

PART THREE: MAJOR ISSUES

This part of the report discusses the current situation of local government funding: the levels of rates and the drivers of expenditure. It looks at the various funding mechanisms and how they are used. Then we look to the future and possible new sources of funding. The affordability of rates and the impact on land covered by Te Ture Whenua Maori Act are examined. After reviewing and making recommendations concerning the properties currently exempt from rates, the report concludes with a discussion on consultation, planning, and accountability in local government.

7 CURRENT LEVEL OF RATES AND RATES INCREASES

The terms of reference asked the Local Government Rates Inquiry to examine the level of rates and level of rates increases, and to consider the phase one and two reports of the Local Authority Funding Project. This requires an in-depth analysis of the sector's expenditures and revenues, both historical and projected.

SUMMARY OF KEY POINTS

7.1 The local government sector is very diverse in terms of size, population, income levels, rateable base, and revenue and expenditure patterns of individual local authorities. This means the expenditure and funding patterns will vary between councils.

Expenditure

7.2 Local government sector operating expenditure has increased over the past five years by 45% in nominal terms. This has been driven by

- increases in the purchase of goods and services, in part reflecting substantial increases in the costs of operating and maintaining infrastructural assets such as roads, pipes, and treatment plants
- increased depreciation costs
- increasing total operational expenditure reflecting a growing New Zealand economy and the need for local government to provide services to an increasing population.

7.3 Operating expenditure is also being driven to some extent by increasing population and an increased number of rateable properties. In addition, local government has faced price increases for some of its expenditures well in excess of the Consumers Price Index (CPI).

7.4 Local government operating expenditure in relation to nominal gross domestic product (GDP) fell from 3.5% in 1994 to 3% in 2002, then rose to a peak of 3.4% in 2006, but is forecast to fall to 3% again in 2016 (for financial years ending in June).

7.5 Capital expenditures are forecast to continue to grow significantly over the next 10 years with cumulative spending on infrastructure of \$31 billion. The largest component of this is transport, followed by the "three waters" (water supply, waste water, stormwater). Capital expenditure in the 2006/07 year is at a very high level compared with past expenditures. With additional capital expenditure come depreciation expenses, interest on debt, and operational and maintenance costs for the extra assets.

7.6 Depreciation is forecast to be a major driver of total operating expenditure over the next 10 years, increasing by 61% to over 22% of total operational expenditure by 2016.

7.7 Total debt is expected to increase to over \$8 billion in 2015/16 from \$3 billion in 2005/06, but despite this increase, overall debt remains low when compared with total assets.

Revenue

7.8 Total local authority operational revenue has increased 85% in nominal terms since 1994, and by 41% in real terms over the same period. The nominal increase over the past five years was 40%, a little less than that for operating expenditure.

7.9 Rates increased in real terms by 38% from June 1994 to June 2006. The nominal increase over the past five years was 37%. Rates made up 56% of total operating revenue in the year ended June 2006 compared with 57% in the year ended June 1994. Rates are forecast to become almost 60% of total operating revenues by 2016.

7.10 Thus rates are forecast to increase significantly above the rate of inflation. A more relevant measure, rates per rateable property in real terms, is forecast to increase by around 2% per year to 2016, with the majority of the increase occurring in the next five years. Rates are expected to increase faster than other revenue sources (government transfers, user charges, investment income, fees, and so on), although development contributions are forecast to grow at an even higher rate.

7.11 From 2000 to 2005 rates were at historically low ratios of between 1.9% and 2% of gross domestic product (GDP). Rates are forecast to climb to almost 2.2% of GDP by 2011/12 before declining to around 2.1% by 2016. These levels are below the peaks of 1970 and the early 1980s when the ratio was between 2.2% and 2.3%. Thus rates are not forecast to rise to historically high levels.

Geographical and size variations within the sector

7.12 Average rates per rateable property for rural councils are currently 7% lower than for provincial councils and 20% lower than for metropolitan councils. The impact of higher business rates in provincial and metropolitan centres may well explain this difference. The largest increases in rates, capital expenditure, debt, and other measures are forecast in the 10 metropolitan councils (with populations exceeding 90,000). This leads to the gap between average rates per rateable property for rural, provincial, and metropolitan local authorities widening by 2015/16. Average rates per rateable property are forecast to increase in nominal figures by 35% in rural councils, 44% in provincial councils, and 50% in metropolitan councils by 2016.

7.13 The Auckland region is forecast to have the highest rates increases in the country over the next 10 years. Allowing for the increase in the number of households, the average increase from 2007 to 2016 in rates for the Auckland region is 62%, compared with 48% for the country as a whole. All of the regions in the country south of Auckland are forecasting average rates increases to 2016 per household less than the national average.

7.14 A few local authorities (less than 10%) are facing high levels of interest costs compared with rates income and/or are planning to take on levels of debt that are seen as being at the upper limit of prudent levels. Conversely, there are nine local authorities forecast to have no debt in 2016.

7.15 The further analysis contained in this chapter generally confirms the conclusions of the Local Authority Funding Project. Rates increases are being driven by investment in infrastructure and the costs associated with operating these new assets, as well as in maintaining existing infrastructure.

Data issues

7.16 There is a need to improve the quality of data on local authority revenues and expenditures so that trends can be better monitored.

7.17 Although the 2006–16 long-term council community plans provide a reasonable indication of planned expenditures, experience in the first year since these were adopted demonstrates that additional projects and activities will arise, costs will change, and some projects will be dropped. The Panel's overall assessment is that there is some risk that the forecast expenditures and rates increases are understated.

Trends in the level of rates and rates increases

7.18 Rates are the end product of a budgetary process that first decides how much expenditure is required for a given level of service that has been determined in consultation with the community. A number of revenue sources are available to fund these services, and the authority goes through an iterative process to determine the level of service that is affordable. The final rates requirement is the funding needed, after all other sources have been considered, to deliver these services.

7.19 The Rates Inquiry has therefore analysed the trends in local authority expenditure and other revenue sources and the forecasts in the long-term council community plans (LTCCPs), as well as undertaking other analysis to get a picture of the expected rating levels over the next 10 years.

Data issues

7.20 The Rates Inquiry's work has highlighted the difficulty in obtaining adequate information from within the local government sector to carry out comprehensive comparative and time series analysis. This is despite the data sets held by the Department of Internal Affairs (DIA), and cooperation from sector groups such as Local Government New Zealand and New Zealand Society of Local Government Managers. Significant improvements in data are necessary if local government finances are to be adequately analysed and monitored. Although DIA maintains a website containing useful data sourced from Statistics New Zealand for all local authorities, it is not timely. The general financial data available on the www.localcouncils.govt.nz website was for the year ended June 2005 up until early July 2007 and was of limited use to the inquiry.

7.21 It is difficult to analyse local government expenditure and revenue trends on an inflation-adjusted (real) basis. There are a number of indices that measure price changes across a range of local government inputs, including the prices of pipelines, roadways, staff, and so on. None of these indices on their own accurately reflect on the cost structure of local government, and each local authority will face different overall cost increases depending on its activity mix. What is clear is that the CPI currently understates the level of price increases facing local government.

7.22 A major limitation is the lack of any reliable information on capital expenditures by standard functional activity over the past years. Statistics New Zealand started to collect better information in 2004, but again this is from local authority annual reports and is not timely.

7.23 Another fundamental information gap is the amount of rates paid by the rural, business, and residential sectors. Few local authorities publish this information. The Panel has been unable to source any data series on rates by sector. Several submitters (such as Federated Farmers [S577]) provided anecdotes and made claims as to the sectoral rates burden, but without undertaking a large amount of research on individual councils, the Panel was unable to verify these.

7.24 The Panel found information on forecast numbers of rateable properties extremely difficult to source and for most councils this was not readily available. Most councils do not have forecast numbers of rateable properties for 2016.

7.25 Another difficulty is analysing overall trends in the composition of operating expenditures, or comparing individual councils, given the lack of a standard functional or activity classification of expenditures.

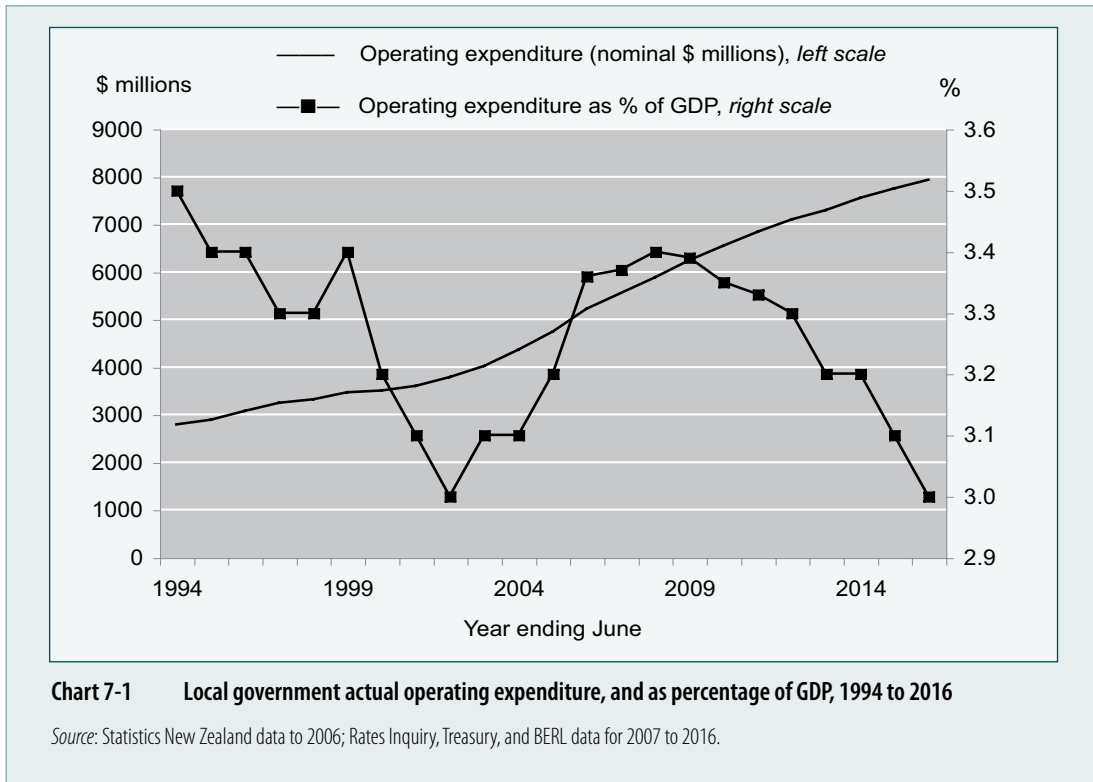
7.26 These data limitations also limit the ability of members of the public to make an informed assessment of their council's comparative performance. In addition there is a clear need for all local authorities to produce a simple one-page summary of standard key information so that the public can make a meaningful input into the LTCCP process. This would include information on

- valuations of residential properties (say quartiles of valuation)
- rateable properties by rural, business, and residential categories
- forecast rates by rural, business, and residential properties
- forecast levels of fixed charges and user charges payable by these properties
- forecast total and net debt
- forecast capital contributions
- forecast other income.

7.27 This information should be readily available to each council as part of its budgeting process for a new LTCCP. We discuss this issue in further detail in Chapter 8.

Data reliability

7.28 Forecasts of expenditure and revenue, particularly other (non-rates) income in the LTCCPs, lack detail beyond year 7. Capital expenditure is concentrated or bunched in the early years, and given past performance across the sector, these forecasts are unlikely to be achieved. The result is likely to be a flattening-out of the capital expenditure line and the transfer of some of the rates increases from years 2 and 3 to later years.



TRENDS IN LOCAL AUTHORITY EXPENDITURE

7.29 The Rates Inquiry has analysed local authority expenditure in terms of operating expenditure (expenditure on goods and services, employee costs, interest, depreciation), and capital expenditure. This analysis is illustrated in Charts 7-1 to 7-9.

Operating expenditure

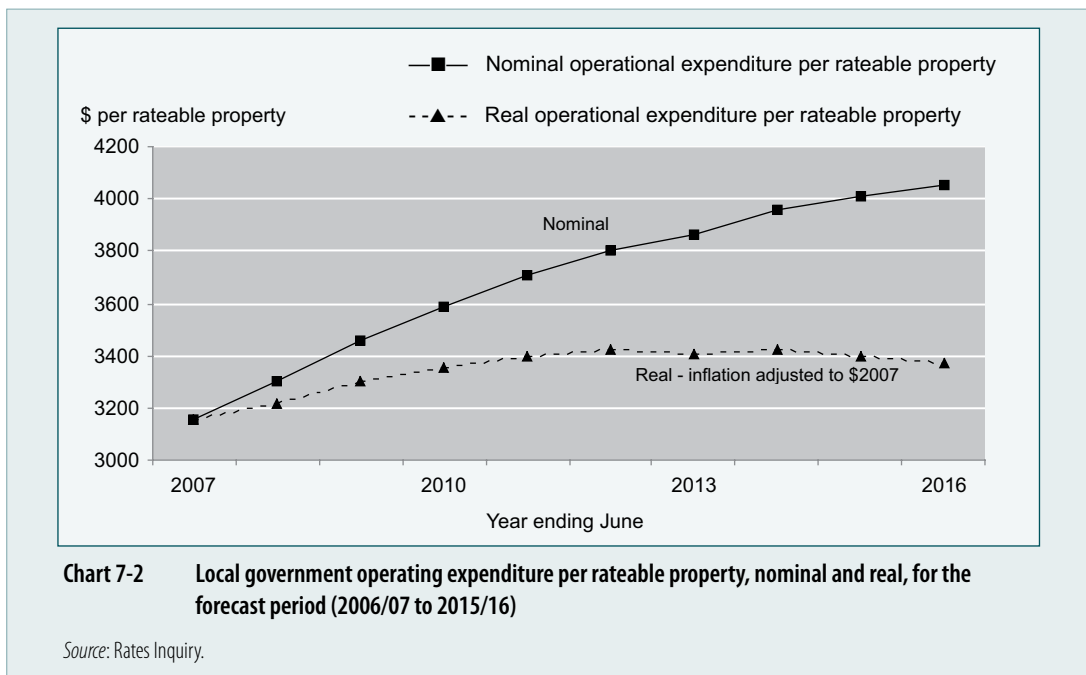
7.30 Operating expenditure has increased significantly over the past decade, by 45% in nominal terms over the past five years alone to \$5.2 billion in 2005/6. Operating costs have increased across all categories, with costs associated with maintaining infrastructure showing the largest increase. The largest category of operating expenditure is the purchase of goods and services. Taking into account inflation (using the CPI) over the period June 1994 to June 2006, total operational expenditure has increased by 42% in real terms.³¹

7.31 Chart 7-1 shows operating expenditure of local government from 1994 to 2016. Total operating expenditure is forecast to increase by 43% in nominal terms from \$5.6 billion in 2006/07 to \$7.9 billion in 2015/16.³² After forecast increases of around 7% a year in the next five years, the rate of increase levels off towards the end of the forecast period to around 2.5% a year. This 43% increase is higher by a considerable margin than the forecast 20% increase³³ in the CPI from 2006/07 to 2015/16.

31 The Consumers Price Index (CPI) has been used as the deflator for real comparisons. Actual cost increases faced by local government over the past five years in particular have been higher than the CPI. Although we acknowledge this, the CPI is generally the index used by local authority rates customers as the benchmark for price changes, especially beneficiaries. A more in-depth look at price as a driver of costs is contained in Chapter 8.

32 Note: In this document years expressed in the format 2006/07 refer to financial years ended or ending 30 June.

33 New Zealand Treasury forecasts to 2011, sourced from *Half Year Economic and Fiscal Update*, December 2006; 2% increases applied from 2011 to 2016.



7.32 However, operating expenditure also needs to be related to the growth of the economy. Operating expenditure as a proportion of GDP fell from 1994 to 2002, before rising again and stabilising from 2006 to 2008. This ratio is forecast to fall from 2008 to 2016.

Operational expenditure per rateable property

7.33 A better measure of operational expenditure is to relate it to the number of rateable properties. Forecast operational expenditure adjusted for CPI and the number of rateable properties shows that total expenditure is expected to increase by just 8% from 2006/07 to 2011/12 before easing slightly out to 2015/16 (see Chart 7-2). The total real increase per rateable property from 2006/07 to 2015/16 is just 7%, or less than 1% per year.

7.34 This data was compiled from work done by DIA, staff from Manukau City Council, and the Rates Inquiry secretariat, but has considerable limitations. Forecasts of the number of rateable properties are not easily available, and for the majority of councils were not available at all. It is of concern that many local authorities do not prepare forecasts of this basic data set. In order to provide a consistent forecast base the latest Statistics New Zealand household projections medium growth series were used.

7.35 There is considerable variation in trends in operating expenditure across the sector. Analysing total operating expenditure by type of local authority shows that generally the larger the council, the greater the increase in operational expenditure (see Table 7-1). This is consistent with the pattern of expected population growth, which is concentrated in Auckland in particular.

Expenditure on goods and services and employee costs

7.36 The largest category of local government operational expenditure is the purchase of goods and services (this also includes grants and donations made by councils), which makes up 53% of the total. The proportion of total operational expenditure being spent on this category has increased slightly since 1993 (see Chart 7-3).

7.37 Employee costs did not increase in nominal terms throughout the 1990s, reflecting the trend of contracting out services and operational functions such as road maintenance or establishing

Table 7-1 Total operating expenditure in 2006/07, 2015/16, and throughout the 10-year forecast period, for local authorities categorised by population

Category of local authority ¹	Number of councils	Total opex ² 2006/07 \$ million	Total opex 2015/16 \$ million	% change 2007 to 2016	% of total sector opex 2007	% of total sector opex 2016	% of population 2006
Rural	25	395.5	514.6	30%	7%	6%	6%
Provincial	37	1,917.2	2,676.1	40%	32%	32%	45%
Metropolitan	10	2,485.6	3,715.7	50%	42%	44%	50%
Regional	12	757.1	1,020.7	35%	13%	12%	
Total sector	84	5,950.8	8,441.8	42%			

Source: Rates Inquiry from 2006 LTCCPs. *Table footnotes:* ¹Using Local Government New Zealand's definitions of rural (less than 20,000 usually resident population), provincial (between 20,000 and 90,000 usually resident population), metropolitan (above 90,000 usually resident population), and regional councils. Unitary authorities have been included in the territorial authority sector for this analysis. Metropolitan covers the four Auckland cities of Auckland, Manukau, Waitakere, and North Shore, as well as Tauranga, Hamilton, Wellington, Hutt, Christchurch, and Dunedin city councils. Local Government New Zealand includes Franklin District, Rodney District, Papakura District, Porirua City, and Upper Hutt City councils in what it terms its "metropolitan" group. However, these five councils were included in the provincial group of our analysis. Chatham Islands Council was not included in the data. ²opex = operating expenditure.

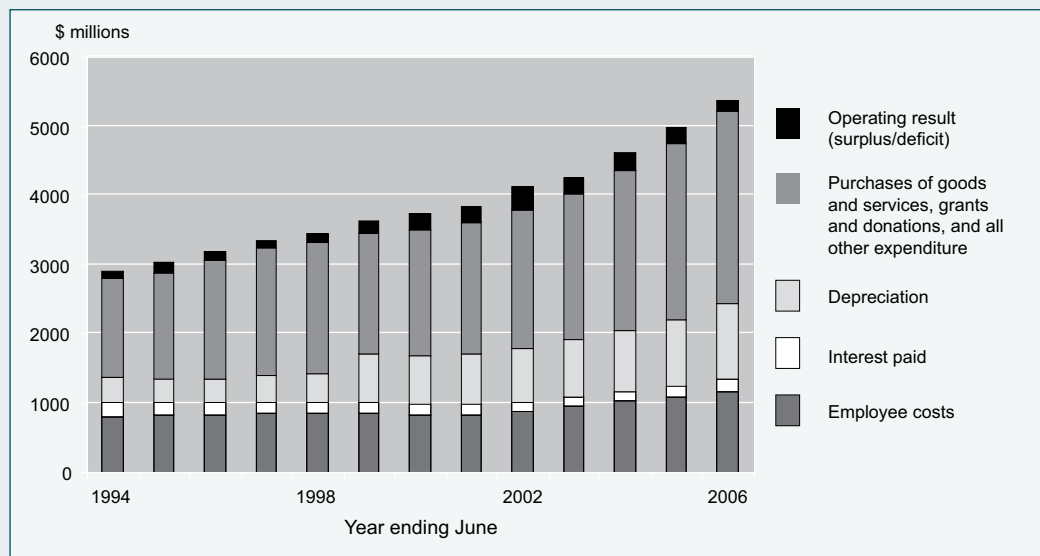


Chart 7-3 Local government actual operating expenditure by components, 1994 to 2006

Source: Statistics New Zealand Local Authority Statistics.

council-controlled organisations (CCOs). Thus some of these employee costs have been transferred to the payments for goods and services category. Employee costs started increasing from 2001, well before the enactment of the Local Government Act 2002. Increased staff requirements have been generated mainly by

- growth in housing construction (requiring more regulatory and inspection staff)
- increasing numbers of recreation and cultural facilities
- increased government regulations and policy requirements (including building inspections)
- increase in infrastructural expenditure (technical engineering staff and project management).

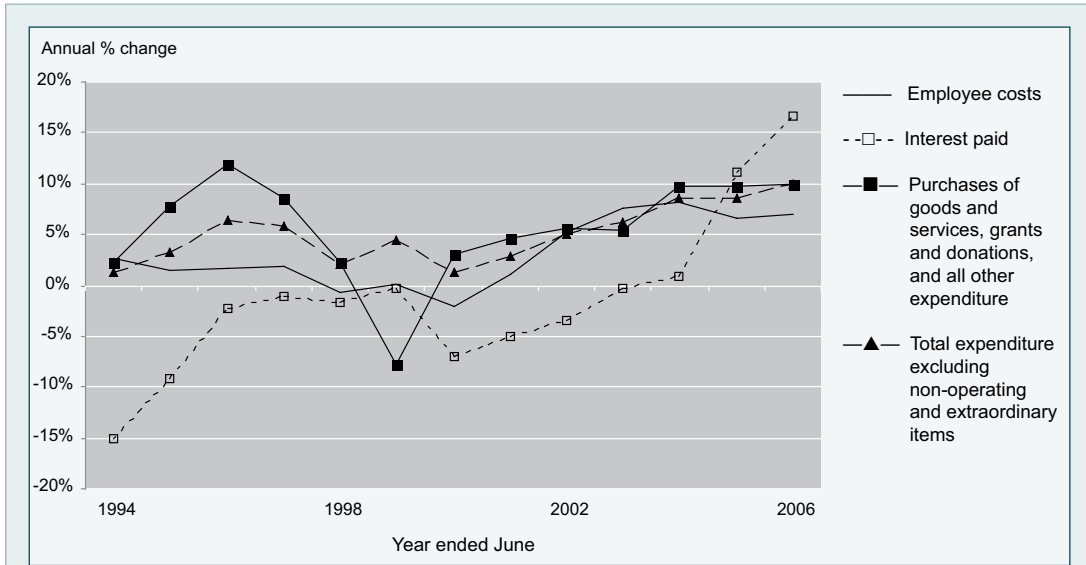


Chart 7-4 Annual percentage change in employee costs, interest paid, and purchase of goods and services, and other components of local authority costs, 1994 to 2006

Source: Statistics New Zealand Local Authority Statistics.

7.38 Employee costs made up 22.5% of total operational expenditure in the year to June 2006. This compares with 29.1% of total operational expenditure in the year to June 1994. Although employee costs have been increasing over the past six years, the increase has been proportionally less than that in other operational expenditure categories. The proportion of total operational expenditure being spent on employee costs is still declining. This issue is further discussed in Chapter 8.

Interest paid, capital expenditure, and debt

7.39 During the 1990s many local authorities had a policy of reducing or eliminating debt, reflecting the impact of several cases of financial difficulties caused by high debt levels. This move was generally supported by ratepayers.

7.40 Over the past 10 years these trends have reversed as local authorities have financed more capital expenditure through the use of more debt. Interest payments remained fairly static until 2004 as low interest rates offset rising debt. Interest costs are now rising as interest rates rise and debt increases (see Chart 7-4).

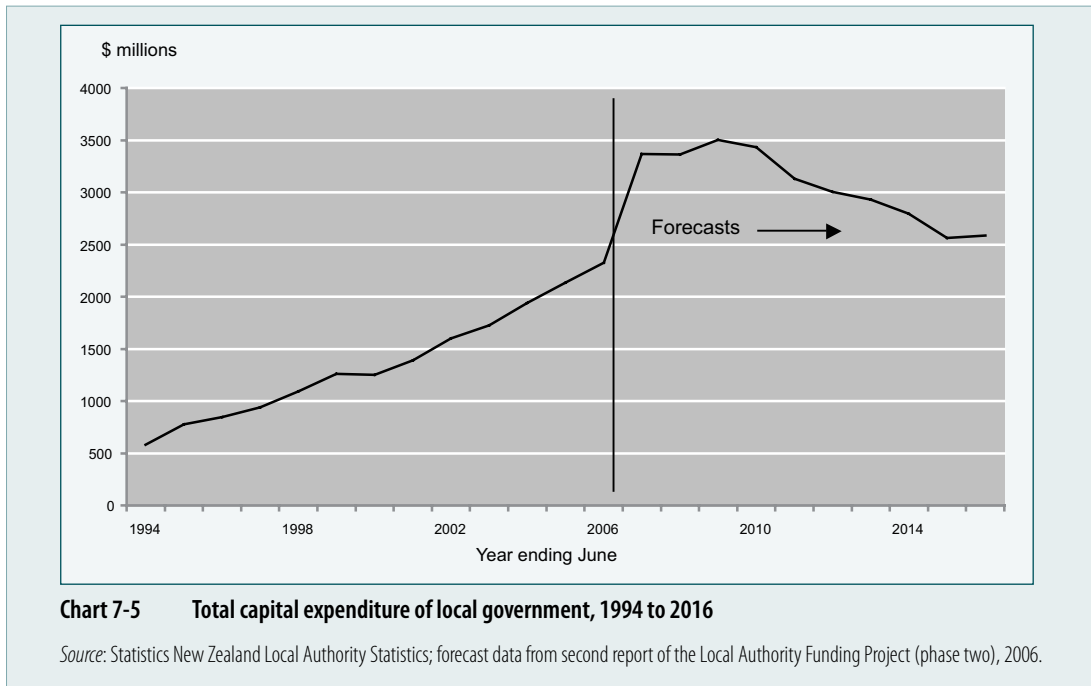
7.41 The overall result is that the level of interest paid in nominal terms in the year ending June 2006 is actually lower than that paid in the year ending June 1994. As a proportion of total operating expenditure, interest paid has dropped from 6.9% in 1994 to 3.4% in 2006, with a low point of 3.2% in 2004. Interest costs thus have not been a major component of increased operating expenditure.

Capital expenditures as a driver of rates

7.42 The relationship between a council's capital expenditure and rates is important, although indirect.

7.43 First, the capital expenditures themselves may be funded from several sources:

- + development contributions
- + borrowing
- + contributions from external parties, for example, to an art gallery



- ✦ Government transfers or subsidies
- ✦ sales of other assets
- ✦ accumulated cash reserves, which arise from the depreciation expense charged in the operating statement, which is used in setting annual rates, and other sources
- ✦ current revenues, of which rates are only one component, although a major one.

7.44 As stated in Chapter 5, council policies for the funding of capital expenditure are required by section 103 of the Local Government Act 2002 to be set out in a revenue and financing policy. These policies may differ significantly between councils. For example, councils make varying use of development contributions and borrowing. There are also different interpretations of the balanced budget requirements and the funding of depreciation, as discussed later in Chapter 8.

7.45 The ongoing impact of capital expenditures on rates comes through the annual operating expenses that occur once the capital asset is in service. This is why these operating expenses will rise even though capital expenditures may be falling – the accumulated amount of assets is increasing. Apart from direct operating expenses such as staffing and maintenance, there are depreciation expenses and interest expenses for those assets. These operating expenses must be covered by operating revenues, of which rates are, on average, a little less than 60%.

Trends in capital expenditure

7.46 The capital expenditure forecasts from LTCCPs compiled by the Local Authority Funding Project³⁴ confirm that capital expenditure in the 2006/07 year is at a very high level³⁵ compared with expenditures seen in the 1990s. However, capital expenditure is forecast to decline significantly from this high level over the 10 years to 2016 (see Chart 7-5). Total capital expenditure over the forecast period is \$30.8 billion, with 55% of this (\$16.9 billion) forecast to take place in the first five-year period. This compares with a total of \$15.7 billion over the past 10 years. Adjusted for historical and

³⁴ Local Authority Funding Project (phase two), *Local Government Funding Issues: An Update*, Second report of the Local Authority Funding Project, Wellington, 2006.

³⁵ It should be noted that local government has a history of not reaching its capital expenditure forecasts because of planning and design delays.

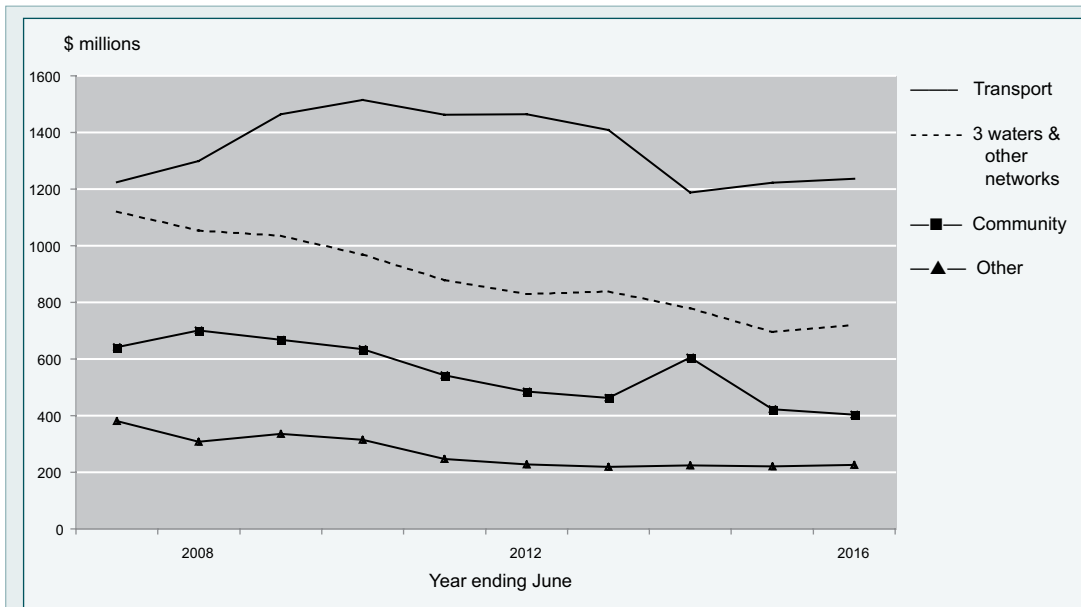


Chart 7-6 Capital expenditure of local government by activity, for the forecast period 2007 to 2016

Source: Local Authority Funding Project (phase two) data, with additional analysis by the Rates Inquiry.

Table 7-2 Capital expenditure in 2006/07 and 2015/16, and total over the 10 years, for major categories of expenditure

Capital expenditure category	2006/07 \$ (thousands)	2015/16 \$ (thousands)	Total over 10 years 2006/07 to 2015/16 \$ (thousands)
Transport	1,223,897	1,236,007	13,486,731
Three waters ¹	1,120,172	719,856	8,920,860
Community	642,259	403,284	5,566,254
Other	380,539	226,204	2,703,241
Total capital expenditure	3,390,197	2,597,127	30,788,019

Source: Local Authority Funding Project (phase two) data, with additional analysis by the Rates Inquiry. Note: Several councils' capital expenditure forecasts were unable to be sourced, so categories do not tally to total figure. Table footnote: ¹Three waters: water supply, waste water, stormwater.

forecast CPI in 2006/07 dollars, total capital expenditure over the forecast period is \$28.1 billion, compared with \$17.7 billion over the past 10 years.

7.47 Chart 7-6 presents a breakdown of the forecast capital expenditure by activity over the 10 years to 2016. Table 7-2 shows that the largest component of the total forecast capital expenditure is transport at 44%, with the "three waters" (water supply, waste water, stormwater) at 29%, community services at 18%, and other expenditure (such as economic development, harbours) at 9%.

7.48 Table 7-2 shows that the transport category is the only one where the nominal level of capital expenditure is at a similar level in 2015/16 as it is in 2006/07. The other categories are significantly lower in nominal dollars. One possible reason for this is the extensive work that has been done on 10-year land transport forecasts as part of the regional land transport programmes, whereas the same amount of work has not been done on forecasts of other capital expenditures. It is possible that forecasts of other capital expenditures are understated, particularly in the final three or so years of the 10-year forecast.

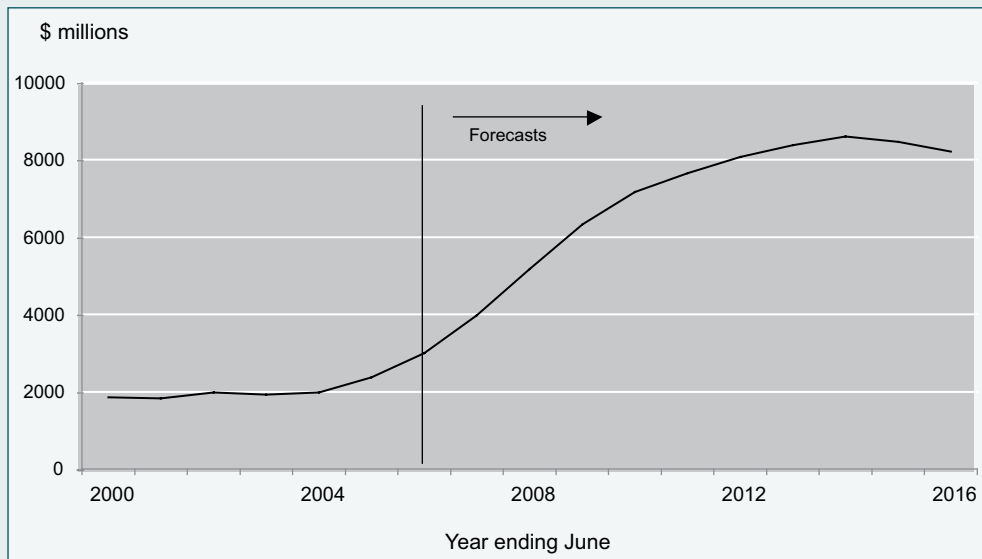


Chart 7-7 Local government total liabilities, 2000 to 2016

Source: Statistics New Zealand; forecast data from the second report of the Local Authority Funding Project (phase two), which excludes accounts payable and term liabilities that are not borrowing. Note: Total liabilities, not net debt.

Table 7-3 Total debt in 2006/07 and 2015/16, by category of local authority

Category of local authority	Number of councils	Total debt 2006/07 \$ million	Total debt 2015/16 \$ million	% change 2007 to 2016	% of total sector debt 2007	% of total sector debt 2016	% of population 2006
Rural	25	187.4	317.0	69%	5%	4%	6%
Provincial	37	1,864.7	2,895.5	55%	47%	35%	45%
Metropolitan	10	1,752.6	4,692.0	168%	44%	57%	50%
Regional	12	165.6	306.5	85%	4%	4%	
Total sector	84	3,970.3	8,211.0	107%			

Source: Local Authority Funding Project data and Rates Inquiry analysis. Refer to footnotes to Table 7-1 for further information on categories of territorial authority by population.

Total debt

7.49 The increasing debt level over the past two years is forecast to continue to 2013/14, after which total debt starts to decline (see Chart 7-7). Total debt is expected to increase from \$4 billion in 2006/07 to over \$8 billion in 2015/16. Although this may appear a large increase, total assets in 2015/16 are expected to be \$116 billion, giving a debt to asset ratio of 7%. The Local Authority Funding Project phase two report covers this area well.³⁶

7.50 Debt levels are not spread evenly across the different categories of councils as set out in Table 7-3.

7.51 Table 7-3 shows that the 10 metropolitan councils are driving the large increase in forecast debt and account for 68% of the total increase by 2015/16. The other categories show a declining share of total sector debt over the 10 years.

³⁶ Local Authority Funding Project (phase two), *Local Government Funding Issues: An Update*, Second report of the Local Authority Funding Project, Wellington, 2006.

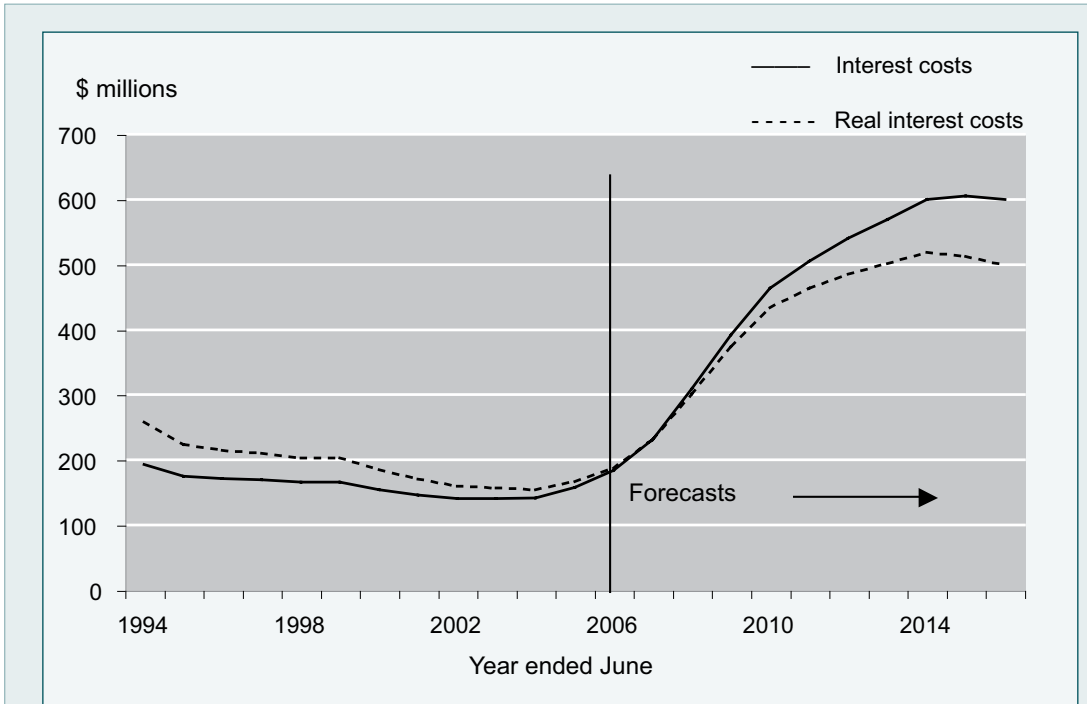


Chart 7-8 Total interest costs of local government, 1994 to 2016

Source: Statistics New Zealand Local Authority Statistics to 2006, Local Authority Funding Project forecast data from 2007, with Rates Inquiry analysis from LTCCPs.

Table 7-4 Number of territorial authorities and regional councils according to forecast ratios of interest costs to rates in 2006/07 and 2015/16

Interest costs as % of rates	Year ending June 2007		Year ending June 2016	
	Territorial local authority	Regional council	Territorial local authority	Regional council
0%	5	4	6	4
1–8%	43	7	33	6
9–12%	13	1	13	2
13–19%	10	-	13	-
>20%	1	-	7	-
Average %	7.4%	2.0%	11.7%	3.4%

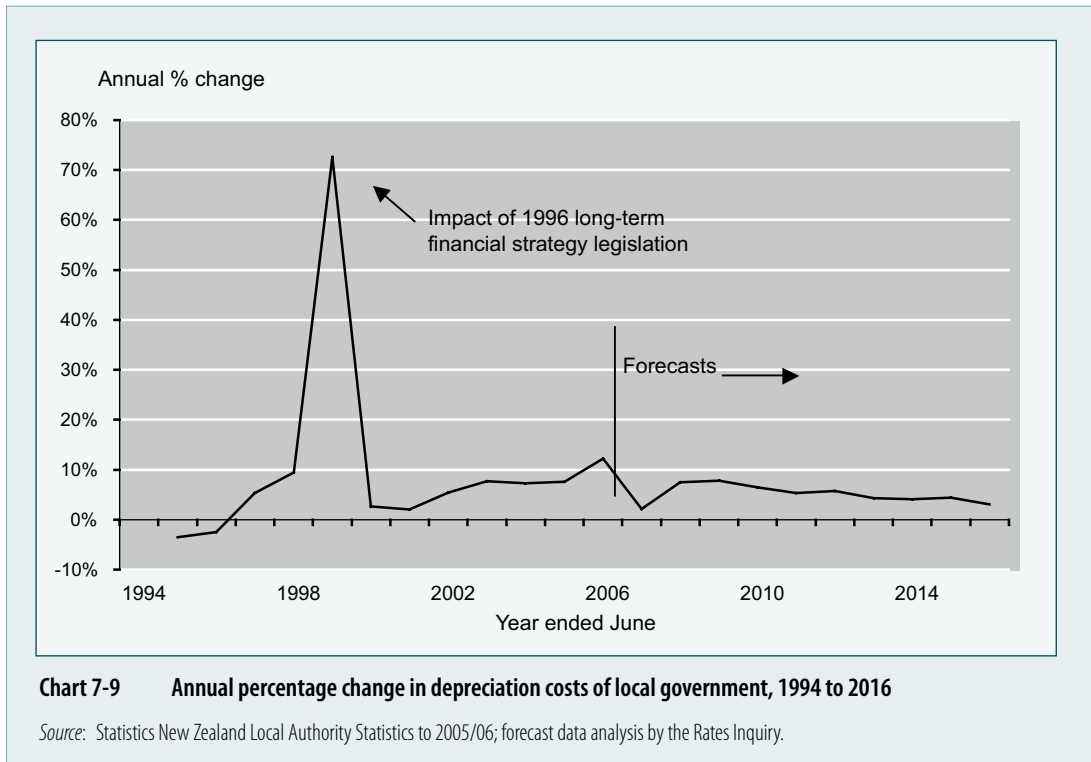
Source: Local Authority Funding Project data and Rates Inquiry analysis.

Interest costs

7.52 Interest costs for the sector are forecast to increase significantly from \$232 million in 2006/07 to \$600 million in 2015/16, an increase of 159% (see Chart 7-8). Interest costs level out in 2013/14, reflecting the levelling off of total debt and the decline in capital expenditure.

7.53 The ratio of interest costs to rates income is an important measure of financial prudence in policies on debt. As stated in the first report of the Local Authority Funding Project, a ratio of 20% is considered the prudent limit.³⁷ See Table 7-4 for interest costs to rates ratios for territorial authorities and regional councils. The forecast ratio for all councils is modest, rising from 6.8% in 2006/07 to reach a peak ratio of just under 12% in 2012/13, before declining to 10.8% in 2016.

³⁷ Local Authority Funding Project (phase one), *Local Authority Funding Issues*, Report of the Joint Central Government/Local Authority Funding Project Team, Wellington, 2005, p. 43.



7.54 The average ratio of interest cost to rates conceals a wide range between individual local authorities (see Table 7-4). At one end of the spectrum there are nine local authorities with no debt at all, increasing to 10 by 2015/16, all of which are smaller rural councils or regional councils. At the other end of the spectrum are seven territorial authorities that are forecasting to be above the prudent 20% ratio of interest costs to rates. These seven local authorities are diverse, including local authorities experiencing high growth, two metropolitan councils, a small provincial council experiencing growth, and small rural councils with declining populations.

7.55 A large majority of local authorities are forecast to be in a sound financial position in 2015/16, and the sector as a whole could take on more debt during this period if it chose to do so. A cautionary note is that the debt data is total debt, not net debt. Some of the councils with the highest forecast ratios of interest cost to rates have significant cash investments, which have not been utilised to repay debt. These are usually the proceeds of a sale of electricity assets or other assets.

Depreciation

7.56 The introduction of the long-term financial strategy requirements in 1996, requiring the adoption of a balanced budget and of full accrual accounting and budgeting, led to a large reassessment of depreciation requirements by 1998/99 (see Chart 7-9).

7.57 Since June 1994 depreciation expenses have tripled in nominal terms and as a proportion of total operational expenditure, have increased from 13% in the year ended June 1994 to 21% in the year ended June 2006, although they have not increased as a proportion of total operational expenditure over the past five years. This data in recent years has excluded depreciation charges on water and waste water assets from Metro Water Ltd (Metrowater), owned by Auckland City.

7.58 Depreciation is forecast to increase 62% over the next 10 years, from \$1.1 billion in 2006/7 to \$1.8 billion in 2015/16. This results in depreciation increasing as a proportion of operating expenditure from 21% in 2006/7 to 22% in 2015/16 and is a major driver of total

operating expenditure. These forecasts exclude figures from Metrowater and Manukau Water (from 2006/07).³⁸

- 7.59 The Panel concludes that local government expenditure has been driven mainly by
- a large increase in depreciation expenses
 - increasing costs to maintain and operate infrastructural assets
 - substantial rises in the costs of building infrastructural assets, such as roads, pipes, and treatment plants
 - increasing employee costs from increased process, regulatory, policy, and consultation requirements
 - increasing debt funding leading to increased interest costs.

7.60 Capital expenditures are forecast to grow significantly over the next 10 years driven by large spending on infrastructure of \$31 billion (roads, three waters, recreation, and other, in that order). This results in higher depreciation, interest and operating costs in respect of these infrastructure assets. Total debt increases to \$8.2 billion, leading to large increases in interest costs.

TRENDS IN LOCAL AUTHORITY REVENUE

7.61 The Rates Inquiry has analysed local authority revenue in terms of components of operating revenue, rates and rating measures, and other non-rates income. This analysis is illustrated in Charts 7-10 to 7-15.

Total operating revenue and total rates

7.62 Total local authority operational revenue increased over the period June 1994 to June 2006 by 85% in nominal figures to \$5.4 billion (see Chart 7-10) or by 41% in real terms. The rate of increase has gathered pace over the past five years, with nominal total operational revenue being 40% higher in the year ending June 2006 compared with the year ending June 2001. Rates revenue increased by 37% in real terms over the same five-year period. Rates made up 56% of total operating revenue in the year ending June 2006, compared with 57% in the year ending June 1994.

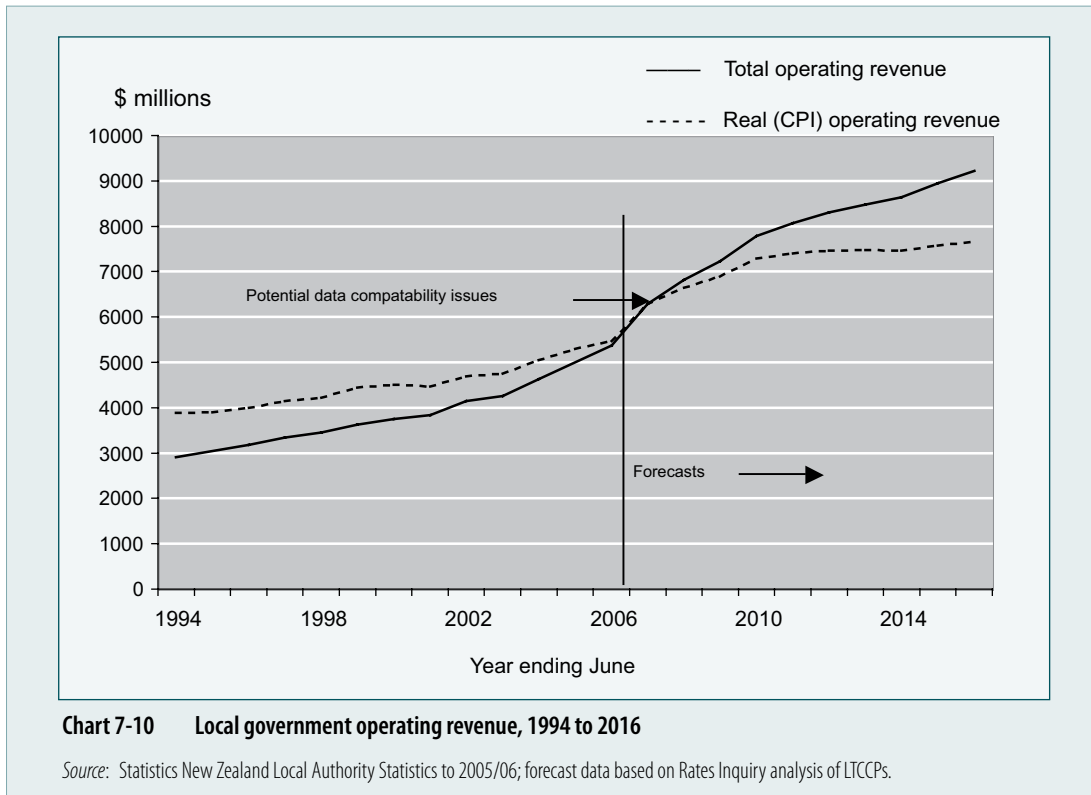
7.63 The term “rates” covers all general rates, including uniform annual general charges and targeted rates (both fixed and by value), but does not include user charges or charges through council-controlled organisations (such as water and waste water charges in Auckland City and Manukau City). This creates some difficulties for this time series data because these charges would have previously been included in rates.

7.64 Total operating revenue is forecast to increase in nominal terms by 47% between 2006/07 and 2015/16 to \$ 9.2 billion. This is higher than the expected increase in operating expenditure (refer Chart 7-1) and will result in the sector having increasing annual operating surpluses reaching \$1.3 billion for 2015/16. These surpluses are partly utilised for capital expenditure and/or the repayment of debt.

7.65 As discussed in Chapter 8 under longer-term funding issues, the Auditor-General has raised some concerns about the extent of local authority operating surpluses.³⁹ By 2014/15 all capital expenditure could be funded by operating revenues. Over the 10-year LTCCP period cash

³⁸ Based on data from Statistics New Zealand Local Authority Statistics and analysis by the Rates Inquiry of forecasts from LTCCPs.

³⁹ Controller and Auditor-General, *Matters arising from the 2006-16 Long-Term Council Community Plans*, 2007, AJHR, B.29 [07c], p. 17.



surpluses total \$24.2 billion and are the main funding source for capital expenditure. By 2015/16 debt is falling and cash investments are rising.

7.66 Taking into account forecast inflation (CPI) over the period June 2007 to June 2016, total operating revenue is forecast to increase by 22% in real terms, while rates are forecast to increase in real terms by 37% over the same period.

Historical components of operating revenue

7.67 Rates have continued to provide the majority of operating revenue for local authorities (Table 7-5), followed by user charges, central government transfers, regulatory income and local authority petrol tax (LAPT), and investment income, in that order.

7.68 The proportion of funding from central government transfers has risen strongly since 2002, consisting mainly of road funding under the financial assistance rate formula for local roads. As the price of maintaining and building the roading network has increased significantly recently, so too has the amount of the transfer. In addition, two schemes have been established to assist smaller communities in funding infrastructure for water supply and waste-water disposal. The transfers include relief following flooding in the lower North Island in 2004 and snowfalls in the South Island in 2006.

7.69 Regulatory income and petrol tax have increased faster than total operating revenue since 1994 (see Chart 7-11). This reflects the implementation of the Resource Management Act 1991 and the passing on of some of the costs of a more complex regulatory system.

7.70 Investment income has declined because of a number of local authorities selling all or parts of business assets during the past 10 years. These business assets were usually ports, airports, and electricity assets allocated to councils as part of the 1989 amalgamation processes.

Table 7-5 Operating revenue in 1993/94 and 2005/06 for major categories of revenue

Operating revenue category	% of total operating revenue, year ended June 1994	% of total operating revenue, year ended June 2006
Rates	57.3%	56.1%
User charges and all other income	20.3%	19.7%
Government transfers	10.3%	12.7%
Regulatory income and petrol tax	5.1%	5.8%
Total investment income	7.0%	5.7%

Source: Statistics New Zealand Local Authority Statistics.

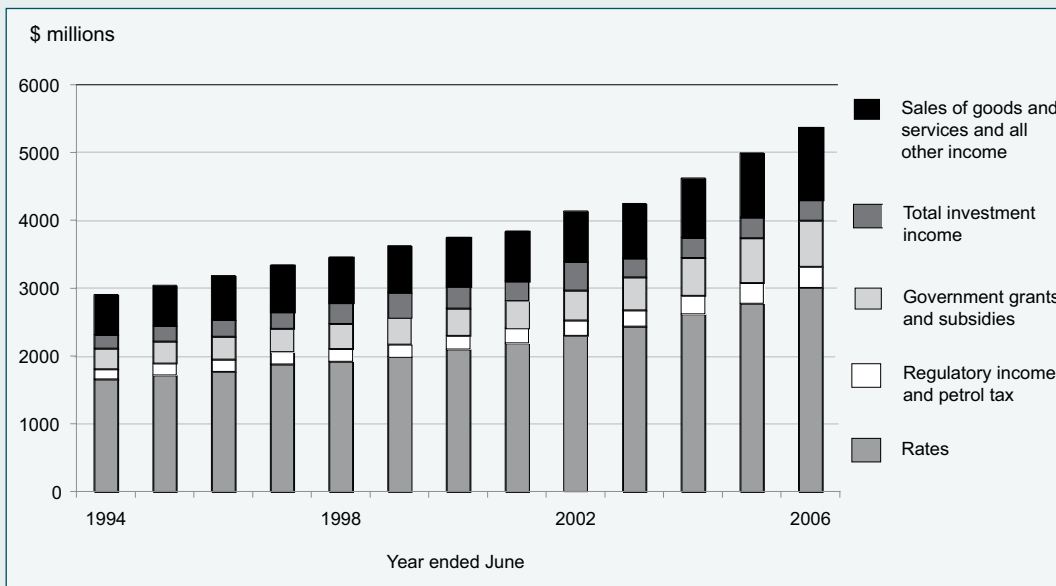


Chart 7-11 Local government operating revenue by category, 1994 to 2006

Source: Statistics New Zealand.

7.71 User charges and all other income have increased by 52% in the past five years, much faster than previously. This category includes volumetric water charges.

Rates and rating measures

7.72 As mentioned earlier the forecast level of rates increases is higher than the increase in operating expenditure.⁴⁰ Nominal rates increases of around 8% a year in the next few years reduce to increases of around 4% a year by the end of the 10-year forecast period. Rates are forecast to increase by 84% between 2005/06 and 2015/16 to \$5.5 billion in nominal terms, increasing rates' overall proportion of operating revenue from 56% in 2005/06 to 60% in 2015/16. This is effectively filling in the gap left by non-rate income growing at a slower rate than operating expenditure.

Rates as a proportion of gross domestic product

7.73 Chart 7-12 shows that local authority rates declined as a proportion of GDP in the early 1970s, the late 1980s, and from the early 1990s right through until 2002. Since then the proportion has increased to around the middle of the long-term trend. Over the years from 2000 to 2005 rates

40 Source: Local Authority Funding Project (phase two) forecast data. This rates series has excluded GST on rates.

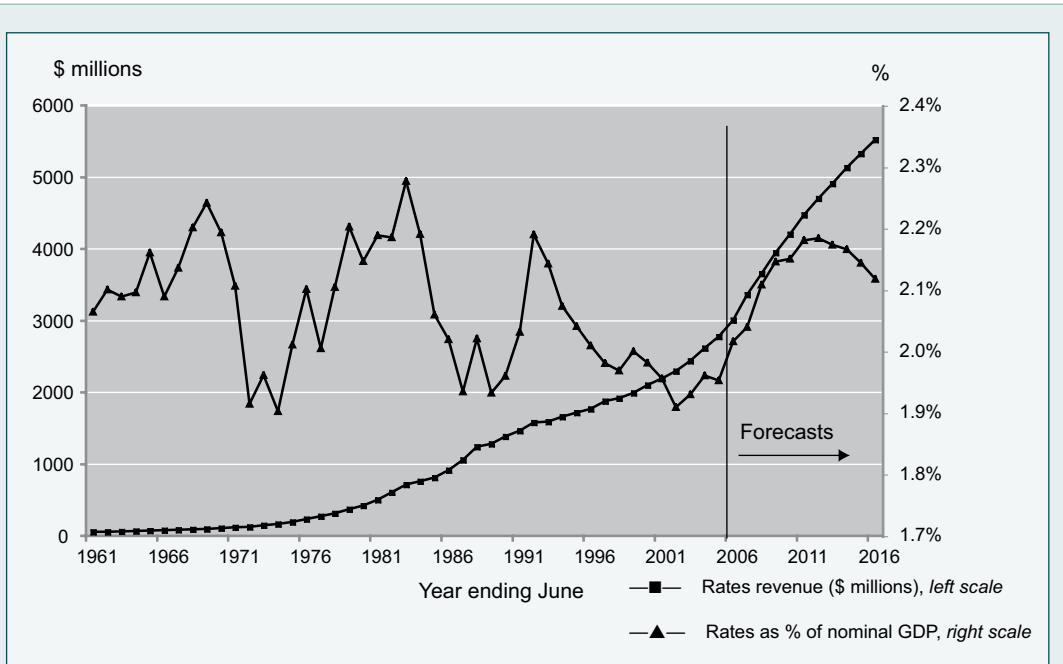


Chart 7-12 Local government rates revenue (by value and as a percentage of nominal GDP), long-term series, 1961 to 2016

Source: Statistics New Zealand, Local Authority Funding Project, Treasury, and BERL data.

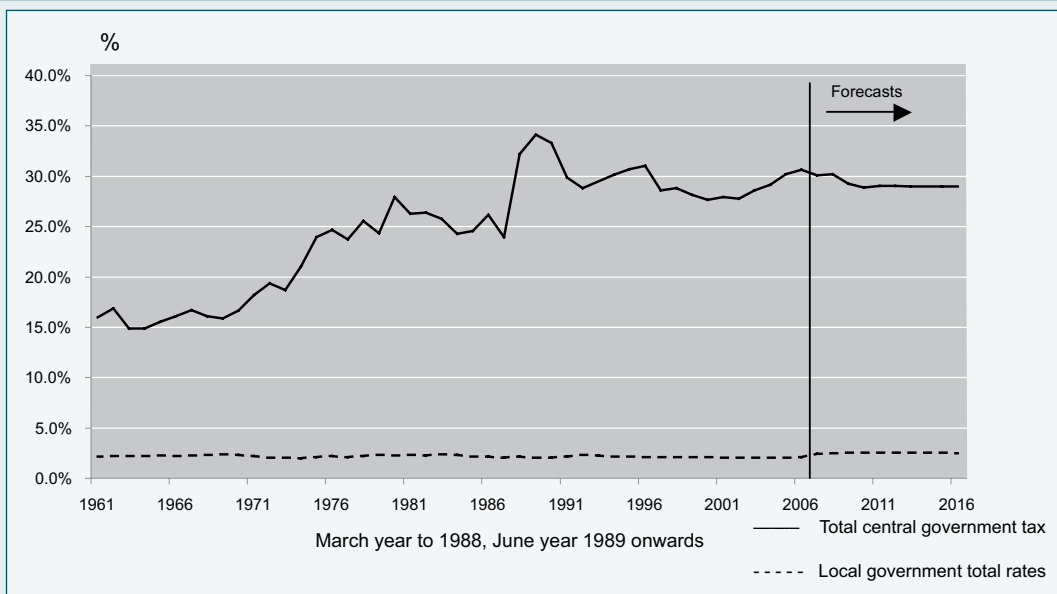


Chart 7-13 Local government rates and central government taxes as a percentage of GDP, long-term series, 1961 to 2016

Source: Statistics New Zealand, Local Authority Funding Project, Treasury and BERL.

were at historically low ratios of between 1.9% and 2% of GDP, but are forecast to climb to almost 2.2% of GDP by 2011/12 before levelling off. These levels are below the peaks of 1970 and the early 1980s when the ratio of rates to GDP reached between 2.2% and 2.3%.

7.74 The Rates Inquiry compared local government rates as a percentage of GDP with central government taxes as a percentage of GDP. Chart 7-13 shows the two ratios. Any increases in local government rates as a percentage of GDP are very minor when compared with central government

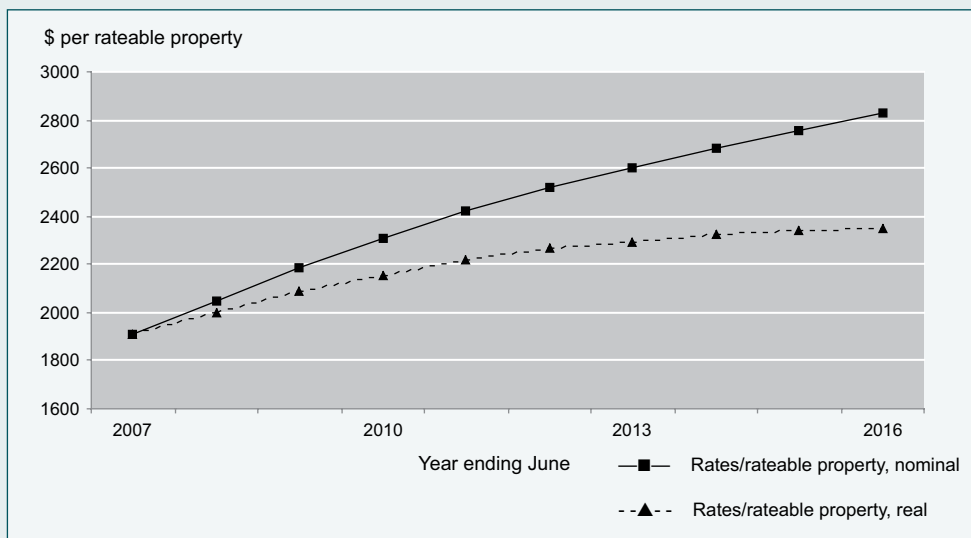


Chart 7-14 Local government rates per rateable property, nominal and real, 2007 to 2016

Source: Statistics New Zealand, Reserve Bank of New Zealand, Department of Internal Affairs, Manukau City Council, and Rates Inquiry. Note: Rateable properties data is an estimate only.

taxes, and local government rates are equivalent to less than 10% of total central government taxation.

Rates per rateable property

7.75 Nominal rates per rateable property are forecast to increase by 48% from 2006/07 to 2015/16 (see Chart 7-14). Real rates per rateable property are forecast to increase by 23% from 2006/07 to 2015/16. (The difficulty in forecasting the number of rateable properties is discussed in paragraph 7.34 above.)

7.76 The Panel concludes that rates are forecast to increase significantly above the rate of inflation. More importantly, rates per rateable property in real terms are forecast to increase by around 2% a year to 2016, with the majority of the increase occurring in the next five years.

Rates increases by size of council

7.77 The forecast increase in rates over the next 10 years is influenced by the size of the council; the larger the council, the greater the expected rates increase. The 10 metropolitan councils alone account for 58% of the increase in territorial authority rates to 2015/16 (see Table 7-6). Smaller rural-based councils are forecasting an average increase in rates income of 41% over the next 10 years.

7.78 Rates per rateable property across the whole sector are forecast to increase by 48% over the next 10 years. Table 7-7 summarises the rates per rateable property by category of local authority in nominal terms. This analysis is a simple average of the amount of rates per rateable property so it treats each council as an equal with no weighting for its relative size.

7.79 It can be noted that average rates per rateable property for rural councils are currently lower than for provincial and metropolitan councils, and by 2015/16 the gap is forecast to widen.

7.80 There are three main reasons for the difference in average rates per rateable property between the three categories of territorial authorities. First, metropolitan councils tend to provide

Table 7-6 Total rates in 2006/07, 2015/16, and percentage change over the 10-year forecast period, by category of local authority

Category of local authority	Number of councils	Total rates 2006/07 \$ million	Total rates 2015/16 \$ million	% change 2007 to 2016	% of total sector rates 2007	% of total sector rates 2016	% of population 2006
Rural	25	243.1	342.3	41%	7%	6%	6%
Provincial	37	1,220.9	1,947.2	59%	36%	35%	45%
Metropolitan	10	1,513.9	2,641.0	74%	45%	48%	50%
Regional	12	384.5	594.5	55%	11%	11%	
Total sector	84	3,362.4	5,525.1	64%			

Source: Local Authority Funding Project and Statistics New Zealand data; Rates Inquiry analysis. Refer to footnotes to Table 7-1 for further information on categories of territorial authority by population.

Table 7-7 Average rates per rateable property in 2006/07, 2015/16, and percentage change over the 10-year forecast period, for local authorities categorised by population

Category of local authority	Number of councils	Average rates \$ per rateable property 2006/07	Average rates \$ per rateable property 2015/16	% change 2006/07 to 2015/16
Rural	25	\$1,659	\$2,243	35%
Provincial	37	\$1,777	\$2,554	44%
Metropolitan	10	\$2,062	\$3,093	50%
Regional	12	\$258	\$359	39%
Total sector	84	\$2,148	\$3,181	48%

Source: Local Authority Funding Project data for rates; Department of Internal Affairs, Manukau City Council and Rates Inquiry data for rateable properties and Rates Inquiry analysis. Notes: Regional council rates are added to the territorial authority total to obtain the total sector rates per household. These figures are GST inclusive.

higher levels of service for recreation and cultural facilities. Second, they often provide facilities and services that provincial and rural councils do not provide at all – and these are often used by residents of smaller neighbouring councils. Finally, metropolitan councils have a much higher proportion of business properties and often have a differential in place that results in higher-than-average rates being levied on business properties. This results in the overall average rates per rateable property figure being significantly higher than for councils with fewer business ratepayers.

Other non-rates revenue, excluding development contributions

7.81 The revenue discussed in this category includes all other fees and charges and transfers (including roading transfers). This revenue is forecast to increase by 22% between 2006/07 and 2015/16 but to fall from 42% in 2006/07 to 35% in 2015/16 as a proportion of operating revenues.

7.82 There is some doubt over the reliability of the LTCCP forecasts for this item, with a possible lack of forecasting rigour beyond 2009/10. User charges, including fees for regulatory functions, are often forecast to stay at current levels. This does not seem plausible, but may reflect the fact that local authorities have not yet considered the issue beyond 2009/10.

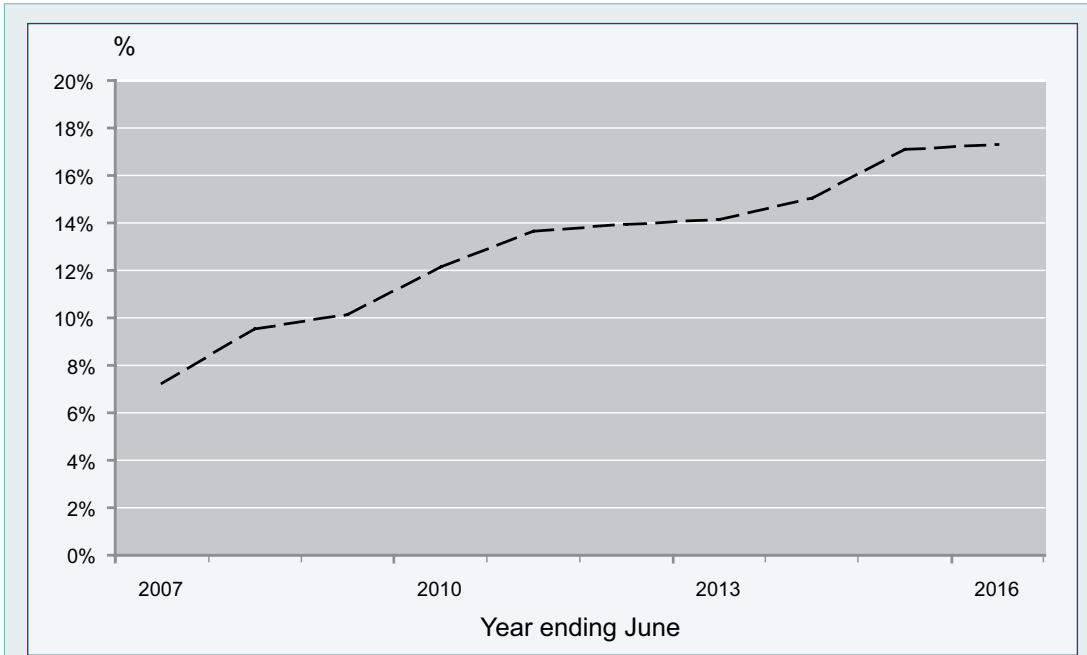


Chart 7-15 Development contributions as proportion of capital expenditure, 2007 to 2016

Source: Rates Inquiry from LTCCPs and Local Authority Funding Project.

Development contributions

7.83 The Local Government Act 2002 gave a new power for councils (excluding regional councils) to charge development contributions to cover a share of the expected future capital costs from new developments. Councils across New Zealand, particularly those with higher growth rates, have moved to utilise these new charges, and forecast development contributions (including ongoing financial contributions levied under the Resource Management Act) show a significant increase over the next 10 years (see Chart 7-15).

7.84 Development contributions are expected to increase from \$244 million in 2006/07 to \$447 million in 2015/16, funding about 17% of capital expenditure by 2015/16 compared with 7% in 2006/07. This does not include financial contributions under the Resource Management Act, which, according to the Auditor-General's recent report on LTCCPs, would increase this funding from developers to 25% of capital expenditures.

7.85 Thus local government is becoming more reliant on development contributions, and this will increase financial risk levels if councils undertake capital expenditures to accommodate forecast growth that does not subsequently occur.

Geographical differences in rates increases

7.86 Table 7-8 highlights the Auckland region as having the highest forecast rates increases, whereas every region south of Auckland is expecting average rates increases that are less than the national average. The analysis totals rates within each area and measures the change from 2006/07 to 2015/16 so each geographical area is effectively weighted by size of the rates take of each council.

7.87 The percentage change in rates per household from 2006/07 to 2015/16 was analysed by geographical area (see Table 7-9). This takes the effects of growth in the number of households into account. This analysis is a simple average of the amount of rates per household so it treats each council as an equal with no weighting for size. The effects of strong growth reduce the Auckland

Table 7-8 Percentage change in total rates over the 10-year forecast period to June 2016, by geographical area

Geographical area	% change in total rates, 2006/07 to 2015/16
Otago-Southland	49%
Canterbury-West Coast	57%
Tasman-Nelson-Marlborough	57%
Wellington region	41%
Hawke's Bay-East Cape	37%
Taranaki-Manawatu-Wanganui	60%
Bay of Plenty	64%
Waikato	60%
Auckland	91%
Northland	71%
New Zealand average	64%

Source: Local Authority Funding Project data and Rates Inquiry.

Table 7-9 Change in level of rates per household over the 10-year forecast period to June 2016, by geographical area

Geographical area	% change in rates per household, 2006/07 to 2015/16
Otago-Southland	38%
Canterbury-West Coast	34%
Tasman-Nelson-Marlborough	31%
Wellington region	30%
Hawke's Bay-East Cape	35%
Taranaki-Manawatu-Wanganui	47%
Bay of Plenty	37%
Waikato	44%
Auckland	62%
Northland	57%
New Zealand average	48%

Source: Local Authority Funding Project data and Rates Inquiry.

and Bay of Plenty rate increases in particular, although Auckland still tops the regional areas. The forecast increase in the CPI is around 20% over the same period.

Comment on Local Authority Funding Project analysis

7.88 There are a number of minor problems with the data sets used for the Local Authority Funding Project in their analysis of trends in rates, including some missing data from individual councils and a few small errors. However, these problems did not affect the overall analysis.

7.89 Of more concern is the basing of the analysis on the number of households rather than rateable properties to determine the impact on communities. The assumption used by the Local Authority Funding Project was that businesses and other non-residential rateable properties are usually owned by home-owners and that all costs eventually are borne by households. The problem with this is that a number of metropolitan councils have large numbers of business ratepayers that pay a large share of the overall rates. Many of these business owners live in neighbouring councils.

Another issue with using household numbers is the difficulty in capturing holiday homes, and the fact that these rates are paid by owners who reside in another district. Although large business communities will still skew the results to some extent, including all rateable properties in the analysis would give a better picture of the impact of rates on the rating base of each council.

7.90 The Rates Inquiry has managed to compile a list of the number of rateable properties for each local authority. This has been used in the analysis of rates affordability in Chapter 12 of this report. Analysing rate trends by rateable properties produced considerable differences within the sector, particularly councils with a large rural sector or a high proportion of absentee holiday homeowners.

7.91 The analysis contained in this chapter generally confirms the conclusions of the Local Authority Funding Project. Rates increases are being driven by investment in infrastructure and the costs associated with operating these new assets, as well as maintaining existing infrastructure. Local authorities are taking on significantly more debt, but overall debt remains low when compared with total assets.

Concluding comments

7.92 This report raises doubts about the reliability of the LTCCP forecasts in a number of areas. This issue is also discussed in Chapter 8, particularly in relation to forecast capital expenditures. Forecasts of expenditure and revenue, particularly other (non-rates) income, lack detail beyond year 7. Capital expenditure is concentrated in the early years, and given past performance across the sector, these forecasts will not be achieved. The result is likely to be a flattening-out of the capital expenditure line and the transfer of some of the rates increases from years 2 and 3 to further into the medium term. The lack of forecast increases in user charges is also puzzling. It is possible that it was politically difficult to indicate significant increases in user charges (pools, reserves, landfills, cemeteries, building fees, and so on).

7.93 The LTCCP forecasts provide a reasonable indication of how a council is planning for infrastructure over time. However, nothing is more certain than that additional projects and activities will arise over time, costs will change, and some projects will be dropped. The Panel's overall assessment is that there is some risk that the forecast expenditures and rates increases are understated.

7.94 The Panel has concluded that there is a need to improve the quality of data on local authority revenues and expenditures so that trends can be better analysed and monitored.