New Zealand households (most of whom do not own their own homes).

The Rates Rebate Scheme

The RRS was introduced in 1973, long before the AS and its predecessors were available to homeowners not receiving a working-age main benefit. The RRS was designed to assist low-income and older ratepayers facing affordability pressures and who wished to stay in their homes.

The maximum RRS is \$640 a year (or a little over \$12 a week). Assistance reduces above an income threshold, which varies by the rates bill and number of dependants. For example, a single person whose sole income was from New Zealand Superannuation would be eligible for the full rebate if their total yearly rates were \$1 050 or higher. A couple receiving New Zealand Superannuation would be eligible for a full rebate if their rates bill was \$3 450 or higher (and no rebate at all, if their rates bill was under \$2 455). For a household without dependants, eligibility ceases with incomes above \$43 000 and rates below \$3 500. Unlike the AS, the RRS is not subject to any asset test (including any cash asset test).

In 2018, the Government amended the Rates Rebate Act 1973 to provide eligibility for residents of licence-to-occupy retirement villages (s 7A).

In 2017, just under 98 000 households received a rebate, with a total value of \$55 million (DIA, 2019b). While the number of recipients is around one-third of those receiving the AS, the amount of the rebate is very modest compared to the AS. The maximum RRS payment is only 5.5% of the maximum AS payment for a two-person household.

Recipients of New Zealand Superannuation are the main beneficiaries of the Rates Rebate Scheme

Of the people who received the Rates Rebate in 2017 and recorded their income, 78% were New Zealand superannuitants (Department of Internal Affairs (DIA), pers. comm., 4 February 2019). In a striking contrast, only 2% of AS recipients were homeowners of New Zealand Superannuation. Despite beneficiary and non-beneficiary homeowners greatly outnumbering New Zealand superannuitant homeowners in the AS, they do not feature strongly in the RRS. The main explanation is that homeowners of New Zealand superannuitants are unlikely to qualify for the AS unless they have a mortgage. Yet, as noted above, most homeowners of superannuitants have no mortgage. Also some who receive the RRS would not be eligible for the AS because of the cash asset test applying to the AS.

F8.2

Recipients of New Zealand Superannuation payments are the main beneficiaries of the Rates Rebate Scheme. Most recipients are not eligible for the Government's Accommodation Supplement because their accommodation costs are below the threshold to qualify, unless they have a mortgage or substantial essential repairs.

Income thresholds affect numbers eligible for the Rates Rebate Scheme

The maximum payment and the income-abatement threshold for the RRS were not adjusted between 1979 and 2006. As a result, the number of rebates fell from 102 000 in 1977 to under 4 000 in 2004. The Government then introduced a revamped RRS in 2006 that increased the maximum to \$500 and the income abatement threshold to \$20 000. The number of recipients leapt to 109 022 (Shand Report, 2007, pp. 197–198).

The number of rebates reached a peak of over 115 000 in 2011, but has since steadily declined. The main reason is that the income abatement threshold has not kept pace with increases in the value of New Zealand Superannuation payments (especially households where both couples receive New Zealand Superannuation) (McCarthy & Thurston, 2018).

A cumbersome application process likely reduces the uptake of the Rates Rebate Scheme

The current application process is cumbersome. Ratepayers must apply to their council to receive the rebate and submit a statutory declaration about their income and family composition. They generally have to visit their local council offices personally, and often queue to submit their details. Although ratepayers apply to their local council, central government provides the rebate through the DIA. The DIA transfers funds to the council to enter it in the applicant's rates account.

The RRS has suffered from low uptake since its inception. According to LGNZ, this is likely to have been because of "a combination of insufficient promotion, complex administrative processes and a sense that it is a state hand-out" (2015, p. 61). Because the rebate reduces to a very small dollar amount for people on higher incomes, many eligible people would not bother to apply. The DIA does not hold information on the eligible population to determine uptake rates (McCarthy & Thurston, 2018; DIA, pers. comm., 27 March 2019). SOLGM submitted that uptake is low (sub. 24, p. 90).

The DIA has been leading an initiative in collaboration with councils and supported by the Service Innovation Lab to provide a digital web-based alternative to the current application process. The Lab collaborated first with Tauranga City Council and then three other councils to trial the digital process. To date, the trial has reduced processing times both for applicants and councils, and made the process more user friendly for applicants (DIA, 2019e; McCarthy & Thurston, 2018).

Further improvements would result from removing the requirement for applicants to make a statutory declaration every year about their circumstances. The Government has introduced a bill, currently before select committee, to abolish the requirement for a statutory declaration. This will enable the scheme to move to an entirely online application process (DIA, 2019a).

The Shand Inquiry recommended passing the administration of the RRS to Inland Revenue Department (IR), although many submitters to that inquiry favoured the Work and Income service of the Ministry of Social

Development (MSD) on the grounds that the service already held personal and household income data on most applicants. The Shand Inquiry preferred IR because this would “better present the scheme as a rebate designed to adjust the incidence of tax rather than a form of social welfare payment” (Shand Report, 2007, p. 201).

Submitters see the Rates Rebate Scheme as useful but needing improvement

Many submitters supported increasing the generosity of the RSS and streamlining its administration. The Ōpōtiki District Council, for instance, recommended reviewing the income threshold for abatement of the rates rebate each year (sub. 126). Ken Palmer (sub. 10) thought the maximum rebate should be increased to \$1 500 and then indexed for inflation.

SOLGM proposed a “first principles review”, pointing to the outdated and cumbersome administration, and the RRS shifting towards being a system of “social assistance” (sub. 24, pp. 90-92). BusinessNZ recommended administering the scheme centrally through Work and Income because councils have no information on residents’ incomes and “should not be in the business of income redistribution” (sub. 54, p. 26). Wellington Chamber of Commerce and Business Central thought that better education and promotion of the RRS would improve uptake (sub. 72). Auckland Council submitted that the scheme should be extended to cover new accommodation ownership structures such as papakāinga housing, and to cover water charges levied by a Council Controlled Organisation (sub. 120).

Some submitters valued the RRS because it reduces pressure on councils to avoid rate increases, either generally or for particular groups of ratepayers. Federated Farmers of New Zealand, for instance, submitted:

Council reference affordability when they are reducing the UAGC [uniform annual general charge]; we find this perplexing given the existence of central government’s rates rebate scheme for low income ratepayers that is provided to address affordability concerns. The Rates Rebate Scheme is related to income, the accepted measure of affordability. (sub. 75)

The Horowhenua Grey Power Association submitted, on the other hand, that

[t]he scheme provides easily accessed and greatly appreciated financial assistance to low-income households in Horowhenua.

But, it does not deserve to be regarded as we strongly suspect our elected council representatives are inclined; as a salve to their conscience for failure to honour their ‘first principle’ responsibility to design and maintain a rating model which delivers affordability to low-income households. (sub. 21, p. 5)

Assessment of the Rates Rebate scheme

Almost all submitters on the Commission’s Draft Report who commented on the RRS strongly supported its retention.

The RRS has, over its long existence, served as a device to enable mostly households of older people on low incomes to meet their rates bills without unduly reducing their incomes after they have met their housing costs. This reflects the fact that property taxes (unlike income taxes and GST) are not necessarily associated with cashflows that make payment easy (Chapter 6). Many older homeowners are on limited incomes, yet may receive fairly large rates bills due to the value of their properties.

Even so, the RRS levels of assistance are modest – the maximum rate is a little over \$12 a week (although every extra dollar is welcome to income-constrained households). Also, as shown above, the main recipients are among the least likely of New Zealanders to be experiencing material hardship.

As some submissions show, the existence of the RRS has also played a role in the political economy of setting rates. The very existence of the RRS (despite its relatively modest provisions) gives some groups a means to urge councils to apply the benefit principle more rigorously, and to downplay the ability-to-pay principle. It also gives councils more courage to raise rates to meet spending preferences.

The Commission considers, as discussed below, that greatly improved rates-postponement arrangements would better tackle the problem that the RRS was designed to tackle.

Administrative efficiency

The current administration of the RRS is clearly cumbersome and inefficient for applicants and officials. If the RRS is to continue, a central government department, such as Work and Income, is likely to provide greater administrative efficiency. Work and Income has efficient access to information on incomes and has well-developed digital systems for accepting and processing applications and updating information on applicants. Work and Income already holds current records on most applicants for the RRS.

Does the Rates Rebate Scheme meet the equity test?

The RRS clearly fails to meet the principle of horizontal equity (discussed in Chapter 6). While the RRS provides extra assistance to homeowners, renters with the same number of dependants and with the same incomes and housing costs are not eligible for the RRS.

The RRS also does not meet the principle of vertical equity. On any measure of material wellbeing, homeowners are better off than renters, if income and household composition are the same. This is partly because homeowners, unlike renters, have access to equity to finance expenditure. It is also because sustained good incomes are usually required to accumulate a substantial property asset; these sustained good incomes also allow people to acquire other assets (such as household durables and financial assets) that make life easier over time.

F8.3

The Rates Rebate Scheme (RRS) is administratively inefficient and satisfies neither the horizontal equity principle nor the vertical equity principle. The level of assistance currently offered by the RRS is a little over \$12 a week at most. Low-income homeowners can, as an alternative, access equity in their properties to help meet living costs, including rates.

Local government assistance to meet the cost of rates and user charges

Councils determine their own local policies to help low-income ratepayers and residents meet the cost of rates and user charges. These can include rates remission, concessionary user charges and rates postponement. At least one council – Kāpiti Coast District – supplements the RRS with additional assistance of up to \$350 a year, targeted to the neediest ratepayers, and with overall assistance in the district capped at around \$200 000 (Kāpiti Coast Grey Power, sub. 12; Kāpiti Coast District Council, sub. DR271).

Rates remission

Under section 102(3) of the LGA, local authorities have the option to develop a rates remission policy. Yet the Shand Inquiry found that remission policies tended not to focus on solving financial affordability problems – the most common remission policy provisions dealt with the waiver of penalties for late or non-payment of rates (Shand Report, 2007). Similarly, SOLGM reviewed a selection of 28 such policies in 2016 and found that they were used more “to simplify the administration of the rating system, ameliorate the impact of sudden change in incidence or support cultural, recreational, heritage or charitable endeavours” (sub. 24, p. 82). Even so, rates remission is one tool that councils could use to address affordability.

Rates postponement

Under section 102(3) of the LGA, local authorities have the option to develop a rates postponement policy. Rates postponement occurs when a local authority agrees to delay the due date of rates payment until a specified time or a specific event occurs, such as the sale of the property.

The Shand Report (2007) found that rates postponement can help ratepayers who are asset rich and cash poor, but found that the level of rates remitted or postponed was usually very small – at between 0.3% and 0.7% of total rates revenue.

Rates postponement policies vary across councils. Some councils offer postponement for low-income households where paying rates would mean they could not pay for “day-to-day needs, healthcare or urgent maintenance” (New Zealand Government, 2019). Those same councils may also, or instead, offer

postponement for people over a certain age (60 or 65) if those people choose to let their rates be paid by their estate when they die, or when their property is sold.

Councils typically limit the total debt from postponed rates allowed on a property (eg, to 80% of the current valuation), and register the debt as a statutory land charge on the rating unit's title. They may require the owner to make a statutory declaration each year that sets out their relevant circumstances, and charge a yearly fee to cover administrative and financial costs (see eg, Auckland Council, 2019b). SOLGM reviewed a sample of 28 rates postponement policies in 2016 and found that most policies allowed for postponement in cases of extreme financial hardship (sub. 24, p. 82).

Rates postponement is not used much to tackle affordability issues (SOLGM, sub. 24; Local Government Business Forum, sub. 52; and Waikato Regional Council, sub. 125). Likely reasons are:

- a homeowner's caution about the risk of running down home equity, either because they fear eventually losing their home, or because they are concerned about not being able to pass the home to their heirs;
- confusion about how current rates postponement schemes work, given the wide variety of such policies across the country;
- cumbersome administration of current schemes which might, for instance, require the homeowner to make yearly statutory declarations about their financial circumstances;
- councils' lack of enthusiasm about rates postponement because, to the extent homeowners take up such postponement, councils will have more debt on their books (though also more assets); and
- lack of effective education about, and promotion of, rates postponement to homeowners as an option for easing financial difficulties.

Concessionary user charges

Under the LGA (eg, s 101(3)), councils can design user charges to reflect ability to pay, and to encourage greater use of community-financed services. Many councils vary charges for services such as public transport, by discounting rates for children or tertiary students. Councils sometimes also offer concessions to seniors, for example for access to swimming pools. In addition, councils offer some services free of charge or at reduced cost, even though they could apply full charges.

8.2 Addressing affordability of rates for households

Rates have generally been keeping pace with household incomes over many decades (see section 8.1 and Chapter 3; SOLGM, sub. 24). This means that, on average, rates are not generally becoming less affordable over time. Even so, rates (whether paid directly or through rents) are likely to pose some difficulties for low-income families. Rating pressures on households will be higher in those small, rural, low-income districts where rates, as a proportion of median incomes, have been rising faster than across New Zealand as a whole (Chapter 6).

Rates are only one aspect of housing costs. Renters pay yearly rents that are generally seven to ten times greater than the rates bills for an equivalent house. Landlords and homeowners need to cover insurance, the cost of housing capital, and repairs as well as rates. So, broad information on the incidence of housing costs is more relevant than information on rates alone when assessing effects on wellbeing.

Fortunately, data from surveys and from the administration of the AS provide reasonably comprehensive information on the incidence of housing costs on different types of households by tenure and composition (see section 8.1). Analysis of these data shows unequivocally that the current recipients of rates rebates are mostly not those facing particular hardship after meeting housing costs. If they were, they would qualify for the AS.

The AS has developed and been tested over time to fit the wide variety of housing circumstances facing low-income New Zealand households in different regions. Work and Income has access to information and systems that allow it to administer the AS in an efficient and equitable manner, so that households in like

circumstances receive similar levels of assistance. The Commission does not see a need for additional programmes to provide direct financial assistance to low-income households who own their own home so they can meet housing costs.

Yet the Commission notes that the Welfare Expert Advisory Group has made recommendations to improve aspects of the AS design (Welfare Expert Advisory Group, 2019). The costs of the AS over recent years have been rising strongly because of the concurrent strong increase in house prices and rents. A significant proportion of recipients require additional TAS payments to meet their essential housing costs (see section 8.1).

F8.4

The Accommodation Supplement is a well-tested major government programme that, compared to the Rates Rebate Scheme, efficiently and equitably provides support to eligible low-income households to meet housing costs, in a range of circumstances across New Zealand.

The Commission acknowledges that most older homeowners may not qualify for the AS. Yet those homeowners could still find it difficult to pay rates bills if they do not give up some other desired spending options. Some submitters proposed extending eligibility for the AS so it covers current recipients of the RRS (eg, Stewart and Raewyn Webster, sub. DR143). To do so would require a very large and prohibitively expensive expansion of the AS programme – a large proportion of all New Zealand households would become eligible and payments to current recipients would substantially increase. Revamped and improved arrangements for postponing rates offer a more feasible way to tackle difficulties that older homeowners face in paying their rates from current income.

An improved national scheme for postponing rates

Each council is currently responsible for its own rates postponement arrangements if it chooses to have one. Arrangements vary greatly across councils, are administratively cumbersome and not well-promoted (see section 8.1). While reluctance to draw on housing equity may partly explain low uptake, improved arrangements that reduce the known problems will likely lead to greater acceptance. Submitters had different views on desirable changes (Box 8.1).

Box 8.1 Submissions on improving rates postponement schemes

Hauraki District Council submitted:

We suggest a Government-funded rates postponement scheme until the sale of property – similar to the reverse mortgage concept would be valuable. This would be a complex area for councils to get into, however we think we could help keep people in their homes if this service was offered. (sub. 43, p. 17)

BusinessNZ saw a primary role for the private sector, combined with public promotion:

While conceptually BusinessNZ is not opposed to the use of rates postponement options, we question the need for activity of this sort to be undertaken by local authorities rather than by the private sector through reverse mortgages and the like. Increasingly, the private sector is providing this type of arrangement for those who are effectively asset rich but income poor, as a means of ensuring people can continue to live in their family home while being aware the payments are a debt against their property or assets.

However, given a noticeable reluctance to adopt reverse mortgages (for a number of reasons), it might be desirable to market these to the general public as mechanisms for shifting expenditure and revenue streams over time. But apart from providing general advice to ratepayers, BusinessNZ does not see this as a core role for councils; councils should not become involved in the process of setting up reverse mortgages and the like. Private sector institutions, mainly banks, are in a much better position to market and manage such instruments. (sub. 54, pp. 26-27)

The South Taranaki and Western Bay of Plenty district councils also favoured private sector provision of reverse equity arrangements (subs. DR231 & DR155).

Auckland Council asked for a more universally available scheme:

For those who are asset rich but income poor rates remission and, more importantly, rates postponement must be implemented more closely to universality for those who qualify. This is so that councils can charge the fair property value rates, which should continue to be the main source of Council revenue. (sub. 120, p. 4)

The Commission considers that, even with public promotion, a purely private market arrangement will not make ratepayers confident enough for the uptake of rates postponement options to substantially increase. Financial firms have offered reverse mortgages for many years. The reluctance to take up reverse mortgages is at least partly due to perceived high fees and doubts about the security of the arrangements. Reverse mortgages are typically used to draw down substantial lump sums; a scheme that provides for yearly payments of smaller amounts would only be viable if fees were commensurately modest.

Development and implementation of a viable national scheme for postponing rates should be a collaboration between central and local government and preferred providers of finance. Potential customers are likely to be more attracted to a nationally recognised product, designed specifically to facilitate rates postponement and offered by a well-trusted public or private financial entity. Only large providers are likely to have sufficient scale to support moderate fees. Yet potential providers will need to be confident that such a market is viable before proceeding. Providers would need to be satisfied that a scheme would attract a sufficient number of customers to keep fees low.

The main features of such a scheme would be:

- a single set of clear and generous eligibility rules that apply across the country;
- administrative systems that allow easy access for applicants;
- moderate and transparent fees;
- clear communication about the effects over time of the arrangement on the equity held by the customer;
- national promotion of the scheme; and
- finance providers with the stability and reputation to give ratepayers and councils the confidence to participate.

Some submitters opposed a national scheme for postponing rates because they thought it would place more pressure on councils' balance sheets (especially smaller councils) (subs. DR204; DR220; DR262 & DR271). These submitters did not understand that, under the proposed scheme, the debt would be carried by independent financial providers instead of councils. These concerns highlight that, under current arrangements, councils have weak incentives to promote rates postponement (as increased uptake means they carry higher debt on their books).

Auckland Council supported a national scheme for postponing rates and proposed that eligibility should not depend on demonstrating hardship (sub. DR185). Northland Regional Council (sub. DR158), Hauraki District (sub. DR210) and Tasman District (sub. DR236) also supported a national scheme.

The Commission has discussed a scheme with several financing organisations. The discussions indicated that such a scheme would be feasible but needs careful design.

R8.1

The Government should work with local government and suitable financial providers to develop and implement a national scheme for postponing rates. The scheme should:

- have a single set of clear and generous eligibility rules;
- be accessible and have provisions that are easy to understand and work with;
- have moderate and transparent fees; and
- be nationally promoted.

The Rates Rebate Scheme should be phased out

The RRS offers only modest assistance to low-income homeowners, is inequitable (because renters facing similar housing costs do not get equivalent assistance) and is administratively inefficient (see section 8.1). Once an effective and well-accepted rates postponement scheme is available, there will be no need for a continuing RRS.

It will take time to set up a new rates postponement scheme. In the meantime, the RRS should continue for a defined period (perhaps five years). During this phase-out period, the current income abatement threshold and maximum payment should remain unchanged. This will mean that over time the number of eligible people will fall, as a new rates postponement scheme comes on stream.

R8.2

The Government should phase out the Rates Rebate Scheme (RRS) over a defined period, such as five years, from when an effective national scheme for postponing rates is in place. Until the RRS is phased out, the current income-abatement thresholds and maximum payments should be maintained.

The RRS currently costs central government around \$55 million each year. If the scheme is phased out, central government could use the savings to fund increased support for councils facing sustained challenges to their rating capacity (as discussed in Chapter 7).

If the Rates Rebate Scheme is retained, its administration should be improved

Submitters who argued for retaining the RRS often commented that its administration could be improved (eg, Palmerston North City Council, sub. DR215; Tauranga & WBOP Grey Power Association, sub. DR206). The DIA has already been trialling online applications and the Government has introduced legislation to remove the need for applicants to appear in person at council offices (see section 8.1).

Three main options exist to streamline administration of the RRS and its application process:

- transferring administration to MSD;
- transferring administration to IR; or
- expanding the current DIA-led trials to move administration substantially online while still being administered by DIA.

Each of these options has strengths and weaknesses. While most RRS recipients are MSD clients, MSD does not hold information on other income received by recipients of New Zealand Superannuation. MSD (like DIA currently) would have to rely on declarations of income by applicants. This would be subject to audit through random matching of the MSD database to the IR database. Compared to other MSD programmes, the risk of overpayments would be relatively low. MSD would likely hold information on the composition of applicant households – another factor affecting eligibility and the amount paid to RRS recipients. MSD does not hold information on rates invoices, but applicants should find it relatively easy to upload such information electronically or otherwise deliver it to MSD. Councils could even upload information directly from their rates

records (Kāpiti District Council, sub. DR271). MSD has told the Commission that it would be reluctant to take on administration of the RRS.

IR holds information on the incomes of all recipients. Generally, it holds no information about household composition or rates. IR has progressively been moving to automated processing of tax liabilities. Taking on another programme that would require less automated submission and processing of data would not fit with this strategy.

DIA is not an agency that specialises in what are, in effect, income support payments. On the other hand, it has successfully trialled online processing of RRS applications, and it makes regular payments to grant applicants. The DIA does not have the means to directly verify information on household composition and income of applicants. Even so, the RRS is a low-risk programme, given that the amounts payable are small, and most recipients do not have substantial sources of income in addition to their New Zealand Superannuation (DIA, 2019e). It may also be possible, with the consent of applicants, for DIA to verify information with MSD and IR through electronic links (a possibility raised in the current Service Innovation Lab trials of an online application process).

F8.5

The Government has several options for streamlining the administration of the Rates Rebate Scheme if it chooses to keep the scheme.

- The Department of Internal Affairs could move to full online administration, building on trials it has already undertaken.
- Administration could be passed to either the Ministry of Social Development or Inland Revenue.

Each of these options has strengths and weaknesses in terms of data processing and verification.

If the RRS is retained, then the Government should, to maintain policy integrity, periodically adjust income abatement thresholds and maximum payments.

8.3 The statutory 30% cap on uniform charges

The Local Government (Rating) Act 2002 currently specifies that revenue from uniform charges (including UAGCs and uniform targeted rates applying across the district, but excluding uniform water and wastewater rates) must not exceed 30% of rates revenue (Chapter 2). SOLGM submitted that this cap is inappropriate:

The existence of the cap devalues the regime of accountability and community choice promoted in the *Local Government Act* ... The cap is also inconsistent with the purposes of the [Local Government (Rating) Act] (one of which was to provide local authorities with flexible powers to set and assess rates). (sub. 24, p. 55)

Federated Farmers of New Zealand (sub. 75), the Local Government Business Forum (sub. 52) and BusinessNZ (sub. 54) also support removing the 30% cap. BusinessNZ argues that the cap prevents councils from effectively signalling costs to ratepayers.

The 30% cap was intended to prevent the rating system being too regressive by, in effect, requiring a substantial proportion of rates to be levied on the basis of property values. Even so, no rationale exists for where the cap is set (as noted by the Local Government Business Forum, sub. 52). Only four councils are close to the cap (Insight Economics, 2019a).

Councils had mixed views about removing the 30% cap on uniform charges. Six councils (Waimakariri, Western Bay of Plenty South Taranaki, Waikato and Timaru districts and Auckland Council) supported removal while six (Waipa, Hauraki, Whanganui, Tasman and Whakatāne districts and Northland Regional Council) argued for retaining the cap (though two, Hauraki and Whakatāne wanted the cap raised). The Local Government Business Forum (sub. DR177) and LGNZ (sub. DR263) also supported removing the cap; while Clare St Pierre (sub. DR172) wanted it kept.

The Commission sees little value in keeping the cap. A statutory cap is inconsistent with local government having the autonomy to determine their rates policy guided by the statutory considerations of section 101 of the LGA. Section 101 requires councils to consider the effects on community wellbeing of their rating decisions, and section 103 requires them to explain how they have done this (Chapter 7). Long-Term Plans and submissions show that councils are very aware of effects of decisions on ability to pay. In reality, only a small number of councils are currently near the statutory cap. One council near the cap wants the cap raised while also favouring its retention (Whakatāne District Council, sub. DR225). Overall, there is very little risk that, without the cap, councils will use uniform charges to substantially shift more of the burden of rates on to low-income households.

F8.6

The statutory 30% cap on uniform charges (covering uniform annual general charges and uniform targeted rates applying across the district, but excluding uniform water and wastewater rates) has no clear rationale and unnecessarily restricts the discretion of councils to use rates to reflect the benefit of services and amenities. Currently, few councils are close to the cap.

R8.3

The Local Government (Rating) Act 2002 should be amended to remove the statutory cap on uniform charges.

8.4 Conclusion

The Rates Rebate Scheme (RRS) (a central government policy) is inconsistent with central government's principal policy to assist low-income families living in private accommodation to meet their housing costs (ie, the Accommodation Supplement (AS)). Most people who receive the RRS are not eligible for the AS, because their accommodation costs (mostly rates and insurance) are too low. Other low-income households who rent but have the same or higher housing costs are not eligible for assistance from the RRS.

An effective rates postponement scheme is the obvious solution for low-income homeowners who wish to increase their current income after paying their housing costs. Central and local government should collaborate with suitable financial providers to develop, implement and promote such a scheme. Once such a scheme is in place, the RRS can be phased out. If the RRS is retained, then its administration should be improved by moving to online applications and processing.

The 30% cap on uniform charges does not appear to be necessary to prevent rates from being overly regressive. The cap is inconsistent with local government autonomy to set rates according to local preferences. It should be removed.

9 Adapting to climate change

Key points

- A new, challenging and growing pressure on local government funding comes from climate change – in particular, the threats from sea-level rise and more frequent and extreme weather events. The most direct threat for councils is climate-induced damage to local government infrastructure such as roads and bridges, and stormwater, wastewater and flood-protection assets.
- Councils are responsible for planning and regulating development on at-risk land. They therefore have an urgent and important role in reducing future climate risk exposure and long-run adaptation costs. Councils must resist pressure for risky development, and deal with property owners who shun talk of retreat and demand councils invest in hard defences against sea-level rise and flooding.
- Councils with exposed coast or floodplains must prepare for change. Some, such as the councils in the Hawke’s Bay, have already started. To help councils prepare for climate change, central government needs to provide leadership and tackle barriers to action. Councils need a centralised and authoritative source of high-quality and consistent science and data, as well as legal, decision-making, social, economic and technical guidance. Laws and regulations are also needed to support councils to make tough decisions, and make them stick.
- New Zealand’s laws and institutions acknowledge the risks from climate change, and require local governments to plan for the approaching and rising hazards it will cause. Yet, a significant shift in policy thinking and implementation is needed to deal with the nature of climate risk even though how climate risk will unfold is very uncertain. In contrast, much thinking and practice is still dominated by assumptions that risks are unchanging.
- Institutional and legislative schemes need to move from their current focus on post-event recovery towards pre-event risk reduction. They need to lean against the tendency to continue along current pathways that rely on hard structures to protect new and existing land use; encourage the use of anticipatory and flexible decision tools; and incentivise actions that reduce long-term costs.
- Two broad principles to guide climate adaptation funding are minimising long-run costs and fairness. Both principles point to avoiding perverse incentives that lead people to increase risk exposure at others’ expense (“moral hazard” behaviour). The principle of fairness brings into play New Zealand’s tradition of societal support and risk sharing, and inter-generational equity. Communities should also be closely involved in preparing for the effects of climate change.
- Not all councils are exposed to the same level of climate risk. This makes a strong case for some national risk sharing through central government co-funding the adaptation measures of local government. The Commission recommends extending the New Zealand Transport Agency’s co-funding model to help councils with land-transport infrastructure at risk from climate change.
- The Government should also create a climate-resilience agency and associated fund to help councils redesign, and possibly relocate and rebuild, three-waters, flood protection, and other local infrastructure and assets under threat from climate change.
- The Government should contribute when council measures protect Crown assets from the impacts of climate change. Councils should also be able to recover appropriate costs when they protect the assets of utility companies.

The most challenging new and growing pressure on local government funding arises from climate change, including the threat of sea-level rise and extreme weather events. The effects of climate change are already evident in events such as major floods, landslides and sea damage to property. Although the main pressures still lie in the future, they will grow inexorably, affecting some locations more than others. There are also

significant uncertainties about just when, where and how the effects will materialise. A considerable literature already exists on adaptation to climate change, including research in and about New Zealand. Adaptation is on the radar of most councils, and some are already grappling with it.

Climate change threatens to put significant cost pressures on councils on three main fronts.

- Councils are the owners of a large amount of the infrastructure that is directly at risk from sea-level rise and other adverse weather events (eg, more frequent and intense storms and floods).
- Councils are the authorities responsible for planning and regulating development on at-risk land, and therefore have an important role in minimising future risk exposure and long-run costs. Yet in taking, or not taking, action in this role, councils face the threat of challenge and future liabilities (Hodder, 2019).
- Councils are the branch of government closest to communities and have a clear role in supporting community wellbeing. This could entail considerable expense in community engagement on an adaptation strategy, responding to pressures from property owners to invest in sea-level rise and flood defences, and from overseeing managed retreats from vulnerable locations. Councils could also be drawn in to assist and support citizens for private losses from climate-related events.

Examining the funding aspects of climate change for local government requires exploring possible new frameworks and institutions, because funding arrangements only make sense within a wider context. The analysis in this chapter will be exploratory because climate change and the challenge of how societies adapt to it is unprecedented, and because so much is still uncertain. Policies and institutions suited to meet the challenges may require novel features, such as mechanisms that can cope with changing risks (because some uncertainties will reduce, and new ones will emerge). The arrangements will need to be fit to operate in a complex, dynamic and uncertain environment.

9.1 Impacts of climate change

The severity of climate impacts will depend in large part on global greenhouse gas (GHG) emissions in the future. The Intergovernmental Panel on Climate Change (IPCC) clearly states that “increasing magnitudes of warming increase the likelihood of severe, pervasive, and irreversible impacts”, and that “the overall risks of climate change impacts can be reduced by limiting the rate and magnitude of climate change” (IPCC, 2014b, p. 14).

However, while the risks increase if global GHG emissions remain high, a certain amount of damage is already “locked in”. Globally, climate change will lead to greater weather extremes – more frequent and intense rainfall, storms and heatwaves. The IPCC notes that “impacts from recent climate-related extremes, such as heat waves, droughts, floods, cyclones and wildfires, reveal significant vulnerability and exposure of some ecosystems and many human systems to current climate variability” (Field, 2014, p. 40).

The impacts of climate change on New Zealand will be significant, with more frequent and extreme storms, cyclones and rainfall events resulting in more (and more frequent) flooding around the country. Each council will face different risks based on its location and characteristics (NIWA, sub. DR198, p. 1).

According to the Ministry for the Environment (MfE), flooding is already New Zealand’s most common natural hazard (MfE, 2008). Many towns and cities are built on floodplains, often protected by stopbanks and other flood defences. In hillier parts of the country, the risks of flash flooding and landslides will increase. In many places, droughts are expected to become more severe (MfE, 2018).

At the coast, increased flooding and storms will interact with rising sea levels, which will be one of the biggest impacts of climate change for New Zealand. The IPCC estimates that sea levels globally have risen by about 20 centimetres since the early 20th century, and that they could rise by up to an additional 38 centimetres by 2065, potentially reaching 98 centimetres by 2100. Sea levels will continue to rise well beyond 2100, and could reach several metres by 2300 (Wong, 2014, p. 369). The IPCC (2014a) also notes that the rate of sea-level rise has accelerated over time, and will continue to do so.⁵⁵ Sea-level rise in

⁵⁵ The IPCC estimates that sea levels rose at a rate of about 1.7mm each year between 1900 and 2010, and at a rate of 3.2mm between 1993 and 2010 (global mean sea level).

New Zealand to date has largely been in line with global trends, with New Zealand's relative sea level rising by about 20 centimetres between 1900 and 2015.⁵⁶ Also in line with global trends, the rate has accelerated over that time (MfE, 2017a, p. 82).

That the sea level is rising, and will continue to do so, is certain. Yet the scale and timing of the rise is highly uncertain – and more so the further into the future. This is due largely to uncertainty around future global emissions levels and temperature rise. These will influence the rate at which water in the oceans expands, mountain glaciers retreat, and polar ice sheets melt – three main contributors to sea-level rise (PCE, 2014). The rate at which the three polar ice sheets melt will have a huge impact. The Greenland, West Antarctica and East Antarctica ice sheets collectively hold such massive amounts of ice that if all three were to melt, global sea levels would rise by about 64 metres.⁵⁷ Yet the extent to which they will melt, and when or how fast, is unpredictable.

Future impacts from sea-level rise at different locations are also very uncertain. Sea levels will not rise in line with the average in all places, and the impacts of sea-level rise on a specific coastal location also depend on local geology, as well as natural features and local human-induced changes to the landscape. Vertical land movement is a significant issue in many parts of New Zealand, and will affect the impact of sea-level rise in some places. There are parts of the lower North Island, for example, where local subsidence is exacerbating the impact of sea-level rise (MfE, 2017a, p. 76).

Sea levels vary naturally all the time with tides (including spring and king tides), storm surge due to high winds and low air pressure, waves caused by high winds, and changes in sea level due to El Niño and La Niña phases (PCE, 2015). These various causes can occur together in a way that increases their impact on coastal communities (eg, storm surge during a king tide). With sea-level rise, these natural variations will become even greater, and the impact when they combine even more severe. It is therefore not simply the slow creeping rise of the sea level itself that will impact coastal communities. More damaging are the other impacts that come along with it – three in particular:

- coastal flooding becoming more frequent, severe and extensive;
- erosion becoming more widespread as waves and currents damage shorelines; and
- groundwater rising, and saltwater intrusion into groundwater.

These impacts are already occurring in some coastal communities (eg, South Dunedin, Hawke's Bay and the Kāpiti coast). Given New Zealand's long coastline, the number of communities and amount of infrastructure on that coast, sea-level rise presents a large challenge for the country. Box 9.1 defines the components that influence the damage that climate change will cause in specific locations.

Across New Zealand, around 2 000 km² of land area, 49 000 buildings and 72 000 people are already exposed to coastal flooding. Canterbury has the most people living on flood-prone coastal land, with more than 18 000 people at risk. Otago and Bay of Plenty are home to more than 10 000 people currently at risk from coastal flooding (NIWA, 2019, pp. 30–47).

As the risks of climate change unfold, areas of low-lying land already prone to flooding will experience more frequent and severe inundation. Around the country, almost 200 000 people live on land that is less than 1.2 metres above current sea level (NIWA, 2019, pp. 30–31). Some communities will experience more damage to assets and property, incur increasing costs to manage and maintain urban facilities and infrastructure, experience more frequent disruption to business operations, and see large reductions in land values (CCATWG, 2017). Some existing communities will ultimately become unviable.

⁵⁶ At a rate of about 1.78mm each year.

⁵⁷ The two Antarctic ice sheets together could contribute 58 metres of sea-level rise (Fretwell, 2013), and the Greenland ice sheet could contribute seven metres of sea-level rise (Bamber et al., 2013).

Box 9.1 Components of overall damage due to climate change

Hazard: a climate hazard is a physical process caused by a climate event or climate variability (eg, sea-level rise, flooding, drought), which has the potential to cause damage to natural and/or human systems.

Exposure: exposure to climate risk is a measure of the potential damage from a climate hazard (or hazards). Exposure includes the presence of people, buildings, livelihoods, ecosystems, infrastructure and other assets in places and settings that could be adversely affected by climate hazards.

Vulnerability: the propensity or predisposition to be adversely affected by climate hazards. The vulnerability of a community depends on its sensitivity to the impacts, and how limited its ability is to adapt to changes (both reflect a lack of community resilience).

Source: IPCC (2014b); PCE (2015).

Risk to local government infrastructure

A recent Local Government New Zealand (LGNZ) report examined how much local government infrastructure is exposed to different amounts of sea-level rise (LGNZ, 2019c). The report found that a sea-level rise of 1 metre would expose local infrastructure worth approximately \$5.1 billion (replacement value).

Three-waters infrastructure is the most exposed, making up about half of this cost. Of this, wastewater infrastructure is the biggest by far, followed by stormwater. Roothing infrastructure is also vulnerable, with more than 1 300 kilometres exposed to 1 metre of sea-level rise. Council-owned assets are also at risk, including buildings and community amenities, parks, sports fields, and airports (LGNZ, 2019c). Most of the roads at greatest risk are council-owned local roads (Bell, Paulik, & Wadwha, 2015, pp. 16–17).

These risks are not evenly distributed. The regions with the greatest amount of exposed local government infrastructure are Canterbury, Hawke’s Bay, and Auckland. Many other regions also have a lot of infrastructure at risk (including Bay of Plenty, Waikato, Greater Wellington, Otago, and Nelson/Tasman). More infrastructure is exposed in the North Island due to the larger population, but regions in the South Island face higher per-capita replacement costs. Exposure (and associated replacement costs) increases with higher levels of sea-level rise – a rise of 1.5 metres would expose local infrastructure worth about \$8 billion.

The effects of climate change on different types of infrastructure, and the impacts of those effects, vary. For roading infrastructure, increased inundation will lead to more rapid degradation, requiring more frequent maintenance and replacement, and increasing incidents of road closures and access disruptions. Major flooding or erosion events will destroy some roads completely.

Both national and council roading infrastructure provides access to many private homes and businesses. As some roads become degraded or are destroyed, government, councils and communities will need to decide whether to replace those roads, and how. If that infrastructure is damaged or destroyed, communities may be cut off, and their access to essential services jeopardised. The West Coast flooding in March 2019, which destroyed the Waiho Bridge on State Highway 6, provided a stark reminder of the risk extreme weather events pose to roading infrastructure and to the communities it services. The Insurance Council noted this point in their submission: “[L]ocal government infrastructure underpins the activities and assets of communities and businesses” (sub. 69, p. 3).

The West Coast flooding also highlighted the vulnerability of landfills in flood-prone areas. The historic Fox River landfill in Westland district (which operated between the 1960s and the early 2000s) was washed out during the flooding. The flood washed large quantities of rubbish into the river and along hundreds of kilometres of beach and Department of Conservation (DoC) land. Westland District Council received \$300 000 in government assistance for the clean-up, but the council found this level of funding insufficient. DoC took over responsibility for the response in June 2019, and coordinated a huge volunteer effort that

cleared rubbish from more than 1 300 hectares of land over a two month period (Department of Conservation, 2019).

Many other current and historic landfills around New Zealand are at risk of damage from flooding and extreme weather events as climate impacts worsen. LGNZ's recent report estimated that 110 open and closed landfill sites across New Zealand are exposed to 50 centimetres of sea-level rise, with 88 of them in the Auckland region (LGNZ, 2019c). Auckland Council itself estimates that 86 closed landfills in its region are potentially exposed to just 25 centimetres of sea-level rise (Golubiewski, Hu, Balderston, & Boyle, 2019).

Stormwater and wastewater infrastructure is particularly vulnerable to climate change, and to the effects of both sea-level rise and increased weather extremes. Many stormwater and wastewater systems have their discharge points at the lowest elevation of populated areas. In many coastal areas, sea-level rise will lead to saltwater infiltration that will reduce the overall capacity of wastewater systems, and result in the corroding of pipes, components and machinery. Problems are also likely with overall wear-and-tear on flood-management infrastructure from increased pump running hours due to greater flows of stormwater and groundwater infiltration. For gravity-fed systems, sea-level rise will likely cause backflows of saltwater onto parks and roads during king tides.

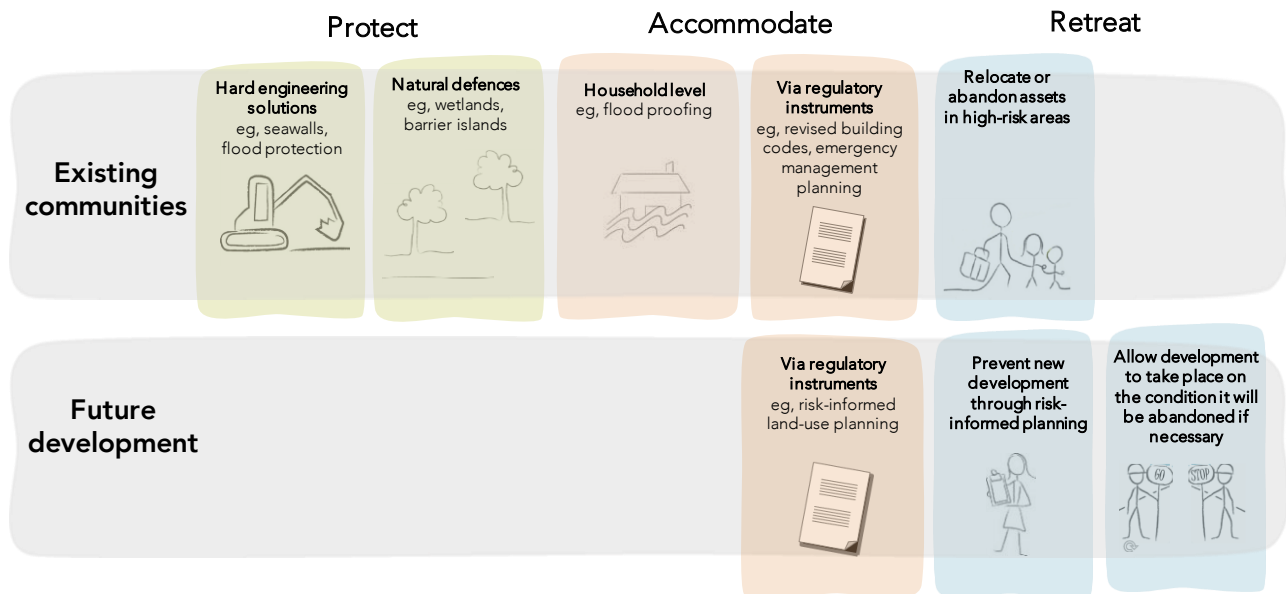
Extreme rainfall can also overwhelm stormwater and wastewater systems, leading stormwater to enter wastewater systems and overload their capacity, potentially leading to the discharge of untreated wastewater (White & Storey, 2017). More frequent extreme rainfall events will result in stormwater systems being overwhelmed more often, particularly in denser urban areas. Failure of stormwater systems can lead to property damage as well as damage to other infrastructure like roading and drinking water networks, potentially leading to public health issues (Lawrence, Blackett, Cradock-Henry, & Nistor, 2019).

9.2 Preparing for change

Local governments with exposed coasts or flood-prone areas must prepare for climate change. Beyond risks to their own infrastructure, they face other challenges – the effects of climate change on private homes and businesses, as well as wider economic and social impacts. Councils face difficult decisions about whether and how to protect vulnerable communities, and with respect to land-use planning for future development.

The Commission undertook a case study of three Hawke's Bay councils (Hawke's Bay Regional, Hastings District and Napier City) who have been working together to develop the Clifton to Tangoio Coastal Hazard Strategy. This endeavour is one of the first in New Zealand to grapple with long-term planning for the impacts of climate change on vulnerable coastal communities. It provides valuable insights into where opportunities and barriers may lie in preparing for change, and as impacts unfold. The Strategy process is outlined in Box 9.4, and some of the discussion in this chapter draws on the experiences of some of those involved in that process.

For existing communities, councils will need to decide how to adapt as the impacts of climate change unfold, including decisions about where, when and how to protect, accommodate or retreat. Protection strategies are wide-ranging (Figure 9-1). They can include hard engineering solutions such as the construction of stopbanks and seawalls, or nature-based defences such as coastal wetlands. Accommodation strategies can be implemented via regulatory instruments (eg, revised building codes) or at a household level (eg, flood proofing) (OECD, 2019b). When communities become unviable, a managed retreat of people and infrastructure will be necessary (Box 9.2).

Figure 9-1 Adaptation in coastal and flood-prone areas: minimising future risk exposure

Source: Content adapted from OECD (2019b).

With respect to future development, councils need to make decisions about where and how development on the coast or in flood-prone areas takes place. These decisions will have a major impact on their future risk exposure, because inappropriate development can be a major cause of increased risk. Risk-informed land-use planning will be important as councils make decisions about land-use zoning through their district plans, and impose conditions on land-use consents. Barriers to implementing such planning changes are likely, as owners of at-risk properties resist the imposition of restrictions on development rights through the Environment Court and other legal procedures

As noted by the Organisation for Economic Co-operation and Development (OECD), investment in risk reduction through adaptation measures will save money in the long term though avoided future disaster costs (OECD, 2019, p. 83).

To help councils prepare for the impacts of climate change, central government needs to provide leadership. It makes little sense for councils to be working individually on such a novel, important and complex challenge.

Central government needs to take leadership on three elements that will be critical to ensuring councils can effectively limit and manage their future exposure to climate risk. They are high-quality and consistent science, data and guidance; a robust, adaptive process appropriate for making decisions under deep uncertainty; and legal frameworks that councils can use to make risk-informed land-use policy decisions "stick". The three elements are discussed in turn below.

The need for leadership in these areas is urgent. Without it, the result is likely to be a patchwork of different approaches around the country leading to inequities and inefficiencies, as well as increasing future climate damage and the risks of moral-hazard behaviour.

Box 9.2 **Managed retreat as a response to natural hazard risk**

Managed retreat refers to the strategic relocation of people, buildings, assets or infrastructure away from at-risk areas. It can also refer to the abandonment of as yet undeveloped land to manage natural hazard risk. Managed retreat is a deliberate intervention, undertaken by a party that enables or implements the relocation.

Hino, Field, & March (2017) identify 27 examples of managed retreat in 22 countries over recent decades as a response to natural-hazard risk. These cases have varied in many ways. Interventions have ranged from the acquisition of individual vulnerable homes, to the mass resettlement of entire communities. Some relocations have been forced or mandatory, particularly following major natural disasters. Others have been voluntary, or have arisen from local efforts.

As climate impacts increase, more people than ever are exposed to risk from natural hazards. However, despite these examples, the use of managed retreat as a response strategy to date has been limited. This reflects the many social, emotional and political challenges that come with managed retreat. It is not a response that is easily reversed.

There can be a tendency to think of managed retreat as a process that is immediate and total. Yet managed retreat can be the final point on an adaptation pathway. For example, communities can defend their property and common infrastructure in the short or medium term until certain thresholds or trigger points are reached.

For communities at risk, comparing the costs and benefits of managed retreat with other adaptation options is challenging. Discount rates and timescales used will have a large bearing on cost–benefit analyses, and the social and political challenges will also have a significant influence on outcomes.

No clearly defined model exists for how managed retreat should be implemented, who should pay for it, and where responsibility lies between private property owners, local and central government.

Protection and accommodation can prolong the lifetime of existing assets, and may be economically sensible in some instances. In other situations, a faster and complete retreat is likely to be appropriate.

High-quality and consistent science and data and guidance

Decisions around local adaptation, and future land-use planning, need to be based on robust science. A thorough understanding of the risks, and uncertainties, is critical to ensuring appropriate action and avoiding ad hoc responses to climate-related events. Some councils appear to be well prepared in this respect, and the recent Climate Change Adaptation Technical Working Group (CCATWG) stocktake report concluded:

Local government appears to have a good understanding of the climate related changes they can expect for their region. This understanding comes from regional climate change projections including for groundwater, sea-level rise, ocean acidification and warming; and local government funded research to develop more local information. (CCATWG, 2017, p. 54)

Yet the report also noted that many councils want better data and information on local impacts, and the costs of obtaining this information is a barrier to action on adaptation (CCATWG, 2017, p. 55). Some councils raised, in meetings and submissions, the need for more information. Whangarei District Council, for example, requested “greater support in terms of expertise, data and resources for local government to understand the risks to infrastructure and communities. The costs of exercises such as risk assessments is significant, particularly for smaller Councils” (sub. 46, p. 4). Environment Canterbury also stated that

[i]t is not efficient for each council to run their own resilience risk mapping process, and some smaller councils do not have the budget or resources to undertake risk mapping at all. Undertaking risk mapping at a regional level would provide consistency and economies of scale. This work will ensure that significant resilience gaps are identified and provide a consistent, robust, evidence-base for managing these gaps. (sub. 111, p. 6)

LGNZ and the Parliamentary Commissioner for the Environment (PCE) have called for central government to do more to keep local authorities informed about how climate change will impact specific locations. LGNZ

advocates for a centralised risk agency which would cover all natural hazards. The former PCE, Dr Jan Wright, made several recommendations for national direction and guidance. Box 9.3 outlines several of their key reasons.

Box 9.3 A centre of knowledge and guidance about adaptation

In 2015 LGNZ proposed a central risk agency to pool and coordinate local government resources to lower the risks and costs of disasters. LGNZ has engaged with central government about the idea. LGNZ argues the need for a risk agency because New Zealand has a high natural-hazard environment, with exposure to earthquakes, tsunami, landslides and volcanic activity. Also, climate change will cause more severe and more frequent river and urban flooding, storms and high winds, storm surges and coastal erosion in coming years.

The agency would establish guidelines, models and common data standards for local government to manage risks and share information. It would harmonise practices, improve skills in risk management and financing, provide quality assurance, and supply expert staff.

Dr Jan Wright, the former **Parliamentary Commissioner for the Environment**, concluded in her report titled *Preparing New Zealand for rising seas: certainty and uncertainty* that local government needs better direction and guidance in three broad areas:

- scientific assessment of the impact of a rising sea on coastal hazards;
- the process of engaging with the community; and
- the planning and management decisions that follow.

She pointed to the difficult and complex questions that councils will increasingly face, such as:

- Where should protective seawalls be built and who should pay for them?
- Where should beaches be left to retreat inland?
- When is abandoning maintenance of a coastal road justified?
- When does the retreat of a whole community become inevitable?

Councils and affected communities will have to plan and act in the face of uncertainty – never easy, but particularly difficult when choices will affect people’s homes. In most situations, Dr Wright argues, haste is not necessary or desirable. Councils should take time to develop strategies and make fair decisions based on robust and fair assessments.

Dr Wright made seven recommendations to the Government aimed at improving direction and guidance from central government to councils. These included recommendations about:

- the best locations for the direction and guidance;
- nationally consistent land-elevation measures;
- consistent use across the country of the IPCC’s projections of sea-level rise;
- specified planning horizons for different types of development; and
- more explicit use of uncertainty ranges rather than the vague use of the “precautionary principle”.

Source: LGNZ (2016a); PCE (2015).

Existing and future guidance

Various official guidance publications aimed at local government already exist. Examples include:

- *Coastal hazards and climate-change: guidance for local government* (MfE, 2017a);
- *Preparing for future flooding: a guide for local government in New Zealand* (MfE, 2010b); and
- *Climate change projections for New Zealand: Atmosphere projections based on simulations from the IPCC Fifth Assessment* (MfE, 2018).

The Climate Change Response (Zero Carbon) Amendment Bill passed its third reading in parliament in November 2019. The legislation mandates the Climate Change Commission (which is established under the Bill) to carry out regular National Climate Change Risk Assessments (NCCRAs) at least every six years. The assessments are intended to provide a national overview of the likely impacts of climate change on New Zealand, to inform and help prioritise effective adaptation action. The Government will then include, in a National Adaptation Plan, its approach to addressing the most significant risks identified through those risk assessments (MfE, 2019a).

The MfE appointed an expert panel in mid-2019 to develop a framework to guide the development of the NCCRA. The panel's framework was released in September 2019, laying out the means through which the nature, severity and urgency of climate change risks and opportunities will be evaluated (MfE, 2019b). The first NCCRA is due to be completed by mid-2020.

A centralised source of knowledge and guidance

Considerable guidance for councils on climate adaptation already exists, but more is needed. Local government needs more high-quality and consistent information on climate impacts, as well as legal, decision-making, social, economic and technical guidance. It would be very challenging, and risk inconsistency and inequity, for councils to resource and undertake these individually.

A centralised source of high-quality information and guidance, which is expert and authoritative, would be hugely beneficial for councils and other parties. Councils will welcome it and find it helpful not only as advice but as backing for taking the difficult and unpopular decisions that will sometimes be necessary.

A centralised source of knowledge and guidance (perhaps a “virtual” centre) should combine expertise from multiple sources:

- In terms of science and data, it should combine expertise from climate scientists and practitioners throughout New Zealand, and draw on their extensive international networks. This would include expertise from universities, NIWA, GNS Science and Manaaki Whenua–Landcare Research as well as in local government and from other experts.
- Guidance and advice is needed for local government on community engagement, risk management, regulation and planning, as well as legal, social, economic and technical aspects. Multiple organisations, including MfE, LGNZ and the Society of Local Government Managers, should offer their resources and work cooperatively to produce the guidance.

MfE's 2017 guidance has useful material on community engagement and on dynamic adaptive pathways planning (which are discussed in more detail below). This will need to be further developed together with training modules and updates that incorporate lessons from experience and assist with practical implementation. The Insurance Council noted, for example:

By drawing on quality scientific data and employing (existing) frameworks, councils (and businesses) can estimate the impact of climate change and integrate them [the data and frameworks] into long-term strategies. The resources and expertise to carry out this work are limited, so the establishment of a well-resourced centre of expertise to support councils would be critical. Such an initiative would both increase expertise while avoiding duplication. (sub. DR205, p. 3)

In addition, as the Clifton to Tangoio Coastal Hazard Strategy in the Hawke's Bay progresses, new areas are emerging that require more guidance, advice and support from central government. For example, no guidance is currently available around how to determine what the “trigger points” should be for moving from one adaptation measure to another along a pathway, within a particular community. Likewise, participants in the Strategy process highlighted a need for guidance on how to apportion the cost of coastal protective measures and managed-retreat responses in line with public and private benefits and the requirements of section 101(3) of the Local Government Act 2002 (LGA). Having national guidance on these types of issues is important to avoid waste of council time and resources, ad-hoc decisions and inconsistent outcomes around the country.

A centralised source of knowledge and guidance could also take on the broader role envisaged by LGNZ as a local government risk agency by covering both climate-change hazards and other natural hazards, and

would be consistent with recommendations made by the CCATWG. In 2018, the CCATWG recommended investing in developing and disseminating nationally consistent science and information on adaptation through an information portal, to support decision making. It also recommended establishing a centralised service to provide expert advice to local government for risk-based decision making (CCATWG, 2018, recommendations 4 and 5).

The new Climate Change Commission will have an important role with respect to adaptation – preparing NCCRAs, and providing scrutiny of the Government’s national adaptation plan. The Climate Change Commission will be an independent advisory body. As such, it will not have a direct role providing official guidance to councils. Given its role preparing national risk assessments, the Commission’s work may contribute to, and directly benefit from, an authoritative source of up-to-date science and data that draws together a wide range of expertise.

In September 2019 the Government created the Infrastructure Commission – an independent Crown entity to “lift infrastructure planning and delivery to a more strategic level” (Infrastructure Commission, 2019). The Infrastructure Commission will have an important role coordinating and planning the delivery of a wide range of infrastructure projects – including roading, three waters and other local government infrastructure.

The Commission will have three main roles:

- developing a broad consensus on a long-term infrastructure strategy;
- enabling the coordination of infrastructure planning; and
- providing advice on best practice to infrastructure initiatives (The Treasury, 2019).

The Commission will develop a 30-year infrastructure strategy and deliver an infrastructure plan to the Government every five years. The infrastructure strategy will look at how existing infrastructure can meet community expectations, identify current and future infrastructure needs and priorities, and identify barriers to the delivery of that infrastructure. Given the serious impacts that climate change will have on infrastructure, climate risk will clearly need to be a central consideration of the Infrastructure Commission as it carries out its roles.

F9.1

More guidance for councils on climate-change adaptation is needed, and providing it through central, specialised sources of knowledge will be more cost-effective than each council inventing its own solution. Most councils will welcome guidance and find it helpful not only as advice but as backing for taking the difficult and unpopular decisions that will sometimes be necessary.

R9.1

Central and local government should jointly develop and provide a centralised source of knowledge and guidance about climate-change adaptation for councils. It should be authoritative and up to date on science and data, regulation and planning, risk management, legal issues and community engagement.

A robust, adaptive process for making decisions under deep uncertainty

Developing and adopting a robust approach to making decisions about adaptation and land-use planning will be critical for councils to effectively limit and manage their future exposure to climate risk. As noted above, even with the best available science, deep uncertainties exist about the course of climate change and the damage it will cause. In their respective domains, scientists and local communities will learn more over time. This means that the risk profiles local governments and their communities face will constantly shift. Embarking on a specific adaptation plan that appears to be optimal given current knowledge may turn out to be unwise in the light of new information that becomes available a few years down the track – adaptation too early or late can be costly (Lawrence, Bell, & Stroombergen, 2019).

Decision tools to handle this sort of deep uncertainty, in which knowledge evolves over time, should be used in preference to decision making that assesses all relevant information available at a point in time and then sets an “optimal” path that is locked in for the future. The watchwords should be anticipation, flexibility and “keeping options open”. In looking at ways to address coastal risk, the OECD (2019b) recommends an adaptation approach that builds in flexibility and identifies solutions that can perform well against a range of different scenarios to avoid “policy lock in”.

Two decision tools that embed these features are Real Options Analysis (ROA) and Dynamic Adaptive Pathways Planning (DAPP). These tools are consistent with cost–benefit analysis (CBA). They are forms of CBA that explicitly recognise and value keeping options open until more information is available.

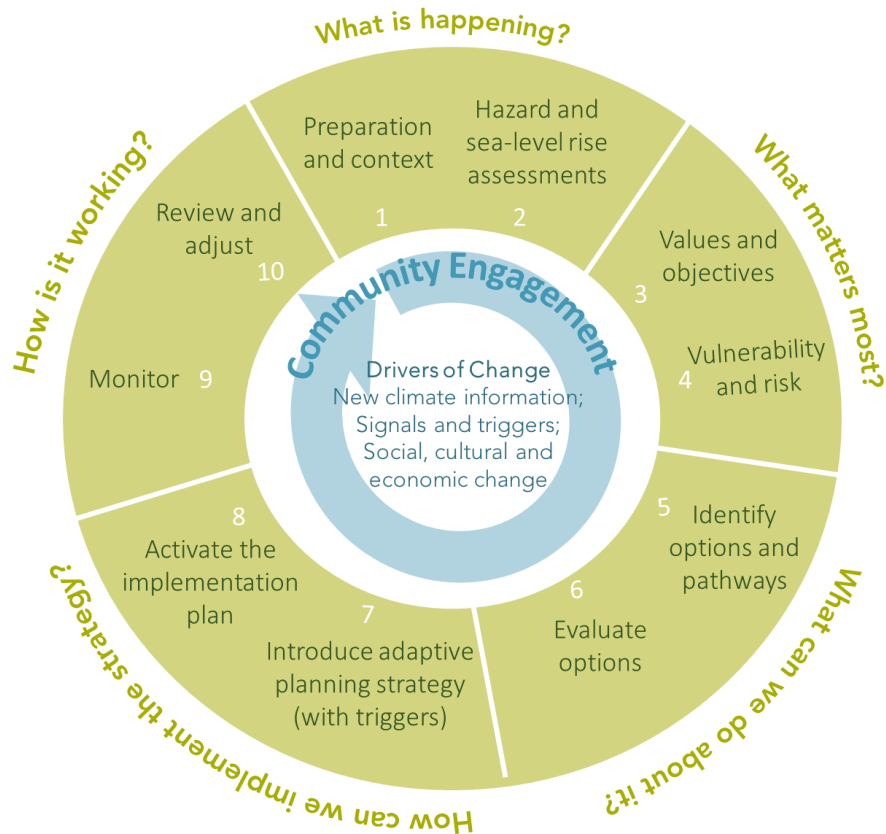
Real Options Analysis – the essence of ROA is recognition of the value of keeping options open for the future (when more information will be available to inform choice). It will often pay to avoid expensive investments now that lock in one solution that may turn out to be wrong. Rather, it will pay to invest in better information, or in actions that create options or keep existing options open. For example, investing now in expensive hard defences against rising seas, when it is unknown how quickly the sea level will rise, destroys the option value of choosing later with better information whether to defend or retreat.

Sometimes, ROA will indicate that early action is desirable. For example, where erosion is incremental, cumulative and threatens a valuable asset, failing to take early action could remove the option of saving the asset later.

Dynamic Adaptive Pathways Planning – DAPP is a technique very much in the spirit of ROA, but it gives greater practical guidance to decision makers about how to proceed. Decision makers begin by defining their objectives and consider several or many scenarios about how the future could evolve (in the area that is subject to deep uncertainty). They also identify future timing points or trigger events where more information will become available and it may be possible to adjust the pathway taken to that point, or transition to a different pathway. The question, then, is what pathway to embark on initially to achieve short-term objectives, while enabling adaptation to changing circumstances to best achieve long-term objectives.

Funding arrangements for local governments that promote cost-effective adaptation to climate change need to encourage and support good decision making. Given the nature of the shifting risk profiles of climate change hazards, this means supporting the use of tools like ROA and DAPP. Fortunately, DAPP is explained and recommended in the MfE’s guidance to local government on coastal hazards and climate change (MfE, 2017a), and councils are beginning to implement it.

Undertaking such an approach is however challenging and complex for councils, and will require considerable knowledge, capacity, specialist skills, and time. For example, the DAPP approach recommended by MfE calls for consultation at all stages of the proposed 10-stage decision cycle, as well as frequent re-assessment of plans and revisiting of decisions (Figure 9-2), all of which requires significant investment and use of limited council resources. Even so, if done well, the DAPP approach will likely be least cost in the long run.

Figure 9-2 10-stage dynamic decision cycle for adaptation to climate change

Source: Adapted from MfE (2017a).

The Hawke's Bay Clifton to Tangoio Coastal Hazard Strategy process is closely aligned with the MfE guidance. Participants in that process reported that, while time consuming and resource intensive, the DAPP approach generally worked well, and was an effective means to ensure community engagement and buy-in. Even so, challenges remain because this approach can allow difficult but necessary decisions to be put off, and commitments to act on future trigger points may not be enforced.

The three Hawke's Bay councils have been at the leading edge in implementing the MfE guidance, and have encountered some challenges where specific aspects have not been clearly defined – for example, how to design triggers to ensure the strategy is adaptive. As more councils use the guidance, important lessons will emerge about what has worked well and where gaps remain. These lessons and new material to fill the gaps can then be incorporated into future guidance.

Legal frameworks to make risk-informed land-use policy decisions “stick”

Getting laws and regulations right to support councils to make tough decisions is also crucial. High-quality data and information, and a robust and adaptive planning approach, need to be supported by appropriate legal frameworks. Councils have been calling for more central government leadership in this area. A major source of climate-change pressure on local government funding arises from councils' responsibilities to regulate land use.

New Zealand has an intersecting collection of laws and institutions that set frameworks, rules and responsibilities relevant to the challenge of adapting land use and local-government infrastructure to climate change. As described in Chapters 2 and 4, the Resource Management Act 1991 (RMA) and the LGA are pivotal in defining the responsibilities of local government in these areas.

The RMA (currently under review) requires local government to consider the effects of climate change and incorporate climate change into decision making. It charges regional councils with the main responsibility to control the use of land so as to avoid or mitigate natural hazards (including flood hazard management).

Under the RMA, the New Zealand Coastal Policy Statement 2010 (NZCPS) has statutory force. It requires all regional councils and local territorial authorities (in exercising their authority and in their regional policy statements, regional plans and district plans) to recognise the exacerbating effects of climate change on coastal erosion and other natural hazards and where these effects threaten existing infrastructure and private property. Objective 5 of the NZCPS is:

To ensure that coastal hazard risks taking account of climate change, are managed by:

- locating new development away from areas prone to such risks;
- considering responses, including managed retreat, for existing development in this situation; and
- protecting or restoring natural defences to coastal hazards. (Department of Conservation, 2010, p. 10)

Policies in the NZCPS require councils to:

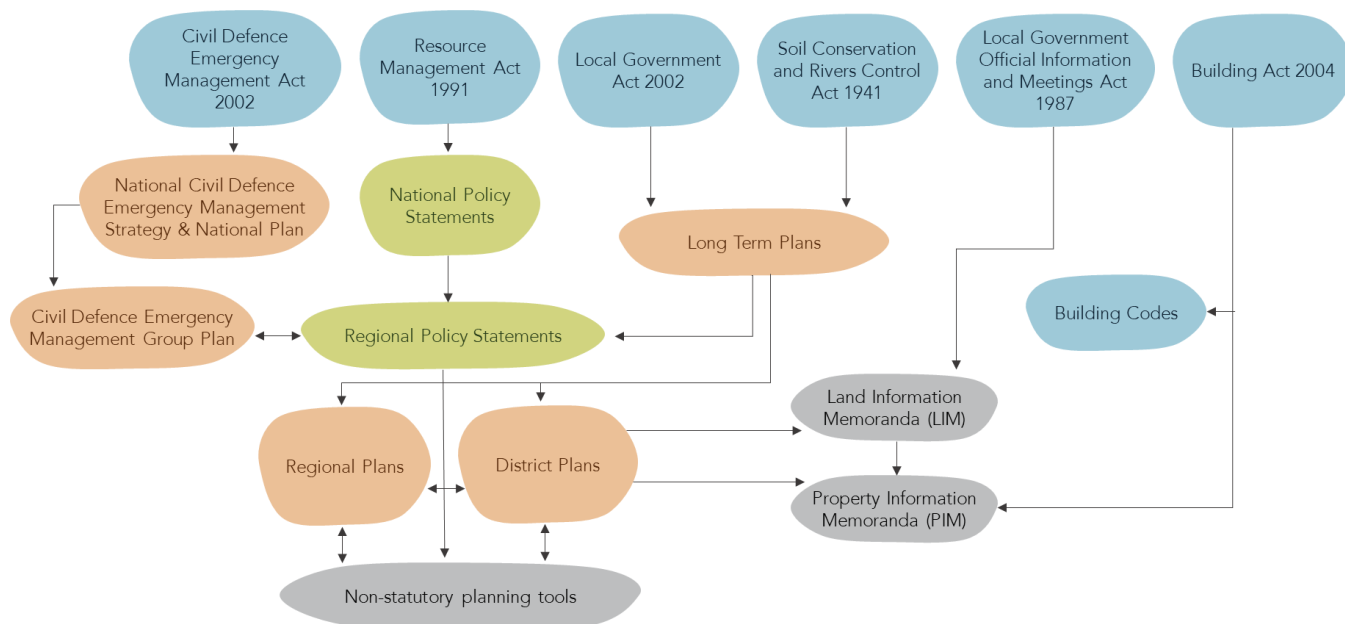
- identify coastal hazards over at least a 100-year horizon, including the “cumulative effects of sea-level rise, storm surge and wave height under storm conditions”;
- “avoid redevelopment, or change in land use, that would increase the risk of adverse effects from coastal hazards”;
- promote and identify long-term sustainable risk-reduction approaches, including the relocation or removal of existing development or structures at risk; and
- prefer natural defences (eg, wetlands, coastal vegetation, dunes) and their protection, restoration or enhancement to hard protection structures.

Yet while the NZCPS provides for councils to make precautionary decisions around land use, a DoC review in 2017 found that implementation has been challenging and very controversial for some communities. It found that in some areas pressure for development is

conflicting with best practice to set development back from the coast. This points to a need for stronger alignment between the NZCPS and the RMA versus the Building Act and any future NPS [National Policy Statement] for Natural Hazards, particularly the need for consistency between timeframes, extreme events and the assessment of climate change effects. (Department of Conservation, 2017, p. 44)

As well as its guidance on climate-change coastal hazards, MfE also provides guidance for local authorities on flood-protection schemes under the Soil Conservation and Rivers Control Act 1941 (MfE, 2010b, 2017).

Figure 9-3 gives a picture of New Zealand’s legislative and planning framework for natural hazards, including readiness for them and responses to adverse (disaster) events caused by natural hazards. The figure does not show the Land Transport Act 1998 and regional land transport plans, which are relevant to the planning, funding and resilience of land transport.

Figure 9-3 Legislative and planning framework for natural hazards

Source: Adapted from Rangitāiki River Scheme Review Panel (2017).

Existing frameworks need to be better aligned to cope with climate-change risk

The legislative and planning framework, as a whole, appears to cover the rising risks from climate change, and requires the various actors (including regional, unitary and local councils) to plan for the upcoming and rising hazards from climate change in their decision making. Yet, there are reasons to question the fitness of current institutional frameworks and practices to effect sensible climate-change adaptation in New Zealand.

First, the various acts and bodies do not mesh perfectly. For example, while the planning horizon of the NZCPS is 100 years, it is 50 years for assessments under the Building Act 2004, and 30 years for council infrastructure strategies. A second example is that no link is made in the RMA under matters of national importance between natural hazards and “the effects of climate change”.

A third example of inconsistency is that “civil defence emergency management” is defined in the Act as “the application of knowledge, measures, and practices that... are designed to guard against, prevent, reduce, recover from, or overcome any hazard or harm or loss that may be associated with any emergency”.⁵⁸ Despite the “prevent” and “reduce” components in this definition, other parts of the legislative framework put most emphasis on recovery.

Such examples show the need for greater integration across emergency management, natural-hazard management and planning practice when preparing for and adapting to risk related to climate change. As the CCATWG noted, “misalignment across legislation and policy creates confusion for local government regarding what is expected of them in terms of adaptation” (2017, p. 55). The Commission agrees with the recommendation in CCATWG (2018) that a review is needed of existing legislation and policy to integrate and align considerations about, and responsibilities for, climate-change adaptation.

Second, the current system focuses too much on the response and recovery stages of an emergency event and too little on reducing risk before disaster strikes. For example, the national civil defence and emergency management plan currently provides for central government to cover 60% of the costs of response to, and repair of, some essential council infrastructure *after* a natural disaster (Ministry of Civil Defence and Emergency Management, 2015). This substantial assistance, combined with lack of central-government co-payments for council investments to reduce risks *before* a disaster, is likely to undermine the incentive of councils to make such investments.

⁵⁸ Civil Defence Emergency Management Act (2002), Section 4.

Third, as highlighted by Glavovic and Smith (2014), Lawrence (2016), Boston and Lawrence (2018) and the CCATWG (2018), an assumption of unchanging risk profiles for natural hazards is embedded within many institutions and current practices. Yet climate risk will change in unpredictable ways and generally increase over time.

As Lawrence (2016) argues, the normal assumption that risks are unchanging has led to a default use of static protective structures and plans (eg, stopbanks and hazard zones) to mitigate risk, which, in turn, has led to path dependence and a public expectation of ongoing protection. This thinking reflects the limited capacity of institutions to contemplate or cope with variations in climate that are outside the range of current experience.

Fourth, most regional councils have been reluctant to use their statutory powers for constraining land use. District plans that have attempted to change hazard zones to prepare for climate change have been successfully challenged in the courts. This is often because councils face people and organisations with strong interests who push for land-use consents and investment in hard protective structures, and who resist any shift from the current course.

The courts have sometimes allowed for the “voluntary assumption of risk” and used notions of “acceptable risk” and “risk mitigation”. However, as highlighted by Lawrence (2016), this has generally been done without enough consideration of several important factors, including that:

- the level of risk that cannot be eliminated (ie, residual risk) will rise over time with climate change;
- those assuming risk today will not be those bearing it in the future; and
- conditions of a consent could become unenforceable in the future, creating a moral hazard for future generations.

Councils are calling for stronger leadership from central government, and for frameworks to give them more backing and knowledge to do the right things in land-use planning and infrastructure investment. Legal challenges to proposed regional plan and district plan changes and resource-consent decisions impose heavy costs on councils. So, on the one hand, the risk of immediate challenges may inhibit councils from saying no to development. On the other hand, the risk of future liability claims against councils can dissuade them from consenting a proposed development in a potentially vulnerable location (Hodder, 2019). The PCE describes these two sides of the situation:

Some may argue that individuals should be allowed to make their own choices and bear the consequences. It may be possible to do this in some situations, but this should be done at no cost to the public.

There are also risks with council planning. Restrictions on development that are premature or overly precautionary will incur significant opportunity costs. (PCE, 2015, p. 80)

These opposing risks can put councils in a quandary. Christchurch City Council expressed the frustration that many councils experience about the opposing risks:

Councils need to be able to control development in at-risk areas, passing an appropriate level of risk on to property owners without there being a risk of this being overturned. Councils need to be able to plan for those communities vulnerable to climate change. The current national policy vacuum has paralysed councils at a time when planning for future action is essential. (sub. DR200, pp. 3-4)

In its draft report, the Commission asked whether the use of legal mechanisms could make consents subject to the assumption of risk by the landowner. The undertaking would need to attach to the title of the property and bind all future owners. If this mechanism were legally watertight, the council could be confident it would not suffer future obligations, no matter what future climate hazards affect the property.

Many councils expressed scepticism about such a mechanism. Some of this stemmed from tension between the legal assumption of risk and the political economy when following through should disaster strike. Hawke’s Bay Regional Council, for example noted that “regardless of the individual’s stated understanding and acceptance of risks, communities of people typically will always look out for each other” (sub. DR248,

p. 6). Jonathan Boston also noted that “Governments can, and do, override privately-agreed arrangements” (sub. DR184, pp. 3-4).

Some councils suggested the use of building and resource consent conditions as a useful tool for extending the life of some risky locations, while ensuring retreat can still happen when appropriate. Such conditions could include things like setbacks or requiring homes to be readily relocatable, which are already conditions of development in some places.⁵⁹ Horizons Regional Council suggested that such an approach

could mean that further coastal development is not prevented in the short term, but that housing types may be designed to be able to be relatively easily relocated – or abandoned – once climate generated trigger points are reached. These kinds of approaches may recognise the importance of amenity values to our communities, while allowing for building longer term resilience to better manage climate change. (sub. DR153, p. 5)

However, some councils also noted that attaching conditions to a property title could be problematic because the nature, frequency and severity of risks will change over time. Therefore “conditions which are put in place at the time a consent is granted will not be able to incorporate new risk information as it becomes available” (Whangarei District Council, sub. DR203, p. 7).

For this reason, some councils submitted that the setting of national direction may be a more practical approach. Some councils have called for stronger standards or “bottom lines” from central government for development in at-risk areas, to reduce risk to councils.

It would be useful if recognised national standards for development were generated, publicised and kept up-to-date. This would allow Councils to adopt ‘best practice’ when permitting (or declining) development proposals and therefore mitigate against the likelihood of a successful legal challenge. (Waipa District Council, sub. DR178, p. 5)

Previous attempts to address hazards more widely with local planning instruments have led to lengthy, and unsuccessful, court processes (Franz Josef Alpine Fault Avoidance Zone – Westland District Plan). Strong government direction through legislation would assist in this space. (West Coast Regional Council, sub. DR200, p. 5)

In engagement meetings, several councils said that their experience of repeated challenges in court to their land-use decisions highlighted a need for central government regulation. Many participants involved with the Hawke’s Bay Clifton to Tangoio Coastal Hazard Strategy also expressed the view that national rules are needed to help councils overcome the social and political complexities of decision-making around land-use, or around defence of existing assets. They see a need for national standards to ensure that decisions are more robust against challenge, as well as consistent both within and between regions. Such standards could be added to the existing NZCPS, or be implemented through a new NPS or NES.

The Commission notes that awareness of climate-change hazards and their likely effects are rising. This will influence institutional actors including regional and local governments and the courts. For example, a current focus for many councils is building “resilience” into plans and built structures. The Department of Internal Affairs is also progressing work with LGNZ on community resilience, including looking at options to reduce risk from natural hazards – including those associated with climate change (Cabinet Economic Development Committee, 2019). In addition, LGNZ has prioritised climate change as a major focus of its work programme over the last few years, including assessing the exposure of council infrastructure (LGNZ, 2019c) and preparing and promoting the Local Government Leaders’ Climate Change Declaration (LGNZ, 2017a).

Yet, rising consciousness and a new emphasis on resilience are unlikely to be enough. Poor decisions now will cost councils and communities in the future. For example, in some high-risk locations investing now in hard structures for protection could lead to development on the “protected” land, and create greater exposure to future climate-change risk, making the problem worse in the long term. As noted above, councils risk not only their own infrastructure investments but also future claims from other individuals and entities based on today’s regulatory decisions about land use.

⁵⁹ The Mōkau Sands development in Waitomo district, for example, was granted resource consent with a number of conditions around how it will deal with erosion, including the requirement that buildings be removeable, and must be removed when certain erosion thresholds are reached (Matthews, 2019).

F9.2

New Zealand's laws and institutions acknowledge the risks from climate change and require local governments to plan for the approaching and rising hazards it will cause.

With climate change, the risks are uncertain and changing over time. A shift in understanding is needed to deal with the increasing and evolving nature of climate-change risk. Such a shift will support decisions that:

- lean against the tendency to continue along current pathways (with hard forms of protection for new and existing land use);
- encourage the use of anticipatory and flexible decision tools; and
- reduce risks and costs over the long term and do not overly focus on the response and recovery stages of emergency events.

R9.2

The Government should develop and provide legal frameworks that give councils more backing and confidence to make land-use planning and infrastructure investment decisions that are appropriate in the face of constantly changing, but increasing, climate risks.

R9.3

National and local authorities should adopt anticipatory and flexible approaches to climate-change adaptation, in line with recognising the constantly changing nature of the risks.

R9.4

The Government should review the existing legislative and planning framework for the environment and natural hazards, to ensure that considerations about climate-change adaptation are integrated and aligned within and across that legislation and policy where relevant.

9.3 Funding adaptation to climate change: principles and insurance

Making decisions about where to protect, accommodate or retreat to minimise costs and risks over the long term will be challenging. Most adaptation actions will be costly. A crucial component of decisions will be how to fund adaptation actions.

Policy principles for adaptation to climate change

Principles are needed to cut through the challenge and complexity of making decisions about adaptation and funding the chosen option or options. Such principles should guide what actions to take and when, by whom, who should be supported and who should pay. Boston and Lawrence (2018) offer two high-level principles for adapting to climate change. While having wider application, they are a good starting point for thinking about funding the costs of adaptation.

- **Minimise long-run costs.** This principle guides decisions about whether, when and how to defend/protect, adapt, or retreat. It does not mean these decisions are easy because uncertainties will sometimes make it difficult to tell which sequence of actions will minimise costs and risks over the long term. In addition, the calculation will involve choosing how to weight future costs against more immediate ones (ie, the choice of a discount rate), which may be controversial. The costs of climate change will fall unevenly across local authorities and will be uncertain in their timing and severity. Yet some actions that councils can take in the short term will reduce or increase future costs. Institutions and

policies should encourage the former and strongly discourage the latter (after considering all costs and benefits).

- **Fairness.** Principles of fairness differ, ranging from letting costs lie where they fall on affected property owners, considerations of affordability, the law of tort where those who cause the damage pay, to sharing the losses of those affected across the whole population. New Zealand's tradition of social insurance and risk sharing (explored below) is in this last category. The question of inter-generational equity is central to fairness.

Moral hazard

Both principles dictate the need to avoid perverse incentives on people to increase their risk exposure for private gain, at others' expense (moral hazard behaviour). Moral hazard, in the current context, will occur when arrangements motivate individuals to take on more risk than they would otherwise, because they predict they will be compensated for any losses that materialise from their increased risk.

An example of moral hazard is someone building a new house, or improving an existing house, on a vulnerable seaside property only because they know or anticipate that they will receive seawall protection or compensation should rising sea levels and storm surges damage or destroy their property in the future. This is not, of course, true of many current owners who built their homes in locations vulnerable to climate change long before the risks of climate change were appreciated, and the locations considered vulnerable.

Moral hazard can also occur between levels of government, where local government is responsible for funding protection and risk reduction, but central government is responsible for funding response and recovery (OECD, 2019b).

Moral-hazard behaviour raises overall costs and so violates the principle of minimising long-run costs. In most people's eyes, such behaviour would also violate the principle of fairness. As a result, the designers of institutions, policies and funding arrangements for adapting to climate change should place a high priority on ensuring that they do not trigger moral-hazard behaviour.

Affected communities must be closely involved in finding solutions

A further important principle is to get affected communities involved and actively engaged in preparing for the effects of climate change. This has been a key feature of the Hawke's Bay Clifton to Tangoio Coastal Hazard Strategy.

Giving affected communities the opportunity to be intimately involved is an essential part of tackling climate risks (MfE, 2017a; Schneider, Glavovic, & Farrelly, 2017). The OECD emphasises that "policy makers should engage stakeholders in the early stages of decision making and throughout the entire decision-making process to enhance overall resilience in coastal areas, while supporting community ownership and buy-in" (OECD, 2019b, pp. 84–86). This should be active engagement and empowerment, not simple consultation. Such engagement should involve the community in:

- understanding near and long-term climate risks to the location;
- understanding what the risks could mean in practical terms for the community;
- agreeing on current actions that reduce future risk (eg, no new building in exposed locations, future-proofing new infrastructure investments);
- staying abreast of new knowledge about climate change;
- monitoring the local environment for changes; and
- planning what to do in the future should certain trigger points be reached (including, possibly, managed retreat).

These steps are consistent with ROA and DAPP. Participants in the process should include local government councillors and staff, local iwi, local businesses, central government agencies, technical experts and other members of the community. Two examples of engaging the community in planning for future climate-related risks are the Rangitāiki River Forum (in relation to the Edgecumbe flood in 2017, described in

Rangitāiki River Scheme Review Panel (2017)), and the Clifton to Tangoio Coastal Hazard Strategy process in the Hawke’s Bay (Box 9.4).

In the Hawke’s Bay example, while each of the three councils involved is required to have a 100-year strategy for coastal environments (including assets, infrastructure and human settlements) under the NZCPS (to which they must give effect in all planning consent decisions under the RMA), “the councils chose to jointly respond and work in collaboration with the community, on the basis that a combined response would have greater traction with the community and be more likely to be successful than differing attempts by individual councils” (Lawrence, Bell, et al., 2019). The collaboration included explicit use of the ROA and DAPP frameworks.

Box 9.4 The Clifton to Tangoio Coastal Hazard Strategy

This Strategy was initiated in 2014 to respond to concerns about the ongoing effects of coastal hazards along the Hawke’s Bay coastline. The goal of the Strategy is to develop a planned response to coastal hazards (coastal erosion and inundation) in the Hawke’s Bay, from Clifton to Tangoio, out to the year 2120, and in doing so establish an approach that can be applied to other coastal areas in the region.

The Strategy has been developed through a Joint Committee made up of elected representatives from three councils – Hawke’s Bay Regional, Napier City, and Hastings District – and Maungaharuru Tangitu, Mana Ahuriri and Tamatea-Heretaunga as representatives of tangata whenua. The Joint Committee was formally established through the LGA, which gives it legal standing and makes it subject to standard committee protocol and procedures (including the requirement that meetings be open to the public). A Technical Advisory Group (TAG) made up of senior council staff and advisors supports the Joint Committee.

The Strategy has four stages:

1. **Problem definition:** given a long history of coastal hazards along the Hawke’s Bay coastline, the goal of this stage was to identify the level and extent of coastal erosion and inundation out to 2120. To inform this stage, Tonkin + Taylor undertook a technical study that modelled and mapped sea-level rise under several possible erosion and inundation scenarios, and assessed the risks associated with hazard events. The technical study led to dividing the stretch of coast into 16 “units” based on a combination of ward boundaries, land-area units, coastal processes and topography.
2. **Framework for decisions:** the Joint Committee and the TAG developed a decision-making framework, which was designed to respond to complex technical information, long timeframes, uncertainty, competing values and interests. The framework drew on the decision-making tools of Multi-Criteria Decision Analysis (MCDA), DAPP and ROA.
3. **Develop responses:** two assessment panels were formed (Northern cell and Southern cell) to represent the interests of communities and agencies exposed to, and with interests in, coastal hazard risks. The panels identified nine of the coastal units as priorities, and developed recommendations for them. All three councils were involved in each panel.

The panels used the decision-making framework developed in stage 2 to arrive at recommended responses to coastal hazards over the 100-year strategy period (with responses defined for the short, medium and long term):

- Following vulnerability assessments for each of the coastal units, each panel selected priority units to focus on.
- The panels developed a long list, and then a short list of options for each coastal unit. They then came up with several possible pathways for each unit (and each pathway included an option each for the short, medium and long term).

- Panels then scored the different pathways using MCDA, and ranked them from most preferred to least preferred. After that, economic analysis (in the form of ROA) was “overlaid”.
 - Two community feedback sessions for each panel took place as part of the decision-making process. The first session focused on identification of priority units, long and short lists of response options, and draft MCDA assessment criteria. The second session focused on pathways, the results of economic analysis, and preliminary recommendations.
 - This stage included a programme of 11 workshops over a 14-month period. At the end of it, the panels presented their recommendations to the Joint Committee and through to each council.
4. **Respond:** following the Joint Committee’s adoption of the recommendations, this is the stage currently underway. Stage 4 will develop an implementation plan to carry out the strategy. Five streams of work are currently taking place:
- **Design:** undertaking more detailed engineering and costing work of the options contained in the pathways.
 - **Triggers:** designing what the triggers will be that will prompt moves to a different option along a pathway.
 - **Regulatory:** looking at how the pathways sit within the current policy framework, regionally and nationally.
 - **Governance:** looking at where the pathways and associated infrastructure sit in terms of oversight, ownership and funding.
 - **Funding:** developing how the proportion of public and private benefits are to be calculated for each option identified in a pathway, and how the proposed options will be paid for.

The workstreams currently under way as part of stage 4 are proving challenging, given the lack of guidance or precedents in each of these areas.

A feature of almost all community engagement is that affected property owners will tend to think short term and favour defensive and protective measures. For example, coastal erosion and storms in Mercury Bay at Whitianga have already had an impact on many beachfront properties; yet Schneider et al. (2017) reported that “climate change denial is commonplace and hard engineering solutions such as sea walls persist as the preferred solution”.

In contrast to the tendency described above, the NZCPS directs councils to favour other options (such as natural defences, or retreat) over the use of hard defensive measures.⁶⁰ MfE Coastal Hazard Guidance favours working with at-risk communities to develop an adaptive pathway over time, and these long-term pathways may entirely legitimately include defence-based responses. Yet, defence measures risk creating an expectation of ongoing protection, rather than short to medium term protection. Because retreat cannot easily be reversed, it is an endpoint and as such is unlikely to be a first step on an adaptive pathway.

Perhaps unsurprisingly, communities engaged in the Clifton to Tangoio Strategy process showed a clear desire to protect their homes and communities for as long as possible, with affected communities initially shunning managed retreat even as a distant option (Lawrence, Bell, et al., 2019). Managed retreat was eventually included in the response pathways for a small number of communities as part of the Strategy, but only in the long term. Some observers of the Strategy have expressed concern about its focus on defensive measures. Yet several participants in the Strategy process emphasised that rather than this simply being a symptom of a reluctance to face reality, it is unsurprising given that communities have no model for managed retreat to refer to. Without costings, clarity around where people would move to, or frameworks

⁶⁰ For example, in evaluating strategies to protect existing development from coastal hazard risk, councils are required to “focus on approaches to risk management that reduce the need for hard protection structures and similar engineering interventions”. It also requires councils to promote and identify “long-term sustainable risk reduction approaches including the relocation or removal of existing development or structures at risk” (Department of Conservation, 2010, p. 24).

for how to achieve managed retreat, communities are understandably reluctant to consider it as an option. Several members of the TAG emphasised the need for a national conversation around managed retreat to clarify what it would mean for affected communities, and how it could be paid for.

Analysis for the Clifton to Tangoio Strategy also showed that in some communities, while managed retreat will be necessary in the future, defence in the short term makes economic sense, as it extends the useful life of some communities and their existing assets (Infometrics, 2017). One member of the TAG also emphasised that defending communities in the short term may help to bring them on board with the need for retreat in the longer term.

Yet, implementing the defensive actions identified through the DAPP process in the Hawke's Bay may be challenging, given the NZCPS's caution around the use of hard defences, and inclination towards retreat.

The uncertainty around the nature and timing of climate impacts, and the desire of many communities to defend the status quo, are critical reasons for early engagement with property owners. The first stage is to build understanding and acceptance of what is known and of likely trends based on the latest science. Building trust and empowerment are also important. Only then does it make sense to try to agree on a way forward.

Funding arrangements will be critical to decision making, including how to share the costs of adaptation between property owners, insurers, banks, and local and central government. Whatever the level of assistance from outside a community, it should be fair across communities even when they pursue quite different approaches.

F9.3

Three high-level principles to guide policy thinking and action on climate change are:

- decisions about whether, when and how to defend/protect, adapt, or retreat in the face of hazards related to climate change should aim to minimise long-run costs;
- the way costs of adaptation are shared should be fair across communities and generations; and
- active engagement with, and empowerment of, affected communities in developing adaptation pathways is vital.

The first two principles imply placing a high priority on avoiding behaviour that leads to increased risk exposure for private gain at others' expense (moral-hazard behaviour).

Insurance will become less affordable or unavailable

Local governments (like private home and business owners) currently use insurance to protect against major loss due to natural hazards. Councils do not generally insure the total value of their infrastructure assets, because central government supports them through the 60% (central government) to 40% (council) funding split for damage caused by natural disasters.⁶¹

However, the combination of predictability and inevitability (even with uncertain timing and fluctuations) mean that traditional insurance will not work indefinitely as a means for transferring risks associated with climate change. This is because insurance depends on sharing risks that have a stable probability distribution across a population who do not know who will suffer from an adverse event (eg, illness, fire, theft, and earthquake); in other words, insurance works for uncertain risks, not for certain impacts.

Insurable risks are not, and do not have to be, the same across people. Insurance companies price the protection they offer according to risk factors. Those in riskier situations will pay more. At some point where the risk probability exceeds a threshold, insurance companies will either refuse cover or offer it at such a high

⁶¹ This split is for "four-waters" infrastructure assets: freshwater, stormwater, wastewater and flood protection.

premium that it will be unattractive and/or unaffordable. Some property owners in locations at high risk from sea-level rise and flooding are already at that point.

Insurance can play a valuable role in communicating the level of risk properties face from natural disasters, including from the effects of climate change. However, insurance policies usually last for only a year – unlike mortgages, which usually last for several decades. Banks, as mortgage lenders, are likely to face considerable risk if properties (or the land they are built on) are exposed to climate hazards. The Insurance Council highlighted this, noting that

[w]here the land itself and therefore the property on it is at risk from climate change effects, for instance from sea-level rise, prudent banks will provide mortgages on shorter terms or not at all. This is likely to have an immediate and significant effect on property prices. (sub. DR205, p.2)

This impact on property values is already happening. RNZ News quoted a resident trying to sell his property in the threatened coastal community at Onaero in northern Taranaki:

We've had it for sale for two years and we keep reducing the price, but the banks see the red line and they don't want to lend. (Martin, 2019, p. 2)

Another resident reflected:

Who's going to buy our home if we decide we want to sell it or need to sell it? Who's going to lend money to someone who wants to buy here if this red line is going through our properties? (Martin, 2019, p. 3)

While insurance premiums provide a signal about current levels of risk, they do not indicate how risks will evolve over time (Anderson et al., 2018; OECD, 2019b, p. 54).

In 2016, LGNZ commissioned an expert to write a guide for local governments on using insurance to transfer risk (LGNZ, 2016b). The guide sets out the features that must be present for insurance to cover risks (p. 13):

Homogeneity. There must be enough subjects for insurance of a similar class to produce a reliable average of "loss experience".

Calculability. It must be possible to calculate the chance of loss, either mathematically or through experience. The greater the uncertainty surrounding the probability of a loss occurring, the higher the premium loading.

Fortuity. Although it is known that losses will occur and that the frequency can be measured, a specific loss must be unforeseen. A loss that is intentionally brought about, or which is expected to happen, is not suitable for insurance.

Insurable interest. A financial interest in the subject matter of insurance is what differentiates insurance from gambling.

Climate-change risk challenges two of these requirements. It can be foreseen that losses will happen in certain locations, so it fails the test of fortuity. Also, because the risk is deeply uncertain and changing, it is not possible to use historical experience to estimate loss probabilities. This is a challenge to calculability which insurers are tackling with increasingly sophisticated forward-looking models.

The Insurance Council argued that insurance is likely to remain critical for some time for the more unpredictable climate-related impacts, such as storm damage (sub. DR205, p. 5). Yet in the future, losses incurred may become frequent and significant enough to make insurance unaffordable.

Even now, risks that traditional insurance usually covers (such as material damage, liability and business interruption) are not covered for some local government infrastructure assets such as roads and underground pipe networks. These assets are particularly exposed to climate risk in some locations.

Some local authorities already struggle to insure against floods and other natural disasters. They will find it more difficult to source insurance at a reasonable cost in the future. Upper Hutt City Council, for example, noted that their insurance costs have increased by 40% in the last year, and that it was difficult for them to obtain insurance coverage (sub. 40, p. 5).

Exposed private home and business owners will also find it harder or more expensive to insure their properties, which may also have implications for councils. If insurance companies withdraw cover, or it becomes too expensive, public agencies will face pressure to fill the gap. This will be particularly challenging if insurance companies make quick decisions immediately following an event, whereas public agency decision making can take months or years. If the gap is not filled, it could lead to significant inequities as increasing numbers of home owners in some communities become uninsured (CCATWG, 2018). As insurance becomes harder to obtain, conversations about compensation for climate-related loss and damage will likely become unavoidable (Dudley Tombs & France-Hudson, 2018).

F9.4

Properties at growing risk from sea-level rise, river-plain flooding or other types of climate-change hazard will become increasingly uninsurable. This is because the nature of climate-change risk lacks two characteristics for insurability:

- it is not possible to calculate the probability of loss from past experience due to the novel, uncertain and dynamic character of climate-change risk; and
- losses are not unforeseen – climate damage is foreseeable (even though its precise form, magnitude and location are uncertain).

Insurers can overcome the first difficulty to some extent through the use of forward-looking risk models.

Social insurance

Given the eventual lack, or prohibitive expense, of private insurance, New Zealand will need to make a fundamental choice about who should bear the costs of the damage to property from climate change. The uneven geographic exposure to climate risk makes a strong case for national risk sharing through some level of central government co-funding of local government's adaptation costs.

New Zealand has a tradition of social insurance in which society at large helps those in need who suffer hardship or loss through no fault of their own and where these losses may be uninsurable. This happens under New Zealand's national healthcare system and the Accident Compensation Corporation system of social insurance for accident victims. Several other examples exist.

- Central government, alongside private insurers and the Earthquake Commission (EQC), has funded a significant part of the recovery from recent natural disasters such as the Christchurch and Kaikōura earthquakes and the Edgacumbe floods. The government paid compensation to householders beyond payments from EQC and private insurance.
- The New Zealand Transport Agency (NZTA) funds repairs to storm- or earthquake-damaged roads and bridges (damage from the Kaikōura earthquake and the Westland floods are recent examples). It is notable that contributions to the National Land Transport Fund (NLTF) are unrelated to the geographical location of the risk.
- General taxpayers have funded preventative actions to protect communities from known hazards. An example is the Crown's co-funding of stopbanks and other flood-mitigation works through the National Water and Soil Conservation Authority (NWASCA). Between about 1961 and 1988, the NWASCA subsidy rates to local government for flood-control works ranged between 40% and 70%, depending on the nature of the scheme and the perceived benefits (Ericksen, 1986, p. 124). After the NWASCA was abolished in 1988, regional councils became responsible for the works.

Certain conditions should apply to payments made under any social-insurance scheme. These conditions – which are lacking in some of the above schemes – include:

- losses should not be compensated, or costs met, if they are avoidable by taking sensible actions in the light of what is known about risks. Yet, as Jonathan Boston notes, it will be very challenging to define what losses are avoidable, what actions are sensible, as well as what risks are known by whom, and when (sub. DR184, p. 4).

- schemes should prompt actions to reduce risks before disaster events if this can reduce long-run costs (eg, unconditional compensation for farmers who suffer a bad drought blunts their incentives to change farming practices to make their farms more resilient to drought). The Insurance Council emphasised this, noting that "...clear price signals need to be given to reflect risk and these should not be muted as to prevent action" (sub. DR205, p. 3); and
- schemes should include some co-funding; that is, a distribution of costs across the social-insurance funder and the recipient (eg, in the case of leaky homes, the eventual package on offer was 25% from central government, 25% from local government, and 50% from homeowners). Co-funding is a device to reduce the risk of moral-hazard behaviour.

The Commission supports the idea of well-designed social insurance to help councils significantly affected by climate change fund the adaptation costs of their at-risk infrastructure. Most, but not all people, will see such a social-insurance approach as fair.

F9.5

New Zealand has a strong tradition of social insurance in which society at large helps those in need who suffer hardship or loss through no fault of their own and where these losses may be uninsurable. This tradition provides a possible basis for some form and amount of central-government assistance to councils seriously threatened by losses due to climate change. Any such assistance will need careful design to incentivise risk reduction and avoid moral hazard.

9.4 Assisting local governments facing climate change

As noted, the emerging funding pressures on local government from the impacts of climate change are large. Even now, the yearly cost of repairing land transport networks damaged by weather-related events has more than quadrupled over the past decade (Boston & Lawrence, 2018).

But this does not necessarily imply a need for more assistance from central government. One could say that councils and their citizens must deal with the costs they face within their jurisdictions. A council's costs for infrastructure and local public goods (eg, flood protection, seawalls) should fall on ratepayers. Private property owners' costs should fall on them or their insurers, and some citizens could qualify for support under existing central-government schemes (eg, social housing, accommodation supplement, and income support).

This approach has benefits and drawbacks. A big negative is that it would sharply increase the rating or tax burden on citizens in the worst affected districts. In many cases, these districts will not be sufficiently wealthy or have the capability to fund and manage adaptation.

An alternative approach would be to follow New Zealand's tradition of societal risk pooling and cost sharing in which central government mobilises resources from the general taxpayer to help those hit hardest (Chapter 6). The NZTA model has elements of this tradition: the NZTA distributes funding for roading infrastructure on a regional basis giving those with greater need and/or less ability to pay greater help.⁶² Councils still pay a significant portion of the costs of local roads (while the NZTA pays 100% of the costs of state highways). This is fair, and means that councils have a stake and an interest in achieving value for money. On the other side, the NZTA can use its financial leverage to insist on satisfactory quality standards and business cases, and to act as an honest broker in getting interested parties to agree.

⁶² The proportion paid by the NZTA that varies across councils is known as the Financial Assistance Rate.

Assistance for land transport infrastructure that is at risk

The current NZTA arrangements, supplemented with additional national funding and a clear government mandate expressed through the Government Policy Statement on land transport, are well suited to helping councils deal with the climate-change impacts on an important part of their infrastructure portfolio – their roads, bridges, footpaths and cycle lanes.

Expanding the current way that the NLTF and NZTA co-fund local roads is likely to be a straightforward and cost-effective method for the general taxpayer to help councils relocate or re-align local roads that become non-viable because of climate-induced erosion and flooding. This approach will have several advantages that are evident in the current NZTA model when it works well. It will:

- meet a portion of the cost for councils and their ratepayers with funding geared to council needs (eg, measured by the length of affected roads, the costs of relocation or re-alignment and the rating capacity of the district);
- act as an incentive for councils to be proactive in facing up to climate risks to local roads, and help persuade local people to come on board with the plan;
- prioritise spending in line with net social, economic and environmental benefits while taking account of equity across regions;
- make help conditional on avoiding optimism bias, meeting suitable business-case thresholds, community engagement and achieving engineering and environmental quality standards; and
- make specialist knowledge and skills available to councils and help spread best practice around the country.

Business cases would require the use of a CBA that takes account of deep uncertainty and changing risk over long timeframes, most likely by using ROA, DAPP or both. To lean against optimism bias and the risk of poor value for money, the agency would normally not invest in defensive structures. It might do so in exceptional cases if a high business-case threshold were reached.

Roads are long-lived assets that require major capital investment to build from scratch. Therefore, existing NZTA resources from the NLTF may be inadequate. While there will be scope to stage expenditure, the Government will likely need to supplement the NLTF with either higher revenues from road users, contributions from general revenues or additional borrowing to enable it to assist councils in the way described.

A local-government climate resilience fund for water and river infrastructure

Alongside roads, other classes of local government-owned infrastructure vulnerable to climate damage are the three waters – particularly wastewater and stormwater systems because these tend to rely on gravity flows towards low ground – and river-control assets such as stopbanks (Rangitāiki River Scheme Review Panel, 2017; White & Storey, 2017). As noted above, council assets under threat run to billions of dollars. Many of the assets are ageing and require extensive investment, including so they can meet new higher environmental standards. This need for renewal is also an opportunity to relocate and redesign in line with intelligent adaptation.

At the current time, the Government is reviewing the regulation, governance and delivery of three-waters services. The Commission is contributing to this review in this inquiry, by examining drinking and wastewater services, and exploring how they could be improved with more effective funding, governance and regulation (Chapter 11).

Whatever approach emerges from the three-waters review, the Commission believes that central government help – like roading help – should go to councils with water assets seriously threatened by climate damage. The institutional vehicle to provide this assistance could be a Crown agency somewhat like the NZTA and with access to a Local Government Resilience Fund (LGRF).

The agency would co-fund qualifying council infrastructure costs, with the share from the LGRF based on council need and capacity. The agency would bring the same disciplines, and play a similar enabling,

facilitative role, as the extended NZTA model for roading. This would include incentives for councils to proactively face climate risk, prioritising spending in line with net social, economic and environmental benefit, and making assistance conditional on meeting suitable standards.

This approach should also apply to river-management and flood-control works.⁶³ Most existing flood protection systems were put in place under past climate conditions. With protections in place, many locations that had traditionally been floodplains were made more suitable for housing, agriculture and other uses. The development of those locations has led to greater exposure to climate impacts under current and future conditions. Many of these existing assets are now old and need renewing, and some are no longer fit for purpose in the face of increased flooding risk from climate change – or will require far greater maintenance to provide the same level of protection.

Under ongoing climate changes, risk protection levels are being exceeded with ongoing loss of service levels. Failure of stormwater systems leads to failures in other infrastructure, such as roading networks and potable water supplies, creating public health issues, such as enteric diseases, and the ability of health providers to cope. (Lawrence, Blackett, et al., 2019, p. 22)

The amount of flood-control infrastructure varies widely between regions, but around the country about 364 different schemes protect about 100 towns and cities, thousands of hectares of farmland, as well as significant Crown assets and national infrastructure (Hutchings, Williams, Lawson, & Chamberlain, 2019).⁶⁴ Decisions will need to be made about where to improve and strengthen existing river and flood defences, and where to decommission or relocate them. Such decisions are difficult and complex, and a national approach will be important to avoid ad hoc decisions, increase resilience, and minimise risk.

This approach would be consistent with that proposed by the regional authority river managers in 2018:

In the absence of central government co-investment in mitigating risks, scheme re-design and re-construction will not be able to deliver nationally needed outcomes. This will inevitably mean more central government funds having to be directed towards recovery and rehabilitation. (Hutchings et al., 2019)

Their proposal includes a scheme of national annual funding, to be allocated through a funding formula similar to that of NZTA – offering co-investment of up to 75% towards the cost of new works, up to 50% towards the cost of capital works to upgrade existing schemes to be able to cope with climate change, and up to 33% towards maintenance of existing schemes (Hutchings et al., 2019, p. 5).

A co-funding approach would echo arrangements in New Zealand's relatively recent past when the NWASCA co-funded with regional catchment bodies many of the country's flood-control schemes that exist today. The history of these arrangements, what they achieved and why a new approach is now needed in some locations are instructive. Box 9.5 describes the older approach of river containment and why it has given way to a new philosophy of "making room for rivers".

A Local Government Resilience Agency, and associated fund, should retain enough flexibility to extend support to other types of local-government infrastructure as the impacts of climate change emerge, and as risks become clear. This includes council buildings, parks, landfills and other assets that may be at risk from flooding, coastal erosion or other climate-related hazards.

⁶³ This includes stopbanks, floodgates, pump stations, river structures, dams and drains.

⁶⁴ Capital expenditure and operating expenditure for these assets are currently paid for through regional-council rates – generally targeted rates on the direct and indirect beneficiaries of flood protection (Hutchings, Williams, Lawson, & Chamberlain, 2019).

Box 9.5 Making room for rivers

The older philosophy of river containment (largely using stopbanks) is described in *River control and drainage in New Zealand* (Acheson, 1968). It focused on the confinement of river systems both to “flush” sediment through to the coast and to maximise the area of additional productive land, largely for agriculture, with corresponding returns on investment for the national economy. River schemes built in line with this philosophy exist across New Zealand. Subsidies for such schemes were often as high as the central government paying double the local government contribution.

Over the past decade, more frequent river-flood events have occurred, and this is likely related to climate change. The stopbank failure on the Rangitāiki River leading to widespread flooding and property damage in the Bay of Plenty town of Edgumbe in April 2017 is a dramatic example. Events like these, growth in environmental, recreational and cultural values, and the 1986 publication *Creating Flood Disasters? New Zealand's need for a new approach to urban flood hazard* by the NWASCA (Ericksen, 1986) have given impetus to a new philosophy of river management. The report that the Bay of Plenty Regional Council commissioned about the Edgumbe disaster (Rangitāiki River Scheme Review Panel, 2017) described this philosophical shift (pp. 118–119):

[A] paradigm shift began in the overall philosophy of floodplain management in New Zealand, especially with regard to the construction of stopbanks. The concept of stopbanks encouraging the intensification of floodplain development and, therefore, an increase in the value of assets at risk on the floodplain, which then led to even higher stopbanks and further development, has played out across New Zealand as well as in almost every other country across the world.

The realisation around the potential increased risks associated with higher and higher stopbanks led to the re-evaluation of methods, especially the position and height of stopbanks and was the start of the “Making Room for Rivers” concept which is now generally agreed to be best practice.

...The idea of “Making Room for Rivers” is based around reducing flood levels and velocities by having a wider river corridor that can utilise floodplain attenuation and controlled compartment spilling and storage to more safely manage flood risk. The idea is fundamentally based around restoring the natural functioning of river floodplains whilst working around the constraints that exist due to floodplain development.

A key aspect of making these programmes successful is achieving multi-functionality so that when these areas are not being used to store or convey flood waters they can be used for cultural wellbeing, agriculture, wetlands, recreation, ecological reserves and any other uses that the community values. The key barriers to the implementation of this philosophy in the New Zealand context are the legacy of “protection” provided by narrowed river systems, private property rights and, predominantly, the very high cost. It would generally only be considered feasible if the value provided by the other functions, which are often difficult to value in dollar terms, is included in the overall assessment and funding from the wider community is used to support these developments.

As indicated in the above passage, “stopbank retreat” and reconfiguring river systems to “make room for rivers” may involve property purchases and rebuilding infrastructure. This will likely not only stir up local political opposition but also be beyond local resources (largely drawn from targeted rates on local property owners). Yet such sweeping changes will be needed in many (but not all) places across New Zealand as climate-related flooding increases in frequency and intensity.

Source: (Rangitāiki River Scheme Review Panel, 2017).

Applying design principles for intergovernmental transfers

Both the extended NZTA model for land transport infrastructure and the resilience agency and fund that the Commission is proposing should follow the design principles for intergovernmental transfers (Chapter 6). Desirable features of each arrangement would be that it:

- has a clear purpose;
- gives local government reasonable predictability (eg, based on a formula);
- requires councils to be accountable to both the funding agency and their citizens;
- is administered by an arms-length agency (NZTA in the first arrangement and the new resilience agency in the second); and
- involves co-funding – the extent of which will depend on both local need and rating capacity. This is similar to how co-funding shares for roading are currently determined. A transparent formula – the Financial Assistance Rate makes allowance both for the need and rating capacity of each local district.

Protection of Crown and other third-party assets

Central government should contribute to costs when councils invest in adaptation defences that protect not only their own but also Crown assets. Many state highways and other Crown infrastructure are already protected by flood defences. In the future, the instances and value of central-government assets protected by coastal and flood defences are likely to increase. Yet while central government pays for 100% of the costs of construction and maintenance, it does not contribute to the construction or maintenance costs of defences that protect central-government assets, because such assets are deemed non-rateable. Likewise, co-funding for local roading infrastructure generally does not extend to defences that protect those roads.

As the Clifton to Tangoio Coastal Hazard Strategy has progressed, the Hawke's Bay councils have found central government reluctant to discuss funding contributions towards protection. Yet it is important that central government contribute to the costs of protection, just as would be expected of any other asset owner or beneficiary.

A similar issue exists with respect to electricity and telecommunications utilities. Much utility infrastructure (eg, powerlines) is on council, Crown or private land. This means that local governments have limited ability to apply rates on the utilities themselves to help recover the costs of flood protection and other defences.

F9.6

The New Zealand Transport Agency's model of co-funding local land-transport infrastructure could be extended to provide central-government assistance to relocate local roads and bridges that will be non-viable because of climate-change-induced sea-level rise, flooding and/or storms. This approach has potential benefits to:

- incentivise councils to anticipate climate risks to local roads, and encourage community engagement and buy-in;
- prioritise spending in line with net social, economic and environmental benefits while taking account of equity across regions;
- counter optimism bias by requiring that the discipline of a strong business case and engineering and environmental quality standards are met; and
- make specialist knowledge and skills available to councils and help spread best practice and successful innovations around the country.

To do this, the Government will likely need to supplement the National Land Transport Fund with either higher revenues from road users, contributions from general revenues or additional borrowing.

F9.7

The past approach of containing many New Zealand rivers within relatively narrow stopbanks for flood protection and to maximise the area of productive land for agriculture and other uses will become less viable as climate change increases the risk of more frequent and more intense rainstorms.

Best practice is now to allow wider river corridors that give rivers room and make space to more safely manage flood risk. But making this change faces barriers of existing property rights, expectations of continued protection, and high costs.

R9.5

The Government should extend the New Zealand Transport Agency's role in co-funding local land-transport infrastructure to include assistance to relocate or protect local land-transport infrastructure at risk from sea-level rise and more intense storms and flooding due to climate change. The amount of assistance should reflect the scale of the threat facing each council and its rating capacity.

Assistance should be conditional on a strong business case and meeting engineering and environmental quality standards. It should only be available to defend existing infrastructure when business cases indicate that this option is clearly superior to other options.

R9.6

The Government should create a new agency and a Local Government Resilience Fund. The new agency should work with at-risk councils to:

- co-fund the redesign and possible relocation and rebuilding of three-waters infrastructure when it becomes no longer viable because of sea-level rise and more intense flooding due to climate change;
- co-fund the redesign and possible relocation and rebuilding of other non-land-transport local government infrastructure and assets at risk from the impacts of climate change;
- work out the best way to lessen future flood risks from rivers. This could include moving to a new, more sustainable and best-practice paradigm of giving rivers room and developing multiple innovative uses of the wider river corridors.

Funding should be conditional on a strong business case and meeting engineering and environmental quality standards. It should only be available to defend existing infrastructure when business cases indicate that this option is clearly superior to other options. The level of funding should be based on a formula that reflects local need and rating capacity.

9.5 Support for private citizens and businesses

While risk-informed adaptation and land-use planning can reduce the level of risk communities face from climate change, the question of how to fund the necessary adaptation measures remains.⁶⁵

In their paper "Funding climate change adaptation – the case for a new policy framework", Boston and Lawrence (2018) find that neither New Zealand's governance, planning and regulatory frameworks nor its current funding arrangements are well suited to cope with the challenge of funding adaptation to climate change.

⁶⁵ Although, as the OECD (2019b) notes, it is not technically feasible or economically sensible to reduce the level of risk to zero.

Tens of thousands of people – and perhaps more – will eventually need resettling on higher ground. Large investments will also be required to redesign, reposition and future proof public infrastructure, especially transport networks and water services. Additionally, the damage caused by climate-related natural disasters will impose growing financial burdens – on citizens, businesses and public authorities. (p. 2)

Therefore, in addition to support to improve the resilience of local government infrastructure, consideration must also be given to the effects of climate change on private citizens and businesses. Several points can be made at the outset.

- Climate-change costs will be large and unevenly spread across geography, population and time.
- The size and inevitability of the costs, and that they will land largely on future generations even though past and recent generations have contributed to them, points to a strong financial and ethical case for an immediate start to pre-funding.
- Some costs will materialise in the near term in the form of falls in property values, increases in insurance premiums, business-interruption costs and higher repair and maintenance costs.
- Early and wise actions can save a lot of cost over time.
- Many deprived communities are already among those most vulnerable to the effects of climate change. This may be compounded if high-risk properties lose value and more wealthy residents relocate and the poorest community members move into the most vulnerable (cheapest) homes.
- Private and public action will often need to be coordinated, but political opposition to expensive, pre-event collective actions to reduce risk will be strong because the full benefits will be realised only well into the future (in contrast to the political support that tends to be forthcoming for recovery spending after a disaster).
- Local government is not responsible for compensating private losses in ordinary circumstances, but any use of compulsion is likely to trigger a lawful need for compensation from public sources (Dudley Tombs & France-Hudson, 2018).

In relation to the sixth bullet point above, Boston and Lawrence (2018, p. 24) note that

[t]his phenomenon is common across advanced democracies. It reflects humanity's cognitive biases, including myopia: citizens tend to value post-event cures over preventative interventions. Finding ways to counter such propensities will be crucial over the coming decades. Otherwise, there will be many sub-optimal policy decisions – ones that increase and entrench risk exposure, thereby placing additional burdens on future generations. This works in the opposite direction to what effective adaptation requires, namely to reduce risk now and for the future.

Participants in the Clifton to Tangoio Coastal Hazard Strategy are currently grappling with the challenge of how to fund the adaptation measures identified in the Strategy. The TAG has spent considerable time looking at how the proportion of public and private benefit for different adaptation options should be calculated, and how the options proposed in the Strategy should be paid for. Yet these deliberations have proved challenging.

The public–private benefit split will vary considerably for each piece of infrastructure, depending on where it is and the nature of the infrastructure or other property it protects. Determining who benefits, and how much, will always be a highly emotive and political decision. Several TAG members expressed a desire for more guidance, or national rules, around how to make such decisions (particularly for managed retreat, where fairly determining beneficiaries, and apportioning costs accordingly, is challenging).

The three councils involved in the Strategy have found it difficult to agree on how and who should collect ratepayer funding for the construction and maintenance of protection measures. Other issues include where any funds (once collected) should sit and be governed, and the respective roles of the regional and territorial councils and central government. The legality of collecting funds when specific projects are not well defined is another issue. Opinions also differ as to how broadly to socialise the private costs of adaptation. Some believe only affected residents should contribute; others believe costs should be spread more broadly across the region or country.

As other councils develop strategies to address the impacts of climate change, they will encounter similar challenges. Without clear national guidelines or rules in place, the result will be a patchwork of different approaches and models around the country, and it could lead to decision-making paralysis.

The case for and against public support for private adaptation costs

Arguments have been made both for and against leaving citizens and businesses to bear their own adaptation costs. The different perspectives on this issue generally reflect differing views on the extent to which wider society should share the costs and risks associated with climate change.

Central government will need to decide which course to take. Yet the existence, or not, of such support will have consequences for local governments grappling with climate-change adaptation, as they have the tricky job of working with exposed communities to try and agree on a wise course forward. Any public funding should be provided in a way that supports councils in this process.

Arguments that have been put forward *against* extending public support and risk-sharing arrangements for climate adaptation include those listed below.

- Under existing law, citizens and businesses are responsible for their own property. Private insurance is available, and for residential property EQC cover applies to the first \$150 000 of property loss in relation to specified natural disasters. While insurance can sometimes be costly, premiums reflect real risks. Citizens and businesses have choices about the risks they take on and risk premiums play a useful role in incentivising risk reduction.
- Existing arrangements already provide public cover for citizens' health needs and provide a variety of social safety nets to help those with housing or income needs.
- Property at risk from adverse climate-change events is a component of overall wealth. Other forms of wealth, such as financial wealth, are held at a private owner's risk. It would be unfair to privilege one form of private property by making only it eligible for public compensation.
- The worst risks from climate change are still two or more decades away. The vulnerable locations for property are reasonably clear and will become even clearer soon (eg, with the NCCRA currently under way). This window gives adequate time to adapt by reducing existing risk and not creating new risk.
- A comprehensive scheme to compensate citizens and businesses for the costs to adapt to climate change would be a huge expense on the public purse, administratively complex to design and operate, and will inevitably not be fair to all. It could incentivise quite egregious moral-hazard behaviour.

On the other hand, arguments put forward *in favour* of public support to fund adaptation measures for private citizens and businesses include those listed below.

- Many existing properties and communities were built before any awareness of climate-change threats. The citizens who built them or have been occupying these properties for a long time did not have the opportunity to make informed choices about climate change.
- New Zealand has a tradition of societal risk pooling and cost sharing for natural disasters. As well as the EQC and the Adverse Events Fund (administered by the Ministry for Primary Industries), many instances exist of ad hoc public compensation for property damage from natural disasters (eg, the Christchurch earthquakes, the Edgecumbe flood, and the Matata landslide disaster).
- In the absence of a scheme with clear rules that supports risk reduction, people will expect governments to put things right after damage has happened and to fund hard protections. This will exacerbate risk exposure (eg, through continued development in vulnerable locations) and cost more money over time.
- Accommodating the effects of climate change in a location, or managing retreat from it, requires coordination between public and private actions. Private owners are strongly inclined to stay put and hope for the best against the evidence. So decisive action to achieve the lowest long-run cost (eg, managed retreat) requires the incentive of public support to persuade communities to agree.

- Moral hazard can be managed and indeed reduced by placing conditions on publicly funded support. For example, property owners in the United Kingdom are compensated for flood vulnerability only if their buildings were built in 2012 or earlier.
- Property owners who suffer losses due to climate change will not simply be victims of bad luck. They will be victims of identifiable human activities in the form of GHG emissions. As such, they have a strong moral case and a possible legal case to receive some compensation for damages. Some funding for compensation could come from auctioning emission permits under New Zealand's Emissions Trading Scheme.⁶⁶
- At-risk communities will vary widely in their abilities to fund measures to adapt to climate change: poorer communities will find it much harder to prepare and protect themselves than wealthier communities. Elisabeth Ellis highlights this issue, stating "central government should...resource adaptation nationwide, so that community resilience does not vary according to ratepayer capacity" (Ellis, 2018).

The decision whether to offer public support for private climate-change adaptation is one that central government will need to make following a lot of scrutiny, public debate and analysis. It is a question that is largely outside the scope of this inquiry. Yet the existence or not of such support will have consequences for councils.

Local authorities will lead initiatives to reduce climate risks for their exposed communities. Even at best, these will be difficult conversations and processes. If councils fail to get community agreement to managed retreat (where that is the best option), it could leave them exposed to obligations to supply services to properties where people still live. Councils could be forced by court decisions to continue to supply services at very high costs which they could not recover.⁶⁷ Any public funding would need to be provided in a way that supports local government to achieve risk reduction and minimise long-run costs.

F9.8

The decision whether to provide public funding to support private owners to undertake cost-effective climate-change adaptation is for central government to make. Yet the existence or not of such support will impact local authorities' responsibilities for leading and implementing managed retreat or other forms of adaptation.

Considerations for funding private adaptation costs

Parliament passed the Climate Change Response (Zero Carbon) Amendment Bill into law in November 2019. The Bill includes a framework for adaptation that consists of:

- a national climate change risk assessment, to improve understanding of climate risks;
- a National Adaptation Plan, outlining the Government's approach to improving New Zealand's resilience to the effects of climate change; and
- monitoring and reporting against the National Adaptation Plan.

In developing the National Adaptation Plan, the Government will inevitably need to consider who will pay, and how, for the actions identified in that plan. This analysis will need to consider how costs of adaptation should be shared between central government, local government and private citizens, and how (through what mechanisms) any public support should be delivered.

Several options have been put forward. Boston and Lawrence (2018), for example, conclude that a case exists for proportionate pre-funding of future climate-adaptation costs (both public and private costs). They consider three options for nationally funded support:

- expand and modify existing instruments and continue with ad hoc initiatives in response to specific situations, to be funded from yearly or multi-year budget appropriations;

⁶⁶ Through auctioning, the government sells emission permits to the market to the highest bidders (with a possible reserve price to avoid very low prices). The government announced in May 2019 that it will introduce auctioning into the Emissions Trading Scheme in late 2020 (Minister of Climate Change (Hon. James Shaw, 2019).

⁶⁷ A possible counter is that councils could charge targeted rates on remaining residents that would cover the full costs of the services.

- amend the legislative mandate of the EQC so that it becomes responsible for pre-disaster funding (ie, for protective and preventative measures) as well as post-disaster funding; and
- establish a new national Climate Change Adaptation Fund with a statutory mandate to fully fund, partly fund or co-fund various specified costs related to adapting to climate change.

Boston and Lawrence favour the third option and argue for an early start to build up the Fund. The concept of pre-funding is already used in several existing funds. Pre-funding is a principle of the EQC and is mirrored even more clearly in the NZ Super Fund. This fund's purpose is to anticipate a future, known cost (ie, the cost of paying superannuation to the future large cohort of retirees at a time when the ratio of workers to retirees will have significantly fallen). Pre-funding has two key advantages:

- it allows time to build up the large sums that will be needed to fund adaptation; and
- it is fair that those who cause the problem should contribute towards the costs of remedying it – an instance of the exacerbator principle (noting that here it has a strong intergenerational dimension).

A similar type of pre-funding mechanism may also be a useful model at a local level. Yet some councils have expressed concern that there is currently ambiguity around whether councils have the power to collect pre-funding from ratepayers, without it being linked to a specific project.

Any public funding mechanism to help private owners of residential property undertake cost-effective climate risk reduction, up to and including managed retreat, would need to clearly specify criteria for who qualifies for assistance, how much they should receive, and with what conditions. A robust set of rules would be needed. The design of any mechanism should also encourage community ownership and initiative.

9.6 Conclusion

The impacts of climate change present a substantial and new pressure on local government funding and financing. A mismatch exists between resources and capability at the local level, and the scale of the adaptation challenges that exposed communities face. Billions of dollars of council infrastructure are at risk from the effects of climate change, as are communities throughout New Zealand. But these risks are distributed unevenly. Making decisions about where to protect, accommodate or retreat to minimise future risk and costs will call for challenging and intensive community processes. A particularly challenging aspect will be how to fund adaptation actions.

Greater central government leadership is urgently needed to support councils to adopt robust and consistent approaches to dealing with these challenges. Without such leadership, councils around the country will continue working individually without the guidance and tools needed. It will lead to a patchwork of sub-optimal approaches – some fairer and more effective than others.

Central government needs to take leadership on three elements that will be critical for councils to limit and manage their future exposure to climate risk. They are high-quality and consistent science, data and guidance; a robust, adaptive process appropriate for making decisions under deep uncertainty; and legal frameworks that councils can use to make risk-informed land-use policy decisions “stick”.

The Commission suggests two new funding mechanisms to support local governments facing major climate damage to their infrastructure. The first extends the NZTA model to co-fund the costs of adapting land-transport infrastructure. The second is a Local Government Resilience Fund and associated agency to support affected councils to adapt their water infrastructure, their river and floodplain management and their other major non-land-transport assets to meet new climate risks and realities.

Central government funding to support adaptation by private citizens and businesses has advantages and disadvantages. What the Government decides will have consequences for local government. Councils should receive support in ways that help them work with their exposed communities to achieve risk reduction and minimise long-run costs. In the absence of a well-defined stance by central government, managed retreat, in particular, will be challenging to implement at any scale.

A lack of national leadership and support creates a risk of disorganised, ad hoc adaptation to climate change, and of short-term, stopgap measures in place of more far-sighted, adaptive responses. Short-term

and myopic approaches are more likely to invite legal challenges and compensation claims. They are also likely to lead to greater risk exposure, higher long-term costs, and less fair outcomes where some vulnerable and high-risk communities are left exposed, while other locations are prioritised for protection.

10 Responding to tourism pressures

Key points

- Tourists use a range of local infrastructure and amenities provided by councils – including roads, three-waters infrastructure, car parks, public toilets, parks, and other amenities. They also contribute to the need for local services such as street cleaning and rubbish collection.
- Tourists' use of local infrastructure and services imposes costs on councils, though the impacts are not evenly distributed. Sometimes these costs are modest because of scale economies. But they can also be significant if additional capacity is needed to accommodate visitor use at peak times. Councils can fund infrastructure and services they provide to tourists in several ways, including through rates, user charging and with funding from central government.
- Tourists already pay for most of the costs they create. They pay indirectly for their use of some local infrastructure and services through the price of the goods and services they purchase from businesses (who in turn pay business rates for the council services they use to meet tourists' needs). Tourists who stay with family or friends use services provided to these homes, which are funded from residential rates.
- However, there is a small shortfall because tourists do not pay for the local public-good type amenities and services they consume directly, but which are paid for through rates. These include public toilets, car parks, walkways, gardens, CBD street cleaning and rubbish collection from public bins. This shortfall likely amounts to less than 2% of total council revenue in most districts.
- International tourists pay a large amount to central government in the form of GST, making it different to other export industries that are zero-rated for GST. This is far more than what is needed to cover the costs international tourists do not already pay for.
- While central government receives the GST, councils bear the costs. Central government does provide significant funding to councils for local services and infrastructure to support tourism. However, these funds are distributed in an ad-hoc way through multiple funds that do not provide certainty, or enable councils to plan and manage tourism growth effectively.
- Some councils citing difficulties in dealing with pressure from tourism have had a focus on keeping debt and rates growth low. This has led to a backlog of infrastructure investment to meet both residential and visitor needs. They are now having to play catch up.
- The Commission analysed several options for new tools for funding tourism shortfalls, which would require legislative change. An accommodation levy on sales to guests in both formal and informal accommodation scored relatively well. Yet, given the modest funding shortfall, and the significant implementation and administration costs, introducing new tools may not produce a net benefit.
- To cover the modest funding shortfall from tourism, local governments should make better use of existing funding and financing tools, including more user charging, greater use of debt, raising more in rates (including efficient targeted rates), and better use of strategies and tools to manage peak demand.
- Significant scope also exists to improve central government funding flows to councils for tourism-related amenities and services. Funding should be distributed in a more systematic, ongoing, predictable and fair way by using a transparent allocation formula. This would also help preserve local government autonomy and avoid disadvantaging well-run councils.

New Zealand has a long history as a tourist destination, with communities around the country hosting large numbers of domestic and international tourists. In 2018, domestic and international visitors together spent about 40 million guest nights in communities throughout New Zealand.⁶⁸

Over recent years New Zealand has experienced a rapid and significant increase in international visitor arrivals. In 1990 New Zealand had fewer than one million international visitors; by 2018 this number had increased to 3.8 million. Yet, despite this growth international tourists still make up less than half of New Zealand's total "tourism load", increasing from 42% of total commercial guest nights in 2008 to 44% in 2018.

For the communities hosting these visitors, tourism can bring many benefits. A strong tourism industry supports business – including in accommodation, travel, tourist activities, cafés, restaurants and retail. In the year ending March 2018, for example, domestic and international tourists in New Zealand collectively spent almost \$39.1 billion (including GST) on products including retail sales (\$12 billion), food and beverage services (\$4 billion), and accommodation services (\$3 billion) (Stats NZ, 2018d).

The influence that tourism has on commercial activity in a region can be positive for councils and residents. Businesses that generate revenue from tourism in turn contribute to local government revenues through business rates. Businesses catering to tourists also provide jobs, and local residents benefit from the expanded employment opportunities that tourism brings to a community (NZIER & McKinlay Douglas, 2001). In 2018, about 216 000 people around New Zealand were directly employed in tourism – including in the accommodation, food and beverage services, retail and transport industries (Stats NZ, 2018d). Tourism can also bring less tangible benefits to some communities, such as increased vibrancy and cultural vitality.

Tourists use a wide range of public and private infrastructure, amenities and services, including airports, roads, visitor accommodation, water and sewage systems, public toilets and car parks. Of relevance to this inquiry is tourists' use of the services and amenities funded by local authorities – such as local roads, three waters, waste management, car parks, street cleaning, parks and other amenities.

10.1 Costs on councils

Tourists' use of public amenities and services imposes additional costs on councils. And the highly seasonal nature of tourism in New Zealand can create a challenge in this respect. Most domestic and international tourists travel throughout New Zealand in January and February. As shown in Figure 10-1, almost twice as many commercial guest nights in New Zealand occur in January as in June (Stats NZ, 2019b).

These peaks are problematic because local infrastructure, amenities and services must be able to accommodate use (including by visitors) at peak times. The additional costs that tourists impose on councils may be significant if additional capacity is needed to accommodate visitors at peak times – even if high visitor numbers only last for a few weeks or months.

The scale of the costs that tourists impose on councils varies, because tourists are not evenly distributed. Some communities are tourism hotspots, while others receive relatively few visitors.

The ratio of visitors to total population (residents and visitors) can indicate the additional cost tourism may impose on a council. The visitor-to-population ratio varies hugely even among the tourism hotspots. In communities with a large local population compared to the number of visitors, the costs each additional tourist puts on local infrastructure, amenities and services are spread among more ratepayers than in communities with high visitor-to-resident ratios.

Yet it is worth noting that in some cases where the visitor-to-resident ratio is relatively low, the tourist peak period may still push infrastructure and services beyond the capacity needed only for residents.

⁶⁸These figures only include guest-nights spent in accommodation classed as commercial, and captured in the accommodation survey (hotels, motels, backpackers and holiday parks). The figures do not include visitors staying in paid accommodation that is not classed as commercial (such as homestays or Bed and Breakfasts, or Airbnb and Bookabach) or in unpaid accommodation (such as freedom camping or staying with family and friends).

Figure 10-1 Number of commercial guest nights in New Zealand, by month

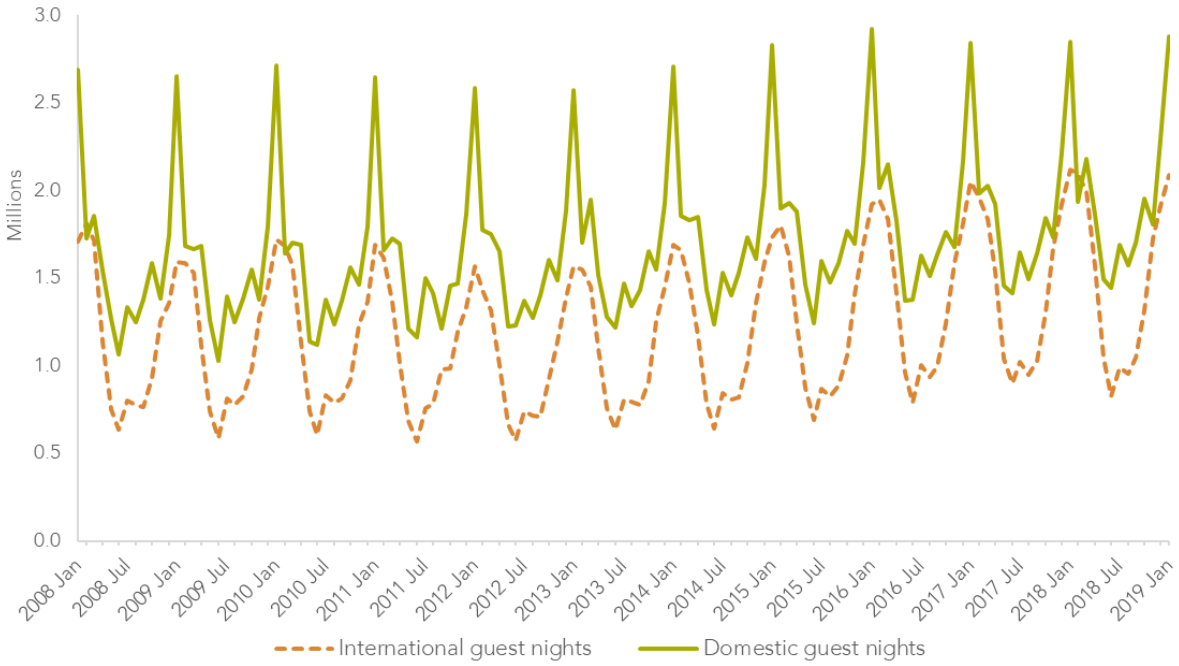


Figure 10-2 Proportion of people locally who are visitors, by month (visitor-population ratio), June 2017 to May 2019

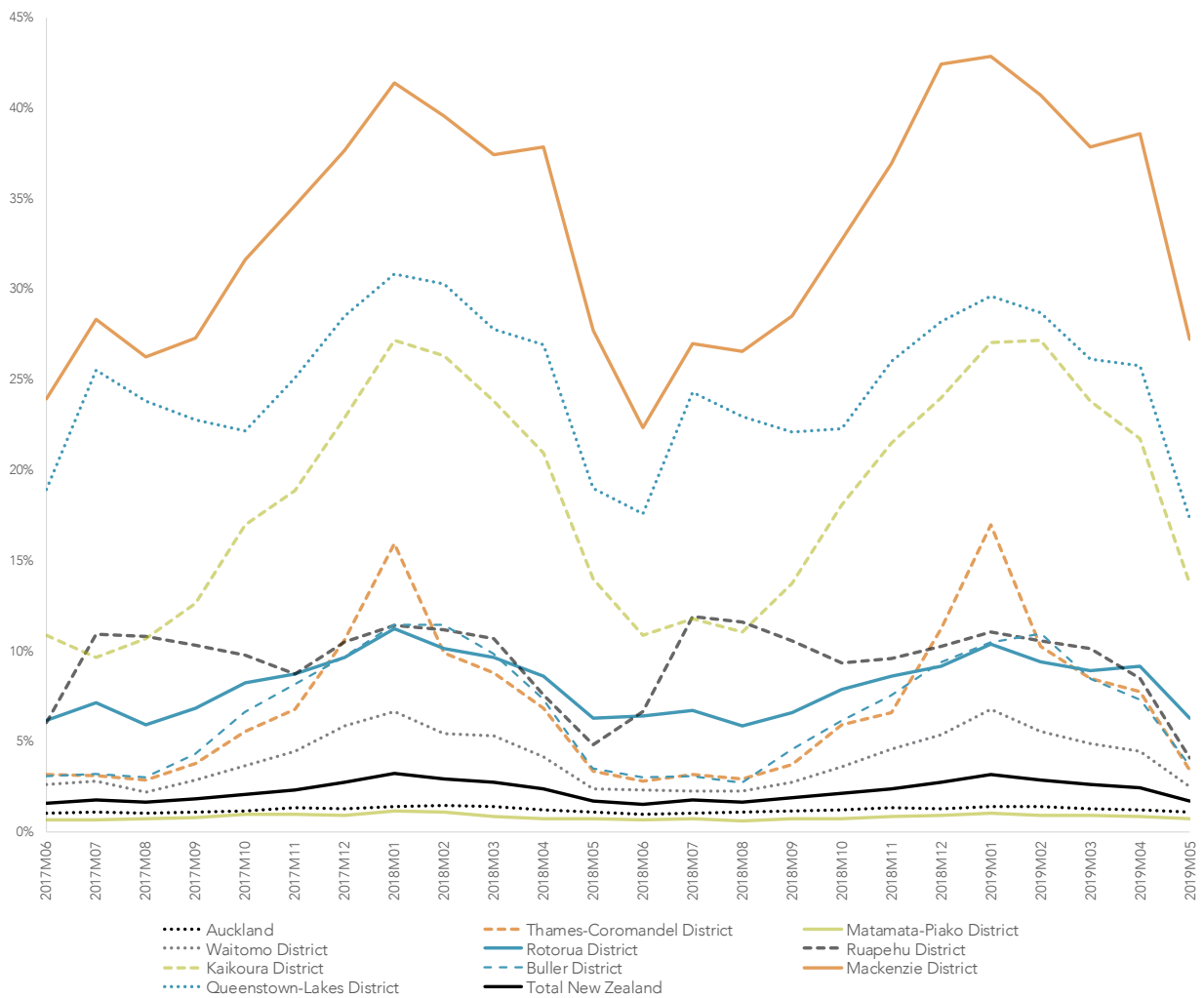


Figure 10-2 illustrates the wide variation in visitor-to-population ratios between selected tourism hotspots. Yet, it is difficult to get an accurate picture of the visitor-to-population ratio using only commercial accommodation data. These figures are likely to be a significant under-estimate for several reasons.

First, the monthly averages shown in Figure 10-2 will not reflect variation within the month, or within a district. The visitor-to-resident ratio may be higher on some days, or week, than others – the monthly average will not capture this. For example, in many tourism hotspots the visitor-to-resident ratio is likely to be significantly higher during the first few days of January (new-year period) than in late January. Likewise, the ratio may be higher in some communities within a district than in others. For example, Nelson Regional Development noted in their submission that communities within the Nelson Tasman region, including Golden Bay and Kaiteriteri, receive many more visitors over the summer peak than other parts of the region (sub. DR233, p. 3).

Second, the visitor-to-population ratios are likely to be an under-estimate because the Accommodation Survey captures only guest nights spent in commercial accommodation. A significant proportion of visitors use other forms of accommodation, including online platforms like Airbnb and Bookabach, as well as freedom camping and staying with friends and family.⁶⁹

StatsNZ recently estimated that accommodation-sharing platforms like Airbnb could have contributed around an additional 8.8 million guest nights in the year ended March 2018, potentially making up about 18% of total guest nights across the country (Stats NZ, 2019a). Some councils also have their own estimates. Mackenzie District Council, for example, estimates that online platforms and informal accommodation add between 20% and 30% to their official guest night figures (sub. 27), and Queenstown Lakes District Council estimate that, on a peak day, more visitors stay in informal accommodation than in commercial accommodation (sub. 67; pers. comm., 14 June 2019).⁷⁰

Third, the guest night figures do not capture visitors who may be visiting or passing through one district, but staying in another district. Mackenzie, Buller and Matamata-Piako are examples of districts where the number of visitors passing through to visit popular tourist sites (eg, Church of the Good Shepherd in Tekapo, the Punakaiki rocks on the West Coast, and the Hobbiton movie set in Matamata) is likely to far exceed the number of visitors staying one or more nights. Yet day visitors also put pressure on local infrastructure, including roads, car parks and public toilets.

Some councils emphasised the need for better data to address some of these shortcomings. Ruapehu District Council, for example, emphasised the need for central government to collect data that reflects all visitor numbers, including day visitors (sub. DR204, p. 2).

As well as wide variation in visitor-to-resident ratios among districts, there are also large differences between the tourism hotspots in terms of where tourists come from. In Queenstown Lakes District, for example, international tourists make up about 70% of guest nights. In contrast, international visitors in the Thames-Coromandel district make up only about 30% of guest nights.

Funding local government costs

Councils can raise revenue to pay for infrastructure and services they provide to tourists in several ways:

- **Rates:** both businesses and residents pay general rates to cover the costs of council-provided infrastructure and services. They may also pay targeted rates to cover the costs of specific infrastructure and services that benefit them – such as for roading and water.
- **User charges:** users pay user charges for some services (such as for swimming pools and car parks).
- **Funding from central government:** central government provides significant funding to councils to help pay for some local services, including for services specifically for tourists (eg, for public toilets, car parks, walkways and other amenities). This is discussed in more detail below.

⁶⁹ Based on the International Visitor Survey, in 2017 and 2018 (to the year ending June), just over 50% of international visitors reported staying mainly in commercial accommodation while in New Zealand.

⁷⁰ Based on a comparison of Accommodation Survey data and visitor data included in Queenstown Lakes District Council's submission (sub. 67, p. 4).

10.2 Nature of the problems, and their magnitude

Tourists already pay for most of the costs they create

As noted, tourists use a wide range of local public amenities and services when they travel – they drive on local roads, use the local wastewater systems, benefit from clean and safe drinking water, and enjoy local parks and other amenities.

Tourists pay indirectly for their use of some infrastructure and services through the price of the goods and services they purchase from businesses (which in turn pay business rates for the council services they use in meeting the needs of tourists). For example, tourists who stay in commercial accommodation pay indirectly for water and wastewater use through the price of their room.

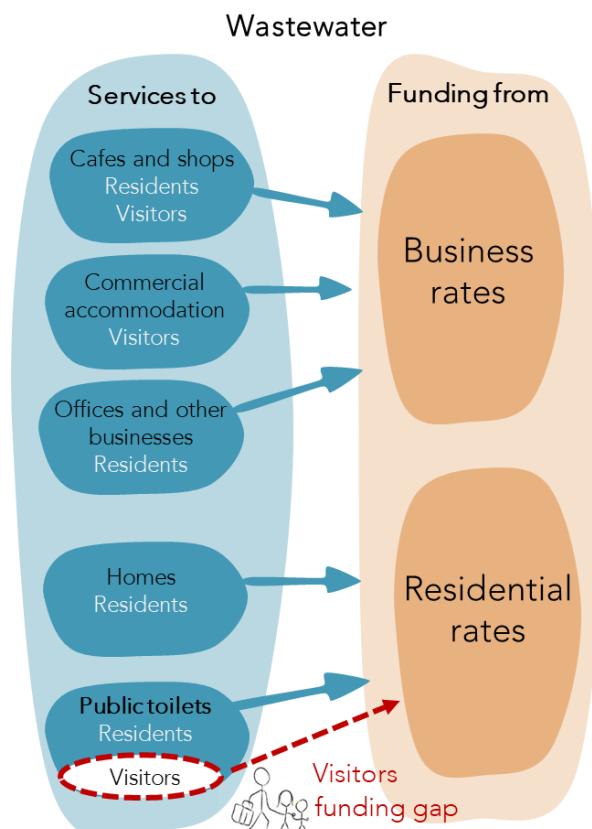
Tourists also pay for much of their road use through petrol excise and road-user charges (but not for the council share of local roads).

Many tourists (both domestic and international) do not stay in paid accommodation. In 2018 around 28% of international visitors reported staying with friends or family, or in a home they own, as their main form of accommodation while in New Zealand (MBIE, 2019b). A much higher proportion of domestic tourists stay with friends or family, or in a holiday home that they, or a friend or family member own.

Tourists who stay in private homes use services provided to these homes. These services are funded from residential rates. Therefore, occupants' use of these local infrastructure and services is already paid for. Indeed, many holiday homes are empty for much of the year, yet pay rates for the whole year.

The category where tourists do not fully pay for the costs they help to create are the local public-good type amenities and services they consume directly, and which are paid for through rates. This category can include things like public toilets, car parks, walkways, signage, CBD street cleaning and rubbish collection from public bins (whatever part of these services are not paid for through user charges). While tourists contribute indirectly to these public amenities and services when they buy from businesses that pay business rates, they do not pay any equivalent of the portion of **residential** rates that goes towards meeting these costs.

Figure 10-3 Illustration of tourism “funding shortfall” for local wastewater services



This is the funding shortfall that needs to be considered when thinking about whether new mechanisms may be needed to address the funding and financing pressure tourists put on local communities. Figure 10.3 shows the shortfall for wastewater. The highly seasonal nature of tourism can amplify costs by requiring additional peak capacity that is underused in off-peak times. Even when a user-pays system is in place, it may not be feasible to charge at the very high rate per tourist needed to fully cover the additional capacity costs (compared to if costs could be spread over a steady, all-year stream of tourists). Yet, it is a relatively narrow cost category, and a relatively small shortfall.

Deloitte recently examined the revenues and costs from international tourism for local authorities in three locations: Southland district, Nelson City and Auckland (Deloitte, 2018). In estimating the costs that councils incur from international tourists, Deloitte employed a “nights metric” for many “mixed-use infrastructure” cost categories: they estimated the number of international visitor nights as a proportion of total nights in the district, and attributed the costs accordingly. For example, based on this metric they estimated that in Auckland about 2.3% of water supply, wastewater and local park and recreation costs (operational and capital costs) are attributable to international tourists. The figure was 6.2% in Nelson, and 14.1% in Southland.⁷¹

Based on this rather blunt methodology, Deloitte estimated the total costs from international tourists in the three districts. Deloitte also estimated the total revenues the councils received from international tourists, including from general and targeted rates, from rates paid by accommodation providers, from capital grants, and from fees and charges. Deloitte estimated an excess of expenditure over revenue for all three councils ranging from 0.5% of council revenue for Nelson to 1.7% of revenue for Southland. (Table 10.1).

Table 10.1 Local government revenues and expenditures from international tourism, year ending June 2017

Revenue (\$m)	Revenue (\$m, average of high and low estimates)	Expenditure (\$m, average of high and low estimates)	Excess of expenditure over revenue (\$m)	Excess expenditure as a percentage of total council revenue
Southland District Council	\$14.8	\$16.2	\$1.4	1.7%
Nelson City Council	\$6.1	\$6.7	\$0.6	0.5%
Auckland Council	\$98	\$135	\$37	0.9%
TOTAL	\$108.9	\$157.9	\$49	

Source: Deloitte (2018)

Deloitte’s estimated costs are those associated with only international tourism. Given that international tourists make up slightly less than half the total tourist numbers across the country, crude estimates of the total shortfall for all tourists would double the percentages in the right-hand column of Table 10.1. The percentages of council revenue would be 1.8 % for Auckland, 1% for Nelson and 3.4% for Southland.

The Commission considers these estimates of the shortfall to be very much upper bounds, for several reasons.

- Some cost estimates appear very high. For example, based in part on sales figures for automotive products, Deloitte estimated that about 29% of road and footpath use in Southland is by international tourists. And in Auckland, Deloitte attributed 36.4% of waterfront development costs and 23% of “economic growth and visitor economy costs” to international tourists.
- The assumptions used by Deloitte for international tourism may not be appropriate for domestic tourists. In the Auckland example above, doubling the first percentage would attribute 73% of waterfront development costs to tourists (international and domestic). Such a high percentage is not credible in a

⁷¹ For other cost categories Deloitte made assumptions based on consultation or other data.

city where the visitor-to-resident ratio is only around 2%. The second percentage – for “economic growth and visitor economy costs” – is likely to be a lot lower for domestic tourists.

- Deloitte estimated higher visitor-to-resident ratios than the Commission believes are appropriate, because they omit residents who are normally resident but are outside the district on any given day.
- In estimating council revenue from international tourism, Deloitte includes a portion of rates paid by accommodation providers, but not from other businesses that sell to international tourists such as cafes, restaurants and retail.

Overall, based admittedly on very crude available data, the Commission considers that a realistic estimate of the size of the tourism funding shortfall for councils is no more than 2% of council revenue. For many councils, the funding gap will be considerably smaller.

F10.1

Tourists already pay for most of the costs they create. But they do not cover the costs incurred by councils for the local public amenities and services that tourists consume directly. While difficult to quantify, this funding shortfall is small in terms of total council revenue.

International tourists more than pay their way

International tourists spent about \$16 billion (Stats NZ, 2018d) at businesses around New Zealand in the year ended March 2018. \$1.7 billion of this expenditure accrued to the central government in the form of GST. The contribution to GST makes international tourism different to other export industries (Box 10.1).

This GST represents a large excess of revenue from international tourists above and beyond the costs they impose but do not already pay for, suggesting that international tourists more than pay their way. Yet, as noted in Box 10.1 and detailed elsewhere, the councils which incur the costs cannot access this tax revenue to cover their costs.

Box 10.1 International tourism and the Goods and Services Tax (GST)

Exports and GST

New Zealand’s international tourism is an export industry – it earns foreign exchange just like other exporters, such as the dairy sector or the wine industry (except for the dairy products and wine that people living in New Zealand consume). New Zealanders benefit because these industries are profitable, and the foreign currency that they generate finances the purchase of desired imports.

Yet, international tourism is unlike other export industries in two significant and related ways:

- The tourists generate foreign exchange through purchasing New Zealand products, but the consumption of those goods and services takes place largely in New Zealand.
- International tourists are charged the standard New Zealand GST rate of 15%, while other export industries are zero-rated for GST.

The rationale for zero-rating exports is that exports are only part way along the supply chain towards final consumption by New Zealand residents (this consumption is where the government finally gets to collect net positive GST, because it does not have to give the purchaser a GST input credit). When the foreign currency gets used to purchase imports, the supply chain resumes and the imports are subject to the full 15% GST.

Yet international tourism not only incurs 15% GST; the imports funded from its foreign-currency earnings also incur 15% GST. This charging of GST on both the export and import sides is not consistent with the principles of a pure GST.

Are there reasons to apply GST to international tourists?

A pure GST would zero rate purchases made by international tourists in New Zealand, just as it zero rates other exports. While the Inland Revenue website states that “Goods and services tax (GST) is a 15% tax added to the price of most goods and services in New Zealand, including most imported goods and some imported services” (Inland Revenue, 2019), a pure GST would make clear that its aim is to tax all final consumption in New Zealand *by New Zealand residents*.

The difficulties of zero rating the purchases of international tourists are obvious. This is the first reason for departing from a pure treatment. It is notable that many other countries (but not New Zealand) go part way to zero rating tourists’ GST by refunding it when they depart the country, for purchases that they take with them.

Apart from impracticality, another reason to impose some tax on international tourists is the already noted point that the tourists do not fully cover the costs they impose on councils through their use of mixed-use infrastructure. While this unpaid use is quite narrow, it is not insignificant in total. International tourists are also eligible for free access to some national services such as ACC, police, search and rescue and day use of national parks.

A third reason to justify GST on international tourism is that it may deliver a net benefit to New Zealand Inc. The benefit of additional tax revenue collected from foreigners may outweigh the efficiency costs caused by taxing this export industry. This is because:

- The efficiency cost directly relates to how price sensitive international tourists are to choosing to holiday in New Zealand: low sensitivity implies low efficiency cost (and an opportunity for New Zealand to collect additional revenue from international tourists).
- Evidence points to low price sensitivity for visitors from traditional markets, but higher for tourists from Asian countries (Schiff & Becken, 2011). Low price sensitivity is associated with New Zealand offering special attractions (eg, wilderness, family and friends). Higher price sensitivity is associated with New Zealand being just one of several holiday or sight-seeing destinations that tourists can choose.
- The limited available evidence (Schiff & Becken, 2011) suggests that, overall, international tourists are relatively price-insensitive with respect to New Zealand. In turn, this indicates that most GST is passed through to international tourists in higher prices and few of them are deterred from coming.

It can even be argued that the 15% GST on international tourist is too low from a strictly New Zealand Inc perspective (CSA, 2019). If so, additional taxes on international tourists such as the new International Visitor Levy or an accommodation levy could provide net benefits to New Zealand.

GST revenue from international tourists and international tourism costs

New Zealand collected an estimated \$1.7 billion in GST from international tourists in the year ending March 2018. This greatly outweighs estimates of costs that these tourists impose on councils and national services that they do not otherwise pay for. Yet an imbalance exists: central government gets the GST whereas councils may face a deficit because their costs from international tourism may exceed their revenues from them.

A key issue for many councils under pressure from tourism, therefore, is the tension between who pays for local public amenities and services to accommodate tourism growth and peaks, and who collects the revenue. Many councils have raised what they perceive as a disconnect between council costs from tourism and central government benefit from tourism (eg, Mackenzie District Council, sub. 27; Kaikōura District Council, sub. 101; Wellington City Council, sub. 61; and Northland Regional Council, sub. 32).

The GST received from international tourists is a welcome addition to government revenue, but central government gets the GST while councils may face a gap in funding tourism costs. Even so, councils may

apply for a variety of central-government grant and funding schemes for tourism-related funding. These are described in the following section.

This GST “overpayment” applies only to international tourism. GST on domestic tourist spending is standard treatment, with no suggestion of double taxation. As such, no case exists to link this GST revenue to the costs of domestic tourism that fall on councils.

F10.2

International tourists pay a large amount of GST to central government relative to the normal benchmark of a zero rate of GST on exports. Some of this GST can be regarded as payment for the costs the tourists do not otherwise pay for. Yet overall, international tourists more than pay their way.

The excess revenue from GST on international tourists could still provide a net benefit to New Zealand even though the GST will cause some efficiency loss. Evidence suggests that many international tourists are relatively insensitive to modest changes in the cost of visiting New Zealand. To the extent they are, the tourists will bear most of the burden of the GST, efficiency losses will be small, and New Zealand Inc will benefit from the additional revenue.

Central government funding for local public services and amenities

Central government provides significant funding to councils for local public amenities and services needed to support tourism. Between mid-2017 and August 2019 significant amounts were distributed through three contestable funds – the Provincial Growth Fund, the Tourism Infrastructure Fund, and the Responsible Camping Initiative (Box 10.2).

Most councils receive central government funding through at least one of these funds – only 15% of the 78 regional, district, city or unitary councils have received no funding through them. Yet the total amount provided to individual councils varies greatly, as can be seen in Figure 10-4.

Box 10.2 Central government funding to support tourism and mixed-use infrastructure between mid-2017 and August 2019

Provincial Growth Fund (PGF)

The PGF is a \$3 billion fund, providing \$1 billion a year over three years to projects that will “lift the productivity potential of the regions”. It funds a combination of “bottom-up” initiatives prioritised by the regions, and “top-down” initiatives prioritised by the Government to address social and infrastructure deficits at a regional level. As of August 2019, the PGF had announced funding for 40 regional and district councils. Most of this has been provided as grants, with \$29.1 million in loans.

Tourism Infrastructure Fund (TIF)

Launched in May 2017, the TIF is a \$100 million contestable fund that provides up to \$25 million a year for tourism-related infrastructure. The funds dispersed through the TIF come from the PGF. Three rounds of funding through the TIF have been completed to date, and round four is currently under way. The three rounds of funding through the TIF to date have allocated \$42.5 million to 49 district and city councils, for 115 different projects. To date, funding has focused on capital expenditure.

Responsible Camping Initiative (RCI)

The RCI was established in August 2018, following recommendations from the Responsible Camping Working Group. Over the two rounds of funding to date, a total of \$14.7 million has been spent on such amenities as toilets, wash facilities, waste disposal facilities, as well as signage, education, monitoring and enforcement.

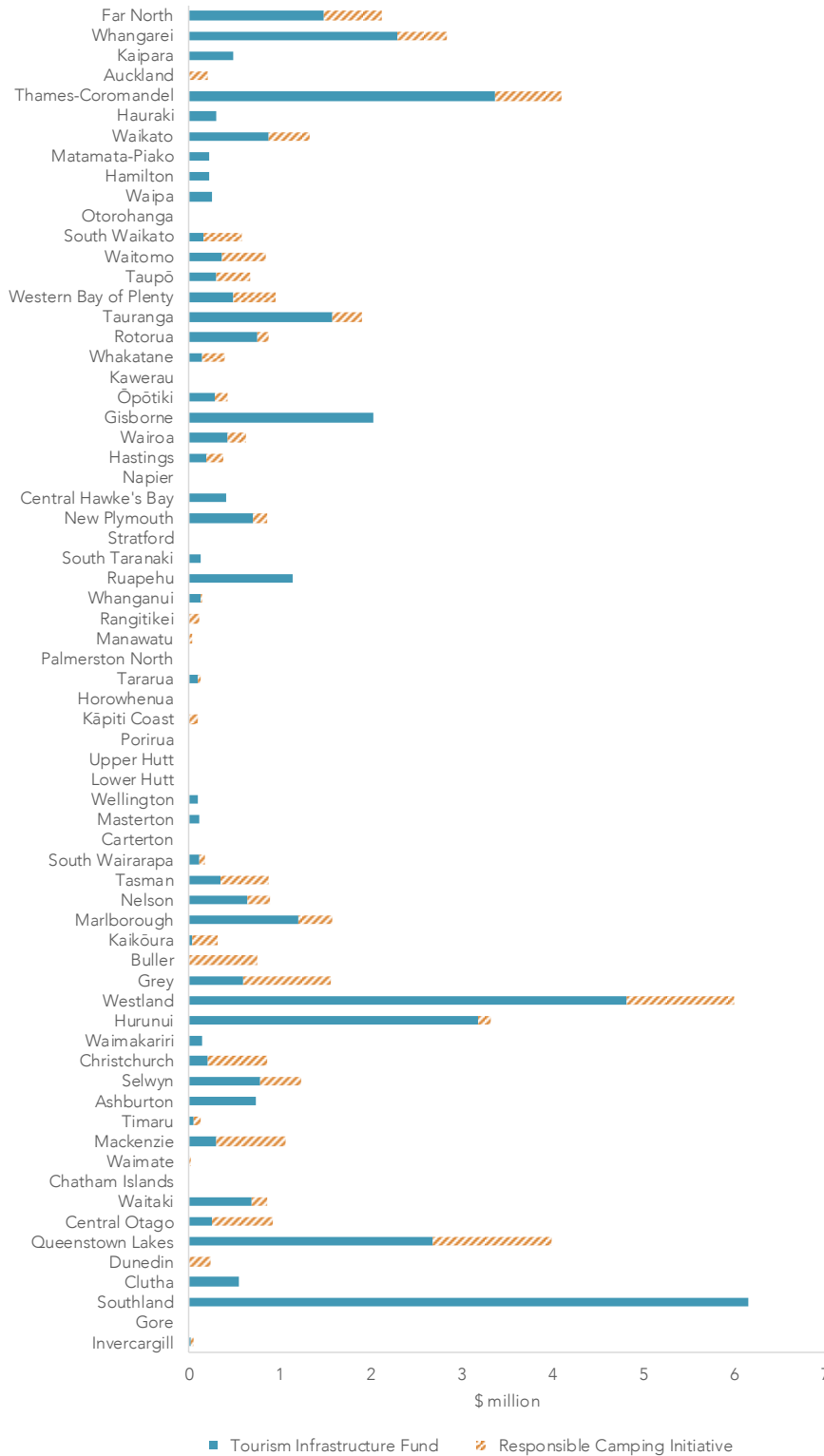
Source: Ministry of Business, Innovation and Employment.

Yet, while most councils have benefited from these existing central government funds, many submitters voiced concern about lack of certainty around tourism funding, highlighting that “such ‘discretionary’ funding cannot be relied upon for future investment by local government on an ongoing basis” (Northland Regional Council, sub. 32, p. 3). Smaller councils also emphasised the challenges they face in accessing these funds. Kaikōura, for example, stressed that “without dedicated resources of larger councils it is difficult to effectively compete with larger councils for contestable funds” (Kaikōura District Council, sub. 101, p. 3).

Many councils also noted that even when assistance is provided towards the upfront capital costs of tourism infrastructure, ongoing operational and maintenance costs are considerable and remain largely funded by local ratepayers. Hauraki District Council noted that they spend \$700 000 each year operating public toilets and reserves for travellers, and \$620 000 each year on their cycleway, which is used mainly by visitors (sub. 43, p. 7). Mackenzie District Council (which has about 4 600 residents) also noted this challenge.

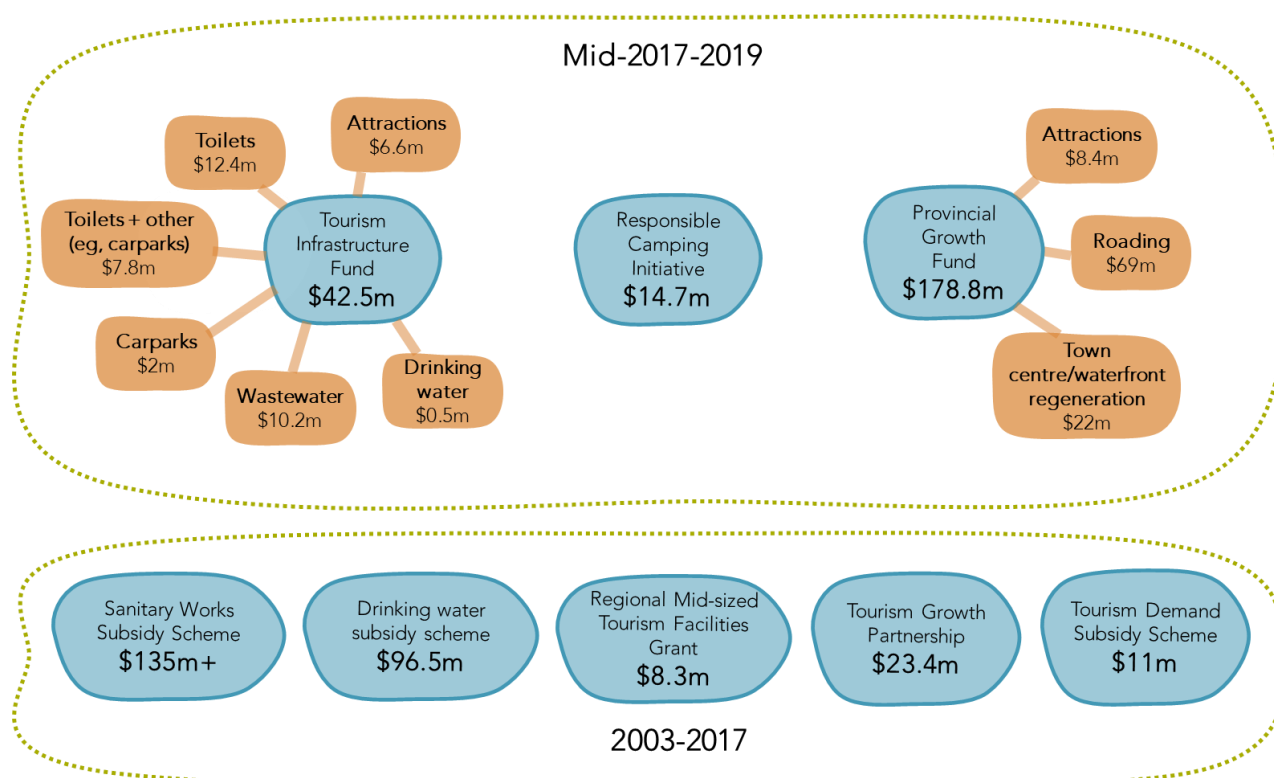
Our Council has incurred increased costs in capital expenditure such as public toilets (the district has gone from having 6 public toilets in 2015 to now having 15 as at January 2019), and increases in operational expenditure such as cleaning and maintenance, increased rubbish volumes, and additional enforcement of bylaws and regulations...The Council will also face increased expenditure on infrastructure renewals as usage increases and capacity is more quickly taken up ...While some capex may be co-funded (for example through the Tourism Infrastructure Fund or the NZTA subsidy), there is still a ratepayer contribution for those capital works, as well as ongoing operational costs that must be fully funded by the ratepayer. (sub. 27, p. 4)

Figure 10-4 Central government funding provided to councils for tourism infrastructure between May 2017 and August 2019 (excluding the Provincial Growth Fund)



Source: MBIE (2019c).

These three current funds are just the most recent in a variety of central government support for local tourism and mixed-use infrastructure. In previous years, other funds have played a similar role. For example, the Tourism Growth Partnership provided \$23.4 million in funding to 40 industry-led tourism projects, the Tourism Demand Subsidy Scheme spent \$11 million to help small communities under pressure for tourism, and the Regional Mid-sized Tourism Facilities Grant provided \$8.3 million to 42 projects to support infrastructure under pressure from tourism. In addition, the Sanitary Works Subsidy Scheme provided up to \$15 million each year for 10 years to support water infrastructure in small communities.

Figure 10-5 Central government funding to councils for tourism and mixed-use infrastructure

Source: MBIE (2019c).

Beyond the funding provided directly to councils, central government also provides funding to support the tourism sector more broadly.

The new International Visitor Levy (IVL) came into force in July 2019, and provides additional funding for tourism related projects. The levy is expected to raise around \$80 million a year, and revenue from the levy will be split 50–50 between conservation and tourism activities. The first projects to be funded by the IVL were announced in August 2019, and include \$5.2 million to promote tourism as a career, \$3.9 million for destination management in Westland, and \$3 million to improve management and protection of Milford Sound.

Central government also allocates funding to Tourism New Zealand for marketing the country internationally as a tourist destination. In 2018 it received \$121 million in central government funding for international destination marketing. Funding is also provided to the Ministry of Business, Innovation and Employment (MBIE) to collect, analyse and disseminate tourism data to support tourism businesses and market development, which received \$4.8 million in 2017/18 for tourism data and analysis.

The central government also provides significant funding for local roading infrastructure. The government funds 100% of State Highway construction and maintenance. It also provides support for the construction, maintenance and upgrading of local roads and roading infrastructure through the National Land Transport Fund (NLTF), which is distributed by the New Zealand Transport Agency (NZTA). In NZTA's 2018–21 National Land Transport Programme, \$1.2 billion has been committed to improving and establishing local roads, and \$3.5 billion committed to supporting the maintenance and renewal of local roads over three years (NZTA, 2018a).

Section 2.7 describes the process that councils follow to engage with NZTA and receive funding for local roading infrastructure from the NLTF. Across councils, the NLTF funds an average of 53% of local transport programmes with a minimum assistance rate of 51% and a maximum assistance rate of 75%. Local

government pays the remaining share through rates, and may include some roads only needed to cater for peak tourist loads.⁷²

F10.3

Central government provides significant funding support for local infrastructure, including local mixed-use infrastructure that tourism puts pressure on.

GST revenues from international tourists greatly exceed the costs of the national services that tourists are free to access. Yet at a local level, some councils face costs of international tourism that exceed the revenues they receive from such tourism. This imbalance is mitigated by councils' ability to apply for and receive funds for tourism costs from central government.

Box 10.3 Department of Conservation funding

The Department of Conservation (DoC) is also a major tourism provider in New Zealand. Many international tourists are drawn to New Zealand because of its natural landscapes, and DoC is responsible for protecting and managing about 8.5 million hectares of land around the country.⁷³ It is often this "DoC estate" that draws visitors to particular districts. For example, the Tongariro National Park draws many visitors to the Ruapehu district, and visitors often pass through Mackenzie District on their way to or from Aoraki Mount Cook.

DoC undertakes a range of activities to support the "management of recreational opportunities" on this land, including providing and maintaining walking tracks, huts, campsites and visitor information. DoC has also received additional central government funding for some tourism-related projects, including funding through the PGF to upgrade car parks and other visitor facilities at Punakaiki, and from the IVL for managing visitors within Tongariro National Park.

Businesses operating on conservation land are required to hold a "concession", and to pay fees to DoC. Concession fees may take the form of a set annual fee or a percentage of revenue, depending on the type of activity and its expected impact. In addition to meeting requirements with respect to environmental impacts, concession holders may also be required to undertake certain actions as part of their concession agreement, such as providing car parking facilities or public toilets. Concession fees are generally passed on to visitors in the price of the goods and services sold by concession holders (eg, a ski lift pass, or guided tour).

DoC is also directly responsible for some infrastructure and services for several small communities inside the DoC estate. The Whakapapa and Iwikau communities are situated within Tongariro National Park, and DoC is responsible for providing services that would normally be the responsibility of local government – including three waters infrastructure and rubbish collection. DoC recovers its costs through a levy on residents, businesses and owners of accommodation in the village. Residents and businesses in the villages also pay rates to Ruapehu District Council, which goes towards the costs of services outside the boundaries of the national park – such as roading infrastructure.

The Commission received several submissions from parties who operate within Whakapapa and Iwikau villages. Submitters stressed that the small base of residents and businesses struggles to meet the rising costs of maintaining and upgrading that infrastructure, which is under pressure from large volumes of day visitors. Ruapehu Mountain Club, for example, notes that

[i]nfrastructure maintenance and upgrade costs for Iwikau and Whakapapa Villages are forecast to increase over 800% within a decade, compared to 2018 costs. The levy-paying base is not increasing and is not able to increase. Over the past decade there has been an increasing number

⁷² These rates include rates paid for holiday homes. In many parts of the country holiday homes sit empty for much of the year, yet they contribute rates all year round. For this reason, owners or friends and family staying in those homes do not create additional pressure on local infrastructure – the pressure those occupants create is already paid for.

⁷³ As of July 2009, DoC legally protected approximately 8,458,400 hectares of New Zealand's land. (MfE, 2010a)

of tourists (local & overseas) visiting both Whakapapa and Iwikau Villages. Most visitors utilise the services that the Iwikau and Whakapapa community fund through the DoC levy and Ruapehu District Council rates. Without a doubt, these visitors put pressure on the local infrastructure. Most of the visitors, however, do not stay at Iwikau or Whakapapa. (sub. DR164, p. 2)

Several submitters noted that they struggle to pass on the costs of DoC levies to their members, because they operate principally as a charitable or voluntary organisation with a focus on facilitating affordable access to the mountain (see, for example, Tokoroa Alpine Club, sub. DR267; Central Plateau School Alpine Charitable Trust, sub. DR160). Many submitters also noted their limited ability to challenge decisions made by DoC with respect to local infrastructure, given that they are not a democratically elected local body (see, for example, University of Auckland Snowsports Club, sub. DR171; Tahurangi Ski Club, sub. DR239).

Visitors to Ruapehu indirectly pay some infrastructure costs each time they purchase goods and services (eg, a ski pass) from Ruapehu Alpine Lifts (RAL) – the company that runs the ski fields, and pays concession fees to DoC. Yet it is unclear whether funds received from this concession fairly reflect the infrastructure costs that visitors impose, or whether DoC uses the funds to help cover the costs of infrastructure within Whakapapa and Iwikau villages. To the extent that day visitors put pressure on mixed-use infrastructure within Whakapapa and Iwikau villages, user charging would be a better means of ensuring that visitors contribute their fair share to the costs of constructing, maintaining and renewing such infrastructure.

As noted in Box 10.3, DoC is directly responsible for some infrastructure, for several small communities inside the DoC estate. It recovers the costs of providing infrastructure to the communities of Whakapapa and Iwikau through a levy on residents, businesses and owners of accommodation in those villages. Yet, to the extent that day visitors put pressure on mixed use infrastructure within those communities, user charging would be a fairer means of ensuring visitors contribute to the costs of such infrastructure.

R10.1

The Department of Conservation should ensure that visitors contribute towards the costs of construction, maintenance and renewal of the mixed-used infrastructure and services it is responsible for providing. This could be done, for example, through user charges that apply, where practical, to both overnight and day visitors.

Historic approaches to funding and financing in tourism hotspots

Tourism hotspots vary widely in their circumstances, the type of pressures they are facing from tourism, how they have been dealing with these issues in the past, and their plans for the future.

Table 10.2 summarises the characteristics of a selection of major tourism hotspots. They include a mixture of static/declining and high-growth areas. Some hotspots are very small rural districts; others are larger provincial areas or cities. The Commission reviewed the Long-Term Plans (LTPs) and other key documents for each of these councils.

Tourism hotspots around the country have historically had very different approaches to financial management and infrastructure investment, and responding to tourism pressures. Some councils in tourism hotspots have focused on addressing past underinvestment in essential infrastructure, with consequent increases in debt levels and rates. Other councils have focused on keeping debt and rates growth low, and are now experiencing the legacy of deferred investment. Several councils make extensive use of targeted rates, including to fund destination marketing.

Councils are also planning to manage their future tourism pressures in different ways. Several councils have significant capital works planned, with accompanying growth in debt and implications for rates. Some are reviewing their current approach to rating and funding, to identify greater opportunities for applying the benefit principle (including to short-term accommodation providers) and user pays (for facilities and services such as public toilets, water use and parking).

Thames-Coromandel District Council is one of the councils focused on addressing past underinvestment in its asset management and renewals. However, rather than investing in new or additional infrastructure to cater to its peak summer load, it intends to use demand management and innovation to manage peak demand, so as not to be left with redundant capacity during non-peak periods.

F10.4

Councils in tourism hotspots have taken very different approaches to financial management and infrastructure investment, and to responding to tourism pressures. Some councils have focused on addressing past underinvestment in essential infrastructure, with consequent increases in debt levels and rates. Some other councils are now struggling to deal with pressure from tourism, at least in part due to a legacy of deferred investment.

Table 10.2 A snapshot of some major tourist destinations

Buller District		Mackenzie District	
Gateway to two national parks, and home to the Pancake Rocks at Punakaiki which receives 500 000 visitors a year, mostly day visitors. Pressures at Punakaiki include car parking and toilets (DoC land), traffic congestion and safety (NZTA) and drinking water quality (Council).		Has summer and winter peaks for attractions ranging from skifields to astro-tourism. Third smallest territorial authority, but with the highest proportion of overnight visitors to residents of all councils. Pressures span the Council's functions, including toilets, car parking, walkways, rubbish, and regulatory, planning and monitoring.	
Peak proportion of overnight visitors	10.4%	Peak proportion of overnight visitors	42.9%
Average per person rates growth 1996-2017	3.5%	Average per person rates growth 1996-2017	3.3%
Matamata-Piako District		Queenstown Lakes District	
Hobbiton receives 600 000 visitors a year, including 17% of all international tourists. A recent Private Plan Change deals with the effects of this tourism on traffic and amenities. Costs of upgrades to local roads are shared between the Council and Rings Scenic Tours. Other pressures include toilets and car parking in Matamata.		Very strong tourism and population growth in recent years. Pressures include traffic congestion (including from residential commuters). Planned infrastructure projects include new water supply schemes, car parking improvements, improvements to the amenity of Queenstown's town centre and development of the Wanaka lakefront.	
Peak proportion of overnight visitors	1.0%	Peak proportion of overnight visitors	29.6%
Average per person rates growth 1996-2017	3.2%	Average per person rates growth 1996-2017	1.1%
Rotorua Lakes District		Ruapehu District	
A longstanding tourist destination, with drawcards including geothermal features, Māori culture, lakes and rivers. Te Puia centre receives 550 000 visitors a year. Council considers its infrastructure can accommodate continued tourism and residential growth in the short term.		Home to two national parks, with attractions including snow sports, walks (including the Tongariro Alpine Crossing) and the National Army Museum at Waiouru. Summer peaks are placing pressure on rubbish, walkways, water services and car parking. The proportion of holiday homes is growing.	
Peak proportion of overnight visitors	10.4%	Peak proportion of overnight visitors	11.1%
Average per person rates growth 1996-2017	1.5%	Average per person rates growth 1996-2017	4.1%
Thames-Coromandel District		Waitomo District	
High and growing proportion of holiday homes. Summer peak is a combination of non-resident ratepayers and visitors, many domestic. Pressures include toilets, car parking and waste management.		The Waitomo Caves receive more than 500 000 visitors a year. The caves complex is in private ownership, as is the wastewater and water supply infrastructure for Waitomo Village. The Council is considering upgrades to public facilities in the village.	
Peak proportion of overnight visitors	17.0%	Peak proportion of overnight visitors	6.8%
Average per person rates growth 1996-2017	2.8%	Average per person rates growth 1996-2017	5.0%

10.3 Dealing with the shortfall

Better use of existing tools

As noted in section 10.2, tourists already pay for most of the costs they create. The modest funding shortfall from tourism is only for local public good-type amenities and services that tourists consume directly, but which are paid for through rates (such as public toilets, car parks and reserves). To cover this shortfall, local governments have several options to make better use of existing funding and financing tools.

More user charging

Many councils impose user charges on facilities such as car parks, and to a lesser extent, public toilets (such as in Tekapo and Taupō). Visitors can also be charged for access to local amenities like museums and other local attractions.

Some councils in tourism hotspots are exploring greater use of fees and charges to help fund at least the maintenance of infrastructure. Mackenzie District, for example, is reviewing its current approach to rating and funding, to identify greater opportunities for applying user pays (to facilities and services such as public toilets, water use and parking) (Mackenzie District Council, 2018, pp. 3, 88).

Some councils have raised concerns about user charging incentivising unwanted behaviours, such as “using the bushes” instead of using the toilet. One option for some locations could be to impose car parking fees that include funding for nearby toilets (on the assumption that many visitors will use both). Another option, employed by Mackenzie District Council, is to have a mix of pay-per-use and free toilets (Tatham, 2017).

Greater use of debt

The political economy around the use of debt is a barrier to necessary infrastructure investment, and has contributed to a backlog of deferrals in some councils. This is partly related to a lack of understanding on the part of both elected members and their ratepayers about the role of debt (section 5.3). There is also political reluctance to increase rates (to fund debt servicing, as well as to cover the depreciation and operating costs of new infrastructure capacity). The implication of keeping rates growth low historically is the deferral of important investments – with negative consequences for later.

In its submission to the Issues Paper, Ruapehu District Council noted that “[p]erception to public debt remains sensitive for Elected Members, Council and the community alike” (sub. 85, p. 12). Chapters 5 and 7 recognise the strong role of politics in rate-setting. Chapter 5 also includes recommendations for improving the financial literacy of elected members (including improving their understanding of public debt), as well as for improving communication and engagement with communities to explain the costs and benefits of investment choices.

Raise more in rates

Almost all tourists stay in property of some description – be it in commercial accommodation, or in the homes of family and friends. Even the biggest tourist hotspots have enough property to accommodate their total population of residents plus tourists (barring day visitors), though properties will be more full at peak times.

Given that rating is a property-based tax, the property base should be large enough to raise enough revenue to pay for the infrastructure and services needed by the total population – residents and tourists. Property will be full and possibly under strain during peak times, and underused during off seasons. On average, there will be enough rateable property to provide enough rates revenue to service the total population.

Businesses and commercial property owners benefit from operating in tourist hotspots. Raising rates on them is a fair and effective way to raise revenue, with some of the burden passed onto tourists. The same attributes that attract tourists to a location also attract residents. While many tourists stay in commercial accommodation, many also stay with friends and family. So, it’s appropriate that both businesses and residents contribute to the public good component of the services tourists use.

Several councils have tourism-related targeted rates on commercial accommodation providers – including Queenstown Lakes District, and Tauranga City councils. However, councils' use of targeted rates to fund tourism costs has been limited largely to funding destination marketing and tourism promotion, with few examples of such a rate being used to fund destination management. For communities under pressure from "over tourism", councils can use targeted rates to fund destination management and tourism infrastructure.⁷⁴

Tauranga City Council, for example, provides \$991 000 of funding a year to Tourism Bay of Plenty, through an economic development targeted rate on commercial ratepayers. The council recently approved \$621 000 of additional funding for Tourism Bay of Plenty, specifically for destination management. This may come from the economic development targeted rate, starting in 2020 (Tauranga City Council, 2017, p. 13).

Yet there is also scope to use targeted rates to fund local public amenities and services. Analysis received from Capital Strategic Advisors (CSA) looked at ways targeted rates might be applied to ratepayers to recover funds from tourists (CSA, 2019b). One option examined in this paper is a broad-based targeted rate levied on land values, and applied to all ratepayers in the business district of the tourism hotspot – which would require no legislative change to implement.

A broad-based targeted rate on ratepayers in the business districts of tourism hotspots could be levied on land-value and applied at a single rate in each such district. It could be set at a level that would raise revenue to match the shortfall in funding by tourists. As a tool for recovering the costs that tourists create but do not already pay for, this option measures up well against the principles of a good local government funding system described in Chapter 6 – appropriate for local government use, coherent within national policies and institutions, efficient, fair and sustainable. It could be implemented within current legal frameworks. Existing property valuation system and valuations would be used to determine the rate.

In terms of efficiency, a broad-based rate levied on land value would likely not be passed-through to tourists themselves, and would impact mainly on land-values. This means such a rate would be likely have a minimal adverse impact on economic efficiency. It would also score well on funding adequacy, as the rate would be set to match the scale of the funding shortfall.

Rates on peer-to-peer accommodation

More councils should explore the option to require peer-to-peer accommodation providers to pay business rates, or some proportion of them. Both Auckland and Queenstown take this approach. Queenstown requires standalone homes rented out short-term through platforms like Airbnb and Bookabach to register with the council, and some properties may require resource consent. Commercial rates are levied on a sliding scale depending on the number of nights the home is rented out each year. Auckland requires all standalone properties rented out online for more than 28 days each year to complete a declaration, and applies a similar sliding-scale model.

Yet avoidance is common, and enforcement can be very challenging due to the difficulty in identifying properties being rented out online. Many peer-to-peer platforms themselves appear not to be forthcoming in assisting councils in identifying homes that may be liable to pay commercial rates, resulting in difficulty in ensuring compliance at a local level. Tasman District Council noted in their submission that they had dispensed with their policy to target all accommodation providers in part due to the difficulties involved in identifying providers (sub. DR136, p. 9).

Homes rented out for a significant proportion of the time are acting as businesses, and it is therefore appropriate that they also pay business rates, or a proportion thereof. Bookabach, a major platform for short-term rental accommodation, noted in their submission that

(short term rental accommodation – STRA) is a commercial activity – distinct from providing permanent rental housing. We are committed to proper and appropriate regulation of the STRA industry and we are in favour of the STRA paying its fair share. (sub. 99, p. 5)

⁷⁴ Destination management involves trying to influence where and when tourists travel, with a focus on dispersing visitor flows more evenly throughout the year, and throughout a district (eg, organising and promoting events during shoulder seasons).

Given the challenge in enforcing compliance at a local level, a centralised system is likely required to ensure such accommodation does contribute as appropriate. Several submitters supported this idea (see for example Buller District Council, sub. DR149, p. 3; Hospitality New Zealand, sub DR188, p. 6). A national register of short-term accommodation providers would help to ensure that councils are able to identify properties operating as accommodation businesses within their district.

F10.5

Standalone homes rented out through peer-to-peer platforms for a significant proportion of the time are acting as accommodation businesses. It is therefore appropriate that they pay business rates, or a proportion thereof.

R10.2

Central government should explore ways to assist councils to identify properties operating as short-term rental accommodation businesses within their districts. Options to explore include requiring booking platforms to provide information to a national register of short-term rental accommodation providers.

Innovative ways of managing and responding to peak demand

Demand management techniques include water metering, volumetric pricing, community education on water efficiency measures, and audits and assessments of non-residential users. Demand response approaches include extending maintenance services/hours during peak times, bringing in portable toilets, and technologies such as self-cleaning (“auto-wash”) toilets, rubbish bins with sensors (that signal when they need emptying) and smart technology for parking enforcement.

Some councils are already using a range of techniques to manage and respond to demand, including peaks. For example, rather than investing in new or additional infrastructure to cater to its peak summer load, Thames-Coromandel District Council is using demand management and innovation to manage peak demand, so as not to be left with redundant capacity during non-peak periods. During peak times, the council opens its transfer stations for longer hours, it collects rubbish more frequently and cleans its community facilities more frequently. The council is also investigating options such as the use of portable toilets during peak periods, rather than building additional public toilets (Thames-Coromandel District Council, 2018, pp. 40, 34, 41).

F10.6

There is scope for many councils to make better use of existing tools for funding and financing mixed-use infrastructure. This includes better use of debt to finance the upfront capital investment in infrastructure, greater use of user charges to help fund the ongoing operational costs, and more effective use of efficient targeted rates. In addition, there is a wide range of strategies and tools that councils can use to manage and respond to peak demand.

R10.3

Councils should make better use of existing tools for funding and financing mixed-use infrastructure, including better use of debt and greater use of user charges.

Councils should also make better use of efficient targeted rates, and communities under significant pressure from tourism should introduce a broad-based targeted rate on ratepayers in business districts benefiting from tourism, levied on land value.

More efficient use of central government funds

In addition to councils making better use of existing funding and financing tools, significant scope exists to improve central government funding flows to councils for public amenities and services.

As mentioned above, international tourism is different from other export industries because it is subject to GST while exports shipped offshore are zero-rated for GST. Box 10.1 explores the implications of this different treatment. Yet, as described in section 10.2, central government already provides significant funding to local government for tourism and mixed-use infrastructure. In 2018, for example, the government provided more than \$100 million in funding to councils through the TIF, PGF and RCI.

Councils clearly expressed in submissions and during engagement meetings that the support they have received from these funds has been very welcome. Even so, as the examples below show, there are currently problems with the way these funds are targeted and distributed.

- Each of these three funds (TIF, PGF and RCI) are time limited. They are also just the latest in a long line of central government funds supporting tourism and mixed-use infrastructure. The short-term nature, and changing focus of these various funds means that there has been no long-term certainty about the scale and nature of central government support.
- To date, the TIF (and most local government investment through the PGF and the RCI) has provided funding principally for capital costs, not ongoing operational costs.
- To date, much central government funding for tourism infrastructure (including the TIF and RCI) has been through contestable funds. Contestable funds do not offer certainty for ongoing or future support, and require considerable time and skill to make a successful application to access the funds. The result is that smaller councils (or those with less capability and capacity) can find it harder to compete against larger councils.

This means that councils in tourism hotspots have very little certainty as to if, when and how much central government support they might receive. Some funds (such as the RCI) have been announced with very little notice and, while welcomed by councils receiving the funds, are reflective of a broader ad-hoc approach to funding provision. Within this context, councils, particularly those under pressure from tourism, are unable to plan and prepare effectively. This message was emphasised in a number of submissions.

Current models of contestable funding (i.e. Tourism Infrastructure Fund) offer time-consuming and insecure income streams, which curtail the ability to plan and invest strategically, effectively and efficiently. (Queenstown Lakes District Council, sub. DR196, pp. 4-5)

The Tourism Infrastructure Fund has provided some much-needed relief for some councils in upgrading and installing new infrastructure. However, this only covers capital costs and councils are still left grappling with how to pay operating and maintenance costs for this essential infrastructure...Similarly, the funding available for Responsible Camping initiatives has allowed many councils to investigate new initiatives to improve the visitor experience for, and reduce the harm caused by some freedom campers. However, like the Tourism Infrastructure Fund, this assistance from central government is irregular and uncertain. (Timaru District Council, sub. DR242, p. 5)

The Tourism Infrastructure Fund and similar government subsidies, while welcome, are not a sustainable source of funding and do not assist with ongoing costs following the initial capex subsidy. There must be a sustainable source of funding for Councils which adequately recognises and addresses these costs. (Mackenzie District Council, sub. 27, p. 8)

Difficulties and opportunities exist with contestable funds such as the Tourism Infrastructure Fund. We need greater certainty as to the long-term availability of these funds so they can be factored into our planning. (Whangarei District Council, sub. 46, p. 1)

LGNZ's submission makes reference to the Tourism Infrastructure Fund. Our view is that these types of funds, while helpful, may not be the most effective way in which to distribute financial support. This is due to the strict qualifying criteria and rules of the funds, or in some cases, limited application...A more effective method might be to simply distribute financial assistance and then allow the recipient councils to decide how ... best to apply the funds within their regions. (Nelson City Council, sub. 107, p. 1)

While these schemes are welcome...they are relatively small, short term and interventionist solutions. If the tourism market is to achieve its potential, more sustainable forms of funding that allow local communities to share in the financial benefits need to be established. (Regional Tourism New Zealand, sub. 58, p. 3)

An effective and sustainable approach would be to provide a stable, predictable and ongoing funding source, which would allow councils to plan strategically for necessary investments, including maintenance and renewals of existing amenities, and operational costs. As Whangarei District Council notes in its submission, “Stable long term policy and funding is a crucial aspect of the efficient and effective provision of infrastructure” (sub. DR203, p. 3).

The IVL introduced earlier this year provides a stable ongoing income stream, with the levy expected to raise around \$80 million a year, to be split between conservation and tourism activities. Many submitters voiced support for using the predictable funding stream generated through the IVL to support small communities under pressure from tourism (see, for example: Northland Regional Council, sub. DR158, p. 5; Dunedin City Council, sub. DR179, p. 4; Auckland Council, sub. DR185, p. 5; Wellington City Council, sub. DR245, p. 14; Tasman District Council, sub. DR236, p. 9; Federated Farmers of New Zealand, sub. DR217, p. 3; Local Government Business Forum, sub. DR177, p. 8). Yet the recent announcements of the first projects to be funded through the levy point to it becoming yet another ad-hoc fund that provides little in the way of certainty to communities under pressure.

The Government has indicated that it is looking to take a more deliberate role in the tourism system, and to better coordinate tourism investment (MBIE Tourism Branch, sub. 28, p. 3). The most effective means of doing this would be to distribute the considerable amount of money it already provides to local government for tourism and mixed-use infrastructure more efficiently, and in a much more predictable way. In designing a better means, the Government should follow the principles for intergovernmental transfers described in Chapter 6. These include revenue predictability, efficiency, equity, transparency and preserving local government autonomy and accountability as far as possible. Using an allocation formula would help to achieve many of these principles.

An allocation formula to determine the level of visitor impact on each district could be developed in several ways. For example, support could be based on metrics such as the proportion of total tourism spending within a district, the proportion of total guest nights within a district, visitor-to-resident ratio, or some combination of relevant factors. But a key element would be the autonomy and predictability that a transparent funding formula would provide, which would allow councils to strategically plan their investments.

Another advantage of using an allocation formula to distribute central government funds is that it does not disadvantage those well-run councils which have made the necessary investments in infrastructure and mixed-use facilities, or made efforts in planning for and managing tourism demand.

Funding allocated in this way would allow councils to decide the best way to use it to support tourism and mixed-use infrastructure needs. Local government has superior knowledge of local preferences and needs, and providing a regular and sustainable funding stream would allow communities to use the funds in the most appropriate manner.

F10.7

To-date central government funding for tourism and mixed-use infrastructure has focused on upfront capital costs, and has been allocated largely through time-limited contestable processes. Initiatives like the Tourism Infrastructure Fund, The Responsible Camping Initiative and the Provincial Growth Fund provide significant funding to councils but provide little funding certainty for councils. This hinders councils’ ability to plan and prepare effectively for tourism pressure and growth.

R10.4

Some central government funding for councils for tourism and mixed-use infrastructure is justified – particularly in tourist hotspots with a high proportion of day visitors. Such funding should be distributed in a more predictable, efficient and fair way by using a transparent allocation formula.

New funding tools

Introducing new funding tools is only likely to result in a net-benefit if there is a large funding shortfall, and if there are limited means to address that shortfall through existing measures. Yet, as discussed above, tourists already cover most of their costs. There is also considerable scope for councils and central government to make better use of existing tools to address the modest funding shortfall.

However, some councils have cited difficulties in managing pressure from tourism, and have been calling for greater support from central government. This has included calls for access to new tools to cover the costs of the additional pressures that tourists place on local infrastructure. For example,

New Zealand has become an international destination – but many of our most popular tourist places are in communities that are ill-placed to afford them. There are a variety of options for taxing tourists – a levy on accommodation, increasing tax taken at the border, or local taxes (such as the Stewart Island levy). Given we are the last stop on the planet and the distances to travel (and price) are so great we'd need convincing that the elasticity of demand is so high that taxation on a small level would have much of an impact at all. (SOLGM, sub. 24, p. 8)

CSA advised the Commission on several options for new tools to address a funding shortfall, including two options for an accommodation levy, and two broad-based targeted rate models (CSA, 2019b). These options would require legislative change.

Broad-based targeted rate models

Several submitters advocated for different forms of broad-based targeted rates to cover the costs of tourism infrastructure. Dr Anthony Brien, for example, advocated for a Multi-Sector Targeted Tourism Rate (MSTTR) applied to all businesses that benefit from tourism spending:

The MSTTR... is a targeted rate, simply applied to identified properties as per the TSA [Tourism Satellite Account] Products (classifications) akin to the present practice of other targeted rates. A MSTTR would therefore be borne by all TSA product classifications meeting the BBLR [Broad Based Low Rate] requirement, whereas a bed-tax is a cost borne only by commercial accommodation operators. A MSTTR meets all the requirements of being: efficient, sustainable, equitable, and fair, coherent, and an 'appropriate for local government use' principle of local government funding and financing as detailed below. (sub. DR141, p. 12)

The Queenstown Lakes District Tax Equity Group also favoured a broad-based approach, stating:

On compliance and administration costs, the legal and administrative requirements for a narrow-based tax are the same as those required for a broad one. The only difference would be that more businesses would need to comply. But this offers the significant advantage of enabling the tax rate to be much lower, low enough to avoid the distortionary effects of a significant price spike in the accommodation sector. There is no difficulty in defining businesses that should be within the catch pool, either regionally or nation-wide. Main players in the tourism sector are easy to identify. (sub. DR145, p. 2)

CSA analysed two different possible approaches to a broad-based targeted rate for the Commission. The first is a multi-sector rate levied on property values, with different tax rates being applied to each business sector based on how much of their sector serves residents versus tourists. The second is a broad-based tax at a single tax rate levied on sales revenue (CSA, 2019b)

Based on this analysis, the Commission believes that a multi-sector rating model would be difficult and costly to implement and would likely have high compliance costs. A broad-based tax levied on sales revenue offers a more practical approach, although significant challenges remain with such a model (see full report for more details).

Accommodation levy

Some councils have called for changes to the LGA to allow them to introduce an accommodation or visitor levy (eg, Auckland Council, sub. 120; and Queenstown Lakes District Council, sub. 67). Such levies are common overseas, and could be either a flat rate per guest per night, or a percentage of the accommodation cost. Currently the Local Government (Rating) Act 2002 does not allow local authorities to set targeted rates on accommodation providers based on nightly occupancy.

Accommodation providers have strongly opposed a levy, or “bed tax”. This is largely based on the providers not wishing to be the collection point for such a levy, and concerns about the equity of a mechanism that targets only a subset of the businesses that benefit from tourism.

Accommodation providers are not the most direct beneficiary of expenditure by Councils or central government to raise visitor numbers. They should not be singled out as the party most likely to pay. (Millennium & Copthorne Hotels NZ Ltd, sub. DR146, p. 4)

It is SHG’s view that where funding is necessary to support tourism infrastructure and the tourism economy, the burden should fall on all those that benefit from it not just accommodation providers. SHG does not support targeted rates, bed-taxes or any other accommodation-only levy, rate or tax (either locally or nationally) as these do not accurately capture all those who benefit from tourism infrastructure and the tourism economy. (Scenic Hotel Group, sub. DR159, p. 2)

We believe the suggestion of an accommodation levy to be a simplistic one. One that is often touted and one which, when investigated further, raises more issues and associated costs which outweigh the proposed purpose – that of increasing funding for local councils. (Bed and Breakfast Association of NZ, sub. DR214, p. 2)

We have particular issue with this recommendation as it does not align with either the ‘principles for local government funding and financing’... established in the Draft Report or the “benefit principle” which the Commission has indicated as being its preferred decision making framework when allocating the financial burden of local government services. (Hospitality New Zealand, sub. DR188, p. 2)

Our main objection to a bed tax is on the principle of equality. Levying a tax on commercial accommodation is an easy target, and technology may now allow this to be extended to some peer to peer accommodation like Airbnb. However, a bed tax unfairly targets one sector, who host only a minority of total visitors. (TIA, sub. DR266, p. 7)

CSA assessed an accommodation levy and other options against the principles identified in Chapter 6 for revenue-raising tools – coherency with national policies and institutions, appropriateness for local government use, efficiency, fairness, transparency and sustainability.

CSA analysed two possible approaches to an accommodation levy – a levy based on guest nights, and a levy based on total sales revenue that accommodation providers receive from tourists (CSA, 2019b). Based on this analysis, an accommodation levy imposed on sales revenue is the better of these two options. Such a levy would take the form of a targeted rate on accommodation providers, yet because it is levied on total sales revenue it would essentially be a local sales tax on accommodation services sold to tourists.

Yet significant challenges remain with this model. In addition, some small tourist hotspots such as Tekapo and Punakaiki do not offer much accommodation and many of their visitors stay for less than a day. An accommodation levy would not work in such places because it would be unlikely to raise enough revenue to cover the costs caused by tourists.

Both the accommodation levy options, and the broad-based targeted rates option explored above would place costs on tourism-related businesses. Yet the full costs would not be borne by those businesses directly, to the extent that they are able to pass the costs on to their consumers – tourists. The legal incidence of these measures does not determine who ultimately pays the costs (economic incidence).

In both cases – accommodation levy or broad-based targeted rate – there would be significant costs incurred for implementation. Complex new systems and processes would also be required for administration, monitoring and enforcement. The upfront and ongoing costs are likely to be significant. To implement either would require amendments to legislation.

The Commission concludes that an accommodation levy based on sales revenue would be a relatively effective and principled new funding tool to cover a significant funding gap for tourism and mixed-use infrastructure. Yet, before any new measures are implemented at a local level a detailed cost–benefit analysis should be conducted. Introducing new tools is only likely to result in a net-benefit if the funding gap is large, and if the means to address that funding shortfall through existing measures is limited.

F10.8

Better use of existing tools and central government funds should be enough to close the tourism funding shortfall. Given the small scale of the funding gap, introducing new funding tools would incur significant implementation, administration and enforcement costs and is unlikely to result in a net benefit to councils.

10.4 Conclusion

Tourists already pay for many of their costs indirectly through the price of goods and services they purchase from businesses that pay rates. The pressure that tourists staying in holiday homes, or in the private homes of friends and family, put on council services is also covered through the rates paid on those homes.

Even so, in tourist hotspots there is a small funding shortfall caused by tourists not paying for the local public-good type amenities and services they consume directly, and which are paid for through rates. This can include things like public toilets, car parks, walkways, CBD street cleaning and rubbish collection from public bins (whatever part of these services are not paid for through user charges).

International tourists more than pay their way. They pay a large amount to central government in the form of GST, far in excess of what is needed to cover the costs that international tourists do not already pay for either locally or nationally. Yet this money goes to central government, and not to councils which may face the funding shortfall.

Given the modest scale of the funding shortfall, the Commission recommends more effective use of the tools already available to councils – including user charging, targeted rates and tools to more effectively manage peak demand. Central government also provides significant funding to local government for tourism and mixed-use infrastructure. This should be targeted more efficiently to ensure that councils can plan and prepare for tourism.

Better use of existing tools and central government funds should be enough to address tourism funding. Given the small scale of the funding gap, introducing new tools would incur significant implementation, administration and enforcement costs and is unlikely to result in a net benefit to councils.

11 Funding and financing three waters

Key points

- Under current arrangements the provision of safe drinking water and cleanly disposing of wastewater and stormwater (commonly called “the three waters”) are key responsibilities of local authorities. Some councils have taken the tough decisions to improve their performance, and they should be applauded for doing so. However, the three-waters performance of many other councils has been poor for many years, with some harming the health of water consumers and the natural environment.
- Local governments spend a high portion of their funds on three waters. Achieving better safety and environmental outcomes may create additional funding and financing pressures on councils, with some small-population districts potentially incurring large cost increases. Combating these pressures requires reforms that sustainably lift council safety and environmental performance, while improving productivity and cost effectiveness. Better investment choices are essential.
- Some councils have prioritised retaining direct control over how their water services are delivered – at the expense of building the *capabilities* of their supplier – even when it is clear significant performance improvement is needed. They have resisted funding, financing, organisational and governance changes that would bring better performance *disciplines* and *incentives* on those making or overseeing operational and investment decisions.
- The Government has announced that existing drinking water standards will become mandatory for almost all suppliers and is establishing a new drinking water regulator to monitor and enforce compliance with those standards. The new regulator will also oversee wastewater and stormwater, but regional councils will deal with the day-to-day regulation.
- The previous regulatory regime has imposed weak disciplines and incentives on council-led water suppliers to meet safety and environmental minimums, and no independent oversight of supplier charges and/or costs. No prosecutions were pursued for breaches of health standards, and too many suppliers of wastewater were allowed to continue operating with expired consents.
- The performance of the three-waters sector would be substantially improved through an approach that (1) rigorously enforces minimum performance standards; and (2) is permissive about the way councils structure and operate their three-waters businesses. However, the Government should actively encourage councils to adopt better governance and aggregation of council water businesses. It should also consider having backstop arrangements to deal with councils that fail to lift performance sufficiently to meet minimum health and environmental performance standards.
- The Government should legislate to enable council-owned water businesses to directly charge water users for their services, in the same way that Watercare (owned by Auckland Council) can do so now. It should also allow councils to adopt volumetric charging for wastewater, similar to what is currently allowed for drinking water.
- The Government is considering the funding and delivery of the three-waters sector and may introduce economic regulation in the future. Independent and effective economic regulation is needed to encourage fit-for-purpose investments to lift the sector’s performance and assist with affordability (by minimising costs).
- While significant cost efficiencies should be possible for most council-led water services, some communities will need financial assistance from government to help them make the transition to achieving minimum performance standards. As discussed in Chapter 7, this should be provided in a principled way as part of a broader system of assistance to local government.

Provision of safe drinking water and cleanly disposing of wastewater and stormwater are key responsibilities of local government, and expenditure on these activities accounts for a significant portion of local government expenditure. For example, drinking water and wastewater accounted for nearly 14% of total local government operating expenditure (opex) and 22% of capital expenditure (capex) in 2018.⁷⁵ The water-related capex of five councils in 2017 exceeded 45% of their total capex.⁷⁶ Despite the overall significant expenditure on three waters, poor-quality provision appears to be occurring in many places in New Zealand.

Funding and financing pressures on councils from the provision of drinking water and wastewater appear likely to increase over the next decade. According to their Long-Term Plans (LTPs), councils' capex on these activities is projected to be 25% of total capex over 2019–2028. Although that is a modest increase from the 22% average for 2018, the LTPs are unlikely to have fully accounted for upgrades to treatment plants to achieve better health and performance levels.

The next section assesses the current performance of water services in New Zealand and describes the Government's approach to reforming them. Section 11.2 outlines the inherent features of three waters and explains why these features are not the reason for the poor performance. Section 11.3 applies the decision-making principles in Chapter 5 to the three-waters sector, and identifies the key drivers of poor performance. Section 11.4 proposes comprehensive reform, and outlines key requirements for central government and local councils to have robust implementation plans. Section 11.5 discusses the benefits of the proposal.

11.1 Current state of play

Water services in New Zealand have often performed poorly, and the Government is taking steps to improve performance.

Poor-quality water services are common in New Zealand

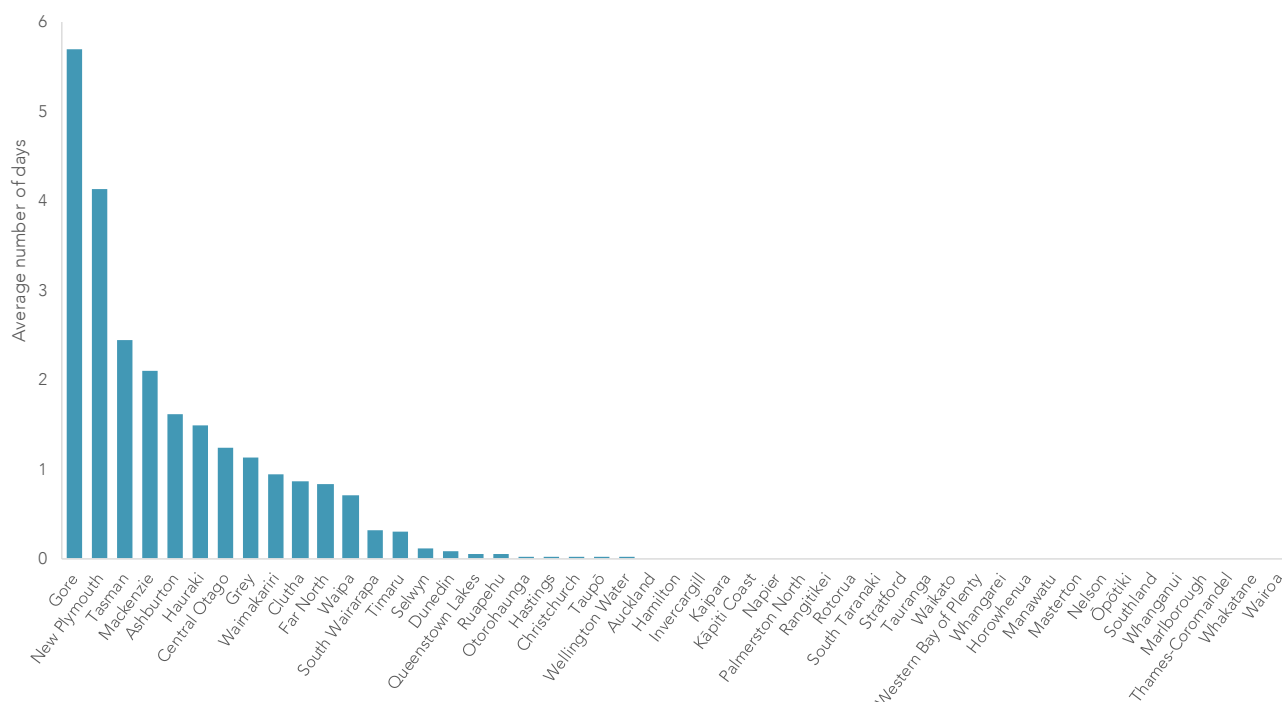
The provision of the three waters came to national attention with the Havelock North contamination of drinking water in August 2016, which is thought to have resulted in four deaths, long-term chronic health problems and widespread outbreak of illness in the area.

The Ministry of Health estimated that between 18 000 and 35 000 people become ill every year by consuming unsafe drinking water; the Government Inquiry into the Havelock North Drinking-water Outbreak accepted an estimate of up to 100 000 people a year (Havelock North Inquiry, 2017). According to the Inquiry, at least 13 other waterborne outbreaks occurred nationally in the 10 years before the Havelock North outbreak.

Boil water notices are issued when the authorities are concerned about the healthiness of the supply of their drinking water. Figure 11-1 shows the average impact of the notices issued in the 2017–18 financial year, for each council participating in Water New Zealand's National Performance Review. It shows that 23 councils issued boil water notices, and eight of those councils recommended water boiling for a period equivalent to more than one day of the entire population served by them.

⁷⁵ In both cases, the costs of stormwater appear to be part of roading or urban design costs and are not separately identified.

⁷⁶ These figures are indicative only, as councils adopt different categories of expenditures. The five councils were Invercargill, South Wairarapa, Whanganui, Horowhenua and Whakatane. As a group, these councils also had high water-related capex over the five years ending 2017, averaging 28% against an average of 18% for all councils over that period.

Figure 11-1 The average impact of notices to boil water in the 2017-18 financial year

Source: Water New Zealand, (2019).

Notes:

1. The chart shows results for councils providing data to Water New Zealand for its 2017–2018 National Performance Review. The vertical axis shows the average number of population-days covered by boil water notices. For example, a score of 4 on the vertical axis means that on average the entire population served by a council was given notices to boil their water for four days. This may have been notices on four separate occasions to boil their water for one day, or it may have been two notices to boil their water for the next two days, etc. If half the population were recommended to boil their water for one day, for example, then the score would be 0.5.

For populations of 10 000 or greater, only 88.4% of supplies are fully compliant with current drinking water standards. The compliance rate declines as a population declines, with only 31.5% of supplies compliant for populations of 101 to 500 people (Minister of Local Government and Minister of Health, 2018).

These results are consistent with a 2014 survey by Local Government New Zealand (LGNZ), which distinguished between minor breaches of current drinking water standards and non-minor breaches. That survey showed that 60% of local councils serving metropolitan areas had minor breaches and none had non-minor breaches, but noted that 15% of councils serving metropolitan areas did not respond to the survey. This contrasts markedly with the results for councils serving provincial and rural areas, where 25% had minor breaches and about 5% had non-minor breaches. However, the non-response rate for these types of councils was about 50% (LGNZ, 2014, p. 17).

The low response rate to the LGNZ survey may mean the number of non-minor breaches is greatly under-estimated. For example, if half the councils that did not respond had non-minor breaches, then about 30% of provincial and rural councils may have had non-minor breaches, rather than the 5% shown in the survey. This rate is more consistent with the evidence presented in the Havelock North Inquiry.

The Havelock North Inquiry reported:

[A]most 10 years after the 2007 amendments [introducing mandatory drinking water standards in the Health Act], there are still 759,000 people (20 per cent of the serviced population) who are supplied water that is not demonstrably safe to drink. Of these, 92,000 are at risk of bacterial infection, 681,000 of protozoal infection, and 59,000 at risk from the long-term effects of exposure to chemicals. (p. 25)

[T]here has been no marked improvement in the number of suppliers supplying safe drinking water throughout the 2009-2016 period. (p. 26)

Some council wastewater systems are also performing poorly. Some wastewater plants are degrading freshwater and coastal water quality, and sewage overflows are occurring at a frequency no longer

acceptable for communities. In many regions, regional councils do not (and are not required to) publish sufficient information to provide assurance about the impact of wastewater services on the environment. If comprehensive information was available, many hidden problems would likely be exposed. An audit of the Waikato and Manawatu-Whanganui wastewater systems showed that 50% of plants did not comply with consent conditions in 2017–2018. Of the wastewater treatment plants in Waikato and Manawatu-Whanganui, 10% are legally operating on expired consents for long periods of time (in some cases, decades).

The challenges facing council stormwater services are different to those facing drinking water and wastewater services. This is in large part because stormwater is an open system closely associated with roading and urban land use. There is a lack of good quality information about the condition of stormwater infrastructure, its susceptibility to climate change, and its propensity to harm the environment. Climate change adaptation issues are discussed in Chapter 9.

Water efficiency, volumetric metering and pricing

As to economic efficiency, Water New Zealand reports that water losses amount to more than 20% of the water supplied to systems with known water loss levels. Only three participants in its survey achieved water loss levels low enough to make further reductions uneconomic. As Water New Zealand reported, “this signals there is room to save both money and water through the implementation of water loss initiatives” (Water New Zealand, 2019, p. 8).

Where applied, volumetric metering and pricing appear to have reduced peak water consumption and waste by up to 30%. The Kāpiti Coast District Council (KCDC), for example, reports reductions in peak daily water use of about 25% (sub. 131, p. 22). A recent report by the Office of the Auditor-General (OAG) reports KCDC’s view that its initiatives have resulted in lower charges for most ratepayers and that it has deferred the need for a new dam for many years (Box 11.1).

Box 11.1 Kāpiti Coast District Council’s experience with volumetric metering and pricing

Kāpiti Coast District Council introduced volumetric metering and pricing for drinking water in 2014. This had benefits for ratepayers through reduced wastage and reduced water consumption.

With volumetric pricing, 75% of ratepayers now pay less for water than they would have under the Council’s previous approach to charging for water supply. KCDC estimates that its approach has deferred the need for a new dam by about 40 years.

Peak daily water use is what drives the need for capacity upgrades in the system supplying the drinking water. Peak daily water use decreased by about 25% in the two years after universal metering was put in place.

- About 20% was saved by fixing leaks on private property and lateral pipes, which surprised the Council because it had assumed that leaks were on other parts of the network. The Council now has a proactive laterals renewal programme.
- About 5% was saved by consumers using less water.
- Based on a range of factors, including reductions in water use and wastewater discharges, water use reduced by an average of 21%. Estimates of reduced water consumption included reductions in dry-weather wastewater volumes of between 5% and 8%.

Each year, KCDC produces a water conservation report that discusses if and how it has met its water use target, the work done to manage water use and leakage on the public and private parts of the network, and planned water conservation work for the next financial year. The report fulfils a resource consent condition, but has greater value than merely meeting compliance requirements.

Source: Office of the Auditor-General, (2018c, p. 9).

Tauranga City Council has achieved a similar result. An independent report identified a 30% reduction in Tauranga's peak water demand, which enabled the Council to delay a proposed water scheme by at least 10 years. Taking into account the costs of installing and operating meters and associated billing systems, the authors estimate the average Tauranga City household would be paying at least 40% more each year for their water if the Council had not introduced water meters (Sternberg & Bahrs, 2011).

Despite the prospect of significant cost reductions for communities, the pace towards adopting water metering and volumetric pricing across New Zealand is slow. Water New Zealand's 2017–2018 report shows that water meters are installed at 63% of residential properties receiving water services and at 87% of non-residential properties. Although Figure 11-2 shows water metering has slowly increased in the past four years, this increase largely reflects the fast population growth in Auckland where Watercare achieves full residential water metering.

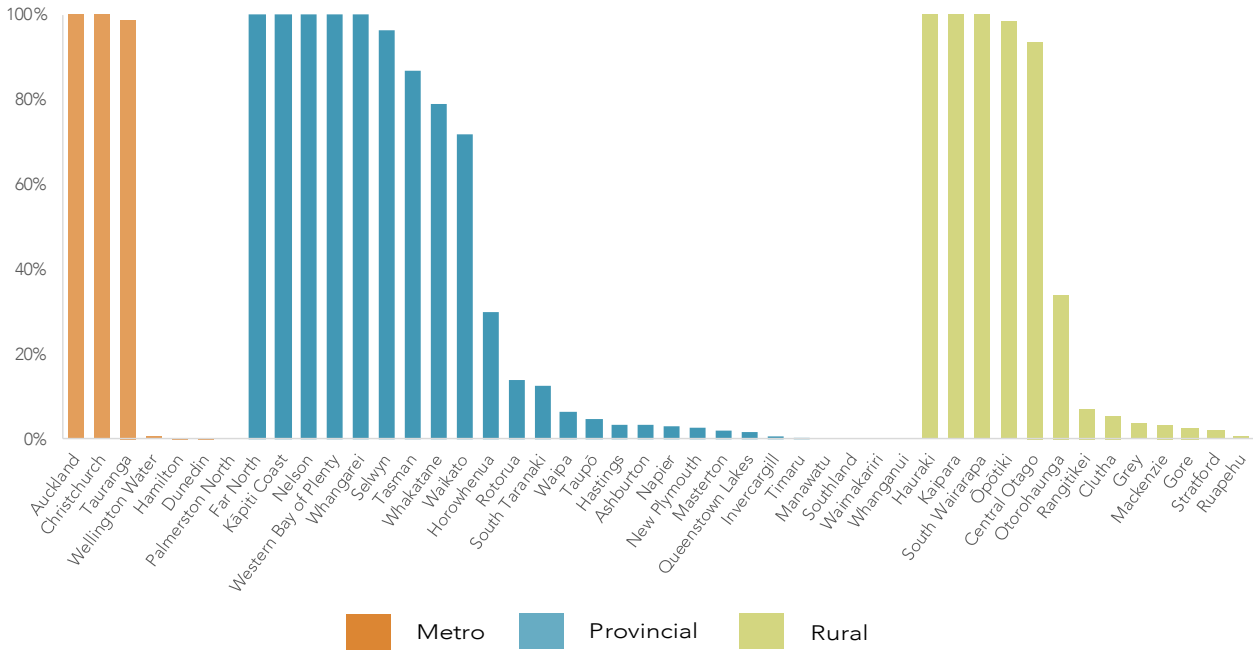
Figure 11-2 Proportion of properties with water meters



Source: Water New Zealand (2019).

Figure 11-3 shows the percentage of residential properties with water meters for each water provider supplying data to Water New Zealand. The chart shows that at least 27 councils had less than 20% of residential properties with water meters, and four metropolitan councils (Dunedin, Hamilton, Wellington and Palmerston North) had almost no water metering. Only 15 participants shown in the chart have more than 80% of their residential properties with water meters.

Figure 11-3 Percentage of properties with meters served by each water provider, 2017-2018



Source: Water New Zealand, (2019).

F11.1

There is considerable evidence of poor performance of the three waters sector in many parts of New Zealand, in terms of impact on human health, the natural environment, productivity and costs to consumers and ratepayers. However, some councils and providers are taking the tough decisions needed to improve performance, including Auckland’s Watercare, Tauranga City Council, Kāpiti Coast District Council and the five councils involved in Wellington Water.

Extensive reform of the three-waters sector

With such poor performance the issue is not whether to fundamentally reform the three-waters sector, but rather how to do so. Earlier this year the Government made the regulatory standards for drinking water mandatory. On 25 October 2019 it announced the establishment of a new drinking water regulator to monitor and enforce compliance with those standards, and more generally oversee and lead the drinking water system. The new regulator will also provide central oversight and guidance for wastewater and stormwater regulation, with regional councils remaining the primary regulators of wastewater and stormwater discharges (Cabinet Minute, 30 September 2019). The Government is continuing to consider delivery and funding arrangements for the three-waters sector.

Better enforcement of safety and environmental standards, and raising those standards, is expected to create additional funding and financing pressures on local government; and some small populations could face very large increases in costs. Yet the focus should be not only about more money going into three waters to assist affordability. The focus also needs to be about sustainably lifting safety and environmental performance and productivity, particularly through future investment choices, to minimise cost impacts on communities. Therefore, the three-waters sector is inevitably an important focus for this Inquiry.

The Commission asked Capital Strategic Advisors (CSA) to undertake an in-depth study of the three-waters sector. CSA proposed fundamental changes to the funding and financing of three waters to significantly and sustainably improve safety and environmental outcomes and minimise funding and cost impacts (CSA, 2019a).

11.2 Inherent features of three waters

Chapter 1 discussed inherent features of many local government activities, and the three-waters sector shows many of these features. For example, the provision of reticulated drinking water, wastewater and stormwater services shows *large economies of scale*, which means it is efficient for a single (monopoly) local supplier of reticulated water to provide each service to serve each population.⁷⁷

Whether it is efficient for a council to have a single provider covering all three water services depends in part on the extent of *economies of scope* across the services.⁷⁸ It can also depend on whether there are economies of scope with non-water transport services, such as with the provision of footpaths and roads. Different views about the nature and degree of these effects naturally lead to different views about the best mix of services to combine in one organisation.

In principle, determining the best combination of services is not important for the findings of this report, which are that (1) councils need to improve their performance across all three water services and (2) the inherent features of three waters are not the reason for the poor performance seen in this sector. The Commission expects councils would source in-depth and expert analysis before deciding those issues.

Another complication can arise when consumers of a local monopoly service receive the same quality of service because it is inherent to the production technology. For example, all consumers of a reticulated drinking water system often receive the same quality of supply (same taste, colour, smell and contamination levels). In this situation, collective decision making by consumers of reticulated water – perhaps via elected representatives – can play a role as the supplier is a local natural monopoly. If consumers have a choice of supplier, then they could purchase from the supplier that best meets their price–quality trade-offs. Consumers do not have this option in situations where a local natural monopoly exists.

Another important feature is that poor quality water can impose *negative externalities* on others. For example, unhealthy drinking water imposes costs on the health sector and the discharge of contaminated wastewater and stormwater can pollute the natural environment. Stormwater overflows can also damage properties; in some instances, very heavy rainfall can result in stormwater mixing with the wastewater system, causing overflows of raw sewage.

Poor performance is not due to inherent features

Section 11.1 outlined the poor performance of the three-waters sector. This poor performance is not due to the inherent features of the sector, as three-waters services are delivered well by many councils and organisations (eg, Watercare, Sydney Water, Scottish Water, suppliers in England and Wales and major suppliers in Finland, to name a few).⁷⁹ Further, electricity and gas distribution services show similar inherent features as three waters, yet deliver acceptable performance.

Rather, the poor performance of the three-waters sector is due to poor decision making by some local authorities, particularly when dealing with the inherent features of three waters. Consumer choice is largely absent when a local natural monopoly provides three waters, which can leave suppliers with weak performance incentives. It is important for local network monopoly suppliers to have effective funding, financing, legal and governance arrangements in place.

Likewise, the human health and environmental externalities arising from poor water quality make it very important that suppliers provide a quality of reticulated water that is good for consumers and the environment. As a result, suppliers need to have the expertise and financial capacity to make sound

⁷⁷ In practice, the sourcing, extracting and treating of drinking water is undertaken by the same entity as the provider of reticulation or conveyancing services, and likewise for the treating and disposing of wastewater.

⁷⁸ Economies of scope arise when a single firm can produce two or more services more cheaply than two or more firms can produce those services. This may occur because the fixed costs of production can be spread across the services or because producing one service reduces the marginal cost of producing another service, due to complementary skills for example.

⁷⁹ For example, as to drinking water quality, public suppliers in England and Wales, large Finnish suppliers, and Scottish Water all had greater than 99.8% compliance with E.coli standards between 2011 and 2015. Further, England and Wales had almost no problems with protozoa during the same period (Havelock North Inquiry, 2017, p. 25).

investment and operational decisions, and councils need to have effective mechanisms to hold suppliers accountable.

F11.2

The inherent economic features of three waters make it a natural monopoly in many cases and there are large negative externalities on communities when poor-quality water treatment occurs. However, these natural monopoly and externality features are not the reason for the poor performance of many council-led water providers. Other industries with similar features, such as electricity and gas distribution, perform well.

11.3 Application of key decision-making principles to three waters

Chapter 5 outlined key principles for high-quality decision making by local government. It discussed the importance of decisions being made by parties with the capabilities, information, knowledge, disciplines and incentives to make consistently high-quality decisions.

Inadequate supplier expertise and capabilities

Most councils have prioritised retaining direct control over how their water services are delivered, at the expense of building the *capabilities* of their supplier. Currently, the scale of water suppliers reflects the size of each local council's area of responsibility and population – which is quite often small. This leaves some local councils with inadequate in-house specialisation and expertise.

Auckland's Watercare has scale, with effective levels of specialisation and expertise. Wellington Water – a joint venture management company owned by five local councils in the Wellington region – appears to be making significant gains in performance due to greater specialisation and better use of scarce expertise, although further time is required to confirm whether these gains are sustainable (Wellington Water, 2018a).

A report by Castalia (2017) for the Department of Internal Affairs looked at how well existing water assets are managed, and reported:

We found two examples of large, urban service providers with disparate AM [asset management] systems, practices and processes [that] have been brought together and standardised. This has created economies of scale and improvements in analysis, data collection, and procurement. (p. iii)

Small service providers typically have one or two individuals responsible for multiple asset classes, whereas larger organisations have teams of up to 400 individuals. This allows people to focus on niche areas and tasks, allowing for deeper analysis and a more thorough understanding of the asset base. It also allows larger service providers to 'look above the day-to-day firefighting' by hiring individuals to consider long-term strategy, the potential roles of new technologies, and advancing innovative practices. (Castalia, 2017, p. iii)

Waikato District Council has recently agreed a contract to receive water services from Watercare, after having tried for many years (unsuccessfully) to form a joint venture water company with Hamilton City Council and Waipa District Council. In its submission, Hamilton City Council reflected on its experience investigating options for collaboration and aggregation of water services. Noting they had invested a significant amount of consulting resource into the project, they submitted:

HCC is therefore of the view that Government intervention is necessary to achieve aggregation of water service delivery. (Hamilton City Council, sub. 130, p. 4)

Hamilton City Council's submission to the Government's three-waters review elaborated on this point, stating:

In addition, some councils appear to be reticent about losing control of their water functions as it is regarded as a significant part of their ongoing operation and, to a certain extent, is seen as justifying their "existence". (Hamilton City Council, 2018)

Similarly, Infrastructure New Zealand submitted that

[c]ouncils have opposed demonstrably superior water service provision, generally because it is feared that the loss of water would undermine other council services and local decision making more broadly. (Infrastructure New Zealand, sub. 128, p. 11)

Apart from Wellington Water, management and governance of water assets across local council boundaries are rare. This is unusual for services requiring significant operational, asset-management and investment decision-making skills and expertise. For example, gas and electricity distribution services require similar types and levels of skills and expertise, and they generally operate across multiple council boundaries. Currently, 29 electricity distribution businesses operate in New Zealand compared with 67 councils.

Engineering New Zealand remarked on the fragmentation in the provision of water services, submitting that

[t]here are significant economies of scale and scope in the provision of infrastructure services. But local government does not always have the mechanisms to plan and deliver infrastructure regionally, which can result in disjointed investment decisions. An example of fragmentation is wastewater and drinking water services outside of the Auckland and Wellington region. (Engineering New Zealand, sub. 98, p. 3)

The comments above reinforce the findings of the Commission in its *Using land for housing* report:

The current governance arrangements for water infrastructure have three major shortcomings that are likely to inhibit affordable and efficient provision:

- fragmentation in water provision;
- problems associated with monopoly provision; and
- evidence of inefficient pricing. (NZPC, 2015, p. 10)

Only six suppliers of reticulated drinking water and wastewater services serve England and Wales, and only one serves Scotland. Scotland, for example, went from having 13 suppliers in 1976 to three suppliers in 1996, and then a single entity in 2002, called Scottish Water. Since 2002, Scottish Water has reduced operating costs by 40%, reduced the number of lost-time accidents from around 30 per 1 000 employees to around 2.5 per 1 000 employees in 2015/16, and increased its customer satisfaction rating from 63% to 90%. Since 2010, compliance with water-quality standards has improved steadily from 99.83% to 99.93% and the number of environmental pollution incidents has reduced from around 750 a year to around 250 a year (Hutchison, 2017).

Councils should focus on service performance, which for many will require the requisite expertise and much of that may only come from increased organisational scale. This could come from merging council water businesses and/or pursuing business expansion opportunities such as offering commercial services to other councils.⁸⁰

Poor governance capabilities and incentives

Poor governance capabilities and incentives appear to inhibit the performance of council-owned water suppliers. Except for Watercare and Wellington Water, the governance of drinking water and wastewater suppliers is carried out directly by elected councillors, supported by their officials. In many instances, this will be compromising supplier performance and muddying the supplier's accountability to councils.

Virtually all councils organise their water business as a department within the council, with governance decisions made by a committee of elected members. These arrangements typically provide weak performance disciplines and incentives because of weaker legal requirements on committee members. Within-council arrangements also shield committee members from the full suite of accountability requirements that company directors face. These weaknesses flow through to weak performance disciplines and incentives on council management and staff.

⁸⁰ This discussion is about merging or expanding business organisations, not about physically connecting adjoining water reticulation systems. As discussed in the Commission's report *Using land for housing*, councils should undertake a careful assessment of costs and benefits before deciding whether or not to merge their water businesses with the water businesses of other councils (NZPC, 2015, p. 241).

For example, in an audit of four councils about management of their water assets and services, the OAG asked the councils about the reasons for consistently failing to spend their budgeted capital for drinking-water infrastructure. The OAG reported:

Reasons given to us included poor or overly optimistic planning, inefficient procurement practices, staff vacancies, lack of capability and capacity, limited interest from private firms in competing for work, and weak management and governance accountability. (OAG, 2018c, p. 11)

As discussed in Chapter 5, MartinJenkins (2017) examined the water-asset governance practices of ten councils where elected members govern the water assets, and found that councillors typically lacked understanding of what is involved in good governance of water assets.

In addition to poor governance capabilities, the MartinJenkins report expressed concerns that elected council members may not have the right focus given the varied interests and priorities among members (MartinJenkins, 2017, p. 17). At the central government level, members of parliament and ministers are not directly involved in the governance of any government-owned business for the obvious reason that doing so would compromise their ability, and the ability of their colleagues, to hold the business accountable for its performance. The same logic applies to council members and local government services.

Best-practice governance involves:

- restricting member involvement to appointing independent directors (ie, no councillor or council staff or any people related to them); and
- requiring the information and meetings needed to robustly monitor the performance of the business.

Box 5.2 in Chapter 5 outlines the advantages and disadvantages of Council Controlled Organisations (CCOs) and outlines the importance of councils having the capacity and capability to monitor performance and manage a relationship with a CCO.

Poor financing arrangements

Most councils finance their water-related investments from their own rates and borrowing. This leaves council members to decide three-waters investments, inhibiting the supplier's overall performance and leaving the supplier less accountable. Councils could, instead, place these water assets in CCOs and leave it to the CCO to obtain their own finance (as occurs for council-owned electricity businesses).

Watercare is the only major supplier of reticulated drinking water and wastewater in New Zealand that is incorporated as a company, with the water assets owned by the company rather than directly by Auckland Council. In principle, this should enable Watercare to borrow against its assets, but in practice it cannot borrow significantly because its balance sheet is consolidated with Auckland Council's balance sheet. This effectively constrains Watercare's investment activity which, in turn, affects Watercare's performance and makes their accountability less clear.

Poor funding and pricing arrangements

Another factor inhibiting supplier performance arises from councils making decisions about water pricing.⁸¹ Almost all councils set supplier price levels and price structures and collect the charges through their rates.⁸² Watercare sets its own charges, but it does so in line with section 57 of the Local Government (Auckland Council) Act 2009, which in effect requires Watercare to set its charges no higher than needed to cover costs.

Section 11.1 outlined the significant cost reductions that communities can achieve by introducing water metering and volumetric pricing, and highlighted that KCDC reported water savings of 25% of peak daily water use. In response to serious supply issues in the late 1990s and early 2000s, KCDC embarked on a

⁸¹ Although water is free in New Zealand, it can be costly to acquire, treat and convey water to consumers. Discussion of water prices and charges in this report is about paying for the service rather than for the water resource.

⁸² The Local Government (Rating) Act 2002 empowers council-led water suppliers to use rates to charge for their services. Garnett and Sirikhanchai (2018) report that in 2014 five council-led water suppliers charged consumers directly rather than through the rates system. These were Auckland, Tauranga, Whangarei, Hauraki and Kaipara.

multi-year programme to investigate and implement several measures to address the problems it was experiencing with its drinking water. The programme's process took about 15 years.

In its audit of four councils discussed earlier, the OAG asked KCDC what other factor or incentive would have made KCDC act earlier. The OAG reported:

Councillors and council officers told us that crisis and regulation are the only sure ways to achieve more comprehensive planning for, and management of, drinking water supply under the current arrangements. Incentives to stay with a traditional supply management approach and to make short-term decisions are strong, and there are political pressures to keep rates and rates increases low. (OAG, 2018c, p. 12)

Although single-supplier situations raise market power concerns, it is important to deal with those concerns in ways that preserve supplier performance incentives as much as possible. Lack of customer choice in single supplier situations leaves suppliers with weak incentives to innovate to improve their performance. So it is important to avoid pricing regimes that further weaken performance incentives.

Yet, many councils reduce performance incentives by funding suppliers with general rates and targeted fixed rates, which are not based on the services, and service levels, delivered. Further, these revenues are often insufficient to cover supplier operational costs, asset depreciation, and interest costs. Water New Zealand, for example, reported that at least 20 of the 46 councils that gave them data did not achieve full cost recovery (Water New Zealand, 2019).⁸³ As well as undermining performance incentives, these pricing and funding approaches inhibit performance measurement and the ability of councils to hold their supplier units accountable for their performance.

In contrast, electricity and gas distributors receive their funding from charging consumers directly and set their own pricing structures. Market power concerns are dealt with by the Commerce Commission setting maximum prices and minimum service requirements for suppliers subject to price control, and requiring information disclosure about these matters from the suppliers not under price control. The Commerce Commission operates an incremental rolling incentive scheme to give price-controlled suppliers incentives to improve their performance over time.⁸⁴

Weak safety, environmental and economic regulation

Weak regulation is at the heart of the poor performance continually observed with three waters. As noted, the Government recently strengthened the regulatory regime. The previous regime had imposed weak disciplines and incentives on council-led water suppliers to meet safety and environmental minimums. No prosecutions have been pursued for breaches of drinking-water standards, and supplier costs are not externally regulated.

The weak regulatory regime may have arisen because of regulatory capture by council-owned suppliers. It may also have arisen because the health sector is a major service provider, with a "we're here to help and care for you" culture, rather than being a respected and feared regulator that rigorously enforces performance standards.

Another reason for weak enforcement may be that the regulators were ill-equipped to deal with non-compliance with drinking-water standards for reasons of affordability. Until the recent amendments, the Health Act 1956 essentially allowed affordability as a defence for not meeting drinking-water standards. The Act did not contain any requirement for financially weak suppliers to achieve affordability over a specified

⁸³ These figures are biased up due to the revenue measure excluding developer contributions and biased down to the extent that depreciation charges are not fully funding asset costs. The 46 authorities participating in the benchmarking exercise represent about 94% of the population served with reticulated water.

⁸⁴ Price-control regulation can create incentives for 'gold plating' of investment if the regulated price is based on an incorrect weighted-average cost of capital (WACC). This can occur when the regulated WACC exceeds the correct WACC. In these cases, the price-controlled entity has incentives to inflate its regulatory asset base (RAB); for example, by installing excessive capacity so that the entity earns high profits (ie, high WACC x high RAB). This effect is often called the Averch-Johnson Effect.

period of time.⁸⁵ It appears health regulators lacked the power to require affordability issues to be tackled and lacked the regulatory economics, financial and investment expertise to do so.

Effective regulation of three waters is essential because consumer choice is largely absent. This lack of choice considerably weakens performance incentives for council-led suppliers. Lack of contestability for greenfield developments further weakens performance incentives. Effective regulation would impose significant financial penalties for serious performance breaches, providing financial and reputational incentives for councils to confront the inadequacies of the arrangements they have in place for three waters. Effective regulation could also provide positive financial incentives for performance improvements, rewarding councils that improve their performance. Credible financial penalties and incentives help managers to build the business case for incurring the costs needed to lift performance.

F11.3

Poor performance in the three-waters sector in New Zealand generally arises from the following factors.

- Inadequate supplier expertise and capabilities, resulting from some councils prioritising local control of their three-waters activities rather than increasing their operational scale through shared services, joint ventures or mergers.
- Poor governance capabilities and incentives, due to lack of independent directors and insufficient use of company-type structures when they are likely to be beneficial.
- Poor financing, funding and pricing arrangements, due to under-recovery of costs and funding from council rates rather than water service charges.
- Weak safety, environmental and economic regulation, due to poorly designed regulations, weak enforcement and lack of regulatory expertise.

11.4 Improving the performance of three waters

As discussed in section 11.1, the three-waters sector is performing very poorly in many parts of the country and this has been occurring for many years. It is important that the owners of the three-waters assets, predominantly councils, accept responsibility for their poor performance and take the tough decisions needed to lift performance to acceptable levels. The Government should focus on establishing an effective regulatory regime that strongly incentivises councils to make those tough decisions, and on offering financial assistance to communities in ways that encourage performance.

Councils must lift their performance

For many councils, a strong case can probably be made for them to aggregate their suppliers across council boundaries to achieve far greater specialisation of resources. In practice, many aggregations are successful; yet many are not. A great deal depends on choosing the right entities to merge and skilfully merging them. Choosing the right entities involves much more than technical similarity (eg, use of similar equipment), or whether the entities are near each other. Complementary skillsets, compatible cultures and strategic directions are often more important for long-term success.

In its *Better urban planning* report, the Commission stated it saw little merit in a large-scale structural reform for urban water services (NZPC, p. 300). Aggregation should instead be viewed as a journey rather than a one-off event, and the journey could involve different forms of collaboration ranging from formal mergers to cooperation agreements. Adjustment of arrangements should be expected as the effectiveness of those arrangements becomes apparent and as new risks and opportunities arise.

⁸⁵ Sections 69H, 69V and 69ZZS of the Health Act 1956 allow affordability as a factor affecting whether a supplier has fulfilled requirements to take all practicable steps to comply with drinking water standards.

Few submissions argued directly against aggregation. Gary Law, former CEO of Watercare Services Limited, put the case for greater aggregation succinctly:

Clearly the professional capability is higher or more focused in those larger organisations to achieve the water outcome. New Zealand is exceptional in the small size of many of its undertakings, and as well in the infrequency of commercial structures (like CCOs) put around them. The size of water undertakings in their geographic spread does not often of itself require scale. They are typically local. However the efficiency to be gained in shared professional direction, professional management and targeted shared services is considerable ... In my experience of this transition it would provide this, as well as greater focus on customers and the industry fundamentals and clearer disciplines around price setting and capital expenditure. (Gary Law, sub. DR192, p. 4)

The main concern of Gary Law was that greater scale and specialisation would not happen of its own volition. He stated it is not happening and that Auckland was forced by government to do it. He thought central direction will be needed to make it happen. Some submissions, while supportive of the need for greater scale in general, expressed concerns that it could undermine councils maintaining viable scale for all of their operations, for example Tauranga City Council (sub. DR186).

In many cases, the aggregated businesses should be incorporated in asset-owning CCOs, independent and experienced directors appointed, and the CCOs required to fund themselves, by charging their consumers directly, and secure their own finances independently of councils.⁸⁶

Adopting a company structure is often essential for effectively managing and governing activities that need significant operational, investment and asset management expertise. A company structure provides a suite of accountability arrangements that provide disciplines and incentives designed to promote high-quality management and governance decision making. It assigns appropriate decision rights to management and boards that have the information, knowledge and skills to make complex investment and production decisions. Appointing independent directors frees elected councillors to focus on holding the board to account for the company's performance, and it enhances transparency of performance and the trade-offs involved.

Central government has used the company approach to good effect for its trading businesses, including for the critical functions of air traffic control and navigation (Airways New Zealand) and electricity-system operation and transmission (Transpower New Zealand).⁸⁷ Auckland Council has made widespread use of asset-owning CCOs, including for provision of its drinking and wastewater services.

Having emphasised the benefits of corporate structures and independent funding and financing, the Commission does not advocate a one-size-fits-all approach (as discussed in Chapter 5, and particularly in Box 5.2). If councils are concerned about an asset-owning CCO structure being a step towards privatisation in the future, they could retain ownership of the water assets and restrict the CCO to provision of water-management services, as is the case for Wellington Water. Another approach would be for councils to tender the provision of management services from other providers.

The Palmerston North City Council stated in its submission that a study by councils in the Manawatu-Whanganui region will soon to be completed, but even now it is clear that greater regional collaboration in the three waters is required (Palmerston North City Council, sub. DR215). And the Waikato District Council noted in its submission that it had negotiated a long-term three-waters servicing arrangement with Watercare to take advantage of scale and specialisation (Waikato District Council, sub. DR232).

However, some councils may avoid changes that reduce their direct control of their three-waters services even when the quality of those services remains poor. Political risks can inhibit local councils from exploring and executing collaboration that involves sharing control with other councils. Councils need to become far more proactive in this area for the Government to be convinced that councils are serious about sustainable performance improvement.

⁸⁶ Under these arrangements, most councils would have a minority stake in their water CCO. With this stake, they would not be required to consolidate CCO assets and liabilities on council balance sheets.

⁸⁷ The Government operates 12 other state-owned enterprises. It also has Crown-owned companies such as the Crown Research Institutes, the broadcasting companies Television New Zealand Limited and Radio New Zealand Limited, and the New Zealand Venture Investment Fund Limited.

An effective regulatory regime is needed

The performance of the three-waters sector can be substantially improved by (1) rigorously enforcing minimum performance levels; and (2) leaving it to councils to decide how they structure and operate their water businesses to meet these performance levels.⁸⁸

In particular, the Government should set clear health and environmental performance standards for all three-waters services. Councils achieving those standards within a specified time period should be free to structure their three-waters business how they wish, but they should remain subject to regulatory oversight and possibly subject to price control. The regulator should pursue significant financial penalties for *serious* breaches of health and environmental standards and interact collaboratively with the sector in ways and in circumstances that do not compromise the regulator's ability to hold water providers accountable for their performance.

The new approach to health and environmental standards carries a risk that costs will escalate far more than estimated. Independent and effective economic regulation is needed to provide the disciplines and incentives to encourage fit-for-purpose investments to lift the sector's performance and assist with affordability (by minimising costs).

Once the Government's new water regulator is established and working effectively, the Government should encourage the sector to move to arrangements like those discussed above. The Government should also apply economic regulation when and where it would improve performance. In the Commission's view, there is a strong case for the Government to actively encourage mergers; for example, by requiring greater transparency about the commercial and technical performance of suppliers, providing financial assistance for merger investigation studies and perhaps providing loans to cover transition costs.

The Government should also consider introducing a backstop regime that empowers stronger yet temporary intervention in council water businesses that fail to sufficiently lift their performance within specified timeframes. Backstop regimes are in place to address serious governance failures of schools, hospitals and local councils, and a backstop approach was adopted for the New Zealand electricity sector reforms in the late 2000s. Formulating a backstop regime would encourage councils to progress their own improvements and provide the Government with a ready mechanism to intervene in the interest of consumers where councils fail.

Economic regulation should be administered by a credible and independent regulatory agency, with expertise in investment, service quality and pricing analysis. The Commerce Commission already regulates many other natural monopolies in New Zealand and is a natural candidate to do so for the monopoly parts of the water sector. It has the right culture, and is clearly a professional, independent and authoritative organisation, with a credible "industry watchdog" reputation. It has significant experience with applying supplier specific regimes, and with managing light-handed regulation for some suppliers and explicit price control for other suppliers.

Consistent with this emphasis on encouragement, the Commission recommended in its *Better urban planning* report several initiatives to lift the performance of council water services, including:

- improving the clarity of the statutory and legal frameworks for water supply, wastewater and stormwater;
- acting to ensure that the CCO model is fit for purpose;
- investing in common national standards for quality, data collection and analysis;
- greater transparency and benchmarking; and
- encouraging councils to collaborate through joint CCOs to achieve scale and specialist capability where doing so is cost effective (NZPC, R10.4, p. 300).

⁸⁸ Some submissions on the Commission's Draft report mis-interpreted this permissiveness as suggesting water providers should be free to decide how they treat and test their water supplies. The Commission has no view on these technical regulatory issues.

Those recommendations remain just as relevant and important as when they were made in 2017.

F11.4

The performance of the three-waters sector would substantially improve by using an approach that (1) rigorously enforces minimum performance standards; and (2) is permissive about the way councils structure and operate their three-waters businesses. Without effective economic regulation there is a risk the new approach to health and environmental standards will exacerbate cost increases. Independent and effective economic regulation is needed to encourage fit-for-purpose investments to lift the sector's performance and assist with affordability (by minimising costs).

R11.1

The Government should actively encourage aggregation of council water businesses and better governance arrangements. It should also consider having backstop arrangements to deal with councils that fail to lift performance sufficiently to meet minimum health and environmental performance standards. The Government should place water providers under economic regulation when and where doing so would improve investment performance and minimise costs.

Direct funding and pricing of three-waters services is essential for sustainable performance improvement over the longer term

In the Commission's view, there is a strong case for water providers to charge water users directly rather than through council rates, and for those charges to be volumetric or capacity-based.⁸⁹ Capacity charges can be in the form of monthly fixed charges and/or connection charges, such as Watercare's Infrastructure Growth Charge.

Allowing council-owned water providers to directly charge water users is essential for establishing independent and professional governance of water services, as it allows the providers to make their own investment, financing and pricing decisions and places councils in a stronger position to hold those water providers accountable for their performance.

Under current legislation, only Watercare in Auckland can charge water users directly, which it does for drinking water and wastewater services. It levies both volumetric and capacity-based charges to households and businesses, although its volumetric measure of wastewater discharged into the wastewater system is not separately metered (the measure is set at 90% of the metered volume of drinking water).

Watercare's charges must satisfy section 57 of the Local Government (Auckland Council) Act 2009. Provisions in this section require Watercare to charge no more than its overall costs and prohibit it paying dividends or distributing surpluses to any owner or shareholder. These provisions are working well, with Watercare widely regarded as the best performing council-owned water provider in New Zealand.

F11.5

Allowing all council-owned and corporatised water providers to directly charge their water customers, under provisions like those currently applying to Watercare, is essential for enabling councils to sustainably lift the performance of their water businesses. Establishing water-service businesses with their own funding sources is an essential first step for establishing independent entities that are able to make their own financing and investment decisions.

⁸⁹ Although volumetric charging appears to have achieved substantial benefits for the councils that have adopted it, adopting it universally is not necessarily the best approach. CSA (2019, pp. 41-47) explains at some length the importance of water providers deciding their own funding and pricing arrangements, and the incentives on them to adopt volumetric charging when efficient to do so.

R11.2

The Government should legislate to enable any council-owned water provider, incorporated as a council-controlled organisation, to directly charge water users for their services, with provisions similar to those applied to Watercare in Auckland.

Not all councils will establish their water businesses as independent CCOs. In these cases their investment, financing and pricing decisions would remain under the direct governance of councils.

Apart from Watercare, council-owned water providers recover their drinking-water costs through general or targeted rates set by councils. Councils can set volumetric targeted rates for drinking water under section 19 of the Local Government (Rating Act) 2002, however they are not empowered to do the same for wastewater or trade waste discharges.

The Western Bay of Plenty District Council (sub. DR155) stated that volumetric charging for wastewater is the most urgently needed new tool, and Tauranga City Council (sub. DR186) stated volumetric charging would have significant financial and environmental benefits. The Whanganui District Council (sub. DR233) also mentioned the need for legislative changes to allow councils to adopt the same approach for wastewater as they can adopt for drinking water, and LGNZ (sub. DR263) argued that volumetric charging for wastewater should be made possible without creating a CCO.

R11.3

The Government should legislate to enable councils to set targeted rates for wastewater on a volumetric basis, just as they can set volumetric targeted rates for the provision of drinking water.

Financial assistance needs to reinforce the regulatory incentives

Although significant cost efficiencies should be possible for most council-led water services, in some situations these efficiencies are unlikely to offset higher costs to meet higher minimum standards for drinking-water services and wastewater services. Financial assistance to communities needs to be, and can be, designed in ways that reinforce the above regulatory incentives and avoid rewarding past poor decision making.

Hamilton City Council's submission to the three-waters review supported the idea of an independent regulator for water and pointed to the need for the government to provide incentives for aggregation.

HCC supports a new independent regulator for drinking water.... An independent regulator will provide consistency, dedicated/focused technical competency and expertise to drive the required level of compliance to ensure water is safe to drink.... Any new regulator will need to be funded and resourced appropriately...

To provide an incentive for aggregation, Government assistance for addressing any funding gaps in resilience, asset management and service delivery deficiencies (which nationally are estimated to be significant for water and wastewater), including meeting environmental and waters standards, should only be available to councils who are part of an aggregated service delivery model ie, a CCO.... It would be unacceptable for taxpayers to subsidise small, inefficient three water schemes. (Hamilton City Council, 2018b)

F11.6

Financial assistance to communities will likely be needed to assist deprived communities meet minimum health and environmental standards. The assistance needs to be designed to avoid rewarding past inaction and instead reward action for sustainably lifting the performance of water providers to these communities.

Chapter 6 found that small, rural and low-income councils have been experiencing sustained pressure on their rating capacity and Chapter 7 recommends the Government take account of the rating capacity of councils in determining funding for essential infrastructure such as drinking water infrastructure (refer R7.18).

The funding formula would be conditional on recipients undertaking the action needed to lift their performance, so that small councils that have acted responsibly in the past are not disadvantaged.

An integrated reform package that includes a credible regulator, would lift performance

Many councils may need to pursue an integrated package of reforms to adequately lift the performance of their three-waters services. For example:

- decisions aimed at increasing scale and specialisation will need to dovetail with decisions about organisational form, financing, ownership and governance arrangements; and
- decisions about financing arrangements will depend on decisions about organisational form, asset ownership, funding and pricing.

Implementing an integrated reform package that involves multiple parties and multiple components will require robust and coordinated implementation by councils that are seeking closer collaboration. Councils will need to identify and remove factors that could undermine reform incentives, such as liabilities that may greatly hinder their ability to attract high-quality professional directors. Councils may also identify legislative barriers for the Government to address.

The “tough/permissive” approach outlined above would allow the Government to proceed with regulatory reforms separately from local council initiatives. The Government has announced substantive reforms to improve regulation of water supply and discharge standards. Even so, making sustainable improvements at minimum cost will likely require more extensive changes to the way the sector is governed, structured, financed and funded. In this mix, having water providers charge customers directly for their services is essential to sustainably lift performance.

Directly charging water consumers means economic regulation will likely be needed in the future, at which point the Government will need to legislate for a credible and authoritative regulator to further develop and implement the regulatory regime. In doing so, the Government will need to decide whether setting up an industry-specific regulator or broadening the regulatory mandate of an existing generic regulator such as the Commerce Commission is the best option. Alternatively, the Government could adopt a mixed approach in which a Water Commissioner is established as an adjunct to the Commerce Commission, similar to the Telecommunications Commissioner.

11.5 Benefits of adopting the above approach

The approach outlined in this chapter would lift three-waters performance over the long term. It would provide strong and credible incentives for staff and councillors at local-council level to work constructively to better manage serious risks facing their communities and funding pressures on council budgets. Councils that take the decisions and achieve expected performance levels retain local decision-rights over all aspects of three waters.

This approach would provide the Government with a set of workable reforms that will achieve what matters – tackling the unacceptable performance levels for three waters – while constraining fiscal costs. It would avoid the Government becoming unnecessarily involved in the specifics of how to lift performance and navigating every local circumstance. Instead, the approach would concentrate on advocating for consumers and intervening only where local councils have clearly failed in their duties. Fiscal costs would be minimised by tying Government assistance to situations where councils have taken measures to sustainably lift performance and productivity and by structuring the assistance appropriately.

Finally, lifting the performance of the three-waters sector is consistent with the Government’s wellbeing framework. Safer drinking water will benefit the health of water consumers. Also, better and more consistent treatment of wastewater and stormwater will contribute to improving the natural environment. More efficient provision of three-waters services will contribute to improving the country’s productivity. It will also contribute to New Zealand’s international reputation for being “clean and green” by reducing the incidence of tourists becoming ill from drinking water and by reducing pollution of coastal and freshwater catchments.

12 Bringing it together

The scope of local government responsibilities in New Zealand is relatively narrow compared to many other countries, where local authorities often provide services such as education, social protection and health. In New Zealand, local government's activities are focused on regulating land use, investing in essential infrastructure and local amenities, and with the overall objective of enhancing community wellbeing. Given the scope of their responsibilities, local property taxes, supplemented with specific grants (especially in roading), have generally provided a robust funding basis for councils.

The current suite of funding tools is generally fit for purpose...

The power to levy local rates and charges gives local authorities in New Zealand a great deal of fiscal autonomy. Councils can choose between a range of funding and financing tools to fund their activities. They also have a high degree of autonomy to choose which activities they undertake, and to go about them in a way that suits the preferences of their communities. With this autonomy comes strong transparency requirements, making councils highly accountable to their communities. It also differentiates local authorities in New Zealand from many overseas local authorities that depend more on central government funds to deliver a broader range of responsibilities.

The Commission has found that the current suite of funding and financing tools generally measures up well against the principles of a good system. The tools are mostly simple, efficient and deliver a stable revenue stream. To date, the current framework has been able to provide councils with adequate revenues to meet their spending plans.

...but major new pressures are emerging

Councils are now facing several significant new pressures. Adapting to the impacts from climate change is a large, new and growing pressure on councils. Meeting the demand for infrastructure in high-growth areas, improving the performance of the three-waters sector and dealing with unfunded mandates passed from central to local government are also major challenges. Some councils are also facing pressure from tourism.

The pressures local government is facing are not evenly distributed, but vary according to the type of council as well as location, size, demographics and other characteristics. Local authorities also vary in their capacity to deal with the pressures they are facing. Some councils serving small, rural, low-income districts are already struggling, with an unsustainable funding position. Pressures on rating capacity have continued to increase for these councils over the last decade and are likely to intensify further into the future. This may mean that some councils will simply not be viable in their current form.

The need to address some pressures is urgent

Central government must give high priority to providing leadership to help councils plan for and respond to the impacts from climate change. It should develop advice, guidance and legal frameworks to support local government decisions about land use. Many councils are currently facing a no-win situation where either allowing or limiting development on at-risk land might result in litigation. These uncertainties need urgent attention.

Barriers to supplying growth-supporting infrastructure also need to be addressed as a priority. Many high-growth councils have failed to supply enough infrastructure to meet demand. This has contributed to the undersupply of housing in fast-growing urban areas, creating a serious social and economic problem through escalating house prices and rentals.

The recommendations in this report are aimed at supporting councils across New Zealand, in their diverse circumstances, to be high performing in the service of the communities they represent. The recommended changes vary widely in scale and priority.

This final chapter identifies regional spatial planning as key to efficiently and effectively bring together those funding and financing policies with the highest priority – over different planning horizons and across council boundaries. The chapter also explains how the Commission's funding proposals work together as a package.

Together, these proposals will help build a more effective funding and financing framework for local government.

12.1 Spatial planning

Local governments are facing many different challenges, some of which will combine and interact in complex and costly ways over long timeframes. Many of these challenges have a strong regional dimension, including:

- providing roads, public transport and water infrastructure to support fast-growing cities;
- taking an integrated catchment-wide approach to climate-change adaptation along coastlines (such as in the Hawke's Bay Clifton to Tangoio Coastal Hazard Strategy) and floodplains; and
- working out the most cost-effective way of delivering three-water services to small dispersed (and often low-income) communities within a region.

As councils plan and respond to the many and varied pressures their communities face, spatial planning will aid in coordinating their efforts, both regionally and with central government. It will require an adaptive planning framework, and must protect the environment and Māori interests in resource management.

In its *Better urban planning* inquiry, the Commission recommended statutory spatial planning to provide an integrating framework for local government investment decisions and resource management within a region. The framework would bring together processes under the Local Government Act 2002, the Resource Management Act 1991 and the Land Transport Management Act 2003. All local authorities within a region would work together to develop a suite of plans under the leadership of regional councils. Mana whenua and other Māori interests would participate in decision making. Agencies, such as the New Zealand Transport Agency, the Ministry of Education and the Ministry of Health would be involved in decisions on infrastructure where central government was contributing funding or expertise.

Regional spatial planning will better prepare councils for the future

Regional spatial plans would better prepare councils for the future by:

- Integrating land-use and infrastructure planning across a whole region. Indicative land uses (including for natural hazard management) would be integrated – with provision for future corridors for water, transport and other critical infrastructure, as well as with land for community facilities such as schools, hospitals and recreational spaces.
- Providing a statutory mechanism to ensure better coordination and improving relationships between regional councils and territorial authorities, and between central and local government. The integrated approach that spatial planning supports also helps to nurture more constructive relationships between local government and central agencies, compared to planning and development that happens in a fragmented way.
- Providing a way for councils and central government to more effectively share expertise on infrastructure investment and develop shared services where this is efficient.

Infrastructure New Zealand has proposed a substantial reorganisation of local government to achieve more integrated and effective planning for infrastructure within regions (sub. DR254). The inquiry's Terms of Reference prevent the Commission from making recommendations that directly affect boundary arrangements for councils. The Commission considers that statutory regional spatial planning would achieve many of the benefits of reorganising regions and redistributing functions between territorial authorities and regional councils.

The Government established an independent Infrastructure Commission in September 2019. It will scope infrastructure needs and intentions, and develop a strategy to support major infrastructure projects across local and central government and, in time, the private sector. Given the place-based nature of infrastructure,

the Infrastructure Commission's work will inform and be informed by regional spatial plans. This will be critical to the coordination, planning and delivery of significant infrastructure around the country.

The Climate Change Response (Zero Carbon) Amendment Bill, which passed into law in November 2019, requires the new Climate Change Commission to undertake a national level risk assessment at least every six years. The information gathered through those risk assessments will also be important to inform regional spatial plans. Climate change will impact how and where people live, and the risks will change over time. Spatial planning can help councils prepare effectively for this so that responses to climate impacts do not happen in an ad hoc way.

Providing a statutory base for regional spatial planning

Currently, no statutory basis for regional spatial planning exists (except in Auckland, under Auckland's own legislation). A lack of spatial planning risks significant loss of efficiency in infrastructure investments. High-level, strategic spatial planning will be key to ensuring a coherent, coordinated and long-term approach.

The government is undertaking a fundamental review of the resource management system. This review offers an opportunity to develop and embed an effective spatial-planning approach as a standard and mandatory part of the planning process. Such an approach would help ensure that a strong, well thought through and integrated basis exists for councils to make and prioritise decisions about both land use and investment.

12.2 A funding package to tackle emerging pressures

Local authorities have a wide range of funding and financing options to choose from; and how local authorities use them varies widely. This report has identified ways that many councils can make better use of existing tools, and how better organisational performance and decision making can help relieve funding pressures.

More central government funding will be needed...

While the Commission sees the current funding and financing framework as broadly adequate for business as usual, local government is facing significant pressures that mean it may need to rely more heavily on central government transfers in the future.

Central government support will be needed to fund required upgrades to three-waters infrastructure – particularly to assist councils in small, rural and low-income communities meet national minimum standards. At-risk councils will also need help to adapt their infrastructure to the impacts of climate change.

...but it must be provided in a principled way

Funding from central government means shifting costs from local ratepayers to general taxpayers, and there need to be principled reasons for doing this. This report lays out some important principles for how such support should be provided. Based on these, payments from central government may be justified when:

- local government activities have national-benefit spillovers;
- sharing risks across all taxpayers, when some communities are subject to damaging shocks (such as natural disasters);
- helping low-income communities whose councils are struggling to fund essential services; and
- recycling revenue collected centrally (for administrative efficiency) to cover costs incurred locally.

The current funding and financing system does not measure up well against these principles in some areas. For example, central government has passed responsibilities to councils over the years that have national benefits, without providing a means for councils to adequately recover the costs associated with carrying out those responsibilities. The Commission has recommended several measures to remedy this situation, and to support a more constructive relationship between central and local government going forward.

Funds that central government already provides to councils are not always distributed in an effective or principled way. The distribution of road user charges on heavy vehicles that cause damage to local roads is one example; funding for mixed-use tourism infrastructure is another.

Providing well-targeted support strikes the best balance

The combined scale of the pressures identified in this report is very substantial. There are principled reasons why central government should contribute a share of some of these costs. Doing so in the way recommended in this report will impose a significant fiscal cost on central government. It is difficult to estimate the costs of some recommendations with any precision. By far the largest item that can be estimated is the cost of the Commission's proposals to help councils whose assets are threatened by climate change. Central government's share of this cost could be in the order of \$150 million per year for 20 years. The Commission was also able to make a rough estimate of the fiscal cost of its recommendation for central government to help councils who would otherwise struggle to upgrade their three-waters assets to meet national standards. This cost will likely be much smaller (in the order of \$10 million per year).

Central government funding could be provided to councils through a single transfer, as a form of equalisation to address the various challenges as councils see fit. Yet, despite the superficial appeal of large unconditional transfers, the Commission favours an approach that provides support from central government through a small number of programmes that are carefully targeted at relieving the specific, significant pressures on local government funding and financing. These transfers must be carefully designed with a clear purpose, reasonable simplicity and transparency, and that they are fair and predictable. The Commission recommends a formula-based approach, which takes account of councils' rating capacity. Such an approach provides a level of predictability of future funding and is fairer.

Carefully designed, well-targeted solutions will ensure that advantages of the current property-rates based system are retained (including local government autonomy and accountability), while also achieving important sustainable outcomes in the national interest.

It will be important to keep track of how the different central government funding streams interact with each other, and how well they address council needs – particularly for small, rural, low-income councils. The programmes should provide reasonable predictability for councils while being monitored and evaluated for achieving their purposes after they have been running for an agreed period – perhaps three to five years.

12.3 Conclusion

The Commission believes that the package of recommendations in this report offers a sustainable and effective approach to tackling the current and growing future funding pressures on local government. Better and more transparent use of existing tools, and improvements to the way many councils operate, will be important. Carefully targeted and well-designed transfers from central government to address key areas of funding pressure will also be critical. Spatial planning will also be important to achieving an integrated and long-term approach coordinated at the regional level. The Commission looks forward to resource management reforms elevating the status of regional spatial plans and giving them a statutory basis.

Findings and recommendations

The full set of findings and recommendations from the report are below.

Chapter 3 – Trends in local government revenue, expenditure, prices and debt

Findings

F3.1

Over long periods of time, and with some variation, increases in local government revenue and rates have roughly matched increases in national and household income.

F3.2

Local governments face higher price inflation than general consumers largely because of the specialised inputs councils use to construct and operate infrastructure. Councils have little direct influence on the prices of many of these inputs, but can adjust their demand and mix of inputs, in response to changes in prices.

F3.3

Modelling of price inflation in local government goods and services, using an index that reflects yearly changes in the composition of expenditure, produces a slightly lower measure of inflation than the Local Government Cost Index currently used by councils. This suggests that councils do adjust their mix of inputs in response to prices, to some extent.

F3.4

After adjusting for price inflation using the Commission's preferred price index, local government operating expenditure (opex) per person (excluding depreciation and interest) grew at an average of 1.2% a year between 2007 and 2017. The opex per person of regional and rural councils grew faster than that of metropolitan and provincial councils.

Chapter 4 – Pressures on funding and financing

Findings

F4.1

New Zealand's population has grown by about 30% in the last twenty years, but this growth has not been evenly distributed. Councils in high-growth areas are facing pressure from the costs of funding growth infrastructure, while some councils in small districts or districts with declining populations face pressure from high fixed costs distributed between a relatively small number of ratepayers. These challenges are likely to increase as New Zealand's population becomes increasingly concentrated in the future.

F4.2

All districts across New Zealand are ageing, and this is happening much more rapidly in some districts. An ageing population creates additional costs for councils as elderly residents require a different mix of accessible infrastructure and services.

F4.3

Central government has shifted many responsibilities to local government without adequate funding provision. If some councils are not able to comply with all the responsibilities and functions being passed to them, then the objectives of central government legislation will ultimately not be achieved.

F4.4

Central government's passing of new responsibilities and functions on to local government is not new. However, this process has continued, and the cost burden on councils has continued to increase. Some councils are finding the cumulative impact increasingly difficult to manage.

Unfunded mandates fall broadly into four categories:

- new or stronger standards that councils must meet – without commensurate funding;
- new responsibilities, functions or processes that councils must undertake – without commensurate funding;
- reduction, cessation or removal of central government funding, or of government-funded programmes and services within the community; and
- restrictions on the ability of councils to set cost-recovery fees for services or functions.

F4.5

Central government is often passing new responsibilities to local government without adequate analysis, including consideration of the range of council circumstances. This can result in regulation that is "one size fits all", making it unfit for purpose, or particularly costly to implement, in some localities.

F4.6

To date there has been no comprehensive, independent and in-depth analysis of costs associated with implementing Treaty settlement arrangements – either to councils or iwi. Such analysis would be valuable to clearly identify the additional resources that councils must deploy to carry out this role.

F4.7

Co-governance and co-management arrangements established through Treaty settlement agreements between the Crown and Māori impose considerable costs on local authorities. So far, central government support has been ad hoc, and fallen short of covering the initial and ongoing costs to councils.

F4.8

Some councils are struggling to meet the costs of implementing Treaty settlement arrangements. The durability and effectiveness of some Treaty settlement arrangements may be at risk if funding issues remain unresolved.

F4.9

Evidence reveals no major shifts over the last several decades in the range of services that local government generally provides. The Local Government Act 2002 defines the purpose of local government as to "enable democratic local decision-making and action by, and on behalf of, communities". The quality of councils' democratic decision-making influences the nature, quality and extent of services provided by councils.

F4.10

Community expectations for levels of service from local (and central) government are rising over time in response to factors such as:

- changing perceptions of risk from climate change;
- drinking water quality and impacts of discharges into waterways;
- changes in the age mix of local populations; and
- rising incomes (which make it easier for people to meet the cost of better quality and additional services).

F4.11

Rates of afforestation are expected to increase as New Zealand transitions to a low-emissions economy. This increase in forested land will result in considerable new pressure on many local roads, particularly at harvest time. This will, in turn, lead to a need for more frequent maintenance and replacement of roads, resulting in increased costs. The cost pressure this creates for some councils indicates that Road User Charges collected from heavy vehicles are not reaching the areas where damage is occurring.

Recommendations

R4.1

The Government should commission a comprehensive, independent and in-depth analysis of costs associated with implementing Treaty settlement arrangements – to councils and to iwi. Such analysis should inform an update of Government policy on Crown contributions to support the implementation of Treaty settlements.

Chapter 5 – Improving decision making

Findings

F5.1

The elected member governance model does not consistently deliver a mix of councillors who collectively possess the full range of skills required for effective governance, and evidence shows that many councils lack the necessary expertise for effective decision making.

F5.2

A wide range of training, resources and supports is available for elected members. However, the uptake of these is patchy. Reported barriers include reluctance to travel, public scrutiny of travel and training expenses, dissatisfaction with the training provided, perceptions that training implies a lack of competence, and lack of personal awareness of the need for capability development.

F5.3

Significant scope exists for greater collaboration across councils, including through the use of shared services. The benefits of collaboration can include economies of scale and access to specialist skills, which can be particularly helpful for small, rural councils.

F5.4

The transparency of local government's processes, decision making and performance is the cornerstone of its accountability to local communities.

F5.5

The current performance-reporting requirements on local authorities, including the financial and non-financial information disclosures, are excessively detailed, inappropriately focused and not fit for purpose.

F5.6

Successive legislative reforms aimed at increasing the transparency of council performance through prescriptive reporting requirements have been counterproductive. The performance reporting framework of local government requires fundamental review, with a mind to significantly simplifying the required disclosures, and improving their overall coherence and fitness for purpose.

F5.7

While the purpose and content of the consultation documents for Long-Term Plans are prescribed in legislation, the form and manner of engagement are not. Councils are free to undertake early engagement to ask open-ended questions, and use a wide range of techniques tailored to their local communities. Some councils are doing this effectively.

F5.8

There is scope for councils to be more transparent about how they have considered and balanced the range of community views in their decision making.

F5.9

Long-Term Plans (LTPs) are long, complex and contain duplication. This is partly a function of the legislative requirements, which are disjointed and require an unnecessary level of detail. This works against the strategic intent of LTPs.

F5.10

The benefits associated with auditing Long-Term Plans and their consultation documents currently still exceed the costs. These benefits include assurance and transparency for the general public, as well as recommendations and advice for councils about good practice.

F5.11

A clear strategic framework is an important mechanism for guiding councils' decisions about both prioritisation and resource allocation. While the current legislative requirements impose parameters around the content of Long-Term Plans (LTPs), they do not preclude the preparation of a strategic framework, and alignment of the LTPs and other accountability and planning documents within this framework. A number of councils have done both successfully; others lack a coherent framework to guide their strategic planning.

F5.12

Undertaking long-term planning within a spatial planning approach promotes a more coordinated and integrated approach to strategic planning as well as investment decision making.

F5.13

The effectiveness of the decision-making procedures by local government depends on the public understanding, and taking part in, local democratic processes – both of which are notoriously low. This deficiency weakens the incentives that those processes provide for local governments to be accountable for the quality of their decisions.

Recommendations

R5.1

The Department of Internal Affairs, Local Government New Zealand (LGNZ) and the New Zealand Society of Local Government Managers should work together to improve basic governance, including financial governance, skills and knowledge across elected members. In undertaking this work, they should consider:

- a range of formal and informal mechanisms, such as training, peer support, mentoring (eg, via "sister council" links), and networking; and sharing of resources and best practice; and
- a variety of delivery platforms, including online media and collaboration tools.

LGNZ should ensure that resources and programmes are independently evaluated.

R5.2

Local Government New Zealand should work to achieve greater participation in ongoing professional development by elected members, including new and existing members, to ensure skills and knowledge are built and periodically refreshed.

R5.3

The Local Government Act 2002 should be amended to require all local authorities to have an Audit and Risk Committee.

Councils should draw on the good practice guidance and resources that are available to develop and run their committees. Good practice suggests that Audit and Risk Committees should have at least one independent member, to ensure they span the full range of necessary skills and experience. Independent members should be external to the Council, and appropriately skilled and qualified.

R5.4

The performance reporting framework of local government (including the financial disclosures, Funding Impact Statement and performance measures) should undergo a fundamental, first principles review. This review would:

- identify financial disclosures of low value to users of financial statements;
- examine the mix of financial and non-financial disclosures, and recommend a revised framework that provides the most efficient, coherent and accessible way of reporting the range of information sought by users, whether in relation to financial performance or service delivery performance;
- consider the interaction between the financial reporting requirements under generally accepted accounting practice (GAAP) and other requirements under local government legislation and regulation;
- develop new measures for rates by category of rateable property (recommendation 7.10) and the unit costs of service delivery (recommendation 5.7);
- consider the potential for new forms of extended external reporting, such as integrated reporting, to shape changes in the reporting framework;
- ensure that the conclusions of the review are appropriately taken into account in the proposed review of the legislative requirements for Long-Term Plans (Recommendation 5.5);
- determine how to best implement centralised publication of a set of mandatory disclosures across all councils, to support greater accessibility, transparency and comparability (eg, by using digital filing); and
- be undertaken by a working group including the Department of Internal Affairs, the External Reporting Board and representatives of the local government sector and information users. The Office of the Auditor-General would be consulted.

R5.5

The Local Government Act 2002 should be revised to clarify, streamline and reduce the required content of Long-Term Plans so as to avoid duplication, ease the compliance costs on councils, and help make them more accessible documents. This review should incorporate the conclusions of the proposed review of performance reporting (recommendation 5.4).

R5.6

The scrutiny on long-term planning provided by the audit requirements should not be considered a substitute for internal quality-assurance processes. Councils should have robust quality-assurance procedures across their long-term planning process, including the use of expert review where appropriate (such as for highly technical or complex matters, or large and/or high-risk projects).

R5.7

The review of local government performance reporting requirements should consider how to include measures of the aggregate unit costs of service delivery for a small number of essential infrastructure categories (roading, water supply, wastewater, stormwater and solid waste).

Chapter 6 – Evaluating current funding and financing arrangements

Findings

F6.1

The funding tools of local government in New Zealand are appropriate for local government's role, and coherent with the responsibilities of central government to stabilise the macro economy and redistribute from those well-off to those in need. Responsibilities for making choices about public goods and infrastructure are mostly well demarcated across the two levels of government.

Some areas of tension between central and local government have emerged. These tend to be where local government services have national-level benefit spillovers, yet current funding arrangements do not consider this.

F6.2

The rating tools of New Zealand local governments have low compliance and administration costs. The complexity of development contributions (DCs) causes them to have higher administration and compliance costs.

Rates based on (unimproved) land values cause little or no economic distortion and therefore are a highly efficient way to raise revenue.

Rates on capital value are relatively less efficient because they can disincentivise land and building development. Rates on the capital value of business property can, in addition, cause unnecessary productive inefficiency.

Even so, when rates, user charges, DCs and connection charges reflect costs to the council of providing services, these are efficient ways to raise revenue.

F6.3

Development contribution (DC) policy and implementation are inherently complex. Good examples exist of council DC policies. Councils appear to have been refining and improving them over time. Yet the DC policies of some councils still fall short of best practice. The good policies provide a transparent and reliable platform for setting DC charges in line with the purpose and principles of DCs in the Local Government Act 2002.

F6.4

The fiscal adequacy of local government funding is under strain in the areas of adaptation to climate change, tourism, growth infrastructure, and unfunded mandates from central government. Pressures in these areas are mostly uneven across councils, and in the first two areas are set to continue rising.

Since the early 1990s, rates revenue per person, council expenditure per person and income per person have grown at similar rates. While this suggests that the current funding system has proved adequate and sustainable in the past, the new and growing pressures may require new sources of funding for the future.

Also, some smaller, lower-income and mostly rural local authorities are under additional strain because, to raise enough revenue, they have needed to increase rates to an historically high level as a percentage of income.

F6.5

Councils often make rating decisions in a non-transparent manner that fails to explain the basis for setting rates and suggests a confused consideration of benefits, affordability and willingness to pay.

F6.6

Programmes of central-government transfers to local government are ubiquitous globally but play a smaller role in New Zealand than in many countries. This smaller role is good for local government autonomy and accountability. It is important that programmes have a clear purpose, provide predictable revenue, preserve local government autonomy and accountability as far as possible, and are fair, efficient and transparent.

Among current transfer programmes, the system of grants from the National Land Transport Fund for local roads and other forms of land transport is an example of good design.

F6.7

The current main funding tools of local government in New Zealand measure up well against the principles of appropriateness for local government use, coherence within national policies and institutions, efficiency, enforceability, and the stability and predictability of revenue. Yet scope exists for many councils to make better and more transparent use of their funding tools and this would help relieve funding pressures.

Recommendations

R6.1

Given the limited scope of local government in New Zealand, central government transfers to local government should be restricted to the following situations:

- when local government activities have national-level benefit spillovers;
- sharing risks across all taxpayers, when some communities are subject to damaging shocks (such as natural disasters);
- helping low-income communities whose councils are struggling to fund essential services; and
- recycling revenue collected centrally (for administrative efficiency) to cover costs incurred locally.

Central government payments to local government that do not have one of these principled justifications, or similar, risk undermining the autonomy and accountability of local government.

R6.2

Given the modest scope of local government in New Zealand, the benefits of a property-tax-based system, and the absence of a clearly superior alternative, rating land and property should continue as local government's main taxing power.

To help relieve funding pressures, councils should make better and more transparent use of their rating and other funding tools.

Chapter 7 – Future funding and financing

Findings

F7.1

Councils have a portfolio of charging and rating tools to recover the costs of their growth-related infrastructure. Yet cost recovery may take many years, councils face investment risks (eg, over-investment or investing in the wrong location) and some councils face debt limits. Councils also face political pressure to not support growth. The result is that some councils in fast-growing urban areas are either not willing, or not able, to invest in growth-related infrastructure at levels that match demand.

F7.2

Giving councils powers to levy a value-capture rate, road congestion charges and volumetric wastewater charges would give them additional means to recover the costs of growth from those who benefit from growth.

F7.3

Many councils and ratepayers still perceive that council revenue from local growth does not fully cover related costs, and that therefore growth is financially disadvantageous. This perception is exacerbated by the:

- highly visible way that property owners are billed for and pay rates;
- much less visible way that most people pay income tax and GST; and
- the automatic link between economic activity and revenue from income tax and GST, which does not exist for rates.

F7.4

While local property taxes as a percentage of property values are used in other parts of the world they are not a panacea for aligning the incentives of existing voters and property owners with socially desirable growth in dwellings. Given that property prices in New Zealand have been neither stable nor predictable, property tax revenues would not be either, and this would be undesirable.

The highly transparent system of rating in New Zealand provides a healthy fiscal discipline on councils.

F7.5

None of the options of a local property tax, a local income or sales tax, or a portion of national GST or income tax is a fully satisfactory solution to the problem of councils and existing property owners and voters failing to embrace growth.

These options could provide more direct links between growth and council revenue, but each one fails to meet at least one important criterion for a good local tax. The revenue from local property tax would be neither stable nor predictable, local income and sales taxes would be complex and likely to have high administrative and compliance costs, and a portion of national GST or income tax would risk undermining to some extent local autonomy and accountability.

F7.6

A system of payments from central government to councils based on new building work in territorial local authorities could offer local government an additional funding source. The system would provide a direct link between council revenue and a council's effectiveness in keeping land supply and infrastructure responsive to demand. The payments could be effective in incentivising councils and their existing ratepayers to support growth.

The effectiveness of such payments to incentivise councils to facilitate development is too uncertain, given currently available evidence, to justify recommending them. Even so, given the very strong national public interest in stimulating housing supply, further consideration of incentive mechanisms to achieve that end is warranted.

F7.7

Councils vary widely in their use of debt. Debt can spread the cost of long-lived infrastructure assets fairly over the people and properties that benefit from these assets. Most councils have adequate capacity on their balance sheets to finance their infrastructure development. A few high-growth councils face debt limits that seriously hinder their infrastructure investment from keeping pace with demand for new development.

F7.8

Special Purpose Vehicles (SPVs) are an effective way to reduce the harm caused when debt limits hinder the ability of high-growth councils to invest in infrastructure to serve new greenfield developments. The SPVs raise finance for infrastructure investment in a way that puts debt on the balance sheets of new property owners who benefit from the infrastructure, rather than on the balance sheets of councils or the Crown.

F7.9

The Government and officials are working on ways to expand the use of Special Purpose Vehicles (SPVs) to finance different types of infrastructure investments, including ones that will benefit both new and existing residents. While more challenging to design, and requiring legislation, these expanded SPVs promise to deliver a further valuable means to reduce the barrier of debt limits for fast-growth councils.

F7.10

The partial or full sale of a commercial asset can provide a council with opportunities to improve ratepayer value and finance investments in other assets. Each case needs to be considered on its merits based on maximising net benefit for the district or region.

F7.11

Vacant land is a necessary intermediate stage in a complex process that starts with rural or brownfield land and ends with new occupied houses on developed land. Taxing vacant land would impose an additional tax on this process and would likely impair developer flexibility and risk-taking. It would probably increase costs and slow housing supply. This is the opposite of what New Zealand needs.

F7.12

Vacant-land taxes present severe definitional challenges because it is difficult to distinguish legitimate from harmful holdings of vacant land. Mainly for this reason, the administrative costs of vacant-land taxes are likely to be a high percentage of the revenue raised.

F7.13

Evidence indicates that ownership of vacant land suitable for development is not concentrated enough on the outskirts of New Zealand cities to cause problems from the owners using market power to restrict supply and push up prices.

F7.14

Section 103(3) of the Local Government Act 2002 requires councils to show how they have complied with section 101(3). Section 101(3) sets out the matters that councils must consider when determining the sources of funding to meet their funding needs. Councils' explanations of their revenue and financing policies are often not transparent in showing how they have met the requirements of the Act.

F7.15

Significant examples exist of where central government payments to local government are justified yet not paid. If the Government were to recognise these situations and act on them, it would help to relieve funding pressures for local authorities.

However, central government payments to local government – where no principled justification is present – risk undermining the autonomy and accountability of local government.

Recommendations

R7.1

In choosing among funding tools, rating bases and whether to charge rates as a percentage of property values or as uniform charges or some other targeted feature, councils should give close and explicit consideration to:

- promoting economic efficiency;
- fairness in who pays; and
- keeping compliance and administration costs low.

Sometimes these three goals will conflict, in which case councils must be clear and transparent about the reasons for their choices.

Regarding fairness in who pays, councils must strike a balance between charging in line with who benefits from the service and basing payments on ability to pay. Again, it is important for councils to be transparent about their reasons for striking the balance they choose.

R7.2

The Government should resolve the legislative ambiguity about councils' ability to charge for their work on compliance, monitoring and enforcement (including incident response and investigation) of non-consented activities.

The resolution could be through clear national guidance and/or a legislative amendment that explicitly provides for cost recovery. This work should be done in partnership with Local Government New Zealand, the New Zealand Society of Local Government Managers and local government practitioners.

R7.3

The New Zealand Society of Local Government Managers should review and revise its guidance on setting fees in local government, to more clearly explain how to apply the benefit and exacerbator principles and how to set fees that meet the legal test of "reasonable". The Quality Planning guidance on setting fees for consented activities would be a good model for the revised guidance to follow.

R7.4

The Government should give councils powers to levy:

- some form of value capture using targeted rates;
- road congestion charges; and
- volumetric wastewater charges.

These would give councils additional means to recover the costs of growth from those who benefit from growth.

R7.5

The Government should expand the use of Special Purpose Vehicles to finance investment in growth infrastructure in fast-growth local authorities that face debt limits. If needed, the Government should promote legislation in Parliament to enable the placement of debt-servicing obligations on existing as well as new residents who will benefit from the infrastructure.

R7.6

The Government, Local Government New Zealand and the New Zealand Society of Local Government Managers should work together to develop templates to standardise the structure and format (but not the content) of:

- councils' development contribution (DC) policies; and
- council assessments of DC charges for individual property developments.

Councils should be strongly encouraged to use the templates.

R7.7

While the general approach of local authorities to depreciating their infrastructure assets is satisfactory, three issues are of concern and may require action:

- councils' decisions about the best use of the large amounts of cash that depreciation funding can give rise to should be part of formulating their wider financial and infrastructure strategies;
- councils should prioritise improving their knowledge of the condition and performance of their assets to, among other benefits, avoid the risk of under-estimating asset lives and over-estimating depreciation expense; and
- the Essential Services Benchmark should be reviewed as part of the wider review of the performance reporting framework of local government referred to in Recommendation 5.4. Any reframing should avoid the implication that individual councils must invest in as much asset renewal each year as their depreciation expense.

R7.8

Councils should consider the partial or full sale of commercial assets as an alternative to borrowing so they can finance needed new investment. Councils should consider each case on its merits based on maximising net current and future benefit for the district or region.

R7.9

The Government should not further advance the idea of implementing a vacant-land tax. Councils should tackle the problem of lack of housing supply by reducing regulatory and infrastructure barriers to development.

R7.10

The Commission has recommended (Recommendation 5.4) a fundamental first-principles review of the local government reporting framework, including a review of performance measures. This first-principles review should consider how to implement a requirement that councils publish information on rates revenue by category of rateable property (eg, residential, business and rural), the number of rating units in each category and average and median rates per unit in each category.

R7.11

Section 45 of the Local Government (Rating) Act 2002 should be amended to require councils to provide indicative itemised rates assessments that show ratepayers the dollar amounts they are contributing to each activity funded from each rate. Even so, councils should retain their current budgeting flexibility and should not, as a result of the amendment, be required to hypothecate the dollar amounts for particular activities.

R7.12

Councils should assess rates for business properties in proportion to the cost of the council services that benefit those properties. If business rates are set simply to raise revenue without reflecting benefits, they are likely to cause productive inefficiency that is avoidable.

R7.13

Local Government New Zealand and the New Zealand Society of Local Government Managers should develop advice for councils on transparently showing how their revenue and financing policies meet the requirements of the Local Government Act 2002, including consideration of the benefit principle, the exacerbator principle and ability to pay.

R7.14

The Government should pay development contributions on all projects it undertakes in line with the development-contributions policies of the local authorities in which the projects are located.

R7.15

The Government should pay more than it currently pays (because of the Crown rating exemption) for the services that councils provide to Crown properties.

R7.16

The Government should find an efficient and effective means to fund councils for the cost of damage to local roads caused by heavy vehicles such as logging trucks. While the vehicles pay for their damage through Road User Charges, no effective mechanism currently exists to channel these funds to councils to cover the cost of the damage that councils bear.

R7.17

The Government should remove the few remaining legislative limits on the fees that councils can charge to recover their regulatory costs. Consistent with provisions in the Resource Management Act 1991 and the Local Government Act 2002, it should constrain councils to charging reasonable costs only.

R7.18

Central and local government should strive to achieve a more constructive relationship and effective interface through:

- central and local government providing input (formally or informally) into each other's relevant policymaking processes, under an agreed set of principles or a protocol;
- central government engaging in a meaningful dialogue with local government early in the process of developing relevant new regulations;
- central government explicitly and consistently considering the costs to local government of relevant new regulations, and the funding of the costs, in its Regulatory Impact Assessments;
- cooperative approaches to tackling problems with implementing relevant new legislation, regulations or environmental standards;
- the creation of formal and informal feedback loops to identify problems with delegated regulations when they first appear; and
- the spread of information through the system and the sharing of expertise and knowledge.

R7.19

The Government should, in providing funding to local government for essential infrastructure (such as roading or drinking water infrastructure), take account of the rating capacity of councils in determining the level of support.

Government funding should also be conditional on sensible infrastructure design and local co-funding. The Government should favour designs with the scale and specialisation best suited to help small communities upgrade and then maintain their essential infrastructure.

Chapter 8 – Affordability for households

Findings

F8.1

Concern about rates affordability typically focuses on low-income (particularly elderly) households who own their own homes. Yet such households generally have much lower housing costs than other low-income New Zealand households (most of whom do not own their own homes).

F8.2

Recipients of New Zealand Superannuation payments are the main beneficiaries of the Rates Rebate Scheme. Most recipients are not eligible for the Government's Accommodation Supplement because their accommodation costs are below the threshold to qualify, unless they have a mortgage or substantial essential repairs.

F8.3

The Rates Rebate Scheme (RRS) is administratively inefficient and satisfies neither the horizontal equity principle nor the vertical equity principle. The level of assistance currently offered by the RRS is a little over \$12 a week at most. Low-income homeowners can, as an alternative, access equity in their properties to help meet living costs, including rates.

F8.4

The Accommodation Supplement is a well-tested major government programme that, compared to the Rates Rebate Scheme, efficiently and equitably provides support to eligible low-income households to meet housing costs, in a range of circumstances across New Zealand.

F8.5

The Government has several options for streamlining the administration of the Rates Rebate Scheme if it chooses to keep the scheme.

- The Department of Internal Affairs could move to full online administration, building on trials it has already undertaken.
- Administration could be passed to either the Ministry of Social Development or Inland Revenue.

Each of these options has strengths and weaknesses in terms of data processing and verification.

F8.6

The statutory 30% cap on uniform charges (covering uniform annual general charges and uniform targeted rates applying across the district, but excluding uniform water and wastewater rates) has no clear rationale and unnecessarily restricts the discretion of councils to use rates to reflect the benefit of services and amenities. Currently, few councils are close to the cap.

Recommendations

R8.1

The Government should work with local government and suitable financial providers to develop and implement a national scheme for postponing rates. The scheme should:

- have a single set of clear and generous eligibility rules;
- be accessible and have provisions that are easy to understand and work with;
- have moderate and transparent fees; and
- be nationally promoted.

R8.2

The Government should phase out the Rates Rebate Scheme (RRS) over a defined period, such as five years, from when an effective national scheme for postponing rates is in place. Until the RRS is phased out, the current income-abatement thresholds and maximum payments should be maintained.

R8.3

The Local Government (Rating) Act 2002 should be amended to remove the statutory cap on uniform charges.

Chapter 9 – Adapting to climate change

Findings

F9.1

More guidance for councils on climate-change adaptation is needed, and providing it through central, specialised sources of knowledge will be more cost-effective than each council inventing its own solution. Most councils will welcome guidance and find it helpful not only as advice but as backing for taking the difficult and unpopular decisions that will sometimes be necessary.

F9.2

New Zealand's laws and institutions acknowledge the risks from climate change and require local governments to plan for the approaching and rising hazards it will cause.

With climate change, the risks are uncertain and changing over time. A shift in understanding is needed to deal with the increasing and evolving nature of climate-change risk. Such a shift will support decisions that:

- lean against the tendency to continue along current pathways (with hard forms of protection for new and existing land use);
- encourage the use of anticipatory and flexible decision tools; and
- reduce risks and costs over the long term and do not overly focus on the response and recovery stages of emergency events.

F9.3

Three high-level principles to guide policy thinking and action on climate change are:

- decisions about whether, when and how to defend/protect, adapt, or retreat in the face of hazards related to climate change should aim to minimise long-run costs;
- the way costs of adaptation are shared should be fair across communities and generations; and
- active engagement with, and empowerment of, affected communities in developing adaptation pathways is vital.

The first two principles imply placing a high priority on avoiding behaviour that leads to increased risk exposure for private gain at others' expense (moral-hazard behaviour).

F9.4

Properties at growing risk from sea-level rise, river-plain flooding or other types of climate-change hazard will become increasingly uninsurable. This is because the nature of climate-change risk lacks two characteristics for insurability:

- it is not possible to calculate the probability of loss from past experience due to the novel, uncertain and dynamic character of climate-change risk; and
- losses are not unforeseen – climate damage is foreseeable (even though its precise form, magnitude and location are uncertain).

Insurers can overcome the first difficulty to some extent through the use of forward-looking risk models.

F9.5

New Zealand has a strong tradition of social insurance in which society at large helps those in need who suffer hardship or loss through no fault of their own and where these losses may be uninsurable. This tradition provides a possible basis for some form and amount of central-government assistance to councils seriously threatened by losses due to climate change. Any such assistance will need careful design to incentivise risk reduction and avoid moral hazard.

F9.6

The New Zealand Transport Agency's model of co-funding local land-transport infrastructure could be extended to provide central-government assistance to relocate local roads and bridges that will be non-viable because of climate-change-induced sea-level rise, flooding and/or storms. This approach has potential benefits to:

- incentivise councils to anticipate climate risks to local roads, and encourage community engagement and buy-in;
- prioritise spending in line with net social, economic and environmental benefits while taking account of equity across regions;
- counter optimism bias by requiring that the discipline of a strong business case and engineering and environmental quality standards are met; and
- make specialist knowledge and skills available to councils and help spread best practice and successful innovations around the country.

To do this, the Government will likely need to supplement the National Land Transport Fund with either higher revenues from road users, contributions from general revenues or additional borrowing.

F9.7

The past approach of containing many New Zealand rivers within relatively narrow stopbanks for flood protection and to maximise the area of productive land for agriculture and other uses will become less viable as climate change increases the risk of more frequent and more intense rainstorms.

Best practice is now to allow wider river corridors that give rivers room and make space to more safely manage flood risk. But making this change faces barriers of existing property rights, expectations of continued protection, and high costs.

F9.8

The decision whether to provide public funding to support private owners to undertake cost-effective climate-change adaptation is for central government to make. Yet the existence or not of such support will impact local authorities' responsibilities for leading and implementing managed retreat or other forms of adaptation.

Recommendations

R9.1

Central and local government should jointly develop and provide a centralised source of knowledge and guidance about climate-change adaptation for councils. It should be authoritative and up to date on science and data, regulation and planning, risk management, legal issues and community engagement.

R9.2

The Government should develop and provide legal frameworks that give councils more backing and confidence to make land-use planning and infrastructure investment decisions that are appropriate in the face of constantly changing, but increasing, climate risks.

R9.3

National and local authorities should adopt anticipatory and flexible approaches to climate-change adaptation, in line with recognising the constantly changing nature of the risks.

R9.4

The Government should review the existing legislative and planning framework for the environment and natural hazards, to ensure that considerations about climate-change adaptation are integrated and aligned within and across that legislation and policy where relevant.

R9.5

The Government should extend the New Zealand Transport Agency's role in co-funding local land-transport infrastructure to include assistance to relocate or protect local land-transport infrastructure at risk from sea-level rise and more intense storms and flooding due to climate change. The amount of assistance should reflect the scale of the threat facing each council and its rating capacity.

Assistance should be conditional on a strong business case and meeting engineering and environmental quality standards. It should only be available to defend existing infrastructure when business cases indicate that this option is clearly superior to other options.

R9.6

The Government should create a new agency and a Local Government Resilience Fund. The new agency should work with at-risk councils to:

- co-fund the redesign and possible relocation and rebuilding of three-waters infrastructure when it becomes no longer viable because of sea-level rise and more intense flooding due to climate change;
- co-fund the redesign and possible relocation and rebuilding of other non-land-transport local government infrastructure and assets at risk from the impacts of climate change;
- work out the best way to lessen future flood risks from rivers. This could include moving to a new, more sustainable and best-practice paradigm of giving rivers room and developing multiple innovative uses of the wider river corridors.

Funding should be conditional on a strong business case and meeting engineering and environmental quality standards. It should only be available to defend existing infrastructure when business cases indicate that this option is clearly superior to other options. The level of funding should be based on a formula that reflects local need and rating capacity.

Chapter 10 – responding to tourism pressures

Findings

F10.1

Tourists already pay for most of the costs they create. But they do not cover the costs incurred by councils for the local public amenities and services that tourists consume directly. While difficult to quantify, this funding shortfall is small in terms of total council revenue.

F10.2

International tourists pay a large amount of GST to central government relative to the normal benchmark of a zero rate of GST on exports. Some of this GST can be regarded as payment for the costs they do not otherwise pay for. Yet overall, international tourists more than pay their way.

The excess revenue from GST on international tourists could still provide a net benefit to New Zealand even though the GST will cause some efficiency loss. Evidence suggests that many international tourists are relatively insensitive to modest changes in the cost of visiting New Zealand. To the extent they are, the tourists will bear most of the burden of the GST, efficiency losses will be small, and New Zealand Inc will benefit from the additional revenue.

F10.3

Central government provides significant funding support for local infrastructure, including local mixed-use infrastructure that tourism puts pressure on.

GST revenues from international tourists greatly exceed the costs of the national services that tourists are free to access. Yet at a local level, some councils face costs of international tourism that exceed the revenues they receive from such tourism. This imbalance is mitigated by councils' ability to apply for and receive funds for tourism costs from central government.

F10.4

Councils in tourism hotspots have taken very different approaches to financial management and infrastructure investment, and to responding to tourism pressures.

Some councils have focused on addressing past underinvestment in essential infrastructure, with consequent increases in debt levels and rates. Some other councils are now struggling to deal with pressure from tourism, at least in part due to a legacy of deferred investment.

F10.5

Standalone homes rented out through peer-to-peer platforms for a significant proportion of the time are acting as accommodation businesses. It is therefore appropriate that they pay business rates, or a proportion thereof.

F10.6

There is scope for many councils to make better use of existing tools for funding and financing mixed-use infrastructure. This includes better use of debt to finance the upfront capital investment in infrastructure, greater use of user charges to help fund the ongoing operational costs, and more effective use of efficient targeted rates. In addition, there is a wide range of strategies and tools that councils can use to manage and respond to peak demand.

F10.7

To-date central government funding for tourism and mixed-use infrastructure has focused on upfront capital costs, and has been allocated largely through time-limited contestable processes. Initiatives like the Tourism Infrastructure Fund, The Responsible Camping Initiative and the Provincial Growth Fund provide significant funding to councils but provide little funding certainty for councils. This hinders councils' ability to plan and prepare effectively for tourism pressure and growth.

F10.8

Better use of existing tools and central government funds should be enough to close the tourism funding shortfall. Given the small scale of the funding gap, introducing new funding tools would incur significant implementation, administration and enforcement costs and is unlikely to result in a net benefit to councils.

Recommendations

R10.1

The Department of Conservation should ensure that visitors contribute towards the costs of construction, maintenance and renewal of the mixed-used infrastructure and services it is responsible for providing. This could be done, for example, through user charges that apply, where practical, to both overnight and day visitors.

R10.2

Central government should explore ways to assist councils to identify properties operating as short-term rental accommodation businesses within their districts. Options to explore include requiring booking platforms to provide information to a national register of short-term rental accommodation providers.

R10.3

Councils should make better use of existing tools for funding and financing mixed-use infrastructure, including better use of debt and greater use of user charges.

Councils should also make better use of efficient targeted rates, and communities under significant pressure from tourism should introduce a broad-based targeted rate on ratepayers in business districts benefiting from tourism, levied on land value.

R10.4

Some central government funding for councils for tourism and mixed-use infrastructure is justified – particularly in tourist hotspots with a high proportion of day visitors. Such funding should be distributed in a more predictable, efficient and fair way by using a transparent allocation formula.

Chapter 11 – Future funding and financing of three waters

Findings

F11.1

There is considerable evidence of poor performance of the three waters sector in many parts of New Zealand, in terms of impact on human health, the natural environment, productivity and costs to consumers and ratepayers. However, some councils and providers are taking the tough decisions needed to improve performance, including Auckland’s Watercare, Tauranga City Council, Kāpiti Coast District Council and the five councils involved in Wellington Water.

F11.2

The inherent economic features of three waters make it a natural monopoly in many cases and there are large negative externalities on communities when poor-quality water treatment occurs. However, these natural monopoly and externality features are not the reason for the poor performance of many council-led water providers. Other industries with similar features, such as electricity and gas distribution, perform well.

F11.3

Poor performance in the three-waters sector in New Zealand generally arises from the following factors.

- Inadequate supplier expertise and capabilities, resulting from some councils prioritising local control of their three-waters activities rather than increasing their operational scale through shared services, joint ventures or mergers.
- Poor governance capabilities and incentives, due to lack of independent directors and insufficient use of company-type structures when they are likely to be beneficial.
- Poor financing, funding and pricing arrangements, due to under-recovery of costs and funding from council rates rather than water service charges.
- Weak safety, environmental and economic regulation, due to poorly designed regulations, weak enforcement and lack of regulatory expertise.

F11.4

The performance of the three-waters sector would substantially improve by using an approach that (1) rigorously enforces minimum performance standards; and (2) is permissive about the way councils structure and operate their three-waters businesses. Without effective economic regulation there is a risk the new approach to health and environmental standards will exacerbate cost increases. Independent and effective economic regulation is needed to encourage fit-for-purpose investments to lift the sector’s performance and assist with affordability (by minimising costs).

F11.5

Allowing all council-owned and corporatised water providers to directly charge their water customers, under provisions like those currently applying to Watercare, is essential for enabling councils to sustainably lift the performance of their water businesses. Establishing water-service businesses with their own funding sources is an essential first step for establishing independent entities that are able to make their own financing and investment decisions.

F11.6

Financial assistance to communities will likely be needed to assist deprived communities meet minimum health and environmental standards. The assistance needs to be designed to avoid rewarding past inaction and instead reward action for sustainably lifting the performance of water providers to these communities.

Recommendations**R11.1**

The Government should actively encourage aggregation of council water businesses and better governance arrangements. It should also consider having backstop arrangements to deal with councils that fail to lift performance sufficiently to meet minimum health and environmental performance standards. The Government should place water providers under economic regulation when and where doing so would improve investment performance and minimise costs.

R11.2

The Government should legislate to enable any council-owned water provider, incorporated as a council-controlled organisation, to directly charge water users for their services, with provisions similar to those applied to Watercare in Auckland.

R11.3

The Government should legislate to enable councils to set targeted rates for wastewater on a volumetric basis, just as they can set volumetric targeted rates for the provision of drinking water.

Appendix A Public consultation

Submissions

Individual or Organisation	Submission Number
Amy Brooke	DR 256
Andrew Stevenson	DR 246
Anthony Wilson	114
Aorangi Ski Club	DR 140
AREINZ	132
Art Deco Trust Inc	DR 173
Ashburton District Council	092, DR 174
Auckland Airport	065
Auckland Council	120, DR 185
Bay of Plenty Regional Council	095, DR 187
Bed and Breakfast Association New Zealand	DR 214
Bill Mitchelmore	DR 208
Bookabach	099, DR 209
Brian Sharplin	DR 260
Buller District Council	DR 149
Business Central	DR 249
BusinessNZ	054, DR 189
Capper	DR 194
Carterton District Council	016
Catherine Stewart	129
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Central Plateau Schools Alpine Charitable Trust	DR 160
ChargeNet NZ	060
Chartered Accountants Australia and New Zealand	DR 250
Chris Hook	002
Christchurch City Council	DR 200
Christopher Robinson	DR 138
Clare St Pierre	DR 172
Clive Thorp	DR 219
Corporate Taxpayers Group	DR 237
D Hewison	022, DR 163
Dan McGuire	DR 137
Darby Brooke	DR 213
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Donald Ellis	089
Dr Anthony Brien	134, DR 141
Dr Kenneth Palmer	010, DR 148
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Engineering New Zealand	098
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Environment Southland Regional Council	116, DR 195
Environmental Protection Authority	DR 226

EROAD	036
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Federated Farmers of New Zealand	075, DR 217
Foodstuffs (NZ) Limited	023, DR 235
Foxton Beach Progressive Association Incorporated	041
Garry Law	DR 192
Generus Living Group	DR 224
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Graeme McInnes	001
Gray Southon	DR 238
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Hospitality New Zealand	078, DR 188
Hospitality New Zealand Auckland Branch	029
Hospitality New Zealand Bay of Plenty, Gisborne and Thames Branches	081
Hospitality New Zealand Buller and Westland Branches	063
Hospitality New Zealand Canterbury Branch	033
Hospitality New Zealand Central Otago Branch	136
Hospitality New Zealand Hawke's Bay Branch	076
Hospitality New Zealand Manawatu Branch	059
Hospitality New Zealand Nelson and Marlborough Branches	062
Hospitality New Zealand Northland Branch	044
Hospitality New Zealand Otago Branch	071
Hospitality New Zealand South Canterbury Branch	103
Hospitality New Zealand Southland Branch	051
Hospitality New Zealand Taranaki Branch	056
Hospitality New Zealand Waikato Branch	030
Hospitality New Zealand Wellington Branch	055
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Hutt City Council	074
Hutt Valley Tramping Club	DR 154
Infrastructure New Zealand	128, DR 254
Institute of Directors	DR 259
Insurance Council of New Zealand	069, DR 205
J M Bragger	013, DR 190
Jim Moore	080
John Robertson	020
Jon Turner	014, 015, DR 151, DR 167
Jonathan Boston	DR 184
Justin Johnstone	011
Kaikōura District Council	101
Kāpiti Coast District Council	131, DR 271

Kāpiti Coast Grey Power Assn Incorporated	012
Kathleen and Steve Vitasovich	DR 152
Kathleen McCaughtrie	005
Kawerau District Council	097
Kelvin Coe	135
Kerry Neal	DR 156
Kirstyn Barnett	DR 162
Lindsay McGowan	008
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Local Government Think Tank	105, DR 212
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Mana Whenua Kaitiaki Forum	DR 175
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Marlborough District Council	DR 243
McGuinness Institute	DR 270
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Meridian Energy	073, DR 211
Millennium & Copthorne Hotels New Zealand Limited	026, DR 146
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Ministry of Health	DR 265
Ministry of Social Development	DR 257
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Museums Aotearoa	102, DR 222
National Council of Women of New Zealand	DR 234
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Neville Miller	003
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Oliver Krollmann	DR 142
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Palmerston North City Council	124, DR 215
Paul E Perry	090
Paul Elwell-Sutton	048
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Porirua Economic Development Group	035
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Queenstown Lakes District Council	067
Rangitikei District Council	115
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Engagement meetings

Accident Compensation Corporation
 Anthony Wilson
 BECA
 Better for Business
 Bruce Robertson
 Buller District Council
 BusinessNZ
 David Shand
 Department of Internal Affairs
 Engineering Leadership Forum
 Federated Farmers Golden Bay
 Federated Farmers Marlborough
 Federated Farmers North Canterbury
 Federated Farmers of New Zealand
 Federated Farmers Waikato
 Fulton Hogan
 Hawke's Bay Regional Council
 Hospitality New Zealand
 Ilan Noy
 Independent Assessment Board
 Infrastructure New Zealand
 Jonathan Boston
 Judy Lawrence
 Local Government Business Forum
 Local Government Funding Agency
 Local Government New Zealand
 Local Government New Zealand Metro Meeting
 Local Government New Zealand Policy Advisory and Governance and Strategy Advisory Groups
 Local Government New Zealand Regional Sector Meeting
 Local Government New Zealand Rural and Provincial Meeting
 Ministry of Business, Innovation and Employment, Tourism Branch
 Ministry of Transport
 Morrison Low
 New Zealand Automobile Association
 New Zealand Superannuation Fund
 NZ Airports Association
 NZ Society of Local Government Managers (SOLGM)
 Office of the Auditor General
 Parliamentary Commissioner for the Environment
 Peter McKinlay
 Porirua Economic Development Group
 Property Council New Zealand
 PSA – The New Zealand Public Service Association
 Queenstown Lakes District Council
 Tainui Group Holdings and Raupatu River Trust
 Te Maruata
 The New Zealand Automobile Association
 The New Zealand Initiative

The Treasury
Timaru District Council
Tourism Industry Aotearoa
Waimate District Council
Wairarapa Voice
Watercare Services Limited
Water New Zealand
Wellington City Council
Wellington Water
Whakatane District Council
Whangarei District Council

Council cluster meetings

Auckland City Council including:

- Auckland Transport
- Independent Māori Statutory Board
- Manurewa Local Board
- Waitematā Local Board

Christchurch City Council including:

- Ashburton District Council
- Environment Canterbury
- Hurinui District Council
- Kaikōura District Council
- Selwyn District Council
- Timaru District Council
- Waimakariri District Council

Dunedin City Council including:

- Central Otago District Council
- Environment Southland
- Gore District Council
- Southland District Council

Hamilton City Council including:

- Hauraki District Council
- South Waikato District Council
- Taupō District Council
- Thames-Coromandel District Council
- Rotorua District Council
- Waikato District Council
- Waikato Regional Council
- Waipa District Council
- Western Bay of Plenty District Council

Palmerston North City Council including:

- Central Hawke's Bay District Council
- Horizons Regional Council
- Horowhenua District Council
- Manawatu District Council
- Napier City Council
- New Plymouth District Council
- Ruapehu District Council

- South Taranaki District Council
- Tararua District Council

Tasman District Council including:

- Nelson City Council

Porirua City Council (Local Government New Zealand Zone 4 meeting) including:

- Carterton District Council
- Greater Wellington Regional Council
- Kāpiti Coast District Council
- Lower Hutt City Council
- Masterton District Council
- South Wairarapa District Council
- Upper Hutt City Council

New Zealand Chamber of Commerce meetings

- Canterbury Employers' Chamber of Commerce
- Manawatu Chamber of Commerce
- Otago Chamber of Commerce
- Waikato Chamber of Commerce

Case studies

The Commission undertook five case studies, covering:

- A rural district council
- A provincial district council
- A metropolitan city council
- A regional council
- Three councils involved in the Hawke's Bay Clifton to Tangoio Coastal Hazard Strategy

Interviewees included people in the following roles:

- Mayor/Chair
- Deputy Mayor
- Elected members
- Chief Executive
- Chief Financial Officer
- Senior Divisional/Group Managers
- Team Managers/Team Leaders
- Senior staff
- Independent members of the Audit and Risk Committee (where applicable)

Conferences, forums and presentations

- The Localism Symposium
- BusinessNZ – Corporate Affairs Forum
- Inclusive Growth Summit
- Tonkin + Taylor food for thought breakfast: managing risk and fostering resilience
- Smart Cities and Resilient Communities
- SOLGM - Council Collaboration and Partnering Forum
- LGNZ Annual Conferences 2018 and 2019
- Australian Property Tax Summit
- Road Controlling Authorities Forum
- Economic Development New Zealand Conference
- River Managers Forum
- Water New Zealand Conference

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