

# Non-Rates Funding Options Available to Local Authorities

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Local Government Rates Inquiry

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# Executive Summary

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Local authorities have available to them a range of funding options other than property rates. The purpose of this project is to analyse the advantages and disadvantages of these options, the extent to which they have further potential to assist local authorities, and whether there are barriers to their use.

The most important options for consideration are:

- development contributions
- transfers from central government
- debt funding; and
- income from investments.

Additional consideration is required in respect of user charges and fees, fines, grants and donations, and asset sales.

As noted by the Rates Inquiry Panel, the criteria to be applied in this analysis concern the *efficient* and *effective* use of these sources of funds. Additionally, the Panel seeks to understand whether changes are desirable.

There are widely dispersed views about the merits or otherwise of these funding instruments. The public submissions are likely to reflect this diversity. However many of these views are formed through personal observation of relatively imperfect systems. The task at hand requires a more disciplined approach.

The Panel's questions cannot be objectively addressed without a clear understanding of the principles of local public finance. In this report, we articulate those principles, use them to predict the circumstances in which particular funding sources should be used, compare those predictions with real data, and analyse the implications of any gaps.

## Public finance principles

The overall objective of public finance is to raise revenue in the way that maximizes community wellbeing. The principles of public finance fall into two main categories according to whether they are concerned mainly with efficiency or with equity.

Efficiency principles are concerned with behavioural effects, ie with how people will react to different price signals. Two are particularly important. The first is that behaviour is minimally distorted when necessities are taxed most heavily, because people continue to consume necessities. Thus, property rates have good efficiency properties. Secondly, sometimes market prices are "wrong" in the sense that they omit costs that fall on society as a whole. Road congestion is an example, where individuals do not consider the cost they impose on others. Greenhouse gas emissions are another example. In these cases, adding some form of tax, calculated so that it reflects the spill-over cost, can improve efficiency.

There are two important equity principles. One is “horizontal equity” which requires that people in similar situations face similar charges. The other is “intergenerational equity” which is closely related to the popular concept of sustainability. For local public finance it is most relevant to the financing of long-lived infrastructure, where it points towards debt financing so that the capital costs are allocated across all benefiting generations.

### **Development contributions**

Development contributions are being used by many councils as a way of recovering infrastructure costs associated with accommodating growth. In principle, development contributions have a sound rationale based on efficiency and equity criteria. In practice, it has been difficult for councils to formulate and execute development contributions policies that are consistent with those criteria.

The current difficulties are likely to be temporary ones caused by the need for councils to understand and properly accommodate the additional flexibility offered by development contributions. Radical reform does not appear warranted. However councils do need additional support to ensure that their policies best serve the needs of their communities. Industry groups, notably the Society of Local Government Managers (SOLGM) may be best placed to co-ordinate that support.

Development contributions should be used by councils experiencing population growth. However there is a limit on the legitimate contribution each new unit can be levied. In particular, they cannot legally be used to pay for increasing standards of service to existing communities. Additionally, there is a commercial risk that developers will simply avoid areas that have heavy contributions. It is appropriate that development contributions continue to be used as a way of financing the costs local authorities bear as a result of growth. Beyond that, they should not be seen as a large scale source of non-rate funding.

### **Transfers from central government**

There are efficiency-related reasons for the existence of grants from central government, including:

- Tax efficiency: central government has access to sources of revenue that are not available to local governments (eg fuel tax, income tax) and in some cases it may be more efficient to use these than to rely (or rely more heavily) on local sources.
- Policy efficiency: some central government policies impose costly obligations on local governments. When the cost of those obligations are covered by grants, there is greater discipline on policy makers and the obligations are therefore more likely to be efficient. Consequently, there is a strong case for linking the pattern of grants with the pattern of costs imposed through such standards.

Examination of the existing pattern of transfers from central to local government shows that they are targeted at many different areas of activity, but are heavily skewed

towards roads (63%) and transport (21%). Statistical analysis of the pattern of road grants across local authorities suggests that these are also skewed, in favour of lightly-used rural roads. Similar findings emerge when road and transport grants are modelled as an aggregate at the regional council level.

Rural roads do create nation-wide benefits however. Everyone has the option to use them, which is itself a benefit, and many urban-dwellers do use rural roads while on holiday. Additionally, tourism is a major export-earning industry that provides benefits spread through the whole country. These spill-over benefits provide a rationale for central funding of roads, and for some redistribution away from a purely population-based allocation.

The road funding programme operates through a financial assistance rate (FAR) formula, which differentiates between local governments on an ability to pay basis. Areas with high costs and low rate bases get relatively higher FARs. This approach is broadly consistent with efficient cost-recovery principles for an asset that has nation-wide benefits. Our analysis concludes that while there may be value in reviewing the details of the FAR scheme, radical change does not appear warranted.

We have also considered the merit of an expansion in FAR-like schemes into other infrastructure sectors. However there are few such sectors that have the extremes of per-capita costs as roads do when viewed at the local authority level. And those that do, namely electricity and telecommunications, tend not to be paid for by local authorities. A possible exception is broadband, in which some local authorities are investing. However our analysis concludes that if this is viewed as a national issue it is best addressed by modifying the provisions for rural telecommunications services that already exist.

When central government devolves responsibilities and/or imposes new rules on local authorities, costs are generated. In many cases (eg drinking water, aquaculture) these costs are merely advanced up the priority order rather than generated anew. However such actions do over-ride local decision-making. And since they are relatively costless for central government, it is reasonable to expect this approach to be over-used. Linking a compensating financial transfer to all new cost burdens imposed by central government would restore efficiency.

Finally, there is a link between transfers and debt funding. We note that where transfers are used to fund capital works they need not be on a “pay-as-you-go” basis. As discussed further below, it is likely to be efficient for one party (either central or local government) to borrow. To the extent that local authorities are the borrowers, transfers from central government should be designed to cover operating (ie debt servicing) costs.

### **Debt financing**

There are very good reasons for governments (at all levels) to use debt to finance long-lived investments. Doing so advances the date at which service can be enjoyed from the infrastructure, and spreads the capital cost more equitably across the generations that

benefit from that service. Moreover, governments are generally low risk debtors so they enjoy low interest rates in debt markets.

We found that local authorities use very little debt, with debt to asset ratios are that are generally well under 4%. This position seems to reflect what have been widely held views about the merits of “paying ones way”. While the existing LTCCPs do signal significant increases in debt, there appears to be scope for much greater use of debt to finance infrastructure in growing locations.

Councils have enjoyed direct access to debt markets in the recent past, using a jointly owned intermediary to retail their debt. This contracts out the tasks of issuing a prospectus and maintaining a register.<sup>1</sup> However this is no longer an active source of financing. An important reason seems to be that councils simply do not view debt as a long-term financing mechanism. As a result, they prefer the flexible repayment schedules offered by trading banks over the fixed pattern of coupon payments that bondholders must be paid over the whole period to maturity of the bond.

This recent evidence suggests that there is no real barrier to expanded debt financing by local authorities through the issuance of infrastructure bonds. To the extent that local infrastructure is partly funded by central government, it could issue infrastructure bonds to raise capital.

### **Investment in commercial firms**

Local authorities vary widely in their ownership of commercial ventures for investment income. Such assets were the source of 6% of total revenue by local authorities in 2005, but the variation around that figure is very substantial, ranging from effectively zero to 40%. The rates of return being achieved vary widely but appear to be low on average relative to private sector benchmarks.

Those benchmarks are not appropriate however for businesses, such as water services, that are intended to serve ratepayers on a break-even basis. The real issues, therefore, are at a more strategic level concerning the choice of activities in which councils involve themselves, and the use of governance arrangements that retain efficiency incentives.

Council ownership stakes in of port and airport businesses could benefit from re-assessment. While unregulated hubs such as Auckland Airport have performed well financially, many regional airports are making heavy and risky investments in new facilities that they hope will attract new traffic. The sea port sector is in a state of transition driven largely by the economics of international shipping. Rates of return are low and the future outlook is uncertain.

Councils should be able to clearly articulate their reasons for operating businesses, to link those reasons with community wellbeing, and to explain why private enterprise would not deliver the same wellbeing. A disciplined review along these lines should

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<sup>1</sup> In so doing it appears to avoid the need for unanimity within councils over the issuance of debt.

also explore reconfiguration options. For example, land-use management goals, such as waterfront redevelopment around ports, may be best achieved through council ownership of land, but that need not require ownership of a port business.

Where it is not possible to clearly link business ownership to a market failure, councils should investigate the options for selling those assets.

### User charges and fees

On average, local government earned up to 23% of its income from user charges and fees in the 2005 financial year. Again, variation is significant with actual shares ranging from 5% to 63%.

User charges and fees should be used where there is an identifiable cost caused by an individual. They are price signals, so efficiency demands a close link to the cost of provision. User charges could be used more extensively for water services, and for travel demand management. Greater use of water pricing would allow better allocation of a scarce and costly resource. It could shift up to 22% of the total rate bill to user charges (some of which would be connection fees), but the real benefit would be in the conservation of resources. Similarly, there are significant potential benefits available from the use of economic instruments to manage travel demand.

### Conclusion

Our analysis investigated the existing pattern of non-rate funding methods to understand their coherence with the principles of public finance, the potential for expanded use, and any barriers to such expansion. Table 1 summarises our conclusions.

**Table 1** Summary of findings

Source	Growth source?	Comment
Development contributions	Yes, to the extent that related costs grow	New regime needs to settle
Transfers from central government	yes	Review FAR scheme; New transfers to accompany new roles for local government that have national benefits
Debt funding	yes	Significant expansion desirable
Investment income		Review holdings and governance
User charges and fees	yes	Greater use for water and transport

Development contributions policies are in a state of flux and councils need assistance with making these work properly. Properly applied, they have an important role in helping councils accommodate growth. However they are difficult to implement well and highly contentious. Moreover, the Judicial Review process is the only appeal avenue available at present. We recommend that the Local Government Commission publish best practice guidelines and consider a more effective dispute resolution process.

Transfers from central government are currently somewhat ad-hoc. The road funding scheme (FAR) should be reviewed to ensure it aligns properly with the relevant

principles. Similar schemes may be considered for other local infrastructure that has national spill-over benefits but there are no obvious candidates at this point. Finally, there is a good case for linking new roles and responsibilities that central government devolves to local government to have transfers associated with them.

Debt funding is a major potential source of new income that should be used for long-lived infrastructure, irrespective of which level of government is the investor. Our analysis suggests that the main barrier to growth of this source is that councils are simply averse to long term debt.

Rates of return on council investments vary widely but are on average quite low. We believe that the focus for future attention should be on the rationale for involvement, and governance measures to drive efficiency, rather than the rates of return as such.

Finally, there is potential for greater use of economic instruments in the area of water and transport services.

# 1. Introduction

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The activities of local authorities are governed by the Local Government Act 2002, which provides for local authorities to play a broad role in promoting the social, economic, environmental, and cultural well-being of their communities. This legislation also defines the set of financing options available to local authorities. Section 101 (3) provides considerable scope for selecting from these options:

The funding needs of the local authority must be met from those sources that the local authority determines to be appropriate, following consideration of,

- (a) in relation to each activity to be funded,
  - (i) the community outcomes to which the activity primarily contributes; and
  - (ii) the distribution of benefits between the community as a whole, any identifiable part of the community, and individuals; and
  - (iii) the period in or over which those benefits are expected to occur; and
  - (iv) the extent to which the actions or inaction of particular individuals or a group contribute to the need to undertake the activity; and
  - (v) the costs and benefits, including consequences for transparency and accountability, of funding the activity distinctly from other activities; and
  
- (b) the overall impact of any allocation of liability for revenue needs on the current and future social, economic, environmental, and cultural well-being of the community.

When designing their funding (revenue and financing policy) policies, local authorities are therefore obliged to retain a focus on the four well-beings, and to consider the position of particular individuals or groups with respect to:

- The causation of cost, as is clear from s 101(3)(a)(iv); and
- The way benefits from expenditures are distributed (s 101(3)(a)(ii)).

This report is concerned with a subset of funding options, being those that are in current usage, but not classified as rates. The main options are:

- development contributions;
- transfers from central government;
- debt funding;
- user charges and fees;
- income from investments;
- fines;
- grants and donations; and
- asset sales.

Our objective is to consider the effective and efficient use of these funding options by local government, and to identify any barriers to using options in that way. We therefore start by defining what we mean by effective and efficient use of a funding

option. The implications of that analysis for local government is then considered in light of the statutory objectives set out in the Local Government Act 2002.

## 1.1. Principles of Local Public Finance

Public finance is the act of raising funds to support collectively provided goods and services. The need for funding of this type arose in the earliest civilizations, and the study of how best to raise the necessary funds has a similarly long history. Many of the principles of public finance apply equally well to national and local government funding problems. In the context of pure taxation problems, two types of principles have emerged:

- Efficiency principles, which are concerned with behavioural effects. and
- Equity principles, where the fairness of cost burden allocations is of interest.

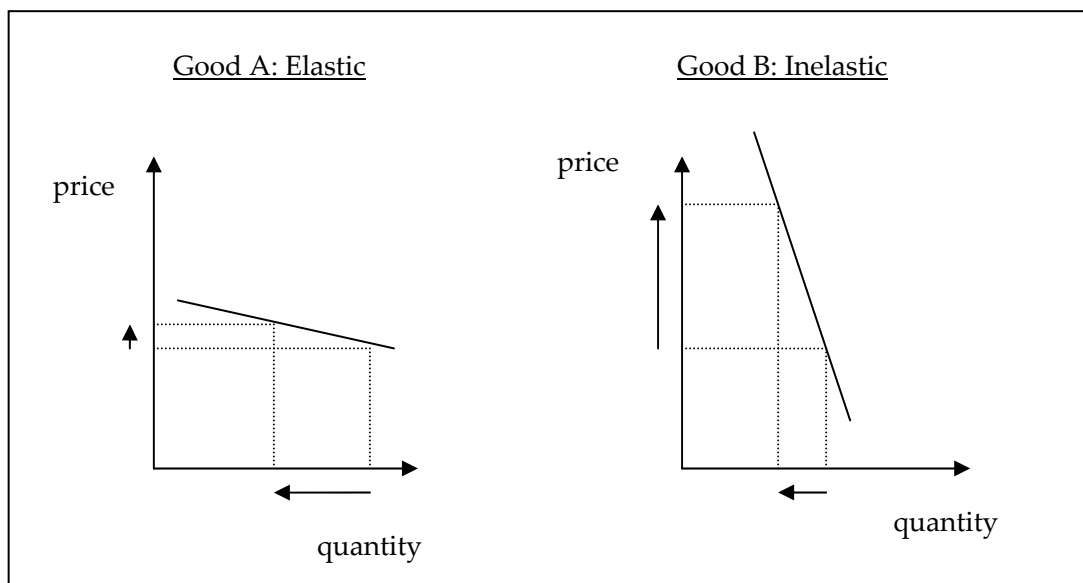
Effectiveness is also important. We view it as a subset of efficiency, because a funding tool that is not effective for any reason (eg if avoidance is easy and widespread) is also an inefficient way of raising revenue.

### 1.1.1. Efficiency principles

The concept of efficiency can perhaps best be understood by imagining a hypothetical tax scheme in which sales are taxed at different rates depending on the goods sold. Let us focus on how to set those individual tax rates, assuming that

- (a) we need to raise a given amount of revenue, and
- (b) we want minimal disruption to the purchasing patterns of end-users.

**Figure 1** Efficiency of Taxation and Price Elasticity



The solution to this problem is a set of tax rates that are inversely proportional to the price elasticities of demand for the products. Goods for which demand is very price sensitive will attract low tax rates, and vice-versa. Figure 1 illustrates this idea for two

different goods, one of which (A) is very price sensitive, whereas the other (B) is not. A very small tax-induced increase in the price of A will lead to a substantial drop in purchases of A. For good B however, a fairly substantial tax would be required to cut demand by any material amount.

The conclusion is that taxes should be levied most heavily on things for which demand is price inelastic. These tend to be necessities rather than luxuries. The efficiency of land taxes and poll taxes derives from this kind of analysis: it is efficient to tax those things because doing so does not alter behaviour very much.

### **1.1.2. When distortion is efficient**

The basic efficiency result outlined above arises directly from the objectives we specified at the outset, and particularly from the use of “non-distortion” as an objective. There are situations in which this (non-distortion) is the complete opposite of our objective. Two categories can be distinguished:

- Pure deterrence; and
- Adjustments to “correct” market prices.

Fines are a good example of a deterrence-related objective. When a council officer issues a parking ticket, the main purpose is to deter behaviour deemed to be undesirable.

Other sources of government funding can be viewed as correcting market prices that are inefficiently low. For example, taxes levied on tobacco and alcohol can be rationalized on the basis of aggregate social harm caused by consumption of those products. In the absence of a tax, retail prices would be lower and consumption would be higher. If that led to higher social costs (eg in the health system) then there is a case for requiring individuals to “see” those additional costs at the time of purchase, an outcome that an excise tax achieves.

User charges (eg for waste collection) are a less extreme example of the same principle. In the absence of a user charge, the cost of council provided services would be spread across all ratepayers. The lack of a price signal would then lead to over-usage. Provided user charges can be levied in a reasonably accurate and low cost manner (an issue discussed in section 1.1.4 below), they are likely to result in more efficient use of Council provided services.

### **1.1.3. Equity principles**

Equity principles are useful guides to local government funding options because they can support an objective analysis in what can otherwise become an unstructured debate about the meaning of fairness. However equity principles are not always free from controversy themselves.

Two principles that have been analysed in the tax policy literature are the “benefit” and “ability-to-pay” principles. The benefit principle, which is based on the view that governments are service providers, calls for alignment between the payments people make and the benefits they receive. This conflicts with the almost universal tendency of

governments to redistribute income via the tax system. By contrast, the ability-to-pay principle supports progressive taxation.

There are two principles that enjoy broad support:

- Horizontal equity, which requires similar payments from people in similar circumstances; and
- Intergenerational equity, which in very general terms is the idea that each generation should “pay its own way”.

The first of these principles is rather weak, in the sense that it does not exclude many funding options. The multidimensional nature of personal circumstances also undermines its applicability to local government funding issues. For example, suppose two households have similar incomes, and live side-by-side in similar dwellings, but differ in their household composition. The horizontal equity principle does not help us determine whether these households can be regarded as similar, nor how to differentiate their treatment if they are not similar.

Vertical equity refers to the idea that different people should be treated differently. While not objectionable as it stands, this principle is similarly unhelpful when it comes to designing funding schemes. It offers no guidance, for example, on whether tax systems should be progressive or regressive, let alone the degree of such tendencies.

Intergenerational equity is a more useful principle for local government funding analysis. It bears a very strong resemblance to the concept of “sustainability” though its implications operate in the reverse direction. Sustainability refers to the idea of leaving future generations no worse-off than current generations, eg as a result of irreversible degradation of the environment. This constrains the utility of current generations. By contrast, an important implication of intergenerational equity is that the cost of a long-lived asset should not be solely borne by the current generation of ratepayers, because it will also benefit future generations. This has financing implications which are discussed further in section 2.3.

#### **1.1.4. Progressive taxation and democracy**

Democratic governments do tend to redistribute income using fiscal policies that include progressive taxation. As discussed, this is consistent with the ability to pay principle. There is also a theoretical explanation for progressive taxation that arises from the electoral process.

Assume that people generally vote for policies that give them the most disposable (ie after tax) income. Assume also that (pre-tax) income distributions are skewed, so that most people have incomes below the mean. In that case, democracies will have a strong tendency towards redistributive fiscal policy. The reason is that a coalition of the poor can out-vote a coalition of the rich. If the income distribution is skewed, the median voter has a pre-tax income below the mean. The vote of this person, combined with the votes of all who earn less, will be sufficient to elect the party promising the greatest income redistribution.

As with all purely theoretical results, there are objections that could be raised to this argument. For example, one might imagine that the median voter would be susceptible to bribery from someone at the rich end of the income distribution. Notwithstanding such objections, the theory does offer a strong intuition for the observed fact of redistribution.

## 1.2. Implications for Local Government

According to the Local Government Act 2002 (s(10)), the purpose of local government is to enable democratic local decision-making and action by, and on behalf of, communities and to promote the social, economic, environmental, and cultural well-being of communities, in the present and for the future. These well-beings are advanced by local governments through the provision of local public goods such as roads, libraries and building inspection services.<sup>2</sup>

There are many ways local governments can raise revenue to cover the cost of such services. Rates are effectively land taxes. They are a particularly efficient way to raise revenue because the supply of land is completely inelastic. However rates are not sufficient by themselves, even if one was only concerned with efficiency. This is because people are free to move between jurisdictions, and those movements have external effects on other members of the community.

If all of the costs of a local government came from rates, land owners would pay for all local public goods enjoyed by residents. Since these groups (residents and land-owners) are not the same, residents would therefore have an incentive to vote for greater expenditures. That would lead to an excessive level of activity by local governments, at least in the short run. However one might also expect that such an outcome would lead to an influx of residents attracted by the unusually generous provision of local services. Rents would increase as a result, and the higher rents would be capitalised into land prices. That would restore efficiency over the longer run: residents will moderate their demand for spending because it will eventually show up in their rent bill.<sup>3</sup>

So free movement of people between jurisdictions can substantially mitigate the risk that a rates-only revenue policy will allow residents to “feed off” landowners. At the same time, however, free movement creates another form of inefficiency when the cost of providing local services depends on the number or the characteristics of residents. In that case, residents impose externalities on one another. That is, individual decisions to relocate from one jurisdiction to another affect the well-being of other residents in both jurisdictions.

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<sup>2</sup> Public goods are ones that can be jointly supplied to many people at once and for which direct charges for use are either not feasible or inefficient.

<sup>3</sup> Starrett, D.A. (1980), “On the method of taxation and the provision of local public goods,” *American Economic Review* 70:380–392.

Many local services satisfy these conditions. For example, the cost of infrastructure services (eg water supply) tends to be lumpy with declining unit costs between the “lumps”. So additional residents may require the addition of another lump of capacity, in which case their marginal cost on the community is high, or reduce service costs for existing residents by helping to use existing capacity. In other cases, the specific preferences of new residents affects the wellbeing of the existing community: vandals inflict property damage; cats reduce the wellbeing of birdwatchers; public spirited volunteers help to keep parks and beaches clean. Councils can (at least to some extent) use non-rate funding tools to affect participation in such activities, and thereby advance overall wellbeing.<sup>4</sup>

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<sup>4</sup> Scotchmer, S. (2002), “Local public goods and clubs,” chapter 29 in A.J. Auerbach and M. Feldstein (eds) Handbook of Public Economics Vol 4, Elsevier Science.

## 2. Non-Rate Funding Options

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Local authorities derive revenue from many sources other than rates. In this section, we analyse the following non-rate funding sources:

- development contributions;
- transfers from central government;
- debt funding;
- user charges and fees;
- income from investments;
- fines;
- grants and donations; and
- asset sales

Our objectives are to understand the current situation, to consider it in relation to the principles outlined in section 1, and to assess what improvements (if any) are potentially available. We are particularly interested in understanding the efficiency properties of these funding sources, and the extent to which each has potential for greater use.

### 2.1. Development Contributions

Under the Local Government Act 2002, councils are able to levy property developers to help cover the cost of providing additional services to the new populations that will be accommodated. At a high level (ie abstracting from the details of particular policies), development contributions are consistent with both the efficiency and equity principles outlined above.

Efficiency is promoted by forcing developers to internalise the cost of additional infrastructure that is caused by the development. If this was not done, excessive levels of development would be expected. A corollary is that if development contribution charges exceed the cost imposed on existing communities by new developments, there will not be enough development. So satisfying the efficiency principle requires that councils set contributions at approximately the correct level.

Development contributions are also equitable, because they prevent some sections of the community (those already living in a location) from subsidising others (new residents). Council services are generally provided on a break-even basis. In this case, a subsidy exists if one group pays less than its “incremental cost” (which is the addition to total cost caused by having that group present) or more than its “stand alone cost” (which is the cost of serving that group alone). Thus, if there is a subsidy, one group would actually be better off without the other’s presence. By avoiding such subsidies, development contributions (properly applied) can enhance overall wellbeing.

#### 2.1.1. Impact on housing markets

Development contributions increase the cost of additions to the housing stock. This pushes up the price of new housing, and demand for the main substitute: existing

housing located nearby. The price of both housing options (new and existing) will therefore increase in locations that levy development contributions.

Those locations are all experiencing population growth however, which increases demand for housing, putting upward pressure on prices. Since population growth is also the motivator for levying development contributions, care is needed to avoid blaming development contributions for price increases that would happen in any event.

If development contributions are assessed correctly, their sole effect will be to redistribute costs in socially efficient ways. They are not additions to the total cost pool. Costs do increase, but only because people want new dwellings, not because local governments charge those people for the costs they impose on the existing community.

### **2.1.2. Current situation**

Many councils have adopted policies for the purpose of levying development contributions. The design and implementation of these policies is fraught with difficulties, at the conceptual level and in their detail. Notwithstanding the existence of policies therefore, local government as a whole is struggling to develop credible methods for assessing development contributions.

A recent Judicial Review of development contributions at North Shore City illustrates some of the difficulties. While the written policy was not over-turned, the court did find in favour of the plaintiffs in respect of the Northern Busway - over 90% of the cost of which was allocated to development. The key implication of this finding is that councils must seriously consider the benefits all residents receive from infrastructure projects.

Of potentially wider concern was the court's ruling that no more than two developments at a time can be accommodated within a single application of the development contribution policy. This finding means that councils cannot assess a development contribution for an area of land unless that land will be developed in at most two distinct projects. This finding, which derives from a strict interpretation of words in the Act, is likely to add substantially to the analytical burden on councils.

Notwithstanding the difficulties currently being experienced, the overall merits of development contributions suggest that councils should persist with their efforts to formulate and implement such policies. Further support is clearly required however, and should ideally have been provided centrally. Significant effort is required to get on top of these issues, and it would be efficient to share this cost between councils rather than have each one incur its own costs. Possible co-ordinating bodies include the Department of Internal Affairs, or the Society of Local Government Managers (SOLGM).

### **2.1.3. Conclusions on development contributions**

Development contributions are being used by many councils as a way of recovering infrastructure costs associated with accommodating growth. In principle, development contributions have a sound rationale based on efficiency and equity criteria. In practice,

it has been difficult for councils to formulate and execute development contributions policies that are consistent with those criteria.

The current difficulties are likely to be temporary ones caused by the need for councils to understand and properly accommodate the additional flexibility offered by development contributions. Radical reform does not appear warranted. However councils do need additional support to ensure that their policies best serve the needs of their communities. It would be cost effective to provide such support centrally, through the Department of Internal Affairs, or possibly the Society of Local Government Managers (SOLGM).

Development contributions do not contribute significantly to house price inflation. House prices rise for a range of reasons that affect demand (eg tax incentives) and supply (eg zoning constraints). Development contributions, if calculated correctly, are primarily an allocation device, which ensures that the cost of new housing units includes the cost of council-supplied infrastructure to those units. They do not add to the total pool of social costs.

There are clear limits on the extent to which councils can and should use development contributions to raise revenue. Councils should ensure that they reach those limits, because doing so is efficient and equitable. But there is no economic rationale for exceeding them.

## **2.2. Transfers from Central Government**

Local Authorities receive targeted grants for a range of functions. Virtually all grants are made by agencies of central government. In the year to June 2005, a total of \$661m was granted to local authorities. These funds were spread over eleven functional areas, in the proportions shown in Figure 2. Grant money is dominated by roading funds (63%) and transport contributions (21%). Regional councils do not receive road funding, but grants are made to this tier for transport projects.

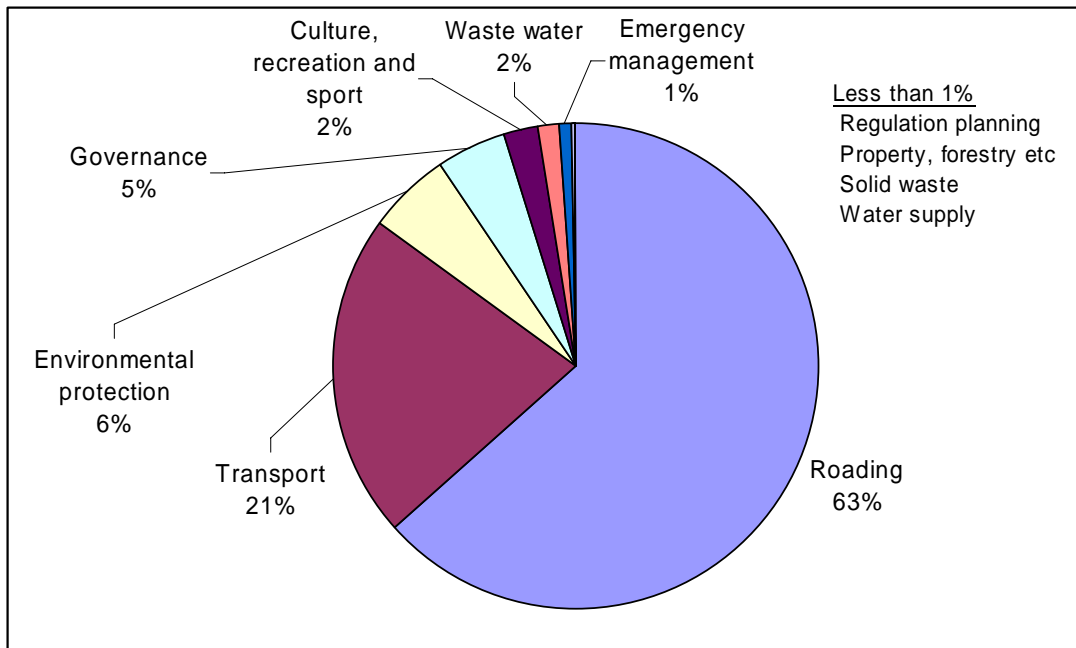


Figure 2 Grants received, all local authorities, 2005 (Source: Statistics NZ)

There are efficiency-related reasons for the existence of grants from central government, including:

- Tax efficiency: central government has access to sources of revenue that are not available to local governments (eg fuel tax, income tax) and in some cases it may be more efficient to use these than to rely (or rely more heavily) on local sources.
- Policy efficiency: some central government policies impose costly obligations on local governments. When the cost of those obligations are covered by grants, there is greater discipline on policy makers and the obligations are therefore more likely to be efficient. Consequently, there is a strong case for linking the pattern of grants with the pattern of costs imposed through such standards.

Equity is also a possible motivation for government grants. We have noted above that democratic governments do generally redistribute income, typically from the rich to the poor. At the risk of over-simplifying the matter, this occurs on both the income and expenditure sides of the government's accounts: rich people tend to pay higher taxes; and poor people tend to benefit more from government spending. Thus, it is possible that grants made by central government to local government could reflect explicit redistribution goals.

Alternatively, and perhaps more plausibly, the pattern of central government grants may be motivated by a desire to shift funds between activities rather than individuals as such. As discussed below (section 2.2.2), rooding grants appear to involve a redistribution of tax revenue from urban to rural areas. Rather than putting funds directly into the pockets of rural-dwellers, this reduces the cost of an important activity: transport. Such a policy could reflect a view that rural roads provide a benefit to urban residents, either in the form of an "option to use" or as an input to nationally important industries such as agriculture and tourism.

The underlying point however is that there should be a reasonably consistent logic that explains the pattern of grants. As far as we have been able to discern however, no single explanation exists of the existing pattern, or even of what is intended to be achieved. As a result, the grant process operates through a range of different agencies, each of which pursues its own objectives largely in isolation from the others. The annual budget round within central government does provide some potential for making trade-offs at the margin. The lack of a firm conceptual basis for making grants nevertheless suggests that the effectiveness of grants could be improved.

### 2.2.1. When grants should be used

Drawing on the material in section 1.1, it is possible to identify the circumstances in which government grants to local government would be economically desirable. Three cases seem especially relevant.

**Spillover benefits.** When locally built or maintained facilities have benefits to New Zealanders as a whole, there is a good case for funding them from national rather than local taxation bases. As discussed above, roads deliver benefits well beyond their local communities, partly because New Zealanders travel around, but also because they facilitate economic activity that has widely dispersed benefits.

Similar arguments apply to environmental protection however. This is valued by New Zealanders (the option to visit nice places) and is also an input into the tourism industry which has dispersed benefits.

**Cost efficiency.** Some public goods exhibit economies of scale such that it is cheaper to provide them nationally than regionally. Emergency management services such as Civil Defence are an example. All localities are exposed to the risk of weather-related emergencies, but pooling that risk across local authorities can reduce total costs.

**Cost causation.** If legislation or other actions of central government causes or contributes to costs in local communities, grants may be an effective and efficient funding mechanism. This is discussed further below in section 2.2.5.

A similar argument applies when the costs are not caused deliberately. The existing problem with leaky buildings is a good example. This appears to be a systemic failure in which central government is at least partly culpable.

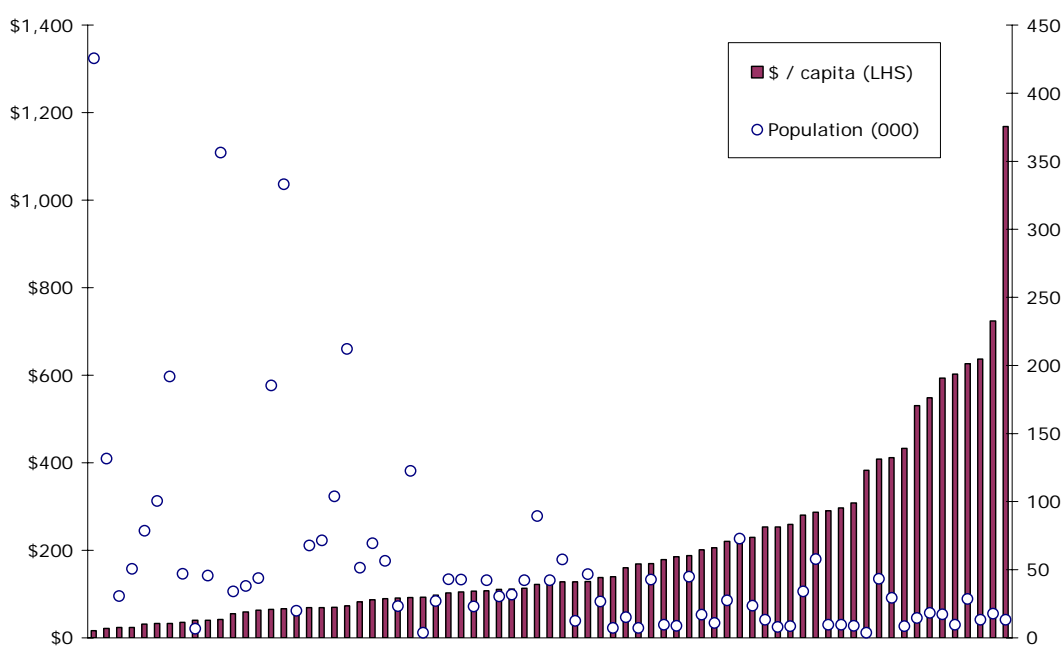
### 2.2.2. Road and transport grants

Central government allocates money from the National Land Transport Fund to regional councils and local authorities. This is achieved through a financial assistance rate (FAR), which is defined as the central government share of costs for approved activities. The FAR varies across local governments in proportion to the ratio of approved roading costs to the total value of rateable land. Areas with high costs and low rate bases receive a higher FAR.

Given the financial importance of road and transport grants from central government, we analysed the distribution of these funds across local authorities. The base data were roading and transport grants for the 2005 financial year sourced from Statistics NZ.<sup>5</sup> These were compared with other features of local authorities thought to be relevant to road costs, such as:

- The length, type, and seal status of roads (excluding state highways) within a local authority area (sourced from LTNZ);
- Vehicle kilometres travelled within the area per annum (LTNZ);
- Vehicles per day using local roads (LTNZ);
- Populations (Statistics NZ);
- Incomes (Statistics NZ); and
- Local authority expenditure on roads (Statistics NZ).

Analysis showed that road grants are only weakly correlated with population. Figure 3 plots road grants per capita against population by local authority area. It shows that localities with high populations tend to get low grants on a per capita basis, and vice versa. Road grants per capita ranged from \$17 (Auckland City Council) to \$1167 (Rangitikei District Council). Across the country, the average roading grant in 2005 was \$105 per person.<sup>6</sup>

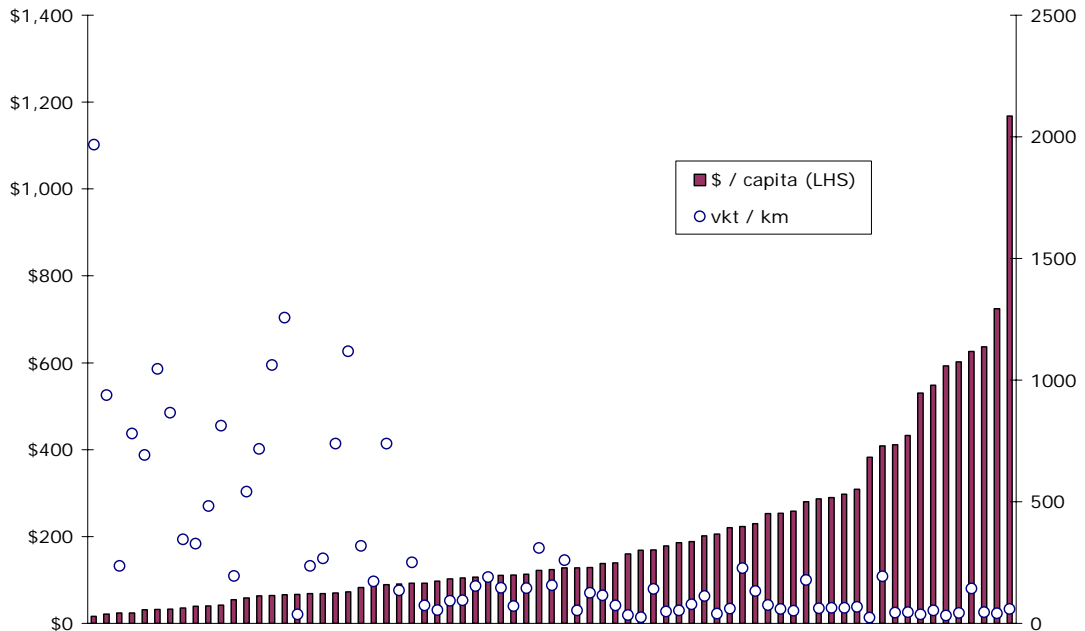


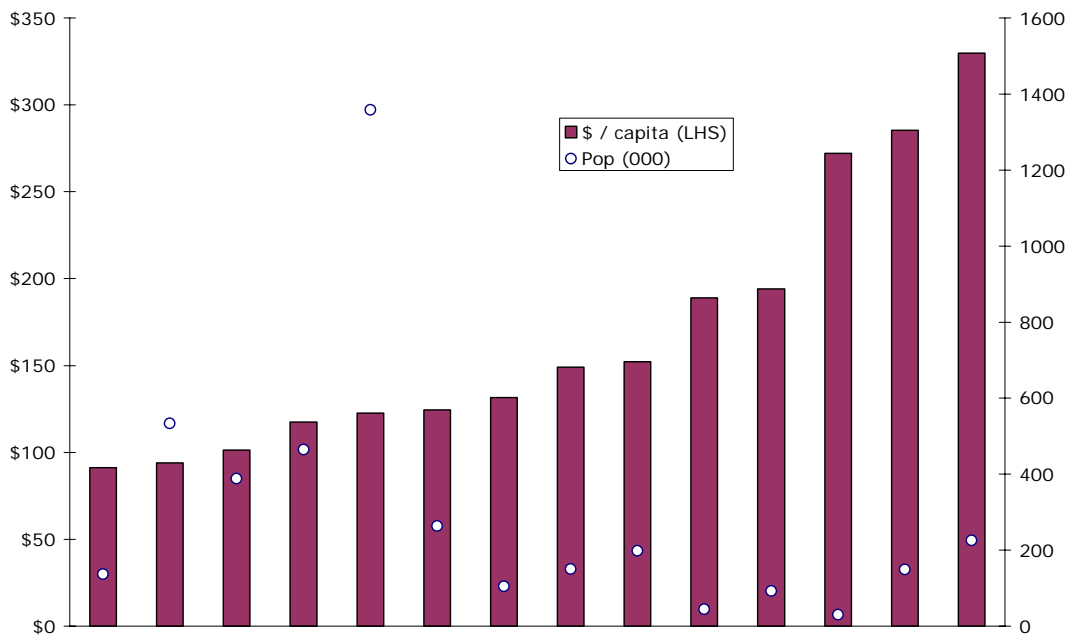
**Figure 3** Road grants per capita and population (local authorities)

<sup>5</sup> The data were aggregated into major categories, so it was not possible to delve below the level of “roading” or “transport”.

<sup>6</sup> Extreme weather events can have a big impact on data in a single year. These data are likely to include expenditure required to recover from the February 2004 floods in the Manawatu, Wanganui, and Taranaki areas.

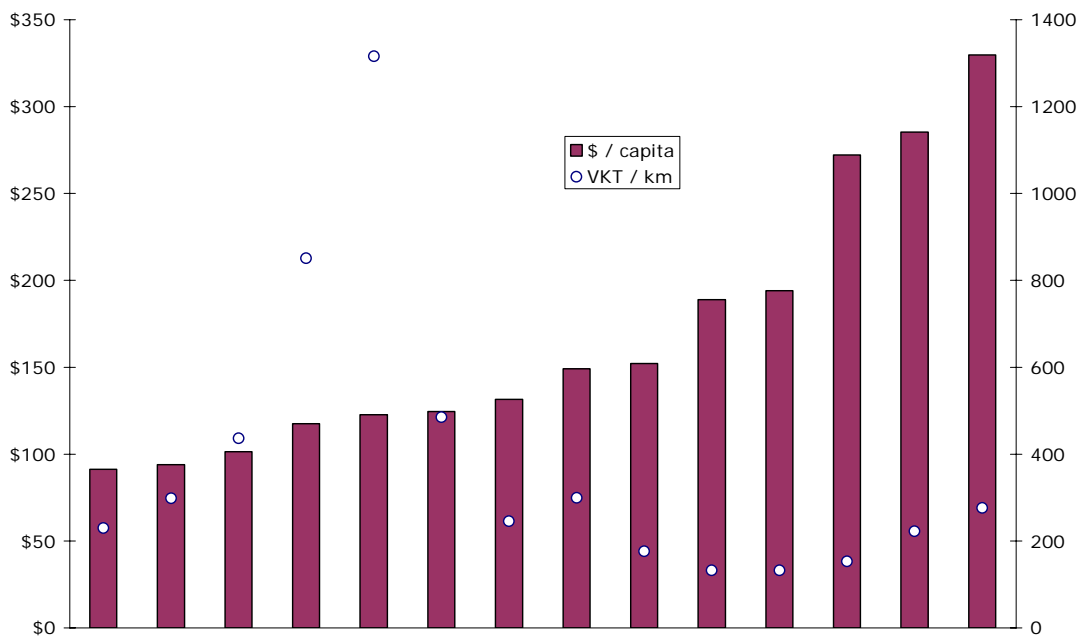
A similar pattern emerges when road grants per capita are compared with congestion. The congestion measure used in Figure 4 is vehicle kilometres travelled (VKT) per km of road network.





**Figure 5** Total (road + transport) grants per capita and population (regions)

In 2005, the total (road + transport) grants averaged \$139 per capita across the country. The range was from \$91 (Marlborough) to \$330 (Manawatu/Wanganui). Figure 5 plots total grants per capita against population, while Figure 6 shows its relationship with congestion. These figures show that the basic lack of correlation observed with road grants and usage indicators at the local authority level is still present when transport grants are included.



**Figure 6** Total (road + transport) grants per capita and congestion (regions)

The variation in grants observed above is to some extent understandable if one views the allocation process as a multidimensional problem, ie one that should consider several aspects of need at the local authority level. It may, for example, be that certain local roads have national importance for some reason (eg heavy tourism demand, servicing of economically important locations). Regression analysis was therefore used to study the interaction between drivers of road costs and attempt to explain a greater proportion of the observed pattern of road grants.

At the local authority level, we experimented with the specification of the regression model. A “general-to-specific” methodology was used, which involved starting with all possible explanatory variables and sequentially deleting those that were statistically insignificant. Our preferred model is shown in Table 2. It explained 60% of the variation in road grants.

**Table 2** Regression explaining road grants (2005)

Variable Name	Estimated Coefficient	P Value
Expenditure on roads	0.385	0
Urban road length	-13.203	0.035
Rural road length	1.399	0.038
Vehicle kilometres travelled	-0.021	0
Population	0.155	0
Population / total road length	-17.149	0.077
Constant	892.44	0.365

Each estimated coefficient can be interpreted as the marginal impact of the associated variable, holding other effects constant. So, all other things being equal, grants are:

- Lower for urban than rural roads;
- Lower in locations with more traffic (vehicle kilometres travelled); and
- Lower in densely populated areas (population/total road length).

This analysis suggests that road grants are currently skewed towards relatively unpopulated areas. It may be that we have neglected to consider some important aspect that would mitigate this conclusion, but it does at least raise questions about the way funds are allocated.

A similar analysis was used to analyse total grants (road + transport) at the regional level. The two models presented in Table 3 resulted from this process.

**Table 3** Regression models explaining total grants (road + transport)

Variable Name	Estimated Coefficient	P Value
Model 1 ( $R^2 = 96.9\%$ )		
Population	0.079	0.000
Rural Road Length	0.810	0.000
Constant	-7371	0.079
Model 2 ( $R^2 = 97.5\%$ )		
Population	0.134	0.000
Rural/Total road length	7052	0.000
Congestion (VKT/km)	-49830	0.013
Constant	-15819	0.012

These show that total grants are positively correlated with population and with the length of the rural road network. Total road length and urban road length were not statistically significant in these models. Model 2 suggests that grants tend to be lower where congestion is more severe.

### **2.2.3. Rationale for differential road grants**

Assuming these findings are robust, it is natural to wonder whether the tendencies identified are desirable ones. It is not difficult to identify reasons for changing the pattern of grants. One is related to the wellbeing of communities: in other situations (health, education) spending tends to follow populations. Another concerns economic growth: if grants are concentrated away from locations with substantial employment, productivity could be reduced.

However rural roads do create benefits nationally. Everyone has the option to use them, which is itself a benefit, and many urban-dwellers do use rural roads while on holiday. Additionally, tourism is a major export-earning industry that provides benefits spread through the whole country. These spill-over benefits provide a rationale for central funding of roads, and for some redistribution away from a purely population-based allocation.

The existing FAR scheme differentiates between local governments on an ability to pay basis. Areas with high costs and low rate bases get relatively higher FARs. This approach is broadly consistent with efficient cost-recovery principles for an asset that has nation-wide benefits. There may be value in reviewing the details of the FAR scheme,<sup>8</sup> but radical change does not appear warranted.

### **2.2.4. Other funding options for transport**

Transport is an essential service in a modern economy. It is therefore essential that it be funded and priced in an efficient manner. The existing arrangements have not arisen from a complete analysis of the relative costs and benefits of different transport options, and as a result they have some obvious weaknesses. For example, we rely heavily on fuel taxes for funding, though infrastructure demands are increasing and vehicles are becoming more fuel efficient. Competitive neutrality for freight services across trucking, rail and coastal shipping is important but absent. Similar issues exist in respect of personal transport in urban areas.

Additionally, one reasonably could argue that it is (or would be) efficient to essential transport services as a source of revenue (via taxes and/or user charges) to support other social services for which it is more difficult to raise revenue. Such issues are beyond the scope of this work, though they are clearly important.

To the extent that local authorities require additional funding is required for roads, there would seem to be two options: to adjust the formulae in the FAR scheme, or to

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<sup>8</sup> For example, the existing degree of differentiation is quite limited, ranging from 43% to 66%.

increase the size of the overall pool. In our view, however, both of these options should be used. This is because demand growth, which is the presumptive cause of the need for increased funding, is not constant across the country. Merely increasing the pool, would allocate it in similar proportions, which would tend to over-fund some areas and under-fund others.

### 2.2.5. Obligations imposed by central government

It is the prerogative of central government to impose obligations on certain sections of the community from time-to-time. Sometimes, these impose costs on private individuals (eg taxes) or firms (eg environmental regulation). Governments are accountable to the community through the electoral process for the burdens they impose upon us.

Central government also imposes obligations on local government however, such as the recently promulgated drinking water standards that are currently at select committee stage. Whatever their merits, such obligations over-ride local decision making about the priorities for expenditure, obliging local government to respect timing schedules laid down by central government. This imposes direct costs, in the form of foregone opportunities to pursue local priorities.

To the extent that the cost of meeting such obligations is not borne by central government, there is a risk that this category of local government costs is (or will become) socially excessive. Confronting agents (including governments) with the true economic cost of their decisions is essential if those decisions are to be socially efficient (see section 1.1.2). This general principle supports two more specific ones.

- First, costly obligations should only be imposed where they correct a market failure<sup>9</sup> and deliver social benefits that exceed social costs. These are the only obligations that are socially efficient.
- Second, within the set of obligations that are socially efficient, some are of greater net benefit than others. So if there is limited capacity to bear obligations, only the most valuable should be imposed.

The first of these principles is widely understood. It reflects a presumption in favour of market provision, but admits the desirability of intervention in specific circumstances. It imposes a two-tier test for intervention: first identify a market failure; then seriously consider whether government intervention will actually improve matters, taking into account all of the costs and benefits of that intervention.

The second principle can be illustrated with the drinking water standard issue. In the absence of a mandated standard, Councils will trade-off investments in water quality against other expenditure that advances community well-being. Things that might be

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<sup>9</sup> If the relevant markets are working properly, they will allocate resources to their highest value uses. There are well understood circumstances in which this mechanism does not work (eg: where there are significant spill-over effects, where one side of the market has superior information, or where public goods are involved). These are market failures.

ranked as higher priorities include safety-related road investments and waste-water processing facilities. The standard over-rides such local priorities, and will tend to push some expenditure items out of the budget altogether.

It should also be noted that Councils often make costly impositions on members of their own constituency. Exactly the same implications follow, except that in this case it is Councils that are obliged to consider the merits of their initiatives, the capacity of their constituents to comply, and the opportunity cost imposed on those constituents (ie the things they need to forego in order to comply).

#### **2.2.6. Conclusions on transfers**

Where locally provided services have spill-over benefits for the country as a whole, central government should contribute to their costs. Greater adherence to this principle would help local government and New Zealanders as a group. There is scope for some expansion in the range of transfers currently made.

Existing transfers from central to local government are targeted at many different areas of activity, but are heavily skewed heavily towards roads (63%) and transport (21%). Analysis of the pattern of road grants<sup>10</sup> across local authorities suggests that these are also skewed, in favour of lightly-used rural roads. Holding other factors constant, road grants are:

- Lower for urban than rural roads;
- Lower in locations with more traffic (vehicle kilometres travelled); and
- Lower in densely populated areas (population/total road length).

Road grants from central government are allocated using a financial assistance rate (FAR). The FAR is increasing in the level of approved road costs and decreasing in the value of the local rating base. This arrangement is broadly consistent with the principles of efficient cost recovery given the national benefits of the road network. There may be scope for improving the extent to which FARs reflect those national benefits, but radical change is not required.

There is some evidence that obligations imposed by central government create a financial burden for local governments, as do the devolution of responsibilities for new central government initiatives. Unless all or most of the benefits of these measures are captured by local communities alone, central funding is warranted.

#### **2.2.7. An Infrastructure Fund?**

The above analysis has concluded that the FAR scheme has a sound economic basis. It is therefore natural to consider whether similar schemes should be used as a means of providing central government support for other types of infrastructure. There are three distinguishing features that make the FAR scheme suitable for road funding, one related to costs and the other to benefits. They are:

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<sup>10</sup> A similar picture emerges when transport grants are included and the analysis is done at a regional council level.

- All New Zealanders benefit from the existence of a national road network;
- At a TLA level, there are big differences in per-capita road costs; and
- TLAs pay for roads.

Are there other types of infrastructure that have similar features? The cost side characteristics of roads are similar pattern to those of other networks that serve all, or almost all, of the population. Electricity and telecommunications networks are the main examples. For each of these cases, the per capita cost of service increases as one moves outwards from densely populated urban areas.

Other infrastructure that would have similar costs, notably water supply and wastewater and sewerage networks, tends not to be provided in rural areas. At the level of individual townships, there is of course be some variation in cost per person served, but this is minor relative to that for roads. The need for a national fund to smooth out local per-capita costs is therefore a good deal less for water networks than for road networks.

In general, electricity and telecommunications network service costs are paid directly by end-users, so the third feature above that makes the FAR scheme desirable for roads is absent from these industries. Nevertheless, there are some clear similarities between the FAR scheme and recent central government moves to sponsor the provision of broadband into rural areas. Project Probe was run by central government agencies between 2002 and 2005, and was instrumental in ensuring that all 891 schools in New Zealand now have broadband access.<sup>11</sup>

Further extension of broadband and other communications services into rural communities appears to be the only area in which an infrastructure fund similar to the FAR scheme could be rationalised. In addition to the cost-side similarities, there are likely to be some widely dispersed benefits in having such services available nationwide. They include network externalities (ie the benefit urban-dwellers receive from being able to contact and be contacted by rural-dwellers), and possibly also some (less measurable) increase in overall rates of economic growth arising from ICT-related innovation. Pointing in the same direction is the fact that several local authorities are actively working on plans to procure enhanced broadband penetration for their communities.

The most attractive alternative to a FAR-type scheme for broadband and communications services is to revise the structure of the existing mechanism for funding high cost telecommunications. The existing scheme is contained in the Telecommunications Act 2001 and known as the Telecommunications Service Obligation (or TSO). It works through a levy on service providers set equal to the net cost of serving commercially non-viable customers with basic telephony. The service specification could be expanded to include broadband, and responsibility for the enlarged Obligation could then be let by competitive tender.

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<sup>11</sup> <http://www.e.govt.nz/resources/research/case-studies/project-probe/chapter1.html>

On balance, our view is that the latter approach (adjusting the existing scheme) is preferable for several reasons. Provision of the services at issue is highly specialised and can be achieved using several different technologies. There are several potential providers, and competition is likely to be important in order to secure good outcomes. There are also deep overlaps with existing services that are already regulated at a national level.

We conclude that the specific features that make the FAR scheme suitable for road funding do not exist in other infrastructure sectors.

### **2.3. Debt Funding**

Householders and businesses use debt to spread the cost of major assets over time, so that outgoings are more closely aligned with revenue flows. Relative to the alternative of paying cash in advance, this approach accelerates the date at which the assets are acquired and start to deliver a flow of value.

Exactly the same benefits arise when governments use debt to fund major assets. In addition, there is an equity benefit because today's population is not paying the full cost of assets that will also serve tomorrow's population. The only way to achieve this intergenerational equity is by spreading the capital cost over time, ie by using debt.

#### **2.3.1. Is debt financing more costly?**

It is sometimes argued that debt funding increases total costs because interest charges are incurred. This argument ignores the concept of opportunity cost. Suppose one has \$100 and wants to acquire an asset of the same value. The options are to buy the asset with cash, or deposit the cash in an interest-bearing account, and borrow \$100 to buy the asset. A stream of interest payments is foregone if the asset is bought with one's own cash. That stream is still available if debt is used to finance the purchase of the asset. So total costs are only higher under debt financing if the interest rate paid exceeds the interest rate received, after the tax implications are considered.<sup>12</sup>

Under the Income Tax Act 2004, most local authority income is exempt from tax, including income "derived from sinking funds relating to the debt of a local authority".<sup>13</sup> Tax effects can therefore be ignored, so the cost implications of debt financing depend only on the difference (spread) between borrowing and lending rates for councils. When councils loan out funds, the rate depends on the risk profile of the borrower. Councils are treated the same way as any other investor in these markets. Conversely, councils are low risk borrowers and should therefore be able to secure debt financing at quite low interest rates. Using government stock as a proxy for the price of

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<sup>12</sup> If interest payments can be deducted from taxable income, the effect of tax is to narrow the effective (ie after tax) gap between borrowing and lending interest rates.

<sup>13</sup> Section CW32 of the Income Tax Act 2004 exempts all local authority income except that received as a trustee, a council-controlled organisation, a port operator, or a port or energy company that would be a council-controlled organisation if section 6(4) of the Local Government Act 2002 did not exist.

council debt, the current cost is around 6.2% per annum, whereas retail deposit rates at banks are around 7.2%.<sup>14</sup> If those are the relevant comparators, debt financing is less costly for councils than paying cash.<sup>15</sup>

A similar conclusion is reached if councils prefer to return funds to rate-payers (through rates that decrease or increase by less than they would have) rather than investing cash in interest-bearing deposits. Then, ratepayers could choose to invest in bank deposits at 7.2% or to consume if they would need a higher rate to elicit saving. Thus, the implied rate of return on spare cash (ie cash not required for investment as a result of the use of debt financing) is *at least* equal to the after tax return on a 7.2% deposit.

An exact cost comparison between funding methods will therefore depend on specific features that affect the opportunity cost of funds in each case. These factors include:

- the deposit rate Council would actually receive if it invested cash;
- the preferences of rate-payers between saving and consumption; and
- the average effective tax rate of rate-payers.

However it is clear from the above analysis that the total cost of an investment project need not increase as a result of debt financing.

### 2.3.2. Does the cash position of councils matter?

Suppose a council has sufficient cash available to buy a long-term investment outright. In this case, debt financing does not advance the time at which the resulting value begins to flow. However debt financing still creates a benefit in the form of intergenerational equity.

### 2.3.3. Debt loadings of councils

To investigate the debt position of councils, we need a scale factor that controls for the overall size of a council's business. The value of fixed assets seems a reasonable measure, since these constitute a tangible form of security against which debt could be raised.<sup>16</sup>

Figure 1 shows the ratio of debt to fixed assets for all local authorities in 2005 and the size of the associated asset base. The five authorities with the largest asset bases have debt to asset ratios that are well under 4%. Only one authority has a debt loading in excess of 10%. The clear conclusion is that local authorities generally have very low levels of debt.

In view of the benefits debt financing brings (advancing investment timing without a commensurate cost increase, spreading capital costs more evenly across beneficiaries), it

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<sup>14</sup> <http://www.rbnz.govt.nz/statistics/exandint/b2/>

<sup>15</sup> Note, however, that for securities of any given risk profile, deposit rates are lower than loan rates. Thus, the reason councils can borrow at lower rates than they will receive is that their debt carries less risk than the asset in which they would invest.

<sup>16</sup> There are some restrictions on the use of council assets as security however (see section 2.5.1).

is surprising that debt levels are so low. One would have thought that areas that have experienced significant population increases would have been investing in infrastructure, and financing that investment with debt. The availability of debt is investigated in section 2.3.4 to gain a better understanding of this issue.

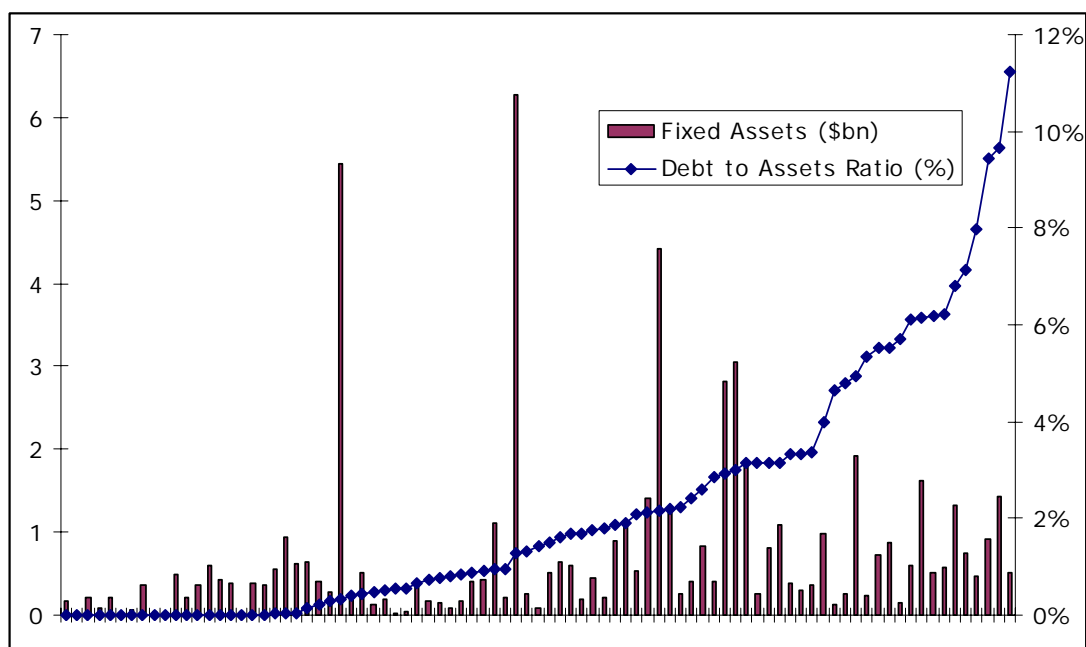


Figure 7 Long Term Debt and Fixed Assets: All Councils, 2005 (Source: Statistics NZ)

Balance sheet ratios are only one aspect of debt positions: interest servicing ability is also important. As debt levels increase, so do interest servicing costs. Local governments need to analyse the prudence of taking on more debt, as all borrowers should. However this analysis does suggest that there is scope for greater use of debt financing.

#### 2.3.4. Availability of debt

Local authorities have two main sources of debt financing. They can issue bonds, and they can borrow from trading banks and other intermediaries. In practice only a few of the larger authorities issue their own bonds.

This is partly a result of a 1998 amendment to the Securities Act (1978), under which local authorities are no longer exempt from obligations on bond issuers, including the publication of a prospectus and register maintenance. This amendment made the issuing of bonds more costly for local authorities.

Although bank lending was very common, local authorities felt that this source of debt was over-priced. As a result, Civic Assurance, a risk management firm owned by 76 of the local authorities, set up a finance company to repackage debt for retail markets. This allowed a single prospectus to be used for bonds that were ultimately backed by many local authorities. While initially successful (taking in over \$100m at rates only slightly

above those for government bonds), this channel has now fallen into disuse. We understand<sup>17</sup> that this is a result of two factors:

- Sharper pricing by banks; and
- Demand from councils for more flexible terms.

The pricing behaviour from banks appears to be a reaction to the direct marketing of bonds to the public by Civic Assurance's finance company. Provided this company stands ready to issue another prospectus, we would expect ongoing pressure on bank pricing.

Flexible term requirements by councils include the desire to repay loans (or parts of loans) as financial circumstances allow. This is in contrast to merely paying the coupon until maturity, which is the standard procedure for a bond. We believe there are three grounds for concern over this preference. One is that it indicates that councils view debt as a relatively short-run financing channel rather than a useful way of spreading capital costs over time. Secondly, interest rates will generally be higher on flexible term debt. Finally, there may well be social benefits from borrowing locally, such as allowing local retirees to invest directly in their own communities.

#### **2.3.5. Infrastructure Bonds**

An infrastructure bond is simply a debt instrument issued for the purpose of financing infrastructure. As discussed above, it is already feasible for local governments to issue such bonds, but demand is currently not strong.

Nevertheless, it is worth considering whether central government could or should assist with raising revenue through infrastructure bonds. It will be useful to divide this subject between local infrastructure that does and does not have nation-wide benefits.

As discussed in the context of roads (section 2.2.3), central government can have an important funding role when local assets have national spill-overs, particularly when the local community has a limited ability to pay. In such cases, central government could and should use debt financing, for the same reasons that apply to local government. Infrastructure bonds are good form of such debt funding, because the funds so raised are targeted. This makes leakage into other government spending unlikely, and backs the loans with physical assets.

For purely local assets the case for central government involvement is weaker, and would depend on the demonstration of a market failure, particularly in the form of an inability for councils to issue their own bonds. Such a failure appears not to exist. We also note that the same conclusion was drawn following recent investigations in Australia.<sup>18</sup> This work found that local governments were generally unwilling to use private debt markets.

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<sup>17</sup> Personal communication, Roger Gyles General Manager – Finance, Civic Assurance.

<sup>18</sup> [http://www.rdcouncil.gov.au/Reg\\_Infra/background.aspx#bg](http://www.rdcouncil.gov.au/Reg_Infra/background.aspx#bg)

Since central government issuance of infrastructure bonds makes sense in some cases, consideration needs to be given to defining those cases. We have argued above that local roads have national spill-over benefits in the form of options to use, and actual use during travel. Similar reasoning could be readily applied to water networks, however, and possibly also to other council supplied infrastructure. Moreover, while the FAR system for road funding has distributional merit, that system is financially constrained as a whole and would benefit from debt funding.

Thus, there is a case for using infrastructure bonds issued by central government to finance infrastructure investment for roads and water infrastructure. The FAR system provides a very approximate template for the release of funds from such a programme. However work would be required to better understand the national spill-over effects of any infrastructure categories considered for inclusion, and to compare these with local ability to pay. This would allow for more accurate targeting of grant monies.<sup>19</sup>

### **2.3.6. Conclusion on debt financing**

There are very good reasons for governments (at all levels) to use debt to finance long-lived investments. Doing so advances the date at which service can be enjoyed from the infrastructure, and spreads the capital cost more equitably across the generations that benefit from that service. Moreover, governments are generally low risk debtors so they enjoy low interest rates in debt markets.

We found that local authorities use very little debt, with debt to asset ratios are that are generally well under 4%. This position seems to reflect what have been widely held views about the merits of “paying ones way”. While the existing LTCCPs project significant increases in debt, it would be desirable for more local governments to issue their own debt.

Councils have enjoyed direct access to debt markets in the recent past, indeed some debt sold this way is still outstanding. However this is no longer an active source of financing. The main reason seems to be that councils simply do not view debt as a long-term financing mechanism. As a result, they prefer the flexible repayment schedules offered by trading banks over the fixed pattern of coupon payments that bondholders must be paid over the whole period to maturity of the bond.

There is a case for expanding central government support for local infrastructure where those assets have spill-over benefits for the country. The FAR system for road grants, appropriately modified, could for example be replicated for water networks. Infrastructure bonds issued by central government would be an ideal way to finance upgrades of such infrastructure.

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<sup>19</sup> The FAR system itself would benefit from a review along these lines.

## 2.4. Public Private Partnerships

Public Private Partnerships (PPPs) are used in some countries with the aim of getting better value for money by using private investment or financing for public projects. They have had mixed success, with the result that costly lessons have been learned and New Zealand can benefit from these.

Virtually all infrastructure projects involve the private sector in some way. The main difference between traditional procurement and PPPs is that private investors expose their capital to some risk in the latter. For example, rather than simply contracting a private party to build a bridge in return for a cash payment, a PPP may be structured so that a private firm would supply some or all of the capital, build the bridge, maintain it, and collect a toll.

Risk and its management is central to the case for a PPP. In principle, governments and private investors differ in their ability to manage particular types of risk. This creates the possibility that total costs can be reduced by contracts that allocate particular risks to those best able to manage them.

Offsetting these potential benefits, it is generally much more costly to arrange a PPP than a traditional procurement contract. Unless the project is of sufficiently large scale, it will not be worthwhile incurring these additional contracting costs.

More generally, PPPs will not make sense unless

- The project is large enough to justify the contracting costs; and
- The government is
  - Capital constrained, including being unable or unwilling to borrow on its own account; or
  - Unable to adequately manage material risks in other ways.

In the rest of this section, the first and third of these conditions are explained further (the second needs no exploration beyond that provided in section 2.3). We also outline and analyse the preferred method for evaluating PPP proposals. Conclusions are then drawn.

### 2.4.1. Project Scale and Contracting Costs

It is generally agreed that tender processes are considerably more expensive for PPPs than for traditional methods of procurement. Both parties to an eventual contract incur additional cost. From the government's perspective, all infrastructure investments require careful appraisal before a commitment is made to proceed. However PPPs additionally require a very detailed comparison of alternative financing methods, which is not necessary when traditional procurement is used.

Private parties also bear additional contracting costs because a PPP is a commercial investment rather than a contract for services (eg construction services). For example, the successful bidder on a 30 year contract to supply electricity service to the London

Underground incurred contracting costs of around £15million.<sup>20</sup> This was almost ten years ago (1988).

As a result, the case for using a PPP relies on the project being of sufficient scale to justify the additional costs of contracting.

#### 2.4.2. Risk Management

If the private sector is best equipped to manage particular risks, social costs will be reduced by arranging projects so that it does so. This principle applies not just to PPPs, but also to more traditional forms of procurement. To analyse the additional risk management benefits that PPPs might deliver, we start with the list of project risks contained in the Victorian State government's PPP policy.<sup>21</sup> These are:

- Design and Construction (cost, quality, time)
- Commissioning
- Service under-performance
- Industrial relations
- Maintenance
- Planning
- Price
- Regulation and legal change
- Taxation
- Technological obsolescence
- Residual value
- Demand (ie volume / usage)

Some of these risks can be managed effectively through traditional procurement or contracting methods. For example, design, construction, and commissioning risks can readily be transferred to construction contractors without a PPP. Service performance and maintenance standards can also be secured through more conventional contracts by using incentive payments.

Others are arguably not manageable at all. Technological obsolescence is exceptionally difficult to predict, as evidenced by the fact that some private firms make decisions that turn out later to be better than those made by others. Similarly, demand is largely beyond the control of suppliers. Certainly it is not manageable independently of price.

A third group of risks is potentially manageable by government, but only through somewhat dubious exceptions to general policies. Taxation, regulatory and legal changes are in this category. Policy development in these areas should have regard to the impacts on the wider community, but it would be unusual, and arguably undesirable, to treat government's own exposures differently to those of others.

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<sup>20</sup> S. Littlechild, *Competitive Bidding for a Long-Term Electricity Distribution Contract*, Review of Network Economics, 2002,

<sup>21</sup> [www.partnerships.vic.gov.au](http://www.partnerships.vic.gov.au)

This does not leave many areas where PPPs have a clear advantage in principle, though more may emerge from the circumstances of particular projects. Two areas where PPPs could deliver value are:

- The trade-off between capital and operating costs; and
- Service delivery innovation more generally.

Because it is generally of long duration, a PPP can potentially exploit private sector understanding of economies that are only available over time, such as investing more initially for an ongoing stream of operating cost reductions. Innovations such as this are cited by Partnerships Victoria as a major motivation for PPPs.

### **2.4.3. Public Sector Comparator**

It is obviously important to understand whether any particular project is suitable for a PPP. This question is usually analysed through the use of a public sector comparator (PSC), which is based on a financial model of a public sector project that would deliver the same services. Ideally, the PSC would be built before a decision is made on whether to pursue a PPP, but it might also be used to help compare tender offers. If there is a reasonable expectation that a contemplated PPP will deliver better overall value for money than the PSC, tenders are called and terms are negotiated with the preferred bidder.

There are formidable difficulties in building a PSC. It requires cost and patronage forecasts over very long horizons of 25 years and more. Risks and uncertainties over costs and patronage need to be estimated and valued. Future streams of cost and value also need to be discounted, but there are widely differing views on discount rates.

Moreover, the PSC provides only one of the two critical inputs to a decision over proceeding with a PPP. In addition, public analysts need to predict the outcomes under the PPP itself. The same forecasting, risk, valuation and discounting issues arise in this process, but with the added complexity of predicting the best private sector offer from the tender process.

These difficulties have led two analysts from the World Bank's Public-Private Infrastructure Advisory Facility (PPIAF) to conclude<sup>22</sup> that the PSC "may not be the best way" to assess the potential value of a PPP in developing countries. New Zealand does not face the same constraints as developing countries in obtaining access to the information and resource required to build a PSC, which remains the preferred method of evaluation in Australia and the UK.

### **2.4.4. Conclusion**

PPPs are a particular way of enlisting the help of the private sector in delivering public services. They differ from more standard competitive procurement processes in that the

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<sup>22</sup> James Leigland and Chris Shugart, "Is the public sector comparator right for developing countries", Gridlines, Note # 4, April 2006.

private party invests capital or provides other financing assistance. PPPs are usually large scale, long term contracts. They are costly to arrange, requiring very careful consideration of a wide set of risks. The anticipated benefit is better value for money as a result of innovation in service delivery and the allocation of risks to those best equipped to manage them.

For local government, PPPs are worth considering for very large projects that would otherwise be difficult to finance, or where ongoing participation of a private partner offers the potential for better risk management. It is additionally important to ascertain that there will indeed be several qualified bidders, and that a detailed financial analysis supports the proposition that a PPP will give better value for money than the alternatives. These issues must be addressed before tenders are called.

## **2.5. Income from Investments**

Many local authorities own, or part-own business units that have a commercial focus. However the total income from such sources is only a small fraction of local authority income. Over the six years to 2005, Statistics NZ data indicates that investment income represented less than 8% of all operating income for local authorities. Examples of council-owned businesses include airports, land-fills, water networks, and forestry assets. In this section, two main issues are considered:

- the rationale for council ownership; and
- rates of return and asset valuation.

Conclusions are then drawn from that analysis.

### **2.5.1. Rationale for council ownership**

The scope of council activities varies widely across the country. Some own extensive commercial operations while others limit their activity to a much narrower core. It is therefore worthwhile to consider, at the level of principles, the rationale for councils undertaking commercial activities.

For some activities, councils have limited flexibility over the extent of their participation. Water is the most important of these, and is covered under s130 of the Local Government Act 2002, which (among other things) prevents councils from:

- using assets of its water services as security for any purpose;
- divesting its ownership or other interest in a water service except to another local government organisation; and
- losing control of, selling, or otherwise disposing of, the significant infrastructure necessary for providing water services in its region or district, unless, in doing so, it retains its capacity to meet its obligations.<sup>23</sup>

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<sup>23</sup> The Act also constrains, but does not prevent, contracting out of water services. Section 136 permits councils to contract out the supply of water services for up to 15 years provided they “retain control over all matters relating to the pricing of water services, the management of water services, and the development of policy related to the delivery of water services”.

For most other activities, councils have considerable discretion. Many core activities that serve ratepayers are contracted out, such as waste collection and road maintenance. Provided the tendering processes are carefully designed and executed, this helps to retain downward pressure on costs which should promote the well-being of the community.

On the other hand, many councils own all or part of a trading enterprise as a Council Controlled Organisation ('CCO'). While the Local Government Act 2002 does require consultation prior to the establishment of such a venture, it does not provide any specific test that must be passed.

We therefore draw on the standards prevailing in New Zealand for assessing the merits of government intervention in markets. These require that governments (at any level) only intervene directly in markets where there is a market failure and a reasonable expectation that the benefits of intervention will outweigh the costs. For local authorities, the assessment should be made with reference to the distribution of benefits and costs within the authority's area.

Ports and airports are good examples to consider since councils often own parts of these businesses.<sup>24</sup> They are frequently viewed as important assets from the perspective of regional economic development, since they act as gateways for flows of goods and people to and from the regions. While this is undoubtedly true, the question that must be asked is whether a private owner would behave any differently than a council owner.

From a day-to-day operational angle, the main differences are likely to show up in service prices. A private operator may be more cost efficient than a council, but both would seek to maximise the value created by the asset. The owners may well differ in their definition of value; private operators would equate value with revenues, whereas a council may interpret value as throughput (ie tonnes of cargo or numbers of passengers). This may lead a council to set lower prices than a private operator and to achieve correspondingly lower earnings.

One could think of this outcome in two ways. A positive view is that councils forego some financial profit in order to stimulate the economic (and possibly the social and cultural) progress of their region. With equal validity, one could argue against such endeavours on the grounds that councils should not use ratepayer funds to subsidise particular sections of the business community. Councils are themselves in a position to influence public opinion on such matters. It would be reasonable to require councils to identify the market failure(s) their investments are intended to correct.

A different scale of problem arises when the time horizon expands to include capital works. It is here that the most significant differences may arise between public and private ownership if councils and private firms are seeking very different outcomes.

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<sup>24</sup> The crown is also a joint venture partner in seven airports: Hawke's Bay, New Plymouth, Whangarei, Whakatane, Taupo, Wanganui and Westport. The first two of these are currently scheduled for corporatisation. All ports are controlled by local government (see section 2.5.2)

Auckland Regional Council's ownership of Ports of Auckland Ltd is a good example. If the purpose of buying out minority interests in this firm was to actively influence the physical development of the waterfront, that could be socially useful. If it was merely to secure the additional dividend flow, then it appears far less so. To our knowledge, the purpose of that investment was not made public.

Airports are another area of interest. Many local authorities have recently invested additional capital in their airports or are planning to do so.<sup>25</sup> It appears that a significant amount of this investment is for the purpose of attracting international flights from Australia, and thereby boosting the local tourism industry. Queenstown has demonstrated that such a strategy can work, but this does not imply that it's experience can be replicated across the country.

**Table 4** Passenger Arrivals from Australia by Airport

	2004	2005	2006
Auckland	472,293	497,067	500,105
Christchurch	227,007	220,679	241,266
Wellington	95,677	89,831	89,794
Queenstown	10,682	16,367	20,785
Hamilton	18,451	16,495	17,909
Dunedin	16,566	17,890	15,540
Palmerston North	12,468	11,948	12,872
Other Airports	113	24	21
Total	855,261	872,306	900,298

Table 4 shows the pattern of visitor arrivals from Australia by airport. It shows that a reasonable substantial scale of operation, in the order of 10,000 arrivals per year, is used to support the existing international airports. While we cannot exclude the possibility that regional expenditure intended to support direct international flights is a sound use of public funds, private investment is likely to require considerably more risk mitigation. For example, a private investor would probably want clear indications from an airline that flights would be scheduled before investing.

### 2.5.2. Ports

The port sector in New Zealand is in a state of transition, initiated mainly by international developments. The volume of global trade has been growing faster than shipping capacity, which has driven up capacity utilisation in the shipping industry and reinforced the trend towards larger ships. This in turn has placed pressure on the operating efficiencies of ports, and is leading shippers to rationalise the number of ports called at in New Zealand.

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<sup>25</sup> To take just three examples: Rotorua Airport is getting a longer runway and a 3-tier car-park; Hamilton airport has recently spent \$15m on a new terminal; and the Invercargill airport runway was extended by 500m in 2005.

These dynamics are particularly relevant to local government, because it controls the port sector in New Zealand. A breakdown of local government ownership by port was provided by McDouall Stuart<sup>26</sup> and is reproduced as Table 5. McDouall Stuart view the sector as becoming increasingly stratified into three groups: international ports which will continue to serve major international shipping lines but experience considerable pressure on pricing; bulk ports that will enjoy local monopolies on particular export trades; and regional ports that will be obliged to adapt their business models to accommodate the gradual loss of container traffic.

**Table 5** Local government ownership of ports (Source: McDouall Stuart)

Port	Local Government Ownership Stakes	%
Northland Port Co	Northland RC 55%, Ports of Auckland 20%	75%
North Port	Northland Port Co 50%, Port of Tauranga 50%	78%
Ports of Auckland	Auckland RC 100%	100%
Port of Tauranga	Tauranga RC 55%	55%
Eastland Port - Gisborne	Eastland Community Trust 100%	100%
Westgate - New Plymouth	Taranaki RC 100%	100%
Port of Napier	Hawkes Bay RC 89% Horizons mw 11%	100%
Centreport - Wellington	Wellington RC 100%	100%
Port of Nelson	Tasman RC 50%, Nelson CC 50%	100%
Lyttelton Port - Christchurch	Christchurch CC 65%	65%
PrimePort Timaru	Timaru DC 74%	74%
Port Otago	Otago RC 100%	100%
South Port - Invercargill	Southland RC 66%	66%

There are good reasons for local government to hold stock in ports, but they mostly concern the strategic value of the land on which the port is sited rather than the port activity itself. Waterfront re-development can contribute greatly to the public amenities available in cities and towns. Local government has a legitimate guiding role in such activity, and holding port stock probably makes it easier to give effect to that role.

On the other hand, there is considerable strategic uncertainty associated with port activity and the sector is achieving relatively modest rates of return (see section 2.5.3).

These factors suggest that there may be merit in seeking to split land holdings from port activity. Potentially, that could allow councils to pursue waterfront redevelopment initiatives around the fringes of ports, and to exit the port business itself.

### 2.5.3. Rates of return and asset valuation

To understand the rates of return being achieved by councils from their commercial operations, we sampled from the Annual Reports of these companies. For a selection of companies, Table 6 presents reported ratios of Earnings Before Interest and Tax (EBIT) to Total Assets. It shows that rates of return vary dramatically, from a low of -7.7% to a high of 13.6% per annum.

<sup>26</sup> McDouall Stuart, The New Zealand Port Sector, December 2005.

The basis for asset valuation has a major influence on the interpretation of the EBIT/Assets ratio. To avoid biasing the interpretation, assets should be valued at their opportunity cost. For practical purposes, this is the sum that would be paid for them if they were sold. If assets are valued at less than their opportunity cost, the rate of return will be over-stated. There is considerable variation in the way assets are valued within this sample group. Several report that land is in the books at “fair value” while plant and equipment is valued at historic cost.

**Table 6** Rates of return on assets of council investments

Company	Council	EBIT/Assets
Northland Port Corporation (NZ) Ltd	Northland Regional Council	2.80%
MetroWater Ltd	Auckland City Council	2.20%
Capacity Ltd	Wellington councils	-7.70%
Waikato Regional Airport Ltd	Hamilton (and others)	2.60%
Dunedin City Holdings	Dunedin City Council	5.90%
Auckland Regional Holdings	Auckland Regional Council	13.57%
New Plymouth Airport	New Plymouth District Council	1.37%
Palmerston North Airport Ltd	Palmerston North City Council	8.10%
Hawke's Bay Airport Authority	Napier/Hastings	5.31%
WRC Holdings Group Limited	Wellington Regional Council	2.43%
Port Nelson	Nelson City Council	6.40%
Target Pest Enterprises	Canterbury Regional Council	11.51%

The financial performance of the port sector varies dramatically but appears poor on average. Basic information for the 2005 financial years is shown in Table 7.

**Table 7** Financial information from ports (Source:McDouall Stuart)

	EBIT	Total Assets	EBIT / Total Assets
Auckland	70.1	627	11%
Tauranga	59.7	648.4	9%
New Plymouth	3.4	92.5	4%
Napier	9.9	113.4	9%
Wellington	10.7	197.3	5%
Nelson	10.5	121.4	9%
Marlborough	6.3	54.1	12%
Lyttelton	20.8	200.5	10%
Timaru	3.4	70.8	5%
Dunedin	15.5	188.5	8%
Invercargill	3.3	29	11%

While most port companies revalue their land assets regularly (only Dunedin and Invercargill do not), only a handful (Auckland, Tauranga, Lyttelton) apply the same discipline to operating assets.

#### 2.5.4. Conclusion on investments

Local authorities vary widely in their ownership of commercial ventures. Such assets were the source of 6% of total revenue nation-wide in the 2005 financial year, but varied from zero to 40%. The rates of return being achieved vary widely but are on average low relative to private sector benchmarks.

Those benchmarks are not appropriate however for businesses, such as water services, that are intended to serve ratepayers on a break-even basis. The real issues, therefore, are at a more strategic level concerning the choice of activities in which councils involve themselves, and the use of governance arrangements that retain efficiency incentives.

Council ownership stakes in of port and airport businesses could benefit from re-assessment. While unregulated hubs such as Auckland Airport have performed well financially, many regional airports are making heavy and risky investments in new facilities that they hope will attract new traffic. The sea port sector is in a state of transition driven largely by the economics of international shipping. Rates of return are low and the future outlook is uncertain.

Councils should be able to clearly articulate their reasons for operating businesses, and to link those reasons with community wellbeing. For example, land-use management goals, such as waterfront redevelopment around ports, may be best achieved through council ownership of land, but that need not require ownership of a port business.

## 2.6. Other Sources of Revenue

There are four other sources of revenue that need to be considered:

- User charges and fees
- Fines
- Grants and donations; and
- Asset sales

### 2.6.1. User Charges and Fees

User charges and fees arise from the sale of goods and services, or from fees associated with various types of consent application. Income of this type is reported by Statistics New Zealand under two headings: regulatory income and sales plus all other income. Summary statistics across all local governments for the 2005 financial year is reported in Table 8.

**Table 8** User charges and fee income as % of total income, 2005 (Source: Statistics NZ)

Category	Minimum	Average	Maximum
Regulatory income	0%	5%	17%
Sales + all other income	4%	18%	59%
Total	6%	23%	63%

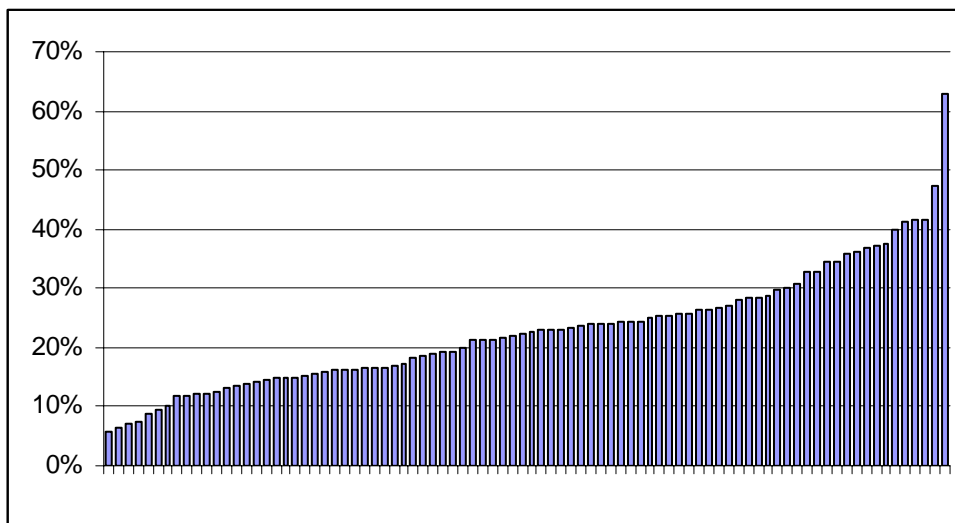
On average, local government raised 23% of its revenue from these sources in 2005, but there is very significant variation around this figure. The maximum value are distorted

somewhat by the West Coast Regional Council which has an particularly large share of “sales + other” income. Figure 8 shows the distribution of total income from these sources.

User charges and fees should be used where there is an identifiable cost caused by an individual. They are price signals, so efficiency demands a close link to the cost of provision.

User charges could be used more extensively for water services. Water is a scarce and costly resource, so there is potential for economic instruments to help ensure it is efficiently used.<sup>27</sup> However water is rarely priced by local authorities. In the 2005 financial year, 71% of local government income for water and wastewater services came from rates. On average, councils allocated 22% of all rates income to water services.

In principle, there are efficiency gains from shifting towards user charges instead of rates for the funding of water services. This would give end-users stronger incentives to control the cost they impose on the system, and to monitor the level of those costs.



**Figure 8** Regulatory, sales and other revenue as a % all income, 2005 (Source: Statistics NZ)

In urban environments internationally, many local governments use economic instruments such as cordon tolls to manage transport demand. Pricing strategies for public transport and parking can also influence traffic patterns. There will be an increasing need for such tools as urban locations gain population. Revenues from such sources should be recycled to fund system costs however, rather than used to finance non-transport expenditures by councils. As a result, transport-related charges are not a major source of alternative revenues to rates.

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<sup>27</sup> The Ministry of Agriculture and Forestry has done an initial survey of economic instruments for water allocation (<http://tinyurl.com/39e73o>).

### **2.6.2. Fines, Grants, and Donations**

These are all minor categories of local government revenue. Their levels can be affected by the amount of effort councils devote to collection. Some charities, for example, actively solicit bequests and other forms of grant. Similarly, some types of fine revenue can be increased through greater policing. Notwithstanding these facts, neither fines, grants nor donations appear to have significant potential as increasing sources of non-rate revenue.

### **2.6.3. Asset Sales**

It was concluded above that many local government investments have performed poorly in financial terms. This does not necessarily mean that asset sales should be commenced however. There are sound reasons for running many local enterprises such as water businesses on a cost-recovery basis, which will inevitably show up as a modest financial return. For investments that are more financially remunerative, there is a different reason for hesitation: the loss of a stream of income.

The diversity of council investments precludes any general advice about the merits of asset sales. However it does seem appropriate that councils

- review their business holdings on a periodic basis,
- be able to articulate the rationale for each investment, and
- link that rationale to community wellbeing.

### 3. Conclusion

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Our analysis investigated the existing pattern of non-rate funding methods to understand their coherence with the principles of public finance, the potential for expanded use, and any barriers to such expansion. Table 1 summarises our conclusions.

**Table 9** Summary of findings

Source	Growth source?	Comment
Development contributions		New regime needs to settle
Transfers from central government	yes	Review and possibly expand FAR; New transfers to accompany new roles
Debt funding	yes	Significant expansion desirable
Investment income		Review holdings and governance
User charges and fees	yes	Greater use for water and transport

Development contributions policies are in a state of flux and councils need assistance with making these work properly. Properly applied, they have an important role in helping councils accommodate growth.

Transfers from central government are currently somewhat ad-hoc. The road funding scheme (FAR) should be reviewed to ensure it aligns properly with the relevant principles. Similar schemes should be considered for other local infrastructure that has national spill-over benefits. Finally, there is a good case for linking new roles and responsibilities that central government devolves to local government to have transfers associated with the.

Debt funding is a major potential source of new income that should be used for long-lived infrastructure, irrespective of which level of government is the investor. Our analysis suggests that the barrier to growth of this source is that councils are simply averse to long term debt.

Rates of return on council investments vary widely but are on average quite low. We believe that the focus for future attention should be on the rationale for involvement, and governance measures to drive efficiency, rather than the rates of return as such.

Finally, there is potential for greater use of economic instruments in the area of water and transport services.