

8 June 1995

The Chief Executive  
Auckland City Council  
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Dear Sir

### **Submission on the Draft Auckland City Council 1995/96 Annual Plan**

1 The New Zealand Business Roundtable is pleased to make the following submissions on the Council's draft Annual Plan. We should appreciate the opportunity to be heard in support of our submissions.

#### **General Comments**

2 For the year ended June 1994, the Council spent \$1,058 per head of population, or around \$3,000 for each household. The activities of the Council and its requirements for revenue to fund them affect the well-being of Aucklanders and the region generally. They can detract from economic and social well-being if they divert resources from more productive to less productive uses.

3 The core functions of the Council are to ensure that local 'public goods' are provided in the right amounts, times and places, and to the right standards - having regard to costs as well as benefits. Local public goods are ones which it is impossible to exclude individuals from using despite the fact that they do not pay for them, and where the use of such goods by some individuals does not reduce their availability to others. Most so-called public goods, such as libraries and museums, are actually a mixture of public and private goods, and identifying the public good element of them is a matter of judgment. Services such as street lighting, roading and parks and reserves come closest to exhibiting the characteristics of local public goods.

4 There is plenty the Council is doing, and should keep doing, to provide services that embody significant elements of local public goods and which help to make Auckland a good place in which to live, work and do business. These functions are its proper priorities. It could perform them even better if it focused sharply on them and avoided the distractions and risks associated with non-core and hence non-strategic activities. The Council should, however, analyse the organisational options for core services, such as corporatisation, to gain best results at least cost. In pursuit of

the goal of best results at least cost, every activity should be exposed to competition to the greatest extent possible.

5 While the Council's stated mission for the city contains many laudable objectives (such as the encouragement of self-help and self-reliance, and working in partnership with the community and business) they do not provide an adequate basis for defining the Council's role. Alternative guiding principles based on generally accepted grounds for government intervention are needed to assess priorities, to focus resources on activities in which the Council has a comparative advantage, and to identify inappropriate services for divestment. The Council's revenue and expenditure policies should be evaluated in the light of such principles.

6 In this context, debates about whether the Council should hold future rate increases to 'headline' inflation, 'underlying' inflation or some mid-point are not addressing the correct issues. Instead, the focus of debate should be on identifying the proper core functions of the Council, the extent to which those activities should be funded by rates or user charges, and mechanisms to ensure continuous improvements in efficiency of delivery.

7 Our view is that a lack of consideration of appropriate core functions is reflected in weaknesses in the Council's strategy - including a slackening of efforts to improve efficiencies in many areas, excessive reliance on rates and commercial income as sources of revenue, undue concentration on non-core activities, and a narrow perspective of options for the future ownership of regional services, such as water supply and drainage systems. An example of the impact of this lack of focus is the fact that budgeted net expenditure on property and city promotion (\$18.5 million, much of which is non-core) is equal to net expenditure on parks, reserves and other recreational areas for public enjoyment.

## Revenue

8 The cost of rates per head of population in Auckland City was \$723 in 1993/94 (or about \$2,000 per household). Auckland is second only to Wellington in rates per head of population. Auckland relied on rates for around half of its income. Income from commercial sources, such as rental income, comprised 26 percent of income while user charges contributed just 15 percent towards revenue.<sup>1</sup> For reasons stated below, rates or user charges are the appropriate sources of revenue to fund core services. Of the two, user charges are to be preferred wherever possible for several reasons:

- *user charges enable people to express their preferences for services they desire through their spending decisions.* If ratepayers don't like or want a service offered they will not buy it. In contrast, subsidies provided through the Council are funded through rates which represent a compulsory levy. The preferences of ratepayers are required to be expressed less directly and effectively.
- *User charges provide important information to providers on the quantities and quality of services that should be offered.* This point is related to the previous one. User charges enable such decisions to be taken on a decentralised basis.

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<sup>1</sup> Management, April 1995, pages 64-65.

- *User charges encourage people to conserve resources.* People are given the opportunity to weigh up the value of the services on offer against their cost. When services are funded by subsidies provided through councils, the direct cost is low and demand for services will often exceed supply. In response, a quantitative limit might be imposed, queuing or waiting might be allowed to develop, or the quality of service might be allowed to deteriorate to encourage some people to satisfy their preferences through non-council-provided services. The supply of metered water, provided water charges reflect the marginal costs of supply, is a good example of the potential conservation benefits of user charges.
- *User charges are likely to be more equitable.* The high cost of subsidising activities such as the Central Library (where less than 10% of gross expenditure is recovered through charges) and the Art Gallery (where around 20% of gross expenditure is recovered) represent a transfer from ratepayers who do not make extensive use of such facilities to those who do. Higher user charges would impose a greater proportion of the costs of services on people who value them most highly and would reduce the rate burden on citizens generally. Higher user charges are therefore likely to be more equitable than subsidies funded through rates.
- *User charges encourage alternative providers to provide competing services.* This helps to contain costs and promotes innovation.

9 There are few Council services where user charges represent a significant proportion of gross costs. Two notable examples are water (where charges marginally exceed gross costs) and the operation of the zoo (where the aim is for user charges to recover 70% of gross costs). Examples where user charges could make a greater contribution to gross costs than currently include:

<b>Activity</b>	<b>Gross Cost (\$m)</b>	<b>Net Cost (\$m)</b>	<b>% Gross Cost Recovered</b>
Drainage	26.3	25.0	5
Aotea Centre	8.8	5.2	41
City Promotions	4.7	4.7	0
Library Services	15.7	14.6	7
Art Gallery	5.3	4.2	21
Subsidised housing	10.7	6.4	40
<i>Total</i>	<i>71.5</i>	<i>60.1</i>	<i>16</i>

10 The extent to which it would be appropriate to ultimately recover gross costs, and the means by which costs would be recovered, would vary for each of the above services. It is conceivable, for example, that the full costs of drainage could be recovered by linking sewage charges to water usage, given that the two costs are likely to be closely associated. The recovery of a greater proportion of the costs of city

promotion and the Art Gallery, to the extent that such activities are appropriate for the Council to undertake, could be implemented through charges on local businesses likely to directly benefit, greater sponsorship and public subscriptions, as well as direct charging. If businesses or sponsors choose not to contribute, the services should be reduced.

11 Increasing the average contribution of user charges for the above activities from 16% to 60% would reduce the call on rates by about \$30 million, or around 13% of budgeted 1995/96 rate income. Such a reduction is entirely feasible as shown by the metering of water and cost recoveries for activities such as the zoo.

12 It would be inappropriate and impracticable to recover through user charges all, or even a significant part, of the costs of such things as democracy and parks. Income from rates will quite properly continue to be the main source of funding for these activities. Currently a variety of differential rates apply among ratepayers. These differentials seem unrelated to the probable costs of different activities. For example, CBD residential ratepayers pay only 62% of the standard residential rate. In contrast, CBD non-residential ratepayers pay a differential of 217%, more than three times that of their residential neighbours.

13 The only justification for differential rating is if ratepayers in certain localities impose identifiable additional costs that are not reflected in additional rates and which cannot be cost-effectively recovered through user charges. On this basis, the current differential rating system cannot be justified. For example:

- extra capacity requirements for drainage and water supply should be recovered directly by user charges, not through differential rates; and
- roading and traffic requirements correlate with the intensity of site use which, in turn, is reflected in rateable values. There is a weaker relationship between such requirements and categories on which differential rating is based, such as residential, commercial or CBD.

14 The current differential is likely to have a significant distorting effect on land use patterns and acts as a disincentive for businesses to locate in the city. The impact of the rate bill on hotels, for example, is significant. Hotels are classed as commercial ratepayers. The cost of rates per room for hotels in the inner CBD ranges from \$1,939 to \$2,362 per room.<sup>2</sup> At an average room rate of (say) \$250 per night, hotel rooms must be let for 8-9 days to recover the cost of rates. In contrast, the rates bill for a suburban hotel in Manukau City amounts to \$294 per room. Money spent on city promotions by the Auckland City Council is likely to be a weak palliative to this disincentive to business development compared with the effect of rate differentials.

15 In passing we note that the tax treatment of businesses is irrelevant to the issue of differential rating. The claim is sometimes made that the ability of some businesses to claim an input tax credit for GST paid in respect of rates confers an advantage on businesses and justifies a differential rate. This view is incorrect. The GST system was designed to impose tax on final consumption spending. For this reason firms, but not consumers, generally receive a deduction for GST paid on inputs but pay GST on their sales. The deduction in respect of GST is intended to avoid a cascade effect where the

<sup>2</sup> NZ Property Investor, 13 February 1995

amount of tax is affected by the number of traders involved in the production and distribution of goods and services. Business firms, other than those supplying exempt services, effectively pay GST on the net value which they add.

16 A similar argument applies to income tax. Income earned by firms is generally subject to income tax. Because firms are taxed on a net rather than a gross basis, a deduction for expenditure on rates is permitted. This does not place firms in a favourable position relative to residents. Residents receive a reduction for rates if their gross income is taxed, for example where property is rented. However, where gross income is not taxed, a deduction for related costs including rates is disallowed. Owner-occupiers are, if anything, advantaged because they do not pay tax on the net income that arises from their investment in housing. It is incorrect to conclude, as some observers do, that firms gain an advantage over residents because they can deduct rates for income tax purposes.

17 The Council also derives significant income from commercial sources. Involvement in commercial activities exposes the Council to unnecessary risks. The Council should divest itself of commercial investments. The result would be that the Council would no longer use income from commercial sources to fund its core activities. In addition to reducing risks arising from involuntary investments being made on behalf of ratepayers, reliance on user charges and rates as income sources will make more transparent to ratepayers the costs of services provided to them. This would enhance accountability. Divestment of commercial assets is discussed further below.

18 The Annual Plan notes that the Council intends to review its revenue policy as part of the strategic plan review. Maximising the Council's contribution to the wellbeing of Aucklanders in the longer term depends on assessing the Council's core functions, rebalancing the mix between income from rates and user charges, and substantially reducing the extent of the existing rate differential. In this context it is worth noting the recent High Court decision on differential rates where Mr Justice Ellis in *Woolworths NZ Ltd and others v. Wellington City Council* noted that "...the dominant consideration for determining a reasonable differential in a rating system must be the value of services rendered to the ratepayer by the Council".

19 Our view is that application of that principle in the forthcoming review would result in significant changes to the rating system. The proper extension of user charges and other proposals in this submission would permit the differential loading to be eliminated or reduced substantially, without any corresponding increase (and possibly a decrease) in residential rates.

### **Expenditure and Core Services**

20 The Council proposes to increase its rate revenue by 4.45% in 1994/95. This indicates a slackening in commitment to seek out more cost-effective ways of delivering services. There are no cost reductions in the core activities compared to forecast net expenditure for 1994/95. Net expenditure on "City Leadership and Development" is budgeted to increase by 7.3% over forecast 1994/95 net costs. The corresponding increase for recreational and cultural services is 8.7%. While the net

cost of all activities is budgeted to increase by less than 1%, the 1995/96 budget makes no allowance for provisions (which amounted to \$7.8 million in 1994/95).

21 The Council could contribute most constructively to the local economy by reducing its expenditure and rates. This would be achieved by restricting its activities to those that should validly be performed by local government and to perform them efficiently. Desirable steps would include:

- divesting itself of most activities under the "city promotion" activity. If visitor centres, expenditure on supporting regional tourism and promoting the CBD are important, those who directly benefit will pay for them. Up to \$4.7 million could be saved;
- divesting itself of commercial investments, including commercial property, carparking buildings and interests in the Auckland International Airport;
- reviewing the Council's holdings and location of functional property, such as workshops, with a view to reducing costs to ratepayers;
- corporatising activities such as contract services and city park services. Setting these units up as separate business units is a worthwhile first step towards greater efficiency. However, if they are to compete with the private sector, as envisaged, it is important that they have a strong business structure and that they do not enjoy advantages unavailable to their competitors by virtue of council ownership. Otherwise, Council activities risk crowding out private sector provision, resulting in an environment that is less conducive to innovation and investment. Such activities should be set up as LATEs and, in the interim, have a required return on investment equivalent to pre-tax rates of return from comparable businesses. This would recognise the current tax-favoured treatment of non-LATE businesses conducted by councils; and
- reducing the provision of subsidised rental dwellings.

22 With the possible exception of emergency housing, there are no valid grounds for the provision of low-cost housing by the Council. Housing is largely a private good. To the extent that there is a case for government involvement on equity grounds, it is a responsibility of central government. Hence, the government owns Housing New Zealand and provides housing subsidies (the accommodation supplement). These are centrally funded and administered using information to which the government alone has access, such as the income of those on low incomes.

23 Currently, ratepayers subsidise around 2,000 units to the tune of about \$3,200 per unit or \$60 per week. As well as being costly, the subsidies represent transfers from ratepayers to general taxpayers since many tenants would receive assistance (or more assistance) from the government if they were paying market rents. The Council should withdraw from providing subsidised housing and make appropriate transitional arrangements for tenants, including help in gaining housing assistance from central government to which they are entitled.

24 Commercial ventures by the Council involve business risks to which ratepayers should not be involuntarily exposed. Commercial involvement detracts from the

Council's focus on its proper core functions. The Council has not disclosed proper financial and economic information on large ventures such as the redevelopment of Britomart Place and the Harbour Edge Development in either the 1994/95 annual plan or the current one. Commercial projects of \$47 million are mentioned on page 25 of the plan in a footnote to the Statement on the Sources and Uses of Funds but no other detail is provided on the grounds that the projects "will be considered by the Council on a case by case basis".

25 We are unaware whether a proper cost-benefit analysis of ventures such as Britomart Place has been undertaken, even though significant resources are being spent on feasibility studies and property such as the former chief post office has been acquired. The general lack of transparency underlines the conflict between the Council's involvement in commercial activities and the imperatives of public accountability which makes the Council an unsuitable vehicle to undertake commercial activities.

26 The historical involvement of central and local government in New Zealand and overseas in commercial ventures is replete with examples of imprudent investments and inadequate accountability that have resulted in substantial inefficiencies and losses. Accordingly, we are surprised and disappointed with the statement on page 18 of the annual plan that "Auckland City will fight any moves to privatise Auckland water supply and drainage systems". The Council has offered no justification for this stance, which seems to be purely an ideological one. This is not an acceptable basis for policy. The Council is failing in its responsibilities in not considering all means, including privatisation, of reducing the costs and improving the quality and reliability of water and drainage services. It should be undertaking proper analysis of the issues and putting it forward for public scrutiny.

27 Doubly disappointing is the inclusion of this statement, without elaboration, under the heading of "leadership". If the statement in the plan accurately represents the Council's position on ownership of commercial ventures, it suggests weak leadership on an issue of vital importance for the future prosperity of the City. There is now clear-cut evidence, summarised, for example, in World Bank reports and many academic studies, that privatisation of businesses owned by governments at all levels brings significant economic benefits. On average, businesses subject to commercial market disciplines perform more efficiently than businesses subject to political control. New Zealand experience with privatisation has been consistent with these findings. In Wellington, for example, the privatised company Stagecoach has held fares in dollar terms since 1990 and reduced them by 10 percent in real terms, increased passenger numbers significantly and reduced subsidy requirements from \$14 million to \$5 million per year, saving ratepayers \$9 million a year.

28 The inability of public entities to take appropriate decisions on a timely basis, because they face poor incentives, is the main reason why activities such as water supply should be privatised. One study of a privatised British water company indicates that its charges are now 13 percent lower than would otherwise have been the case. Corporatisation and privatisation of water are occurring in many countries. Other supply options are available, including tendering for a franchise to supply water on a competitive basis and build, own, operate and transfer schemes.

29 Common objections to privatisation, such as the need for public ownership of 'strategic' activities, do not withstand scrutiny. Fuel, gas, telecommunications and food are equally 'strategic' and are efficiently provided by the private sector. Water is privately provided in parts of the Auckland region (Waiheke, for example). The Council's net financial position would be improved as the result of privatisation because it would capture, through the sale price of assets, some of the expected gains that arise because of likely superior performance under private sector management.

30 The Council does not and cannot have a comparative advantage over the private sector in either running commercially successful businesses or in choosing directors to do so. Even if in any year or years the businesses are profitable, experience strongly suggests that over time they are unlikely to justify the debt-related and other costs and risks that are associated with them. Ratepayers should not be exposed to these costs and risks. The Council's stated position on privatisation is short-sighted and risks handicapping the economic development of the Auckland region.

### **Other Issues**

31 The overall quality of the plan prepared by the Council has not improved over the past year. A consolidated balance sheet and operating statement for each of the forecast years should be included in the plan.

32 Performance indicators are generally under-developed. In particular, there is no indication of whether the Controller and Auditor General's finding that most local authorities have inadequate information on the state of their infrastructural assets (other than roads) applies to Auckland City and, if so, whether any steps have been taken to address the position.

33 The cost of capital is eliminated for "non-discretionary assets," being assets where there are no current alternatives to ownership that do not require major shifts in Council policy. We submit that section 223F(2)(a) of the Local Government Act 1974 does not allow the Council to apply in its Annual Plan or elsewhere a nil cost of capital for core activities. To comply with the Act the council must provide for a reasonable cost of capital. This is also necessary for the Annual Plan and subsequent reporting to give a true and fair view of the costs of each activity. If capital is treated as free, the Council's decisions are highly likely to be distorted, with a resulting misallocation of resources and losses in regional and national production and living standards.



34 Fuller information in future Annual Plans should be provided on financial management policy. This would be aided by setting appropriate financial benchmarks which would facilitate the monitoring of the Council's financial policies. We recommend the Council consider adopting a framework for financial management along the lines of the Fiscal Responsibility Act. The essence of this measure is the establishment of sound financial criteria, the nomination of specific financial goals and the provision of regular information to the public.

Yours faithfully

R L Kerr  
**EXECUTIVE DIRECTOR**