

Funding Local Government:

Executive Summary

Local Government Rates Inquiry

Pakirehua mō ngā Reiti Kaunihera ā-Rohe

www.ratesinquiry.govt.nz

August 2007

Local Government Rates Inquiry

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Letter of Transmittal

31 July 2007

Honourable Mark Burton M.P.
Minister of Local Government
Parliament House
Wellington

Dear Minister

Report of the Local Government Rates Inquiry

At the beginning of the Inquiry the Panel undertook to deliver to you by 31 July 2007 a high-quality report based on wide consultation and sound evidence and analysis. We are pleased to deliver our report, which comprehensively addresses the wide range of issues covered by our terms of reference.

Our report identifies many significant issues and proposes many significant changes. We acknowledge many strengths in the existing system of local government funding, but have not adopted a “business as usual” approach. This is a report that creates an agenda for change that needs to be pursued by central government and local government in partnership with other stakeholders.

INTRODUCTION

Consultation

In our consultation, the Panel

- produced 6,000 copies of a background paper in February 2007 setting out the main issues we expected to address and inviting submissions
- produced 2,000 copies of a discussion paper for consultations on the impact of rates on Māori land
- travelled extensively around New Zealand, starting in February, holding 14 meetings with mayors, councillors, and council officers, 14 meetings with the general public, and 12 hui with Māori
- held separate meetings with a wide range of key interest groups
- held meetings with a large number of relevant government agencies
- developed an extensive website (www.ratesinquiry.govt.nz) containing background information on the issues. All submissions are now publicly available on this website.

This consultative process resulted in some 926 submissions from individuals and organisations, covering approximately 10,000 pages. The Panel members have read each submission. These submissions came from individuals, community groups, farmers and people living rurally, people with Māori land interests, companies and people with business interests, and local government. Submissions came from throughout New Zealand, but there were large numbers of individual

submissions from Nelson and the Auckland region. (A list of submitters is available on the Rates Inquiry website.)

Evidence and analysis

During our meetings with interested parties, the Panel indicated that we were interested in constructive suggestions – not just complaints – and in facts and information – not just opinions. As a result, we have been successful in obtaining high-quality suggestions and information, notwithstanding the relatively short time frame for the inquiry.

The Panel appreciates the information made available from a wide variety of sources. This included the extensive work undertaken by the Joint Central Government/Local Authority Funding Project, which reported in 2005 and 2006. To fill the many information and data gaps we commissioned research from several individuals and consulting firms. Some of this, such as the analysis of affordability of rates and analysis of capital expenditures, is original research that takes the state of knowledge well beyond what previously existed. Our report identifies a number of major data deficiencies that need to be addressed if the operation of local government is to be adequately monitored in future.

Scope of the terms of reference

A number of comments at meetings and in submissions suggested that the Panel's terms of reference were too narrow in that they did not include any review of the system of local government per se. They submitted that any analysis of funding needs to also examine the structure, functions, and efficiency of local government. We consider that this exclusion from our terms of reference was appropriate given that the Local Government Act 2002 (LGA 2002) is relatively recent legislation. An important part of our terms of reference required examination of the drivers of expenditures, which are the basis of many of the current concerns about local government funding. Our report raises important management issues covering consultation, planning, and accountability, all of which are designed to improve the quality of financial decision making in local government. We have therefore focused on *systems*. Any *substantive review* of the performance of local government would require extensive data, much of which does not currently exist, and a much longer time frame for the inquiry.

Follow up of the report

Our recommendations are extensive, reflecting the wide range of issues covered by the terms of reference. A number of recommendations require legislative change. Some require additional funding from central government. Many require action by local government itself in terms of adopting good practice. A number require central government to pursue a lead role, in particular in fixing the vexed issue of the impact of rates on Māori land. However, we expect that central government itself will wish to ensure that the necessary reforms are driven hard and expeditiously. A high-level task force, involving both central and local government and other stakeholders, would be a useful means to address the recommendations.

PRINCIPLES GOVERNING THE PANEL'S RECOMMENDATIONS

Empowerment

The first key principle we identified, enshrined in the LGA 2002 as a key attribute of New Zealand local government, is that of local *empowerment*. Local authorities are diverse in their geographical and human composition. In their required promotion of the four “well-beings” of communities (social, economic, environmental, and cultural) each local authority will make different decisions about the

desirable size and composition of its revenues and expenditures. It is not appropriate for central government to intervene directly in these decisions. We support the concepts of local autonomy and local choice, which is a strong feature of local government in New Zealand compared with the situation in many other western countries.

But these decisions must be made with appropriate use of the decision-making framework – covering consultation, planning, and accountability – provided by the LGA 2002 and the Local Government (Rating) Act 2002. We identify a number of areas where both improvements to the framework and better adherence to it will improve local government financial decision making. However, we note that in a number of respects the consultation, planning, and accountability practices of local authorities are more advanced than those of central government.

Sustainability with restraint

Financial decisions must also be made within a policy framework that ensures affordability of expenditure and equity of funding over the medium to long term. In general local government is paying insufficient attention to these issues. We identify changes that are needed to better achieve this. In particular, the Panel concurs with the view of the Auditor-General in his June 2007 report on the 2006–16 long-term council community plans, that many authorities have insufficiently analysed their existing funding policies, particularly on the use of debt and the funding of depreciation expense. As a result, the current and forecast level of rates appears to be higher than necessary to fund current and forecast levels of expenditure. However, the Panel does not favour blunt instruments such as rate capping to achieve this. We favour better analysis of revenue and financing policies and the application to local government of principles that already apply to central government through the Fiscal Responsibility Act 1994 and the State-Owned Enterprises Act 1986. In particular, this includes councils establishing medium-term financial targets.

Partnership

A further key principle is that of *partnership* between central and local government. Both are deeply involved in the four well-beings of communities and the pursuit of sustainable development. Although some areas such as the Central/Local Government Forum work well, we believe this partnership can be made to work better. There is a need for better analysis, coordination, consultation, and guidance in the development of central government policies that impact on local government. There is inadequate capacity and resources within central government allocated to monitoring the operation of the LGA 2002 and Local Government (Rating) Act 2002, the two major pieces of legislation governing the operations of local government. And as mentioned earlier there are shortcomings in the database of information concerning local authorities.

In terms of our recommendations, the partnership involves central government providing some additional funding for local government and providing two new revenue sources – an increase in the current Local Authority Petroleum Tax and additional government funding for water infrastructure. The partnership principle is also involved in the Panel's recommendation to make all Crown land (except the Conservation estate, Parliament, vice-regal residences, roads, seabed, foreshore, lakes, and rivers) fully liable for rates and providing the legislative changes necessary to implement some of the Panel's recommendations. In addition, local government should recognise that it is inherently involved in income redistribution, along with central government.

Public finance principles

In examining the present funding system for local government we have applied generally accepted *public finance principles* – mainly those of efficiency, buoyancy, ease of administration, and equity. The Panel also considers that rates, as a tax on property, need to be considered in relation to New Zealand's overall taxation system, in which property is lightly taxed. The macroeconomic impact (in

inflation, growth etc) of any changes in revenue patterns for local government needs to be taken into account in considering any major changes to the funding system.

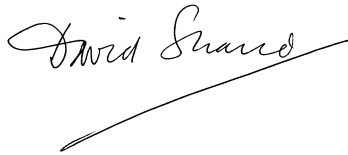
Environmental sustainability

The Panel was also conscious of the need to consider *environmental impacts* – both on the revenue and expenditure aspects of its recommendations. On the revenue side this is the basis of our support for greater user charging for roads (through an increase in the current local authority petrol tax) and for reasonable recovery of the costs of water supply and waste-water disposal through volumetric charges. Both reflect the need for more demand management, which should reduce the needed level of infrastructure. On the expenditure side we consider that local government needs to subject its infrastructure expenditures to close scrutiny to ensure accurate cost estimation, to avoid any “gold plating”, and to more fully consider deferring or spreading this expenditure over a longer period of time. That said, greater central government financial assistance is needed for the funding of water infrastructure, much of which is required to meet higher national environmental standards.

CONCLUSION

We hope that the result of our inquiry will be enhancements to the processes of funding local government. The Panel believes that communities will benefit from the services of a local government that applies to its financing the principles of sustainability with restraint.

We thank you for the opportunity to undertake this interesting and important work.



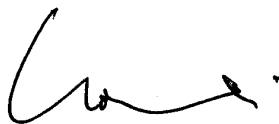
David Shand

Chair



Christine Cheyne

Panel member



Graeme Horsley

Panel member

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PANEL MEMBERSHIP

A three-person panel conducted the inquiry. A list of the members and a summary of their experience is noted below.

David Shand, chairperson. David Shand returned to New Zealand in 2006 after a number of years living overseas. He has worked for three international organisations, most recently for over eight years as a public financial management specialist at both the World Bank and the IMF in Washington DC. This followed four years working with the OECD in Paris on public sector reform issues.

After joining the Treasury in the mid-1960s Mr Shand taught accounting and public finance at Victoria University before moving to Australia in 1977. He left the Australian National University in 1981 to start a career in the Australian public sector and held a number of senior positions in state and federal government, including Deputy Secretary of the Victorian Treasury, First Assistant Secretary in the Australian Department of Finance and Queensland Public Service Commissioner.

In the 1970s Mr Shand spent six years in local politics as a Wellington City Councillor.

He is currently a director of Meridian Energy Ltd.

Graeme Horsley. Mr Horsley is a former partner of Ernst and Young's corporate finance practice and is widely recognised as an expert in property investment and valuation.

A Life Fellow of the New Zealand Institute of Valuers (NZIV), he was for 12 years the NZIV representative on the International Valuation Standards Committee, and was chair of the Committee between 1989 and 1993.

He is a professional director, chair of Ngāti Whātua o Orakei Corporation, deputy chair of the Bay of Plenty District Health Board, and independent director of the AMP New Zealand Office Trust management company. He has held a number of other directorships including Carter Group Ltd, Trustbank Wellington, and Housing New Zealand.

Mr Horsley also has international experience of the real estate sector undertaking consulting assignments in Asia, Australia and the Pacific Islands. More recently he has focused on major corporate and public sector issues in investment and economic analysis.

Dr Christine Cheyne. Dr Cheyne is a senior lecturer in Resource and Environmental Planning at Massey University Palmerston North. Previously she worked in local government in planning and research at Palmerston North City Council. She has specialised knowledge of representation and public participation in local government and social policy. Her research has focused on annual and strategic planning from local authorities, and public participation in local authority decision-making. She is currently a member of Horizons Regional Council Regional Land Transport Committee, as an environmental sustainability representative. She is also a member of the Taranaki/Whanganui Conservation Board.

ACKNOWLEDGMENTS

The Panel extends its thanks to all those who made contributions to the Rates Inquiry and to those who supported the work of the Panel.

First our thanks go to the large number of people who met with the Panel as it travelled around New Zealand. The meetings with councils, public and Māori landowners were central to the work of the Panel in gathering opinions and information. Submitters who took the time to think through the points of concern to them and convey their views in writing provided a crucial source of information that has been fully read and considered by the Panel. This material will continue to be a resource for those considering our report and also provide a reference point in the future.

The Panel has met with many councils and stakeholder groups that have a central interest in the issue of rates and local government funding. This has provided an opportunity to talk through and discuss particular points that have been central to meeting our terms of reference. Many of these organisations and individuals have also provided references and information in relation to both policy and basic technical data that has assisted the Panel.

Government agencies have also provided important information and data to the panel and been willing to meet and discuss rate issues and local government funding.

The Panel would like to thank the Chief Executive of the Department of Internal Affairs and the Executive Government Support branch of Department of Internal Affairs for the secretariat and administrative services and support provided by them.

The Panel acknowledges the contribution by consultants contracted to undertake work on particular aspects of the inquiry and of those individuals who agreed to peer review material at the draft report stage.

Finally the Panel would like to thank those who have worked closely with us and supported our efforts in addressing the complexities associated with reviewing local government rates in New Zealand over a period of eight months. In particular we wish to thank John Gilbert, our Executive Officer; Advisors Paddy Gresham, Malcolm Thomas and David Stimpson; Executive Assistant Rosemary Marshall; Researchers Nicholas Jessen and Rohan Wakefield; Communications Advisor Iain MacLean; Submissions Analyst Louise Fawthorpe; Submissions Support Officer Janet Weir and editor Barbara Hedley.

SUMMARY REPORT OF THE LOCAL GOVERNMENT RATES INQUIRY

This document provides a summary of *Funding Local Government*, the report of the Local Government Rates Inquiry, and lists the 96 recommendations of the Panel.

EXECUTIVE SUMMARY

1. The starting point is that, generally speaking, local government works well in meeting the diverse needs of New Zealanders. It provides, at reasonable cost, a substantial range of basic services, which can be broadly categorised as either network infrastructure (roads and public transport, the “three waters” – water supply, waste water and stormwater – plus solid waste disposal) or community and social infrastructure (cultural and recreational facilities), as well as a range of regulatory activities. Overall it accounts for somewhat less than 5% of national expenditure.
2. The focus of this report is on the spending and funding decisions related to these services. The funding system is under pressure because of significant growth in expenditures and growing affordability problems with the main source of funding, namely rates.
3. Overall, the Panel sees several significant problems, both in the financial decision-making processes in local government and the financial decisions that are being made. Prime responsibility for addressing these issues rests with local government itself, and many of the remedies lie in self-management including the adoption of good practices, and the discipline of the democratic process including meaningful consultation with citizens.
4. Local government in New Zealand has substantial autonomy in its financial decisions. This is a major strength. But with this autonomy goes a requirement for accountability, based on consultation and transparency – both of which require the provision of relevant information. This autonomy also implies the need for expenditure restraint. The Panel considers that some councils are showing insufficient financial restraint and paying inadequate attention to the equity and affordability of their plans. The Panel also considers that many have adopted funding policies that are leading to higher than necessary levels of rates.
5. The main actions required from central government are
 - providing some new funding sources, some of which involve increased funding from central government, to enable the level of rates to be held at sustainable levels over the next 10 years
 - further improving rates affordability through the rates rebate scheme and other government income support packages

- legislating for some changes in the rating system to reduce complexity and improve transparency and equity
- improving coordination within central government on local government issues and liaising better with local government.

6. The Panel has identified affordability problems for rates for some sections of the community, which will increase over the next 10 years. This means that under current practices rates will not be sustainable in 10 years' time. Rates currently account for around 56% of local authority operating revenues, and the long-term council community plans (LTCCPs) forecast they will rise to 60% by 2016.

7. The Panel considers rates should remain as the major source of local government revenue but need to be reduced to around 50% of total revenues. As a tax rates have many advantages – efficiency, difficulty of evasion, and low economic deadweight costs – and there is a reasonable relationship between property values and incomes, even though overall rates tend to be somewhat regressive in their impact.

8. The Panel does not recommend any major new tax to replace rates. There is no need for any “magic bullet” to fix the problem, and indeed there is no such bullet available. However, it makes a number of recommendations to make the rating system simpler and more transparent, equitable, and sustainable.

9. Local government is not in financial difficulties, as it is in some Australian states. The reverse is true. Its finances are generally in a healthy position, with low debt and in many cases significant levels of income earning investments.

10. The Panel makes significant recommendations below to address the many and complex issues concerning the rating of Māori land. These issues have been allowed to remain unresolved for too long and urgent action is needed to address them.

Restraining expenditure and rates

11. Local authority expenditure has been rising rapidly, driven by expenditure on infrastructure renewal, expansion, and upgrading. A major item of increased operating expenditures is depreciation on the larger stock of assets, which most local authorities fund with cash raised through rates. However, over the next 10 years, local authority operating expenditure is forecast to stabilise in real terms (after adjustment for inflation) and decline as a percentage of GDP as capital expenditure and rate of growth in the associated operating costs decline.

12. Rates, however, increased by 38% in real terms (that is, above the rate of inflation) over the 12 years from 1993/94 to 2006/07. The LTCCPs forecast that rates will increase in nominal terms by 8% per year over the next few years but reduce to around a 4% per year increase by the end of the 10-year period.

13. Local government needs to show more restraint in its expenditures, and to improve its planning function, which drives these expenditures. It needs to give more rigorous consideration to the desirability and prioritisation of expenditures, including consideration of deferral or pushing out of expenditures to later years. In general local government is not adequately presenting key choices or alternatives in its LTCCPs to facilitate useful input by citizens and to enable councillors to adequately manage and prioritise expenditures.

14. The Panel has analysed the LTCCPs and concludes that the forecast expenditure figures in the LTCCPs are likely understated. However, questions must be asked as to whether all the proposed capital expenditure is feasible or needed within the 10-year time frame – or needed at

all if demand can be better managed through user charges. The Panel considers there is a need for councils to reassess the forecast infrastructure expenditures contained in their LTCCPs.

15. In addition, many councils are failing to adequately consider the affordability of rates increases for some of their residents. This is not simply a matter that can be left to central government income support policies or the rates rebate scheme, which are valuable mechanisms in assisting affordability. Councils themselves need to undertake more analysis of affordability issues when deciding on total expenditures to be financed from rates and on the rating mechanisms to be used to distribute the burden.

16. The Panel considers a cap on rates is too blunt an instrument to achieve restraint. It would not recognise the different financial position and expenditure needs of different councils and in any case would cover only the less than 60% of local government revenues consisting of rates. A cap based on the Consumers Price Index (CPI) would not recognise either growth pressures or that the price of most local government inputs is rising faster than the CPI. Rather, the Panel considers all councils should be required to adopt clear and honestly measured financial targets, which would be reflected in LTCCPs and a three-year indicative budget. These targets would cover proposed increases in operating expenditures as well as rates.

17. Many councils are not making the best choices in their funding policies, reflecting a strict or unquestioning adoption of the balanced budget requirement contained in the Local Government Act 2002 (LGA 2002). There is scope for considerable reduction in or holding of rates by greater use of debt funding for long-life assets (which is an equitable way of funding such assets). Related to this there is also scope for reducing the extent to which depreciation is funded. The Auditor-General's recent report on LTCCPs indicates that by 2016, despite record levels of capital expenditure, local authorities as a whole will have low debt and will have accumulated significant cash reserves brought about by the funding of depreciation. In the forecasts contained in the LTCCPs, by 2015 all capital expenditure could be funded from operating revenues and accumulated cash reserves, with no further use of debt. This is a very conservative policy, which will lead to higher than necessary rates over the 10-year period and achieve poor intergenerational equity.

18. The Panel estimates that reductions in the forecast level of rates of between \$300 million and \$500 million per year (and possibly more) would be possible by the adoption of this revised funding policy. This is equivalent to around 10% of current rates.

A changed local authority funding pattern

19. As mentioned, the Panel considers that the forecast level of rates is not sustainable because of emerging affordability problems for a significant section of the population. Rates in real terms, therefore, need to be held at current levels or reduced. The Panel considers that this should be achieved by a combination of the following:

- councils exercising greater restraint in their expenditures, particularly reviewing their forecast capital expenditures
- councils reducing the extent to which they fund depreciation from current revenues and instead making greater use of debt to finance long-life assets, resulting in the ability to reduce rates from forecast levels by between \$300 million and \$500 million per year – and possibly more
- councils using volumetric user charges to fund water and waste-water expenditures
- some additional sources of funding being provided to local government, namely
 - removal of Crown exemptions from rates, except for Department of Conservation and other conservation land, which will provide local government with an

additional \$100 million per year (most of this funding to come from the central government Budget)

- increasing the current local authority petroleum tax, first introduced in 1970, by 2 cents a litre to be distributed to local authorities (this will provide an estimated additional \$90 million per year)
- providing additional central government funding to a new Infrastructure Equalisation Fund to meet necessary water infrastructure expenditures of around \$100 million per year, coming from a hypothecated share of GST.

20. It is important that these additional funds be used to replace rates rather than to increase expenditures. Although it is difficult to ring-fence such revenues, various measures to limit any council profligacy in expenditure are possible, as discussed above.

21. If the above recommendations are adopted the result would be different funding mechanisms for the two main functions of councils, each of which has different cost drivers.

22. Network expenditures would be largely funded from user charges and government transfers, plus debt – representing a move away from rates to a funding mechanism that replicates the way such assets are funded elsewhere. These networks are normally monopoly operators, and it is important that there are proper pricing and investment decisions. Currently the land transport network is a partnership between central and local government. There is a need to develop a similar partnership for the three waters infrastructure.

23. This would leave community and social infrastructure being funded by a mixture of debt and rates.

24. Overall, ratepayers will see their burden lessened, or at least stabilised, if the Panel's recommendations are adopted. However, the burden on individual ratepayers will depend on the impact of the Panel's recommendations on restructuring the rating system discussed below, which will differ between councils. These changes would remove the power to set differential rates and uniform annual general charges (UAGCs) (to be replaced to some extent by targeted rates) and see a move to volumetric charging for water and waste water. But to limit any possible regressive impact uniform targeted rates would be limited to 50% of total rates. Councils can also address any possible regressive impacts and maintain affordability through the use of rates remission policies.

A summary of the Panel's conclusions under specific parts of its terms of reference is set out below.

Drivers of local authority expenditures (Chapter 8 of the report)

25. The Panel has spent considerable time analysing this important part of its terms of reference. However, reaching firm conclusions is difficult because of data limitations and because of the need to make judgments about the accuracy of forecast expenditures in the LTCCPs, particularly for capital expenditures. The Panel's analysis suggests that the forecast capital expenditures may be understated, for a number of reasons detailed later in this report.

26. Capital expenditures have been increasing significantly but will peak in 2009 and are then forecast to decline, particularly in transport and particularly in the Auckland region. It should be noted that construction price indices are rising much faster than the Consumers Price Index. The LTCCPs forecast total capital expenditures of \$31 billion over the 10 years 2006–16. However, analysis of these trends is hampered by lack of historical data on the composition of capital expenditures. The expenditure is dominated by “network” assets – land transport and the three waters, which account for 73% of the total (land transport – covering both roads and public transport – at 44% and the three waters at 29%), followed by community infrastructure assets (18%) and other (such as

economic development and harbours) at 9%. Local government roads expenditure is dominated by about four major projects.

27. The Panel has had this forecast infrastructure expenditure analysed to determine the reasons for its growth. These reasons include population growth, higher standards, and renewals of existing infrastructure, but these components clearly differ between high- and low-growth councils. It is difficult to determine the extent to which this expenditure represents a “catch-up” due to past underinvestment; this appears to be a factor in new roading construction (capital expenditure) and public transport. There is little evidence of past underfunding of maintenance and renewals expenditure.

28. This accumulated capital expenditure flows through into significant increases in operating and maintenance costs and in the substantial increase in depreciation expense, most of which councils will fund by way of cash. Depreciation expenditure has grown rapidly from 13% of total operating expenditure in 1993/94 to around 21% in 2005/06, and is forecast to continue to remain around this level over the 10-year period at around 22% of total operating expenditure in 2015/16.

29. Although local government staff numbers have been increasing, this increase should be seen in context, given growth in the economy and population. Local authority administration staffing numbers increased by 22% between February 2000 and February 2006, compared with increases of 27% in central government administration and 24% across all industries. In terms of the impact on rates it appears that much of the increase is in regulatory areas such as building inspection, which will be largely recovered by user charges.

30. The Panel received many submissions suggesting that the LGA 2002 has been a major driver of increased expenditures in that it has encouraged councils to move into activities outside their “core business” by giving them a “power of general competence”. The Panel could find little evidence to support this. It notes that the provisions in LGA 2002 are little different from those in the Local Government Act 1974. It also notes that many councils have been involved for many years in such activities as social housing, the provision of major cultural and sporting activities, and commercial operations such as parking buildings and other trading undertakings. Only involvement in economic development strategies appears relatively new, and this does not account for a significant portion of expenditure.

31. The Panel also carefully reviewed the many submissions that considered that central government’s passing of “unfunded mandates” to local government has been a major expenditure driver. Overall, it considers this has some foundation but has been exaggerated. First the Panel considers that some of the issues raised, such as the requirement to prepare an LTCCP and to have it audited, are normal good practice management, which councils should undertake anyway. These requirements, which are part of the legislative framework within which local government operates, are not appropriately described as “unfunded mandates”, even if they involve some costs.

32. But the Panel accepts that local government has been required to take on a number of new functions that in total involve significant expenditures. Major ones are the management of Resource Management Act 1991 (RMA) processes and the requirements of the Building Act 2004, which increase the level and standard of building approval and inspection. However, with the exception of any costs of policy development and staff training, as well as consultancy and litigation costs under the RMA, the cost of these new functions should be covered by user charges.

33. Many smaller additional functions have been passed on to local government, such as inspection and licensing of licensed premises, gambling machine licensing and supervision, the registration and inspection of brothels, and the implementation of micro-chipping of dogs. However, user charges should be set for these functions so as to achieve full cost recovery.

34. *The Panel notes that in some cases fees are set nationally, which may prevent full cost recovery, and recommends that in all such cases councils be given the power to fix their own fees, based on actual and reasonable cost recovery.*

35. The Panel also notes that all these functions are appropriately carried out by local rather than central government. This devolution may necessarily involve some additional expenditure by local government.

36. A number of local government submissions referred to central government giving these responsibilities to local government without adequate analysis, coordination, consultation, or guidance, a matter that is discussed further in Chapter 15 of this report.

37. Significant additional council expenditures (both capital and operating) arise from the need to meet increased environmental standards, such as the proposed drinking water standards under the Sustainable Water Programme of Action and the National Environmental Standards for Air Quality. The costs of meeting these standards appear to be high, but there is considerable dispute over the amounts directly attributable to the new standards. It can be noted that Local Government New Zealand now puts the estimated cost of meeting the drinking water standards at around \$950 million, although this figure is disputed by Ministry of Health.

38. Nevertheless, councils are planning to spend substantial sums in upgrading their systems covering the three waters. The Panel considers that in view of the national benefits and the high costs to councils, there is a good case for additional government funding being provided to local government to meet some of this expenditure.

39. As discussed further in Chapters 10 and 11, *the Panel recommends funding of around \$100 million per year to a new Infrastructure Equalisation Fund established for this purpose, using an earmarked portion of GST.*

40. One further area of expenditure growth caused by withdrawal from the area by central government is regional council expenditure on catchment management; however, data on current levels of expenditure are not available. Other smaller areas in which central government expenditure has been reduced, but where council expenditure is more discretionary, include library services, social housing, and community safety initiatives.

41. There are possible significant future expenditures not included in LTCCPs arising from climate change and weathertight building litigation, but it is not possible to quantify these.

42. Because of the size and significance of the Auckland region in the “rates debate” the Panel has carried out a separate analysis of the Auckland region’s councils. This shows that although there is some diversity between councils, rates are higher than the national average in all Auckland councils and will grow in real terms per rateable property by around 11% over the period to 2016, driven by capital expenditure on land transport and community infrastructure. These increases appear unsustainable and likely to lead to even greater affordability issues than elsewhere in the country.

Current use of rating tools (Chapter 9 of the report)

43. The Local Government (Rating) Act 2002 (LGRA) gives councils considerable flexibility in spreading the rate burden. Council rating policies are set out in the revenue and financing policy required under the LGA 2002. Although in general councils have not made extensive use of the flexible rating powers, rating systems may still differ quite significantly between councils. This is appropriate given the objectives of the LGA 2002 to promote decision making that reflects local circumstances and preferences.

44. Councils may levy a general rate, targeted rates for particular services, a uniform general charge, and user charges as alternatives to rates. The LGRA limits total fixed charges, (excluding water and waste-water charges) to 30% of total rates revenues. Under the general rate councils may set differential rates for different classes of taxpayers (such as businesses and farms, as opposed to residential properties). They may levy rates at a different rate for different levels of property value – although only two councils chose to do this. And the boundary between rates and some user charges is moveable. For example, councils may levy user charges through water metering as part of the rating system, or user charges may be billed separately by a council-controlled organisation (CCO).

45. Although discussion about rates frequently revolves around property values, it should be noted that less than two-thirds of rates are based on property values – the balance being fixed charges, volumetric charges, rates based on land area, and other permitted bases.

46. Thus, although rates are a tax on property, the LGRA enables them to be set to at least partly reflect services consumed, for example through targeted rates. They are thus better regarded as a hybrid of a tax and a user charge.

47. With the increased use of differentials and fixed charges since the LGRA was introduced in 2002, the rating system has in general become more regressive in relation to incomes. A significant number of submissions sought either an increase in the permitted maximum of 30% on fixed charges or its abolition, which if exercised, would make the rating system more regressive. The Panel's recommendations for UAGCs are set out below.

48. The Panel notes that there is considerable public misunderstanding about how the rating system works.

49. First, many ratepayers believe that increases in property values by themselves increase rates. However, it is council expenditures that drive rates; property values are only a means to distribute the burden of rates. The extent to which the rates on an individual property will rise will depend on increases in expenditure to be funded from rates, the increase in the number of rateable properties, and the extent to which the value of the property increases by more or less than the average increase in property values in the rateable area.

50. Second, the flexibility given to councils means that the system adopted by many individual councils is complex, containing many different components. The rating policy is explained in each council's revenue and financing policy, required by the LGA 2002. However, key issues such as the basis on which differentials or targeted rates are set are often not well explained, reflecting a wide variation in the quality of analysis behind the determination of these policies. Some councils have undertaken a robust analysis of cost and benefits to different classes of ratepayers. In others there is little analysis or transparency.

51. In the interests of transparency and equity *the Panel recommends that the power to set differential rates and to use UAGCs should be removed.*

52. Differentials and UAGCs tend to be set arbitrarily without explicit justification in terms of the services to be funded. There is little transparency of the criteria that are being used. With the removal of differentials and fixed charges, the rating system would comprise only a general rate and targeted rates – plus the possibility of user charges. Thus higher rates charged to businesses through a business differential would be removed. That is not to say that businesses might not be charged higher rates based on targeted rates for particular services. But this would have to be based on the requirements for setting targeted rates provided in the LGRA. And the removal of UAGCs would not prevent councils setting uniform targeted rates. However, to constrain any possible regressive

impacts *the Panel recommends that there be a limit of 50% on uniform rates as a percentage of total rates.*

53. Overall, these changes recommended by the Panel would make the rating system less complex and more transparent. However, councils would need time to develop new rating policies in response to these changes and to consult with their citizens. The Panel therefore suggests that the changes not be required to be implemented before the 2012/13 LTCCPs, although consultation should commence with a view to phasing them in before this time.

54. The Panel also favours greater use of volumetric user charges for water and waste water as a means of demand management, which would be expected to reduce needed infrastructure expenditure, although it does not suggest this charging be mandated. Some councils have user charges in these areas now, although not all are volume-based. Applying volumetric charging to waste water is more difficult but not impossible, and councils should develop equitable policies based on the volume of water used. Depending on the cost structure, these user charges would comprise a mixture of an access charge and a volumetric charge.

55. The Panel considers that all local authorities should be encouraged, where feasible, to use water metering for recovery of water costs. *It recommends that the Government consider providing financial assistance for the nationwide installation of meters where they can be used.*

56. The existing requirement that a CCO be formed before volumetric waste-water charging can be introduced has no logical basis and *the Panel recommends it be removed.*

57. The Panel favours the promotion of a common system of valuation for rating purposes and strongly favours the capital value system because of the closer relationship of capital values with household incomes.

58. The Panel considers that, in fixing their overall rating policies, councils should have regard both to services consumed and to ability to pay. The changes that it recommends above would likely change the distribution of the burden between commercial and residential ratepayers and between different residential ratepayers. Unless councils make other adjustments to their policies they may be regressive in their impact. It is difficult to forecast what the full impact would be and it would differ between councils. However, councils would retain considerable discretion in whether to use targeted as opposed to general rates and to mitigate any regressive impacts through rates remission policies.

59. *The Panel recommends that the LGA 2002 be amended to explicitly require councils to consider rates affordability to lower income ratepayers in designing their rating system.*

60. The Panel has considerable concerns about the overall quality of property valuations used in the rating system. Although these are not intended to reflect actual sales prices, but rather to form a consistent base for the allocation of the rating burden where rates are based on property values, the Panel received considerable adverse comment on the property valuation system. This feedback was discussed with the Valuer-General. Although the Valuer-General does not concur with the criticism, the Panel nevertheless considers that the quality of property valuations has deteriorated over the past 10 years. In a significant number of cases valuations are no longer adequate as a basis for distributing the rating burden. Many councils do not appear to show sufficient interest in the quality of the valuation roll.

61. *The Panel recommends that the previous model of a central government valuation authority be re-established to increase the level of professional resources being applied to rating valuations or that additional resources be provided to the Valuer-General to facilitate better quality control of valuations.*

62. *The Panel also recommends that councils make more use of their flexible rating powers so that the rating burden better reflects value in use, rather than potential sale price.* In the case of farming

properties, this value in use basis would provide some redress for any current inequities in the rating of farmland, particularly given the Panel's recommendation that differentials be abolished.

Currently available non-rates funding mechanisms (Chapter 10 of the report)

Transfers from central government

63. Transfers from central government are an important and growing source of funding for local government. Although they cover many areas of activity, the greatest amounts are allocated towards roads (64%) and public transport (25%).

64. The Panel considers that the existing pattern of financial assistance rates (FARs), funded from the National Land Transport Fund (NLTF), which average 50% of maintenance costs and 60% of construction costs, are appropriate. The actual cost sharing varies between councils based on an assessment of the relative costs of road construction and the rateable base of each council. It notes that they are skewed towards more lightly used rural roads. It considers that the funding of major urban arterial routes should be reviewed and possibly increased.

65. A number of submissions sought an increase in the level of FARs, with suggestions ranging from 75% to 100%. The Panel considers that the existing sharing arrangements are reasonable and does not recommend any change except for the new category of major urban arterial roads discussed above. It considers it important that councils bear a reasonable share of costs to reduce demands for funding of low-priority or unnecessary projects. Some of these submissions saw such an increase as desirable because it would avoid councils needing to allocate rates revenue to roads. The Panel notes that its recommended increase of 2 cents per litre in the existing local authority petroleum tax would assist in achieving this.

66. Although there is a well-established and well-functioning system of central government transfers for land transport (both roads and public transport), there is no such system for the other major area of infrastructure expenditure, namely the three waters – water supply, waste water, and stormwater. There are currently only two relatively small subsidy schemes (plus an even smaller subsidy scheme for authorities having high visitor demand):

- ✦ the Sanitary Works Subsidy Scheme available to small communities with high deprivation levels, for which \$150 million has been allocated over the 10 years from 2003, all of which is now committed
- ✦ the Drinking Water Assistance Programme, which also provides around \$150 million over 7–10 years for capital and technical assistance for small communities with high levels of social deprivation.

67. It can be noted that both these schemes apply only to schemes for small communities and not to council-wide schemes. Before the 1990s the Government provided substantial assistance for local water and waste-water schemes.

68. The Panel considers that a strong case exists for greater central government transfers to meet the cost of the three waters infrastructure and in Chapter 11 recommends new funding of around \$100 million per year, hypothecated as a share of GST, through a new Infrastructure Equalisation Fund.

69. The Panel notes that the existing pattern of transfers from central government does not appear to be based on any consistent principles. The Panel considers that a review of the scope and amount of the current transfers is desirable, so that they better reflect equalisation principles, as part of the development of the new Infrastructure Equalisation Fund.

Development contributions

70. Development contributions are a means of recovering from developers the additional infrastructure costs arising from this growth. In 2006/07 these are estimated to amount to some 7% of capital expenditure, rising to 17% by 2016. There has been considerable contestation by the development industry on the level of development contributions in some cases, and given recent successful litigation by developers against the North Shore City Council, all councils will need to carefully review their development contributions policies to ensure that they meet the detailed requirements set out in the LGA 2002. The estimated revenue from development contributions in the LTCCPs may therefore be on the high side. Councils should carry out any review transparently in consultation with the development industry because continuing litigation on development contributions is not in the interests of either party.

71. The Panel considers that, properly applied, development contributions are an equitable and efficient means of funding new infrastructure. Regional councils are currently unable to levy development contributions in respect of their infrastructure expenditures. The Panel sees no reason why this should be so *and recommends that regional councils be given the right to levy development contributions*. The Panel does not, however, support Transit New Zealand being able to levy development contributions because the link between development and traffic growth on state highways is not sufficiently direct.

Debt

72. As discussed above, the Panel considers that councils should consider using more debt to fund long-life assets, as part of the move away from fully funding depreciation. This is both an efficient funding source given the relatively low rate of interest and an equitable way of spreading the cost of such assets over the users who will benefit from the assets. Councils currently have low levels of debt, with debt-to-asset ratios averaging only 4% across the country. Although the Panel recognises that some councils perceive having low levels of debt or being debt-free as a virtue and may regard borrowing as a licence to print money, it does not agree with this view. Councils should establish appropriate fiduciary limits on such borrowing. In addition, their financial soundness will be reviewed by the rating agencies.

73. Increased local government use of the capital market may also assist in the development of the market and stimulate community savings.

74. The Government has recently indicated it will seek to amend the Securities Act to remove the requirement for councils to issue a prospectus should they wish to borrow on the capital market. Additional borrowing there will stimulate the development of New Zealand's capital markets. *The Panel also recommends that councils be permitted to borrow in foreign currency subject to appropriate hedging arrangements being made.*

Income from investments

75. A number of councils have significant investments in trading enterprises such as ports, airports, forests, and farms, as well as significant holdings of financial assets (often derived from the sale of shares in trading enterprises). Revenue from these commercial investments formed 6% of total operating revenues in 2006.

76. Councils generally justify holding such investments as a means of generating other income, which enables rates to be held at a lower level than otherwise, and in the cases of ports and airports as strategic investments, necessary for them to have greater influence in generating economic development. However, in some cases councils have sold such assets and used them to reduce debt, thus reducing interest payments.

77. Although the holding of such investments is a policy matter appropriately determined by each council, the Panel notes that on average such investments earn less than a commercial return. *The Panel recommends that councils be required to transparently and accurately report on the rate of return earned and to fully articulate the strategic reasons why such investments are being held.*

78. *The Panel recommends that commercial undertakings controlled by councils should be formally required to operate as a business, as applies to central government enterprises under the State-Owned Enterprises Act.*

79. However, a clear distinction should be drawn between such external commercial investments and subsidiary organisations such as CCOs that exist to provide council services such as water supply. *The Panel considers that these should operate on a cost recovery basis but that otherwise they should not be used as a source of revenue to cross-subsidise other council activities. It recommends that this be provided for in an amendment to the LGA 2002.*

User fees and charges

80. User fees and charges generated some 26% of total operating revenues in 2006, covering council regulatory activities for various permits and licences, as well as charges for services such as water supply, waste water, and solid waste disposal. (The LGRA permits targeted rates on a volumetric basis for water supplies, therefore such user charges may technically be part of the rating system.)

81. The Panel supports actual and reasonable cost recovery as far as possible for all regulatory activities. In some cases fees are currently set by central government and prevent full cost recovery. *The Panel recommends that determination of all such fees be a matter for councils.*

82. As discussed earlier the Panel supports greater application of user charges for water supply, stormwater, and waste water, as well as solid waste collection disposal. However, the Panel recognises that some practical issues must be overcome to apply such charging to stormwater and waste water. Greater user charging is justified as a means of demand management, which is also expected to reduce infrastructure expenditure that would otherwise be required. *It recommends a programme of central government assistance towards the costs of installing water meters, where this is practicable.*

Possible new sources of local government funding (Chapter 11 of the report)

83. The Panel examined a range of possible new taxes or other sources that might fund local government, either as an alternative to or a replacement of rates. It is important to place the current system of funding local government in the context of New Zealand's overall system of taxation. Rates are a property tax, and property is only lightly taxed in New Zealand. In addition, New Zealand's tax system appears reasonably well balanced between income and consumption taxes. This balance would be disturbed by the imposition of any major new tax. Given the other advantages of rates as a tax – their relative efficiency, limited economic deadweight, relative low administrative costs, and difficulty of avoidance – the Panel does not support replacing rates as the main source of local authority revenue by any major new tax. There is no “pot of gold” sitting out there that is readily available. Someone must pay, whatever the taxation source that is used.

84. The Panel considered a range of possible new revenue sources, namely

- ♦ a citizens or poll tax
- ♦ payroll tax, including a transport “verusement” tax
- ♦ a local income tax
- ♦ a local consumption tax

- general revenue sharing
- industry and commodity taxes, including a bed tax
- environmental or green taxes, such as a waste levy and road congestion pricing.

85. The Panel does not support any of the first six possible new revenue sources. It considers all have varying disadvantages in terms of equity and economic impact. It does not consider they are worthy of further study. However, environmental taxes have potential value in the medium term.

86. *The Panel recommends that the existing local authority petroleum tax (LAPT), first imposed in 1970 (approximately \$30 million per year), be increased by 2 cents per litre, and distributed to councils for general purposes based on a revised formula that incorporates equalisation principles.*

87. This would provide an estimated \$90 million per year additional funding, which could be used to stabilise rates (in some cases perhaps to cease using rates for roading) and is consistent with a greater user pays approach to the funding of roads.

88. The Panel carefully examined the possibility of a bed tax of up to 5% to defray the costs visitors impose on infrastructure and other services. Such a tax could be levied centrally and distributed to individual councils, or councils themselves could decide whether to levy such a charge. A 5% bed tax would yield approximately \$80 million per year. The Panel does not support such a tax. It notes that a few councils currently levy a targeted rate on accommodation or other business facilities to defray these costs and considers this to be a better approach.

89. The Panel considers that there is merit in the idea of an environmental levy on international visitors as a means of maintaining high environmental standards, on which many international visits are based. *It recommends further study of this option as a means of funding local authority environmental costs associated with high numbers of visitors.*

Sustainability and affordability packages (Chapter 12 of the report)

90. It is imperative that councils pay more attention to analysing affordability for low-income ratepayers when setting their rating policies. *The Panel recommends an appropriate amendment to the LGA 2002 to make this explicit.*

91. The Panel has spent considerable time analysing the affordability of rates. It acknowledges that there are considerable data limitations in doing this, but its work is an important first step in this area and should be followed up by further research and analysis. With rates overall averaging less than 3% of gross household income it is difficult to say that there is an overall affordability problem. However, there are significant pockets of ratepayers where there is an affordability problem. Rates affordability problems are likely to be an issue in low-income households and those reliant on New Zealand Superannuation. They are also more of an issue for Māori and Pasifika households. As a rough benchmark affordability problems arise where rates exceed 5% of gross household income. The Panel estimates that there are between 100,000 and 200,000 or between 7% and 14% of households out of a total of nearly 1.5 million where affordability problems exist. Furthermore, the Panel's analysis shows that these affordability problems for households will increase over the next 10 years, given current trends.

92. The Government's rates rebate scheme has become a valuable tool in improving the affordability of rates, with nearly 110,000 household (two-thirds of whom are national superannuitants) receiving a rebate in 2006/07, after the substantial increases in the income thresholds and the maximum amount of the rebate from 1 July 2006. The existence of such a scheme does not mean that the rating system is fundamentally flawed; rather, it recognises that there will be pockets of affordability problems in any funding policy. However, the take-up rate remains relatively

low at less than 50% and may be improved by better publicity and transfer of administration away from local government. The Panel received considerable evidence that ratepayers are reluctant to disclose their personal finances to council staff.

93. *The Panel recommends that the income threshold and the maximum rebate be indexed annually. It also recommends that the rebate cover water and other charges under the LGRA 2002, that residents of retirement villages, occupiers of papakāinga housing and occupiers of homes subject to a family trust be made eligible, and that administration of the scheme be transferred from local government and the Department of Internal Affairs to the Inland Revenue Department.*

94. The Government's accommodation supplement and working for families schemes have assisted in increasing rates affordability by increasing the incomes of low-income households. The rates postponement scheme operated by a consortium of councils, which is in effect a home equity release or reverse mortgage scheme limited to rates, and the home equity release or reverse mortgage schemes currently being provided by private sector financial institutions may assist some ratepayers. The Panel recognises that many ratepayers who are "income poor but asset rich" are strongly averse to the idea of being required to use the equity in their homes to pay rates. However, the Panel notes that such schemes are at the option of the ratepayer, and they may in effect be used for meeting expenditures other than rates. Only a very small number of ratepayers have postponed rates through the optional rates postponement scheme. However, over 4,500 private sector home equity release (reverse mortgage) loans had been taken out up to December 2006. It considers that these mechanisms can play a useful role in assisting rates affordability. *The Panel recommends that further analysis be carried out to explore the potential of such schemes and that the tax treatment of the schemes offered by private sector financial institutions be clarified.*

95. Local authorities are required to have a rates remission and postponement policy for Māori land and may develop a policy for other land. Only 16 local authorities have a rates remission and postponement policy that covers cases of extreme financial hardship. *The Panel recommends that all local authorities be required to have a rates remission and postponement policy based on a standard template that includes financial hardship, and that this be developed by the Department of Internal Affairs in consultation with local government and other stakeholders.*

96. There were many submissions recommending that GST on rates be removed because it is a "tax on a tax". The Panel does not support removing GST on rates. There is a substantial element of user charging in rates and the Panel considers that the consistent application of GST across all goods and services is a feature of the New Zealand taxation system that should be retained.

97. The Panel also examined the affordability of rates to the farming community and the business sector. A small number of farmers are paying a relatively high level of rates, but overall rates as a percentage of farm cash outgoings were only slightly over 4% in 2006/07. Councils have power to deal with cases of obvious inequity through the flexibility in their rating policies, including remissions policies. Business sector rates are, on average, a small percentage of total costs, although the business sector points to the higher level of rates levied on it through business rating differentials adopted by a number of councils. As discussed in Chapter 9, the Panel considers that business differentials are non-transparent and notes that they can be replaced by use of targeted rates. However, this may not necessarily lead to a reduction in business sector rates, depending on the targeted rates that might be levied in place of the differential.

98. The Panel considers that the issues raised in submissions from the farming and business sectors are essentially matters of equity and transparency, rather than matters of affordability.

Rating of Māori land (Chapter 13 of the report)

99. Based on submissions received and discussions at the 12 hui held by the Panel around New Zealand, there are major issues concerning the rating of Māori land that need to be resolved now. There is a long history of grievances and problems that are well known but have never been resolved.

100. Although there are certain exemptions for Māori customary land and marae and urupā, Māori land is liable for rates under the LGRA.

101. The first issue that arises is whether the rating of Māori land is consistent with the Treaty of Waitangi. *The Panel recommends that the relationship between the Treaty of Waitangi and rating law be addressed by the Government as part of the work programme on rating and Māori land proposed by the Panel.*

102. That important issue aside, the first major issue is whether the current approach to the valuation of Māori land is appropriate. The Panel considers it is not. Valuation of land is based on the assumption of a willing buyer and a willing seller. But Māori regard themselves as custodians of the land. Māori land cannot be sold, except under special and limited circumstances. This was recognised in the decision in the Mangatu case, after which a percentage discount is now generally applied to the values determined for Māori land. However, the Panel does not consider that this percentage discount is an appropriate response to the Mangatu decision. In short it believes that valuations of Māori land are generally significantly overstated. The Panel received numerous examples of landlocked, unproductive Māori land being valued at inexplicably high figures. *The Panel recommends that a new basis for valuing Māori land for rating purposes be established that explicitly recognises the cultural context of Māori land, the objectives of Te Ture Whenua Maori Act 1993, and the inappropriateness of valuations being premised on the “market value” of Māori land.*

103. Another key issue is the relationship between Māori landowners and councils. There is a long history of grievances and mistrust on the part of Māori landowners, reflecting past sales of Māori land for the non-payment of rates and perceived unequal treatment from councils in a number of matters. Although there are exceptions it appears to the Panel that some councils have not been prepared to take the time or invest in the training of staff necessary to deal with landholdings where there are poor ownership records, multiple ownerships, and little or no management structures. Reflecting these special characteristics of Māori land, councils are required to develop a policy on the remission or postponement of rates on Māori land. Although some councils have adopted a pragmatic and collaborative policy with Māori landowners to encourage the development of the land where this is the wish of the landowners, others have adopted a more passive role as collectors of rates, and initiated proceedings to recover rates or register the unpaid rates under an order of the Māori Land Court.

104. *The Panel recommends that a coordinated and consistent approach to remission and postponement of rates on Māori land be developed based on a joint exercise between central government, local government, and Māori.*

105. *The Panel also recommends that the Society of Local Government Managers, in conjunction with Local Government New Zealand, Te Puni Kōkiri, and Māori develop a training programme to build capacity and knowledge within local government to effectively address rating and related issues concerning Māori land.*

106. Māori land cannot now be sold for non-payment of rates. This is but one reason for arrears of rates being a significant portion of total rates arrears. Other reasons include poor record-keeping and the difficulty of finding owners. A number of submissions from councils recommended that the Government should accept rate arrears on Māori land as a national responsibility and fund councils for these uncollected rates. The Panel does not agree with this suggestion. Part of the problem is

the over-valuation and thus over-rating of Māori land. And part of the problem is failure of some councils to adequately engage with Māori landowners. Either way, there is no justification for the Government to make payments to councils.

Exemptions (Chapter 14 of the report)

107. A number of categories of land are exempt from rates, and a few categories are liable for only 50% of rates. This exemption in general applies to general rates, UAGCs, and some targeted rates. Targeted rates for water, waste water, and solid waste disposal are generally payable on all rateable land where the services are provided. It is estimated that the cost of these exemptions is equivalent to about 4% of total rates, but this is spread unevenly between councils.

108. The main category of land that is exempt is Crown land. This does not include State-owned enterprises or Crown research institutes, which are fully liable for rates. Exemptions are provided under the LGRA for certain designated religious and charitable organisations and a 50% remission for some sporting and cultural uses. In addition, roads and the operational areas of airports, railways, and wharfs are currently exempt. The exemption is based on use, not ownership. For example, land owned by a charity but used for business purposes is fully rateable. Individual councils also remit rates for community and other charitable organisations not designated under the Act based on their own remissions policies, which they may develop under the LGA 2002.

109. The Crown exemption may reflect the view that the Crown should not be bound by a lower level of government, and the religious and charitable exemptions presumably reflect some concept of community benefit that might justify exemption. But overall the rationale for these rating exemptions is unclear. The Panel considers that land should not be exempt from full rates, unless there is a clear justification. For example, it is difficult to see the justification for major university buildings located in downtown city areas not paying rates on the same basis as adjacent office buildings used for business purposes.

110. *Accordingly it recommends that all the existing rating exemptions be removed with the exception of the Crown conservation estate and other conservation land open to the general public, some other categories such as the seabed, foreshore, and river beds, roads, and Parliament and vice-regal residences.*

111. It would then be up to each council to determine what exemptions it wished to continue using in its remissions policy developed under the LGA 2002. The Panel assumes that most councils would wish to continue the exemption for religious and charitable organisations but would rate Crown properties.

112. Giving this power to local government would be consistent with the strengthening local autonomy and the partnership between central and local government. It would also enable councils to develop a coherent and consistent remissions policy covering all community, religious and charitable organisations, reflecting their own community priorities.

113. The main category of Crown land affected would be that used by educational and health institutions. Although reliable figures are not available, it appears that the education sector would pay around an additional \$60 million per year in rates and the health sector around \$18 million. *The Panel recommends that these additional costs should be met by additional government funding to these institutions and that payments in respect of schools should be funded centrally.*

114. In addition there are special arrangements for the rating of New Zealand Defence Force property under which rates are based only on land value, and only one UAGC is paid regardless of the number of housing units on the property. *The Panel recommends that these special provisions be removed.*

115. Continuing the exemption of the conservation estate would be consistent with its role of a public good, but also reflects the difficulty of making a meaningful valuation of such land. However, the Panel recommends that such land become liable for an expanded range of targeted rates to cover costs that it may impose on the local community, such as the cost of road access and pest control where this is not adequately undertaken by the Department of Conservation.

116. *The Panel recommends that the existing exemptions for certain classes of Māori land remain and be transferred to Te Ture Whenua Maori Act 1993.*

Financial decision making in local government – consultation, planning, and accountability (Chapter 15 of the report)

117. The LGA 2002 contains detailed and important policies and procedures concerning consultation, planning, and accountability. These are based on sound principles and aim to provide extensive information to citizens to enable them to participate in council decision making and to hold councils accountable. However, a key challenge is to develop public understanding of local government decision making and the funding mechanisms that underpin local government expenditures. Submissions to the Panel and the Panel's meetings strongly suggest that, although their intentions are good, these mechanisms are not working adequately. The current statutory provisions on consultation and planning are onerous, complex, and confusing. They are often implemented in a compliance-based way, with attention to form rather than substance. Nor has their operation yet been adequately reviewed. The forthcoming operational review of the LGA 2002 by the Local Government Commission will enable some of these issues to be more fully addressed. *The Panel recommends that after this operational review there be a further independent review of the consultation and decision-making provisions of LGA 2002.*

118. The consultation arrangements are increasingly viewed by councillors, council staff, and the public as consuming large amounts of time and resources to little benefit. This burden must be reduced, by greater use of more targeted consultation. *The Panel recommends that the current consultation processes be replaced by more selective and streamlined consultation arrangements.*

119. The existing planning mechanisms focused on the LTCCP are also in need of change. The recent report of the Auditor-General on the 2006–16 LTCCPs has highlighted some of the problems. The documents are too voluminous to be used by councillors or citizens in any meaningful way and the summary documents do not focus on key issues. There is an inadequate link between the LTCCPs and the annual plan, with annual plans in many cases differing substantially from what was provided for in that year in the LTCCP, leading to “surprises” concerning proposed expenditures and revenues included in the annual plan. *The Panel recommends that within the LTCCP framework a system of three-year indicative budgets be developed, from which the annual plan will be derived. This should provide closer attention to the near future and ensure a better linkage. The Panel also recommends that the LTCCP processes be better aligned with the three-year electoral cycle to reinforce political ownership of the LTCCP by councillors and that councils adopt medium-term financial targets as part of the recommended three-year indicative budget and that achievement or otherwise of these targets be audited.*

120. The actual level of rates and rates increases across all councils cannot be reliably compared because of the differences between councils in the way they define rates and by the treatment of subsidiary organisations. *The Panel recommends that a template be produced to provide a standard means of reporting on the level of rates and rate increases, thus enabling citizens to see changes within their council over time and to make comparisons with other councils.*

121. There is also a need for more informative rates assessment notices. *The Panel recommends that councils disclose on each rates assessment the amounts that will be allocated to different council activities, as well as containing the information set out in the paragraph above.*

122. There is also a need for better reporting by councils on their performance. The existing requirement for reporting of actual service levels achieved compared with planned levels is not adequately met and does not focus sufficiently on council efficiency. Some work has been initiated already within local government to develop some relevant and standardised performance measures that would be used to measure changes in performance within a council over time and to make comparisons with other councils. This is a difficult but important area and adequate time is needed to develop such a performance measurement and benchmarking framework. The Panel does not recommend a prescriptive approach but considers that the Society of Local Government Managers and Local Government New Zealand should work to develop a template in consultation with other stakeholders, including citizens.

123. A new set of institutional frameworks is needed within central government to ensure that citizen concerns about council policy decisions can be addressed. Some review mechanisms are needed. In particular *the Panel recommends that consideration be given to establishing an independent unit with powers to review council financial decisions, focusing on reviews that could lead to guidelines about best practice.*

124. The Panel notes that the Department of Internal Affairs does not currently have the resources or capacity to provide good-quality information about the local government sector and good practice guidance on the implementation of local government legislation or to monitor and review the operation and implementation of local government legislation. *The Panel recommends that the resources provided to the Department of Internal Affairs be increased to enable it to better monitor the operation of councils and of the local government legislation.*

125. The Panel also considers that improved institutional arrangements are needed within central government to strengthen the partnership with local government. This includes better analysis, coordination, consultation, and guidance within and from central government on decisions that impact on local government.

RECOMMENDATIONS

The Local Government Rates Inquiry has made a total of 96 recommendations. These are grouped below according to specific topics of the inquiry's terms of reference (and hence the report chapter in which they appear).

Recommendations on drivers of expenditure

The terms of reference ask the inquiry to develop an understanding of the drivers for local authority expenditure, such as growth and infrastructural demands on both operating and capital needs.

- 1 **That councils be entitled to set their own fees for all regulatory responsibilities on an actual and reasonable cost-recovery basis.**
- 2 **That the relevant provisions of the Resource Management Act 1991 be reviewed to streamline the power to charge a resource rental for occupation of coastal space.**
- 3 **That councils move away from fully funding depreciation, with the development of longer-term funding policies that take better account of intergenerational equity, and the availability of longer-term debt financing.**
- 4 **That councils review and reduce forecast rate increases where that is consistent with their longer-term funding policies.**

Recommendations on use of rating tools

The application by local authorities of particular rating tools varies widely reflecting the flexibility given by the Local Government Act 2002 and Local Government (Rating) Act 2002. Understanding rating tool trends and their implications also focused attention on the system of property valuation.

- 5 **That the power to set uniform annual general charges be removed from the Local Government (Rating) Act 2002.**
- 6 **That the 30% cap on uniform charges be removed from the Local Government (Rating) Act 2002.**

Recommendations

- 7 That local authorities be encouraged to charge for waste-water disposal by volumetric charging.
- 8 That rating differentials be removed from the Local Government (Rating) Act 2002 from an operative date of 1 July 2012.
- 9 That a common rating system based on capital value be promoted across the country for general rates.
- 10 That councils indicate in their rates remission and postponement policies a policy for postponement of rating of rural property based on reassessed productive values.
- 11 That councils be encouraged to make more use of their powers for flexibility in rating so that the rating burden better reflects value in use.
- 12 That the previous model of a central government valuation authority be re-established to increase the level of professional resources applied to rating valuations.
- 13 As an alternative to recommendation 12, that the resources of the Valuer-General's office be increased to facilitate better quality control of valuations and encouragement for councils to better maintain the valuation roll and databases.
- 14 That the rates assessment notice make it clear that the rating valuation currently represents a means of distributing the rating burden rather than a likely realisable sale price.
- 15 That councils develop explicit standards for valuation covering such issues as the proportion of properties to be physically viewed between each calculation cycle and the inspection of all improvements to properties arising from a building consent.

Recommendations on non-rates funding mechanisms

The Rates Inquiry was asked to examine the use of other sources of revenue currently available to local authorities. The recommendations reflect the inquiry's consideration of how appropriately these other sources of revenue are being used, and their capacity to provide more funding.

- 16 That, as part of the establishment of the proposed Infrastructure Equalisation Fund (recommendation 36), the existing pattern of grants (excluding the financial assistance rate) including the allocation of the increased local authority

- petroleum tax (recommendation 34) be reviewed in due course to better reflect equalisation principles.
- 17 That the low funding rate received through FARs for major urban arterial projects be examined in future reviews of the National Land Transport Fund and the FAR.
- 18 That, with respect to development contributions,
- councils consult closely with one another and with developers in any necessary review of their development contribution policy
 - regional councils be given the same powers to levy development contributions as territorial authorities
 - these powers not be extended to include Transit New Zealand.
- 19 That local government look favourably on making more use of debt to finance long-term assets. This should include the issuance of bonds (including infrastructure bonds) on the capital market, not just shorter-term borrowing from commercial banks.
- 20 That borrowing in foreign currencies be permitted, subject to appropriate foreign currency hedging arrangements being adopted.
- 21 That the Government remove legislative barriers to the funding of transport projects through the use of tolls.
- 22 That the Government extend the limit of 15 years on contracts with the private sector for water and waste-water services.
- 23 That business enterprises owned or controlled by a local authority be required to operate as a business in the same way as State-owned enterprises.
- 24 That councils set clear financial targets for such enterprises.
- 25 That councils report transparently in their annual reports on the achievement or otherwise of the financial targets that have been set for the businesses in which they have invested, including reporting the actual rate of return earned on the investments.
- 26 That councils clearly articulate in their LTCCPs their objectives in holding investments in business enterprises, and include in their annual reports an assessment of the extent to which these objectives have been achieved.

Recommendations

- 27 That councils identify target rates of return for investments held in financial assets and publish the actual return in their annual reports.
- 28 That clear operating targets for council-controlled organisations and other subsidiary service organisations be set and these results included in councils' annual reports.
- 29 That cross-subsidisation between such services and other council activities be not permitted.
- 30 That actual and reasonable cost recovery for water supply and waste water on a volumetric basis be encouraged.
- 31 That the Government explore providing assistance for local authorities to install water meters where this is practicable.
- 32 That the requirement that councils form a council-controlled organisation to be able to levy user charges for waste water be abolished.
- 33 That councils be permitted to set all fees and charges on an actual and reasonable cost recovery basis, and any Government regulations that limit such fees should be removed.

Recommendations on alternative sources of funding

The Rates Inquiry examined a range of possible new sources of funding for local government, considered against generally accepted criteria for assessment of taxes. The Panel's work involved going over, in greater depth, ground that has been well tilled in the past, and drew on earlier reports and new work commissioned from the New Zealand Institute of Economic Research (NZIER) to provide an independent appraisal of the options. The objective was to determine which new sources could be recommended, which deserve further consideration, and which should be rejected.

- 34 That the current Local Authority Petroleum Tax (LAPT) be increased by 2 cents a litre on petrol with a commensurate increase on diesel, to be distributed to councils for general purposes based on a revised formula that incorporates equalisation principles.
- 35 That consideration be given to a "international visitors environmental levy" on overseas visitors as an option for funding local authority environmental costs associated with high levels of visitors. Further, that this funding be paid into the Tourism Demand Subsidy Scheme, which should in due course be subsumed into the proposed Infrastructure Equalisation Fund.

- 36 That a contestable Infrastructure Equalisation Fund (IEF) be established, funded by a share of GST, to provide financial assistance to councils and communities in the development and maintenance of the “three waters” infrastructure – water supply, waste water, and stormwater.**

Recommendations on sustainability and affordability of rates

Concerns about the impacts of rates increases for low-income groups and other sectors of society and the economy contributed to the establishment of the Rates Inquiry. The Panel looked at the sustainability and affordability of rates, the impact of the rates rebate scheme changes in 2006, and other Government assistance for families. In addition, the Panel examined the impact of local authority rates remission and postponement policies. The inquiry also investigated opportunities and constraints for private-sector affordability assistance initiatives such as home equity release schemes.

- 37 That further research be conducted by central government agencies on the affordability of rates for households in the two lowest income quartiles.**
- 38 That data be collected on the ethnicity of applicants for rates rebates applicants so that impacts and take-up issues can be monitored.**
- 39 That central government statistics and monitoring include assessment of rates impacts on both residential and non-residential sectors.**
- 40 That the rates rebate scheme be more widely promoted by appropriate central government agencies in close association with community organisations.**
- 41 That the Department of Internal Affairs and Ministry of Social Development develop an ongoing programme of monitoring the impact of the rates rebate scheme and other financial assistance for low-income families (including households whose sole income is a benefit).**
- 42 That a robust evaluation be conducted to ascertain the level of understanding among target populations about the rates rebate scheme and the benefits of applying.**
- 43 That the Ministry of Social Development provide adequate information about the rates rebate scheme to community services card holders and as part of its advertising about the accommodation supplement. In addition, central government (either the Ministry of Social Development or Department of Internal Affairs) should fund promotional activities by community and voluntary sector organisations to improve take-up by non-beneficiary groups.**
- 44 That consideration be given to administration of rates rebates through the Inland Revenue Department in a similar way to rebates for charitable donations.**

Recommendations

- 45 That there be annual indexation of the rates rebate and income thresholds to the average rates increase.
- 46 That occupants of retirement homes be eligible for the rates rebate scheme.
- 47 That occupiers of papakāinga be eligible for the rates rebate scheme.
- 48 That it be clarified that homes subject to a family trust are eligible for the rates rebate scheme.
- 49 That much clearer information be available on the Internet and in print with regard to the treatment of war pensions in assessment of eligibility for rates rebates.
- 50 That a review be undertaken to ascertain whether there is consistency in assessment of applications for rates rebates from recipients of war pensions.
- 51 That water supply and waste-water charges levied by a territorial authority or a council-controlled organisation be eligible expenditure for which a rates rebate may be claimed.
- 52 That local authorities be required to have a rates postponement policy based on a standard template developed by the Department of Internal Affairs in conjunction with key stakeholders. The policy should include provisions for extreme financial hardship and be updated regularly to reflect good practice.
- 53 That the Auditor-General be requested to carry out regular reviews of local authority optional rates postponement schemes.
- 54 That the Department of Internal Affairs, with advice and input from local government stakeholders, the Ministry of Consumer Affairs, and the Office for Senior Citizens, develop material about optional rates postponement schemes for the purpose of public education and consumer advice.
- 55 That local authorities be required to have a rates remission policy based on a standard template developed by the Department of Internal Affairs in conjunction with key stakeholders. The template should be updated regularly to reflect good practice.
- 56 That the Ministry of Social Development be asked to undertake work to clarify the relationship between reverse mortgages and central government benefits and the relationship between reverse mortgages and tax treatments.

- 57** That further analysis, including international comparisons, be carried out by the Treasury, Ministry of Social Development, and Department of Internal Affairs to explore the potential for home equity release to meet the housing cost needs (including rates) of ratepayers aged 60 and over.

Recommendations concerning land covered by Te Ture Whenua Maori Act

The Rates Inquiry was asked to consider the impact of rates on land covered by Te Ture Whenua Maori Act 1993. The land itself and its history, the validity of its valuation and rates levied on the basis of that valuation, and the land's ownership and productivity all contribute to a complex issue of which rates are one component and for which there is no easy answer.

- 58** That the relationship between the Treaty of Waitangi and rating law be addressed by the Government and form part of the work programme on rating and Māori land.
- 59** That a new basis for valuing Māori land for rating purposes be established that explicitly recognises the cultural context of Māori land, the objectives of Te Ture Whenua Maori Act 1993, and the inappropriateness of valuations for rating purposes being based on the “market value” of Māori land.
- 60** That the Government establish an explicit programme of work aimed at addressing the entrenched problems of rating on Māori land and that this be undertaken in partnership with local government and Māori.
- 61** That, as part of this programme of work, the Government collaborate in a joint exercise with local government and Māori in developing a coordinated and consistent approach to rates remission policies for Māori land.
- 62** That Māori freehold land that was made general land in the 1967 amendment to the Maori Affairs Act and is still in Māori ownership should be permitted to revert to Māori freehold land enjoying the same rates remissions policies as existing Māori freehold land. Further, there should be no restriction on changing the status of this land back into Māori freehold land.
- 63** That the work programme proposed in recommendation 60 should be linked to programmes assisting the productive development of the land.
- 64** That the Society of Local Government Managers, in consultation with Local Government New Zealand, central government, and Māori, develop a programme of training and development that can build capacity and knowledge within local government to effectively address rating and other related issues on Māori land.

Recommendations on exemptions

The Rates Inquiry was asked to examine the impact and need for existing exemptions from liability for rates, including Crown exemptions from liability for rates. In doing this, the inquiry reviewed each of the current statutory exemptions and considered submissions from local authorities that illustrate the effects of such exemptions.

- 65 That the categories of non-rateable (and 50% non-rateable) Crown and non-Crown land listed in Schedule 1 of the Local Government (Rating) Act 2002 should be removed from the schedule with the exception of the following items (clause numbers of the schedule in parentheses):
- the Crown's conservation estate (clause 1) and other conservation land open to the general public (clause 3)
 - the territorial seabed, foreshore, and beds of navigable lakes and rivers vested in the Crown (clause 2)
 - the roads vested in the Crown and local authorities (clause 17)
 - Parliament and vice-regal residences (clause 22).
- 66 That the additional costs to Government-funded organisations and institutions arising from the payment of rates not be at the expense of services provided by the institutions whose land is rated and that provision for extra costs be provided through the votes of the funding agencies such as Health and Education, with central funding of schools for this increased cost.
- 67 That local authorities have responsibility for decisions about what land removed from Schedule 1 of the Local Government (Rating) Act 2002 should be non-rateable, in full or in part, and that this responsibility be exercised through their rates remission policies.
- 68 That a decision to remove statutory exemptions allow sufficient time to enable local authorities to consult their communities and review and modify their rates remission policies.
- 69 That the categories of exempt Māori land in clauses 10(b), 11, 12, 13, and 14 of Schedule 1 of the Local Government (Rating) Act 2002 remain and be transferred to a schedule in Te Ture Whenua Māori Act 1993.
- 70 That the scope of targeted rates on non-rateable land be extended and that regional councils, as well as territorial authorities, be given the power to set such targeted rates.

Recommendations on decision making, planning, and accountability

Improving financial decision making in local government is a key issue underpinning the Rates Inquiry's terms of reference. The Panel looked at how local authorities interact with their communities in making financial decisions and ways in which the planning and accountability mechanisms of local government can be improved.

- 71 **That after the current operational review of the Local Government Act 2002 by the Local Government Commission, a further independent review of the consultation and decision-making provisions of the Act be conducted with a view to substantially streamlining the legislative provisions and providing for greater accountability.**
- 72 **That the Office of the Auditor-General and the Department of Internal Affairs monitor and review the way consultation is working.**
- 73 **That section 82 of the Local Government Act 2002 be amended to limit council discretion in the means of applying the consultation principles.**
- 74 **That the current consultation processes be replaced by more selective and streamlined consultation arrangements.**
- 75 **That local authorities place more emphasis on building capacity among elected members and council staff to engage with Māori in their decision making.**
- 76 **That within the LTCCP framework, a system of three-year indicative budgets be developed with explicit financial targets, from which the annual plan would be derived.**
- 77 **That the LTCCP process be better aligned with the electoral cycle.**
- 78 **That councils improve the quality of the summaries of the long-term council community plan as a basis for decision making and consultation.**
- 79 **That the auditing of long-term council community plans be continued in the medium term.**
- 80 **That council-controlled organisations' financial information be required to be consolidated into the LTCCP.**

- 81 That local government, in consultation with other stakeholders, produce a template, as a good practice guide, so that the amount of rates and annual increases can be better reported, and compared between councils. This template would set out
- total rates and individual components (general rates, targeted rates, user charges, and council-controlled organisation charges)
 - the real change in rates (that is, adjusted for inflation as measured by the Consumers Price Index)
 - the adjustment for increases in the number of rateable properties
 - the average total rate, its change over time, and rates broken down by ward
 - the relative amounts and average rate borne by residential, business, and rural ratepayers and how this has changed from the previous year.
- 82 That councils improve the information in the rates assessment notice, in particular by including detail on allocation of each assessment for particular activities.
- 83 That councils more fully explain the rationale for and impact of the policies required to be set out in the statement of revenue and financing policy.
- 84 That councils set explicit financial targets on a three-year basis in conjunction with the proposed three-year indicative budget (see recommendation 76).
- 85 That these targets be based on a template to be developed by local government, in consultation with other stakeholders, rather than prescribed in the Local Government Act 2002.
- 86 That the audit of the financial statements of local authorities report on the achievement or otherwise of these financial targets.
- 87 That the new template for financial reporting (statement of service costs) proposed by the Controller and Auditor-General be implemented.
- 88 That local government, in consultation with other stakeholders, move to develop a system of performance benchmarking.
- 89 That the Department of Internal Affairs work together with Local Government New Zealand to develop a comprehensive programme of training for elected or aspiring members of local authorities delivered in conjunction with appropriately qualified providers.

- 90 That the Department of Internal Affairs collect data on training undertaken by elected members of local authorities in order to assess training needs.
- 91 That the Department of Internal Affairs work in conjunction with the Ministry of Education and the Electoral Commission to ensure that the national curriculum includes adequate information on the structure, functions, and funding of local government and the way in which citizens may contribute to decision making.
- 92 That properly qualified providers be resourced to develop public education materials about local authority decision-making processes (including financial decision making) utilising different formats and addressing the needs of a range of audiences, using publications, a website, and audiovisual materials.
- 93 That decisions that could be subject to independent review include the basis or reasonableness of particular targeted rates, of user charges and of development contributions, and rates remission policies.
- 94 That consideration be given to establishing an independent unit with power to review financial decisions.
- 95 That the Department of Internal Affairs, as the local government policy agency within central government, be resourced and given responsibility for ensuring that local government policy development has input from key stakeholders (including resident and ratepayer groups).
- 96 That the resources provided to the Department of Internal Affairs be increased to enable it to adequately monitor the operation of councils and of the local government legislation.

APPENDIX:

TERMS OF REFERENCE

LOCAL GOVERNMENT RATING INQUIRY

TERMS OF REFERENCE

Purpose

1. To provide an independent assessment of New Zealand's local government rating system and identify options to enhance rates as a funding tool for local authorities.

Context

2. The Inquiry has arisen as a consequence of public concern in light of financial and rates projections outlined in Long-term Council Community Plans and confirmed in local authority rating decisions during the June-August 2006 period.
3. The Government has announced the establishment of an independent inquiry to provide the public, key stakeholders and the local government sector with a mechanism to outline issues relating to the local government rating system and suggest options to address these issues.

Objective

4. To consider issues relating to current local government rating, and to other revenue raising mechanisms, and provide recommendations to the Government for enhancing rating and other funding mechanisms for local authorities.

Tasks

5. The tasks associated with the inquiry will include:
 - a. Examine the level of rates, level of rates increases and trends in the use of rating tools nationally to fund services, as well as other sources of revenue currently available to local authorities;
 - b. Consider the phase one and phase two reports of the Local Authority Funding Project, their recommendations and implications for the future of rates;
 - c. Develop an understanding of the drivers for local authority expenditure, including, growth, the age and state of infrastructure (eg public transport, roading, water and wastewater), requirements of 'higher standards' (eg water quality) and other infrastructural demands on both capital and operating expenditure needs;
 - d. Examine the sustainability of rates as the major revenue raising tool, having regard to affordability issues for communities, groups within communities, and individuals, particularly those on fixed incomes;
 - e. Examine the impact of rates on land covered by the Te Ture Whenua Maori Act 1993;

- f. Examine the impact of the new Rates Rebate Scheme (and other government assistance packages for families) and local authority rates remission and postponement policies;
- g. Examine the impact and ongoing need for existing exemptions from liability for rates, including Crown exemptions from liability for rates; and
- h. Provide a report by 31 July 2007 on (a)-(g) above along with recommendations to enhance rating and funding mechanisms for local authorities.

Submissions

6. It is expected that the inquiry will invite written submissions on an open basis and hear oral submissions from key sector groups identified by the inquiry.

Assumptions

7. The inquiry is not a review of the system of local government per se, and in particular of:
 - the purpose, autonomy, or structure of local government; or
 - the principles of democracy, transparency, equity and accountability that local government operates under.