New Zealand Business Roundtable

Submission on the Christchurch City Council's 1997 Draft Plan

June 1997

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Executive Summary

- This submission on the Christchurch City Council's 1997/98 Draft Annual Plan (the Plan) is presented by the New Zealand Business Roundtable.

- The Plan states the purpose of the Council is to make Christchurch as attractive as possible a city for its citizens in which to live, work and enjoy life. Wide-ranging objectives for the Council are defined to this end.

- Many of the Council's objectives fall outside the proper functions of local government and are inappropriate because they would make the community as a whole worse off. Some objectives (e.g. those relating to water, soil and air quality) overlap the statutory functions of regional government while others duplicate central government's responsibility (e.g. social assistance) or are the business of the private sector (e.g. business activity and tourism).

- The Council's objectives need to be clarified. They should be focused tightly on those activities which require local government involvement that is justified by a valid public policy analysis. This demands a more disciplined approach by the Council than that implied by the Plan.

- The proper role of all local authorities, including the Christchurch City Council, is funding and - in justifiable circumstances - providing public good outputs which cannot be better provided by firms, households or non-profit organisations. A further role of the Council is to make and administer regulations at the local level and to undertake other activities delegated to it by central government.

- The redistribution of income by subsidising services is not an appropriate role for the Council. It is very difficult to believe that subsidising all users of Council-provided services could be efficient or equitable. A superior strategy is a combination of lower rates on all households, more efficient service provision, and appropriate central government tax and welfare policies.

- The Council is using its coercive powers to force all ratepayers to fund services which users could fund directly. Rates distort behaviour and impose economic costs on the community.

- The Plan provides for excessive growth in expenditure and debt through to 2006/07. The growth in spending reflects the Council's lack of focus on its core functions and it is not justified within the Plan.

- We are opposed to the planned increase in rates of 2.7 percent in 1997/98 and between 2 and 4 percent (up to 2 percent real) a year in the following forecast years. There are ample opportunities for the Council to cut spending and increase user charges so that rates can be reduced rather than increased.

- Council participation in commercial activities involuntarily exposes ratepayers to unnecessary commercial risks. On average and over time, government-owned businesses have been shown to perform less efficiently than privately owned firms.

- The Council's justification for its substantial business investments include the claimed positive impact on rates and the claim that the investments are of strategic importance. These arguments are dubious or invalid.

- We recommend that the Council:

  - sell its off-street parking buildings;

  - corporatise the total works operation unit, including building services and plant hire, with the aim of privatising the operation;

  - cease subsidising tram operations and cancel the poorly defined bus shuttle project;

- put its water supply and wastewater disposal business on a more commercial footing. The Council should seek private sector involvement with its water and wastewater business as soon as possible;

- review the organisation structure and charges for its service delivery and advice activity with the aim of reducing the net cost;

- review the appropriateness of the outputs covered by library and leisure services activities with the aim of discontinuing services or recovering costs from users;
- sell all residential housing units not held for roading development purposes;

- stop its business promotion activities. They are not an appropriate function of the Council and should not be funded by general rate differentials; and

- sell its interests in Southpower, Christchurch International Airport, Lyttelton Port, Selwyn Plantation Board and Christchurch Transport.

• The Council should fully fund the goods and services that it produces from user charges or use-related charges whenever this is an economically efficient strategy.

• Once the Council has focused its role on funding and/or providing core regulatory and public good activities, and determined the proportion that cannot be funded through user charges or proxies for user benefits, it should consider options for efficient taxation (rating) of different ratepayers.

• There are no compelling grounds to impose differential rates on particular classes of ratepayers such as businesses, if user charges are applied where it is efficient to do so. The alleged benefit to business of tax deductions for rates is illusory.

- While the plan meets most statutory reporting requirements and is generally well presented, improvements are required to make it more informative. The Council should explain significant changes in income and expenditure. The assumptions that underlie the forecasts should be stated and the presentation and terminology between budget years should be consistent. Reporting on the Council's holding company should enable ratepayers to monitor variations in consolidated expenditure and revenue on a year-to-year basis.

- The Council can make the best possible contribution to the welfare of the citizens of Christchurch by focusing on its core activities, exiting those that are inappropriate, and keeping its rate and regulatory burdens as low as possible.

1 Introduction

This submission on the Christchurch City Council's 1997/98 Draft Annual Plan (the Plan) is presented on behalf of the New Zealand Business Roundtable (NZBR). The purpose of the organisation is to contribute to the development of sound public policies that reflect overall New Zealand interests.

We have made submissions on the last three annual plans. The thrust of them has been that the Christchurch City Council (the Council) should focus on its core role, withdraw from non-core activities, privatise some aspects of service delivery and sell its shareholdings in commercial enterprises.

The Council appears reluctant to examine its role in a conceptual framework. It tends to justify its activities on the basis of permissive local government legislation, surveys of citizens and public consultation. However, the plan invites discussion on the appropriateness of Council activities:

> Much of the debate which occurs annually surrounding the Plan tends to focus on specific projects or programmes. This is quite appropriate and reflects the format in which the Plan is prepared, but debate on the wider underlying objectives is also welcomed.

The NZBR appreciates the opportunity to discuss the Council's role, objectives, projects and programmes.

The balance of this submission is structured as follows:

- section 2 examines the role of the Council and comments on its objectives;

- section 3 reviews significant activities of the Council and suggests where the Council's involvement should be reduced, discontinued or modified in form;

- section 4 discusses the Council's investment in commercial and industrial businesses;

- section 5 addresses the efficient recovery of the cost of council activities and its funding policy for 1997/98;

- section 6 discusses the adequacy of the information supplied in the draft annual plan and indicates areas where improvements could be made; and
- section 7 presents our concluding comments.

2 Role of the Council

2.1 A Principled Approach

The activities that the Council engages in and how they are funded should be decided on a principled basis which justifies government action as a first step. While consultation about Council activities is an important part of the democratic process, it is no substitute for sound analysis and the responsibility of the Council to make informed choices in the interests of ratepayers and citizens.

The demand for ratepayer-funded services will generally be excessive from the perspective of overall community welfare because people and groups that lobby for particular services do not face the marginal social costs of the services that they demand. Tightly focused groups are able to obtain services that they value by imposing costs thinly over the majority of ratepayers who face excessive costs in monitoring Council activities and representing their views. The absence of information on the real value to a ratepayer of particular services makes it impossible for the Council to accurately assess the preferences of ratepayers. These involve, for example, determining the value to a ratepayer derived from the subsidised use of swimming pools rather than the household's private spending on fitness or recreation. Furthermore, ratepayers are compelled to bear the costs that are imposed on them. Their opportunities to move to another council jurisdiction are constrained.

In past submissions to the Council, we have outlined a framework for improving the efficiency of Council activities. Standard economic analysis suggests that goods and services are best produced by the private sector rather than central or local government where this can be done on a commercial basis. In general, private providers have the best incentives to ascertain and satisfy individuals' needs at least cost. If the Council determines that greater provision of particular goods and services would be in the community's interests, there may be a case for subsidising private provision rather than for public sector provision. The Council should exit from the production of private goods unless there are special reasons for continuing involvement.

The proper role of all local authorities, including the Christchurch City Council, is funding and - in justifiable circumstances - providing public good outputs which cannot be better provided by firms, households or voluntary organisations. Public goods are those which are non-excludable (i.e. where it is not possible to exclude a person from using the service), and non-rival (i.e. where the use of the service by one person does not reduce its value to another person). A further role of the Council is to make and administer regulations at the local level and to undertake other activities delegated to it by central government.

There should be no presumption that Council provision and/or funding is justified simply because particular goods or services have public good characteristics or provide benefits which extend beyond those enjoyed by direct users (external benefits). The private provision of outputs with some public good elements is commonplace and does not justify Council involvement for two reasons. First, in many cases consumers value the service to the extent that private providers can recoup all their costs by user charges. Private bookshops are not subsidised because they sell books of educational value and gymnasiums and fitness centres do not need to be provided by the Council because they may help raise the general health of the community. To the extent that they are profitable, private hotels provide convention facilities that may attract visitors. Similarly, libraries and swimming pools do not need to be publicly provided or subsidised simply because they may help to disseminate knowledge and information, and increase the health of the community, respectively.

Secondly, individuals are willing to donate to private non-profit organisations which provide outputs with some public good or externality characteristics. Private museums draw on private funding and volunteer labour to provide services to the public. Businesses and individuals sponsor rescue operations (e.g. the helicopter).

The Council is just one of a multiplicity of agencies which can assist in the provision and funding of such goods and services and it should not step in to assist when other arrangements might be more efficient and more equitable. It is acknowledged that some goods may be under-provided without government action to force individuals to contribute through rates. However, the lack of willingness of individuals to contribute to private goods with external benefits (e.g. museums, science centres, libraries, or swimming pools) is an indication of their lack of enthusiasm for the expense. Councils have no sound alternative basis for determining the real preferences of citizens and are vulnerable to exaggerated claims of external benefits by vested interests.

In many cases it may not be efficient or equitable for the Council to become involved in funding public goods or social services, particularly when ratepayers are divided over the Council's involvement. The Council should not use its coercive powers to force all ratepayers to fund services which users could readily fund themselves. Rates distort behaviour and impose economic costs on the community which are additional to the losses in well-being from forcing some ratepayers to spend money against their will.

The Council's argument that it needs to ensure that access to particular services is available to everyone, including those on low incomes and the disadvantaged, is not a sound justification for providing private goods on a free or substantially subsidised basis. The redistribution of income by subsidising services is not an appropriate role for the Council. The Council does not generally possess the information required to assess the income or wealth of individual ratepayers. It is very difficult to believe that subsidising all users of Council-provided services could be efficient or equitable. Untargeted subsidies for convention and entertainment facilities, the art gallery, golf courses, and the library are likely to be regressive. A superior strategy is a combination of lower rates on all households, more efficient service provision, and appropriate central government tax and welfare policies. Local Government New Zealand agrees with the view that councils should not engage in income redistribution.

The costs and benefits of Council intervention need to be assessed and, if Council action is justified, the most appropriate form of intervention should be employed. This may involve regulation, subsidisation of particular outputs provided by a private organisation, matching of private donations to a non-profit organisation, Council provision of the outputs, or other options.

2.2 The Council's Purpose and Objectives

According to the Plan, the purpose of the Christchurch City Council:

> ... is to make Christchurch as attractive as possible a city for its citizens - those of today and tomorrow - in which to live, work and enjoy life. To achieve this requires a focus, not only for services to the city's people, but also for programmes to safeguard and improve the physical environment and the economy.

In pursuit of this purpose the Council has defined wide-ranging objectives in the areas of personal safety, public health, social assistance, housing, recreation and leisure, air, water and soil quality, natural features, rural amenities, heritage, natural hazards, business activity and employment, utility services, transport and communications, and property development. The Council states that its strategic objectives are shared with many other public and private agencies. Its role may range from that of the lead agency to a monitoring/influencing responsibility. The Council states that it could act as the provider, funder, regulator, promoter/facilitator or advocate depending on the particular area of interest.

Many of the Council's strategic objectives fall outside the proper functions of local government and are therefore inappropriate because they would make the community as a whole worse off. Objectives in the areas of social welfare assistance, art and culture, housing provision, business activity, employment, transport, and commercial and industrial property are examples. While the Council envisages a minor role (e.g. monitoring and advocacy) in some areas (e.g. sea, air and telecommunication services), it indicates that a provider and/or funding role is possible.

Some objectives (e.g. in relation to water, soil and air quality) overlap the statutory functions of the Canterbury Regional Council. Issues relating to water, air and soil erosion are primarily functions of regional councils (in terms of section 30 of the Resource Management Act 1991). Other objectives duplicate central government's responsibilities (e.g. social assistance) or are the business of the private sector (e.g. business activity and tourism).

Examples of objectives that imply an over-expanded role include personal safety, aspects of public health, and educational facilities. While the Council can contribute significantly to, say, the safety of the roading system, it has little or no influence in many other areas such as law and order, safety in the home or workplace, recreational activities or the health system. Similarly, the Council sees itself as a leading agency in providing educational facilities and services even though its traditional activities under this heading are substantially confined to the provision of library services.

The Council's objectives need to be clarified. They should be focused tightly on those activities which require local government involvement. This demands a more disciplined approach than that implied by the Plan.

3 Review of Activities

The following paragraphs comment on significant activities of the Council that, in our view, should be reduced or discontinued, or continued in a modified form.

3.1 Art Gallery

The Plan shows the net budgeted cost of this activity at $1.8 million. In addition, there is a cost of capital charge of $189,000. The Council has spent $9.7 million acquiring a site to build a new gallery and a further $29.3 million is to be spent over the next 6 years on its construction. The gallery's outputs are private services as the users are identifiable persons who can be excluded. Private galleries and non-profit organisations provide similar services. We doubt that any net external benefits are large. The subsidy is likely to benefit disproportionately people on high incomes. There is no justification for Council ownership and operation of the gallery - this could be undertaken privately under contract - or for a ratepayer subsidy of over 80 percent of its operating costs.

3.2 Off-Street Car Parking

There is no justification for Council provision of off-street parking facilities. The Litchfield and Manchester buildings require a combined rate subsidy of $169,000 while Oxford Terrace is budgeted to provide a surplus of $156,000. These figures exclude a cost of capital charge. If a reasonable return on the funds employed were required, off-street car parking activities would show a significant shortfall. The Council is competing unfairly with private providers of off-street parking who operate without subsidies. The Council is also subsidising workers and shoppers at particular locations at the expense of those who shop and work elsewhere in the city. The Council should sell its parking buildings.

3.3 City Streets

City Streets, which includes the Council's roading activities, is the largest activity of the Council in terms of gross cost ($46 million)[1] and net cost funded by rates ($33 million). While the provision of local roads is a proper function of local government under current roading arrangements, the activities of the Council should be restricted to a funding and coordination role.

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1 Excludes a cost of capital charge of $62 million.

The Council operated a management LATE (Streetworks Management Limited) to tender for Transit New Zealand-funded road works. All work awarded by tender was sub-contracted back to the Works Operation Unit. The Council formed a LATE to meet Transfund's requirements. This involved the amalgamation of the functions of Streetworks Management and the bitumen products undertaking. Although an option, the Council rejected the idea of transferring all its works activities to the new LATE.

The stated justification for this approach was the need to influence competition in the road contracting market in the interests of ratepayers. Without evidence, the Establishment Unit claimed that the Council's works unit had a moderating influence on the ($18 million) market of between 1 and 10 percent. The benefits claimed were dubious given the Establishment Unit's belief that a stand-alone LATE (incorporating Works Operation, the Bitumen Products Plant, and Plant Hire and Building Services) was unlikely to be viable without a cut in staff numbers of up to 35 percent.

The benefit to consumers and taxpayers from corporatisation and privatisation of central government's trading activities are indisputable. Similar exaggerated claims to those of the Establishment Unit were advanced for the retention of businesses by central government. Other councils have accepted that it is not in ratepayers' interests to provide road construction and maintenance services. The Council should acknowledge the overwhelming evidence in favour of withdrawing from road contracting. All the activities of the Works Operation Unit should be corporatised and operated at arm's length from the Council with the ultimate goal of privatising this activity. The potential cost savings to ratepayers are large.

3.4 Tram and Shuttle Bus Operation

About $1 million of the proposed budget for City Streets relates to the tram and shuttle bus operation. The shuttle bus requires a subsidy of $250,000 while the tram requires funding in excess of $600,000 from rates. After taking into account an appropriate cost of capital, the subsidy to the Tram is estimated at between $1.1 and $1.5 million.

The justification for the shuttle bus is unclear but appears to be related to the promotion of the central business district. At the feasibility stage, the tram was projected to be very profitable and there was considerable debate on the desirability of leasing out the operation.

Tram and shuttle bus operations are not appropriate functions of the Council. Both services relate to the provision of private goods and users should be charged the full cost. The Council should drop its proposed shuttle bus operation and it should terminate tram subsidies.

3.5 Water and Sewerage Services

The gross budgeted cost of water and sewerage services exceeds $43 million while the net cost to ratepayers is budgeted at $37 million. Notwithstanding the millions of dollars spent on expanding the city-wide coverage of water meters, the anticipated revenue for 1997/98 is only $5.8 million. It relates mainly to user charges levied on the business sector.

The experience with all network industries owned by central government is that major efficiency gains have resulted from fundamental reform, including the exposure of activities to competition and privatisation. The privatisation of water supply and wastewater disposal internationally has produced similar benefits. There is a good deal of research on this subject, including specific findings which point to the superior performance of privately-owned water utilities in the United States compared with government-owned businesses.

It is sometimes suggested that because water businesses have natural monopoly characteristics they cannot be privatised for fear that they will abuse their market position. However, if monopoly pricing is a concern with private ownership, it is equally a concern with LATEs which also have commercial goals. Thus monopoly pricing must be considered in both situations, and no additional issues are raised by privatisation. Experience has shown clearly that cost padding and monopoly pricing were far more serious problems in utilities such as ports and electricity supply authorities when they were under direct political control, and the same is almost certainly true for water.

A further objection which has been raised by people opposed to the corporatisation and privatisation of water is that water is an essential commodity which should not be provided by a profit-making business. Most essential goods and services, like food, are produced in the private sector. Water is an economic product like any other. People derive benefit from its consumption and, if it is priced correctly, will trade off the benefits of using additional water against those of other goods and services that they may prefer. The Council must generate sufficient revenue to pay for the water services that it provides, including an amount to cover the cost of capital. At issue therefore is whether the revenue is raised efficiently, not whether it is raised.

Structural reforms of the delivery of water have been implemented in many other countries, including the United Kingdom and Australia. There are many issues to be addressed in effecting improvements. These include the control of leakages, improved contracts with customers, pricing - including bundled pricing of supply and disposal - and infrastructural management.

A range of water industry reforms were outlined in the NZBR report, *Reform of the Water Industry,* which was published in August 1995. Various forms of privatisation of water supply and wastewater disposal, including franchising and contracting for services, have produced major benefits for consumers and the wider community overseas. We recommend that, like the Papakura District Council, the Council should seek private sector involvement with its water and sewerage business as soon as possible.

If the Council decides to retain its water business in the meantime, it should implement its original intention to recoup the cost of water services and sewerage through user charges rather than water rates. It appears that concern for lower income ratepayers was a main factor that dissuaded the Council from implementing user charges. However, people on high incomes, such as those with large houses, gardens and swimming pools, can be expected to be large users of water. The funding of water services from rates is likely to be regressive. Secondly, such funding encourages over-use of water and discourages its conservation, and is thus both economically inefficient and environmentally harmful. All ratepayers have considerable discretion over the quantity of water they consume. The problem of inefficient use of water will increase in importance as extraction from the city's underground aquifers reaches its sustainable limits. A reduction in demand of up to 40 percent has been reported in response to user charges.

3.6 Service Delivery and Advice

This activity includes a network of suburban service centres and the counter services at the Civic Offices. The budgeted gross cost of service for 1997/98 is $5.3 million (excluding the cost of capital) while the number of customer contacts is about 685,000 per annum, giving a cost of $6.65 per person. This cost excludes support services for environmental and building administration and technical services for city streets and parks operation. In relation to the number of customer contacts, the cost of such services appears to be excessive. The organisation structure and charges for this activity should be reviewed with the aim of reducing its net cost.

3.7 Library and Leisure Services

The estimated gross cost (including the cost of capital) of providing both library and leisure services in 1997/98 is in excess of $36 million while budgeted external revenue is less than $6 million or 18 percent of operating expenditure.

A wide range of outputs are provided under this heading. For example, leisure and community services include the provision of pools, stadiums, golf courses, camping grounds, events and preschool facilities.

The outputs provided are predominantly private services. Non-payers can be readily excluded from consuming them. The benefit from such services largely accrues to the users. The words "cost effective" are used in the "overall service objectives" for the provision of art gallery and library services, while the words "efficiently and effectively" are used in relation to the objectives for leisure and community services. However, the provision of services at below the marginal cost of supply cannot be justified on efficiency grounds.

The current cost recovery policy can be expected to lead to over-supply of these services. Faced with the option of paying the marginal cost of supply, some consumers would prefer other consumption options (e.g. better accommodation, clothing or a holiday). The consumption opportunities of Christchurch citizens are accordingly being distorted and reduced by Council policies.

The reliance on rates to fund private goods is also inequitable. There is little reason why non-users should, on average, subsidise users for more than 36 percent of the gross operating cost (i.e. allowing for direct and indirect funding) of pools or 94 percent of libraries. It implies non-users of swimming pools (60 percent of the population according to the Council's survey) benefit almost as much as swimmers and that most of the benefits of reading library books accrue to non-readers rather than readers. For some services the current funding policy could well result in poorer individuals subsidising more affluent citizens.

To improve the welfare of the citizens of Christchurch, the Council should review the appropriateness of continuing to supply services that are private goods. Further, to the extent that it is considered appropriate to supply private services, the Council should seek to recover the costs from users where it is efficient to do so. If demand falls in response to more realistic pricing policies, it should be possible to reduce the operating and capital cost of such services and the level of contribution from rates.

3.8 Housing

The Council provides about 2,650 rental units, including a small number on sites held for roading development. The gross 1997/98 budgeted cost of this activity, including an allowance for the cost of capital, is $15.8 million. The cost of capital provision (8 percent) has been calculated at an interest rate which is below the market rate. It implies that the book value of residential units is $105 million or almost $40,000 per unit. The market value of the units is obviously considerably higher. If the Council's cost of capital is adjusted to reflect market interest rates for residential property loans (i.e. around 9 percent) and the average market value of the units is assumed to be about $70,000 each, the gross budget cost increases to $24.1 million.

The average rental required to recover the Council's operating cost and provide a reasonable return on funds employed is estimated at $174 per week. This is considerably more than the average market rent. The nature, characteristics and location of the units suggest that the average market rent is no more than $120 per week. The $54 a week difference between the amount required to cover operating and capital costs and the estimated market rent is a measure of the Council's lack of competitiveness and efficiency in providing housing.

The Council's strategic objectives imply that the justification for its involvement in housing is "the provision of access to quality, affordable housing appropriate to the needs of present and future households." The Council is using assets owned by ratepayers to provide a rental subsidy (i.e. redistribute income) to its tenants. It is central government's responsibility to provide income support to elderly and other people who might otherwise face hardship. The ratepayers of Christchurch are providing an average subsidy to Council tenants of around $55 per week (i.e. the difference between the $120 average estimated market rent and the average rent paid, $65) and $54 to the Council to fund its inefficient operation. Neither subsidy can be justified.

Through Income Support, central government supplements 65 percent of the amount by which a tenant's rent exceeds 25 percent of his or her income. By making tenants not eligible for the accommodation supplement, the Council's housing policy is reducing the taxpayer subsidy at the expense of Christchurch ratepayers.

Housing is a private good. The private sector can provide it more efficiently than the Council. It is a waste of ratepayers' resources for the Council to persist with its policy. Many councils in New Zealand do not provide housing. The Council should follow the lead of councils such as the Auckland City Council and the Hutt City Council and sell its rental units at the earliest opportunity.

4 Investment in Businesses

The Council has significant investments in business activities. It has interests in Southpower, Christchurch International Airport, Lyttelton Port, Selwyn Plantation Board, Christchurch Transport, Canroad Construction and Canterbury Technology Park Joint Venture. With the exception of the last two, these companies are owned through Christchurch City Holdings Ltd. The assets of Christchurch City Holdings are shown in its balance sheet at about $420 million. Its total liabilities are $136 million and the Council's equity is $285 million.

The Council could improve its efficiency and effectiveness by exiting commercial activities. Council participation in commercial activities involuntarily exposes ratepayers to unnecessary commercial risks. On average and over time, government-owned businesses have been shown to perform less efficiently than privately owned firms. International research supports privatisation. For example, a survey of evidence by the World Bank concluded that:

> ... it is clear that ownership matters; that ownership is a significant determinant of profitability and productivity in an enterprise.[2]

Privatisation is a not an ideological issue. It has been embraced by governments of all political persuasions, including socialist governments in Spain and Sweden,

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2 Nellis, John (1994), "Is Privatization Necessary?", FPD Note 7, The World Bank, May, p.4. See also The World Bank (1992), *Privatization: The Lessons of Experience*, The World Bank, Washington.

former communist governments in Russia and Eastern Europe, and by the few remaining communist governments such as China, Cuba and Vietnam.

Central government is to sell its interests in airports, Auckland City proposes to reduce its holding in Auckland International Airport Limited and the federal government in Australia is selling its interests in international airports. Partial privatisation of ports such as Auckland and Tauranga has raised their productivity and competitiveness, and the government of Victoria has fully privatised two ports.

The so-called 'strategic' asset argument for the continued ownership of Southpower, the port and the airport has no more validity than in these other cases where it has been rejected. The Council has argued that their importance to the economy of Canterbury and the possible lack of shareholder interest in Christchurch justifies its control over their future direction. However, ownership of the Port of Lyttelton, for example, does nothing to ensure its continued economic viability. The port industry is becoming increasingly competitive. Marlborough District Council's ownership of Marlborough Port Company will not protect Picton from reduced tourism if the new port at Clifford Bay is developed. Port investment is risky. The investment banking firm Forsyth Barr has stated that the Wellington Regional Council has suffered a loss of shareholder value in the last two years by maintaining its investment in its port company.

In response to a previous NZBR submission, the Council's Director of Finance indicated that the Council was opposed to divestment of its commercial shareholdings because rates would have to go up by 13 percent, making ratepayers worse off. In subsequent correspondence the Council conceded that this argument was flawed as it failed to take account of the impact of asset sales on debt, interest costs and the capacity to return the proceeds of sales to ratepayers.

However, the Council maintained that its argument was valid if the divestment was implemented by a share giveaway. This is also untrue. Giving shares direct to ratepayers crystallises their in-substance ownership status and ratepayers' real funding contribution (i.e. rates and revenue forgone through the Council's ownership of businesses on behalf of ratepayers). The economic implications of giving shares to ratepayers are broadly the same as a sale.

The NZBR's analysis of the Council's financial projections suggests that its ownership of commercial businesses encourages additional spending. If commercial activities kept rates down, the higher than anticipated revenue streams over recent years should have resulted in lower than projected rate increases. However. the Council's projected expenditure has been increased in anticipation of higher revenue from its investments.

An analysis of the profitability of the Council's commercial activities that are subject to competition indicates generally unfavourable results. For example, Christchurch Transport has struggled to produce an acceptable return on shareholder funds while the Tram is budgeted to make a loss. Southpower's associate companies are budgeted to lose between $700,000 and $800,000 in 1996/97 and 1997/98.

The Plan indicates that the Council is to sell Selwyn Plantation Board Limited, a forestry company. This decision is supported. However, in our view, the Council should institute a much more comprehensive sales programme aimed at exiting from commercial businesses and reducing rates. Ratepayers as members of the public should not be forced to be shareholders in risky enterprises. If the Council attaches importance to notions of 'public ownership', the logical approach is to give shares to ratepayers and allow them to decide whether they wish to remain shareholders.

5 Recovery of the Cost of Activities

5.1 Principles to be Applied

The Council is to review its funding policy during 1997/98 as required by the Local Government Amendment Act (No 3) 1996. The broad principles that we believe should be taken into account in the review are outlined below.

The Council should fully fund the goods and services that it produces from user charges or use-related charges whenever this is an economically efficient strategy, as envisaged by the new legislation. Such charges help to balance the cost of providing the service against the benefits that users derive. The weighing up of costs and benefits leads to a better use of society's resources. Under-pricing a good or service leads to its over-provision since the value derived by users from the excess production is likely to be less than its cost to society.

The case on both efficiency and equity grounds for funding private outputs from user charges is very strong. User charges enable consumers to directly express their preferences for goods and services through their spending decisions. They provide important information on the quantity and quality of services that consumers would prefer. Users are encouraged to conserve resources when they directly bear the costs of goods and services. Producers other than the Council are encouraged to enter the market and provide a greater diversity of services when user charges are levied. User charges impose the costs of services on the user whether or not he or she is a resident or visitor.

Economic efficiency generally requires prices that reflect the marginal cost of producing a good or service. The marginal cost of using Council services may be relatively low where capacity is not constrained. Where fixed costs are high and the cost of supplying an additional user is low, it may be efficient to apply a low use-related charge (covering marginal costs), with fixed costs recovered through a fixed charge, such as an annual subscription fee. This is particularly applicable where it is feasible to exclude people who are not prepared to pay. In this case, there are no obvious grounds for government (Council) involvement. Fixed charges should be set at a level that does not discourage consumers from choosing to use the service if they are prepared to pay the marginal cost and make some contribution to fixed costs. Many services provided by the private sector are priced on this basis.[3]

Where services are funded from rates, consumer preferences must be expressed indirectly through the political process. Decisions on the appropriate quantity and

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[3] The implementation of this approach in some areas may require changes to poorly conceived constraints on user charges.

quality of goods must be made by politicians and administrators who cannot know what all individuals would prefer. Where goods or services are funded by rates, there are strong incentives to lobby politicians and administrators for favourable treatment. The administration and compliance costs incurred in collecting rates may also be substantial.

User-pays arguments apply in respect of both public and private goods. It is often argued that public goods should be funded by rates. Although this is reasonable in some situations, in general there should be no such presumption. For some public goods direct user charges may not be efficient, but proxies for use may provide an efficient substitute. It may be excessively costly for a territorial local authority to measure the discharge of sewage from a residential property but, where there is a reasonably strong correlation between a household's water consumption and the volume of effluent discharged into sewers, it may be efficient to base the sewerage charge on water usage.

Similarly, the existence of external benefits does not, by itself, create a case for rate-based funding. Many private sector activities create external benefits for society in such forms as better informed, more educated, more healthy and better adjusted individuals. But private gymnasiums, swimming pools, skating rinks, bookshops, producers of healthy foods, recycled paper and organically-grown vegetables, golf and tennis clubs and a myriad of other providers simply charge their members, customers and users for the services provided and commonly do not obtain government funding.

Because external effects are easy to assert and difficult to refute or quantify, councils are obviously exposed to opportunistic and exaggerated claims by direct users of such services about the magnitude of such effects. An illustration of this risk is the use of models by some consultancy firms which appear to generate implausibly large external benefits. Opportunistic direct users would prefer lower user charges and higher rate-based funding for services. Councils may find it difficult to resist such self-interested pressures, but it is important for community welfare that they do so.

Rate-based funding should apply when the benefits from a service exceed its costs but it is not economic to fully recoup the costs from user charges and use-related fees and levies. Civil defence, open-access parks and reserves and the costs related to the democratic activities of local government are likely to be cases in point. In such cases, no related services are provided to self-selecting customers or users who could be charged directly, thereby testing their willingness to pay against the costs incurred. In other situations, there may be a case for partial rate-based funding where the willingness to pay by direct users falls short of the costs of providing the service.

Once the Council has focused its role on funding and/or providing core regulatory and public good activities, and determined the proportion that cannot be funded through user charges or proxies for user benefits, it should consider options for efficient taxation (rating) of different ratepayers. With this approach there are no compelling grounds to impose differential rates on particular classes of ratepayers such as businesses for the following reasons:

- any differences in the quantity and quality of services provided to each class of ratepayers would be reflected in user charges to the extent that it is efficient to do so;

- the alleged tax advantages that businesses obtain by claiming a tax deduction for rates and a GST input credit are illusory. This argument is elaborated below;

- the optimal tax literature suggests that high rates of tax should be applied where the behavioural response is small and vice versa. This implies lower rates of tax on internationally competitive businesses than residents. However, the information required to apply the theory is not generally available, which leads to the presumption that uniform rates of tax are more efficient. The adoption of a flat rate of GST is an example; and

- rates imposed on businesses are ultimately borne by individuals such as consumers, employees and shareholders. There are no efficiency or equity arguments for imposing a higher or lower rate burden on property used for business purposes than that applied to other property.

The Local Government Amendment Act (No 3) 1996 places some emphasis on the benefit principle. The idea that those who benefit from council services should bear the related cost has much to commend it in terms of efficiency and fairness. However, it should not be pushed too far since there is often no objective basis for determining who is, in fact, the ultimate beneficiary of services provided by a council. Just as the seller of a book or magazine does not know who or how many people will read and benefit from it, a council does not know who ultimately benefits from its activities. It may be one or more of the landlord, the tenant, the employee, the proprietor, the customer or a visitor, or even the person who sold a property to a current owner at a price which reflected the net benefits of council-provided services.

There is a further problem in that the benefit and efficiency principles outlined above may conflict in some situations. Where marginal costs are below average costs, efficiency requires that use-related charges be limited to marginal costs. The benefit principle might imply higher user charges. If the beneficiaries cannot influence the level of output produced, or the costs of production, then efficiency may not support levying that group. Instead, efficiency would suggest that the funds should be raised in the way that minimises distortions to behaviour. This could suggest funding from all ratepayers rather than from ratepayers who use particular services.

In our view, the difficulties of applying the benefit principle reinforce the case for the Council recovering the costs of private goods from users and minimising reliance on rates as a funding mechanism. The Council should divest activities that involve the production of private goods and services. If the Council wants to retain such activities it should fund them entirely through user charges, levied in accordance with efficient pricing principles. There is scope for the Council to increase net revenue from user charges and/or lower subsidies and to reduce its reliance on rates. We believe that there is sufficient flexibility within the Local Government Amendment Act (No 3) 1996 to accommodate this approach.

5.2 Alleged Tax Advantage for Businesses

The claimed benefit of tax deductibility of rates by businesses is a fallacy. Firms do not gain an advantage over residents from deducting rates for tax purposes and the tax deductibility of rates and GST is not relevant to rating differentials. The funding review and the application of the funding principles in the new legislation should result in a discontinuance of the present practice.

The focus on the deductibility of rates payable by businesses overlooks the assessability of related business income (i.e. excluding implicit rents). A firm can only deduct expenditure on rates if it uses the relevant property in an income-earning activity. Deductibility and assessability generally go hand in hand.

Provided that a business earns a profit, which is the aim of all businesses, its before-tax income will be reduced by taxes. The business would be better off if it were free of tax and unable to deduct rates and other expenditure.

The householder appears to be disadvantaged because he or she is unable to claim a deduction for rates whereas a business is able to do so, but this is only half the story. The income of the business is taxed, whereas the income that accrues to the householder (the imputed rents deriving from home ownership) is not.

If businesses were offered the opportunity to be exempted from income tax, provided they gave up the right to claim tax deductions, most would be keen to do so. However, few households would want to be taxed on the gross economic income that accrues from owner-occupation if deductions were allowed for related expenditures such as rates.

Owners of rental housing are already in a disadvantaged position vis-a-vis owner-occupiers. Although they can deduct rates expenditure in calculating their tax, they must pay income tax on the net rental income. Thus, if they obtain some net income from the rental property they must pay tax on it whereas owner-occupiers pay no tax on the implicit rental value of their homes.

GST is intended to be a tax on final consumption spending. For this reason firms, but not consumers, can claim a deduction on inputs, including rates, but businesses pay GST on all taxable output. This enables GST to be collected in stages and ensures that the correct amount of tax is applied to consumption spending. It avoids a cascade effect where the amount of tax is affected by the number of traders involved in the production and distribution of goods and services. The owners of businesses which distribute profits pay GST just like other consumers. Owners of businesses gain no special advantages through the operation of GST.

This incorrect approach to the issue of differential rating is a matter of technical analysis which should be disposed of once and for all. Any arguments for differential rating should be advanced on other grounds.

5.3 Rating Policy for 1997/98

The Plan indicates that the Council is to continue its present differential rating policy pending the adoption of a new funding policy. The present policy is inefficient and inequitable.

First, the justification is based on the presumption that the rates allocation between sectors prior to the application of the uniform charge is optimal. There is no basis for this presumption.

Secondly, the justification refers to the extra cost imposed on the Council by economic development and promotion activities, city amenities that enhance tourism and retailing, roading and traffic management, drainage and water supply and the tax deductibility of rates by business. While some businesses may benefit from visitor and city promotions, these are not an appropriate function of the Council and should not be funded via a differential rate. The businesses that benefit should fund the cost of promoting tourism or the central city. There is little justification to ask their competitors or businesses that receive no benefit (e.g. the export sector) to fund the cost. The same logic applies to city amenities that enhance tourism and retailing.

The general rate is used to fund a large number of activities besides the services listed as justifying a differential rate. They include the art gallery, library, leisure and community services and parks. Commercial and industrial ratepayers contribute more than $6 million towards these activities but account for little of their cost. A consistent application of the Council's differential policy suggests that negative differentials should be applied to activities where businesses impose limited costs.

The Council's differential rate policy ignores the impact of higher capital values on the rates collected from the business sector and user charge contributions. While business may impose additional capacity requirements, this is compensated by higher capital values and/or the site density of buildings.

6 Disclosure of Information

For practical reasons, the Council must limit the information and level of detail presented in the annual plan. While much of the information that is included in the plan is well presented and satisfies most statutory reporting requirements, improvements are required to make future draft plans more informative and meaningful to the general public.

Some of the areas that require attention include:

- the inclusion in the Plan of an explanation for significant changes to financial forecasts. For several years the Council has provided long-term projections of expenditure, revenue and borrowing in the financial overview. The Plan shows financial projections up to 2006/07. The value of the projections is reduced by significant differences between the Plan and previous plans, particularly as a commentary explaining year-to-year changes is omitted.

  The Plan proposes significant increases in expenditure over the next 5-year period compared with the 1996/97 plan. Total operating expenditure for the period 1997/98 to 2001/02 is projected to increase by an additional $69 million cumulatively or 6.5 percent per annum compared with the previous year's budget. Similarly, capital expenditure (excluding the provision for debt repayment) is up 22 percent or $84 million while total budgeted operating and capital expenditure is projected to increase by $153 million (10.6 percent). From 1997/98 to 2001/02 the Council proposes to spend an average of $31 million more per annum than forecast in the 1996/97 budget;

- the financial implications of significant changes to the forecasts need to be explained. The assumptions underlying the forecasts need to be stated and the effect on key parameters of changed assumptions should be tested. For example, what are the implications for gross, term and net debt if interest rates are higher than assumed?

  Higher levels of expenditure lead to increases in rates and debt. While rates are forecast to rise on average by 1.7 percent per annum or $10.5 million compared with 1996/97, total revenue will increase by $71 million (i.e. an average of 6.6 percent per annum) over the five years. Interest and dividend payments from Council LATEs are the main source of the increase in revenue. Debt levels are also forecast to rise to finance the proposed expenditure. Gross and term debt is projected to rise by about 8 percent per annum on average or $107 million by 2001/02 compared with the previous year's projection. While not presented in the draft plan, gross debt rises from $267 million to $842 million over the period 1997/98 to 2016/17 while term debt (i.e. gross debt less term debt) increases from $262 million to $411 million;

- the presentation of expenditure options. The Plan does not provide any indication of the opportunity cost to ratepayers of increased expenditure. While councillors tend to promote the proposed increase in expenditure on the basis that it amounts to only a few more dollars on the average residential rate bill, the fact is the average residential rate bill would fall if expenditure were held at the levels previously projected. For example, if the Council were to hold expenditure in line with the 1996/97 plan and if the 1997/98 revenue projections were realised, aggregate rates for 1997/98 to 2001/02 would be 15 percent lower than forecast in the Plan. The lack of focus on the appropriate role of the Council combined with poorly targeted objectives is the main reason why the opportunity cost of increased expenditure is not adequately considered. Increased revenue generates pressure for new projects and programmes; and

- the adoption of a consistent presentation and terminology between budget years with any changes explained and their implications noted. The Council should, as far as possible, ensure that its statement of financial performance is comparable from year to year. This is not the case with the Plan. The Council operates a holding company (CCHL) which receives dividend and interest payments from its LATEs and incurs debt on the Council's behalf for selected capital (enhancement) projects. One purpose of the holding company is to lower the Council's direct and indirect taxation liability. The holding company has the effect of removing expenditure (operating and capital) and revenue streams from the Council's accounts. In previous plans the Council has provided a consolidated statement of income and expenditure for CCHL and the City. However, such a statement has not been presented for 1997/98. Its omission, which is not explained, is unacceptable as it reduces the public's ability to monitor variations in expenditure and revenue on a year-on-year basis.

The Council defends the large growth in its consolidated debt in the following terms:

> The combined consolidated debt of the Council and CCHL is forecast to grow from $215 M in 1997/98 to $369 M in 2013/14. These amounts should be related to the combined assets of the Council and CCHL of $2945 M, which are forecast to grow by 52% in the same period, and the revenue streams that service the loans, forecast to grow by 72%. It is worth noting that the debt projections are within the parameters set out in the Financial Management Policies ... .

The Council does not define the measure of debt it is using. The above information appears to be in conflict with that supplied by the Council for the purpose of this submission. The latter information indicates that gross debt is projected to increase from $267 million in 1997/98 to $707 million in 2013/14 (i.e. by 165 percent). Term debt is forecast to increase from $197 million in 1997/98 to $414 million in 2013/14 (i.e by 59 percent). It is recognised that the sale of Selwyn Plantation Board Limited may lower debt.

7 Concluding Comments

The key weakness in the Plan is the absence of a valid analysis of the proper role of the public sector and, in particular, that of territorial local government. We believe that the Council should be working more actively to shed non-core activities. The focus of its core business should be on funding, and - in justifiable circumstances - providing public good outputs which cannot be better provided by firms, households and non-profit organisations. This would enable rates and debt to be reduced and would advance the welfare of ratepayers.

The Plan provides for excessive growth in expenditure and debt through to 2006/07. The growth in spending reflects the Council's lack of focus on its core functions and it is not justified within the Plan.

The Council could improve its efficiency and effectiveness by divesting its commercial activities. There are no valid grounds for Council to hold interests in Southpower, Christchurch International Airport, Lyttelton Port, Selwyn Plantation Board and Christchurch Transport, to own and operate off-street parking facilities and to engage in the promotion of tourism.

We recommend that the Council's water supply be operated on a more commercial basis. This could take a variety of forms such as corporatisation, franchising and contracting for services. Similar reforms have produced major benefits for consumers and the wider community overseas.

We are opposed to the planned increase in rates of 2.7 percent in 1997/98 and between 2 and 4 percent (up to 2 percent real) a year in the following forecast years. There are ample opportunities for the Council to cut spending and increase user charges so that rates can be reduced rather than increased.

The level and quality of disclosure should be improved. The omission of data that would enable a meaningful comparison to be made of the Council's planned performance for 1997/98 with at least the previous year is a serious oversight. It calls into question whether the Plan conforms with acceptable standards of financial disclosure and provides an adequate basis for consultation.

The Council's objectives need to be clarified, discrepancies between performance indicators and outcomes identified, corrective action noted and major changes from the previous year's plan explained. The level of disclosure generally compares unfavourably with that of central government.

The Council can make the best possible contribution to the welfare of the citizens of Christchurch by focusing on its core activities, exiting those that are inappropriate, and keeping its rate and regulatory burdens as low as possible.