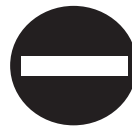
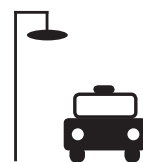


# Local Government and the Provision of Public Goods



# Local Government and the Provision of Public Goods

LOCAL GOVERNMENT  
FORUM



The Local Government Forum comprises organisations that have a vital interest in the activities of local government. Its members include Business New Zealand, the Electricity Networks Association, Federated Farmers of New Zealand, New Zealand Business Roundtable, New Zealand Chambers of Commerce and New Zealand Retailers' Association. The Forum was established in 1994 to promote greater efficiency in local government and to contribute to debate on policy issues affecting it.

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## EXECUTIVE SUMMARY

The purpose of this report is to provide a primer on the core role of local government: the provision of public goods.

The purpose of local government in New Zealand, as expressed in the Local Government Act 2002 and the Resource Management Act 1991, is to provide for the well-being of communities by upholding local democratic processes, setting rules and regulations to govern local activities and ensuring the provision of certain local services and infrastructure, with recourse to local taxation and charges to recover costs.

Governments have to distinguish their roles from those of the private sector and prioritise their plans because the demands on them are unlimited, but resources are scarce. They need to be clear about their focus if they are to best serve the interests of their communities. There are some tasks that it is vital for governments to perform, and governments need to excel in them. There are a great many more tasks in a community that citizens can better undertake themselves through market transactions and other voluntary arrangements.

As the Local Government Forum's report *Democracy and Performance: A Manifesto for Local Government* indicated, one of the two primary functions of government is to ensure the efficient provision of public goods (the other is to maintain order).<sup>1</sup> Without such provision, the economy and society will not prosper. Both national and local governments have public good responsibilities.

The distinctive features of public goods are, first, that non-payers cannot easily be excluded from receiving the benefit that others pay for (that is, public goods are susceptible to free riding) and, second, that one person's consumption does not reduce the consumption opportunities of others. These are known as the non-excludability and non-rivalry characteristics of public goods.

Goods with both of these characteristics are likely to be under-supplied by private firms or not supplied at all (unless under contract to a government entity). Firms cannot provide the level of such goods and services that would maximise net benefits across the community and still recover the full costs of supply.

The terminology of public goods can be misunderstood. It does not simply mean goods supplied to the public. From the above definition, it is clear that public transport and public conveniences, for example, are not pure public goods.

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<sup>1</sup> Local Government Forum (2007), *Democracy and Performance: A Manifesto for Local Government*, Local Government Forum, Christchurch.

Standard examples of pure public goods include, at the national level, national defence and, at the local level, street lighting. There are also various categories of quasi-public goods that only exhibit one of the distinguishing characteristics.

For example, goods depending on infrastructure of fixed capacity (such as roads) become so congested at some level of use that one person's consumption affects the ability of others to make use of them. If it is technologically feasible and economic to charge for such services (for example, through electronic road charging), it may be worth doing so, at which point the service effectively becomes a private good.

There are also some services, such as flood control, that, although non-rival in consumption, are excludable at reasonable cost. For these services, it is feasible to recover costs from the sector of the community that benefits from them. Localised services that exclude potential consumers because of their geographical distance have this characteristic.

These are similar to private clubs. They provide facilities to members on the basis of fixed membership fees rather than charging on the basis of how often each member uses the facilities. Clubs with congestible facilities (for example, squash courts) may also charge for individual use if transaction costs can be kept low.

Many local government services can be likened to goods provided by clubs because of the excluding effects of locality, distance and congestion. Local government legislation in New Zealand recognises this in its provision for user charges and targeted rates, which enable costs to be imposed on those who benefit rather than all ratepayers.

A categorisation of local government services on the basis of their public good characteristics would find relatively few pure public goods but more impure public goods or club goods. Libraries, museums, art galleries and swimming pools, for example, have some public good elements. The list of public goods depends on the feasibility of excluding non-payers and the transaction costs of charging for services. It will vary across local authorities according to such factors as population size and level of use, and it will and also change over time with technological advances.

Local authorities are likely to have a comparative advantage over central government in providing public goods and services where:

- local knowledge is required in provision (for example, in reflecting local preferences);
- the costs and benefits accrue locally; and
- appropriate incentives apply at the local level.

This approach is consistent with the principle of subsidiarity, which requires responsibilities to be devolved to the lowest level of collective authority capable of discharging them.

In all cases, local provision is only efficient if it is expected to deliver a net benefit to the community as a whole. Moreover, local government provision should be limited to an optimal (efficient) level. This means avoiding oversupply or under-supply and minimising the cost of producing the services supplied.

Most services provided for the public do not have public good characteristics. They are provided by firms and funded from the revenue raised. These are termed private goods. If it is cost-effective to charge directly for a service, it is likely to be a private rather than a public good.

An examination of local government activities would identify many that are clearly private good in nature, such as ports, airports, off-street car-parking facilities, cinemas, forestry and farming. Economic analysis suggests that community well-being would be enhanced if councils exited from such activities.

Local government may also have a role to play in providing or facilitating the provision of services on equity grounds. However, it is doubtful whether it is appropriate for councils to engage in income or wealth distribution. Moreover, councils are less well placed than national government to do so because of their narrower tax base, greater susceptibility to people relocating to lower taxed jurisdictions and their limited information on the income and wealth of ratepayers and residents. A forthcoming Local Government Forum paper discusses the issue of income redistribution at a local government level.





# I

## ROLE OF GOVERNMENTS IN MODERN ECONOMIES

Section 10 of the Local Government Act 2002 sets out the purpose of local government as:

- enabling democratic local decision making and action by and on behalf of communities; and
- promoting the social, economic, environmental and cultural well-being of communities in the present and for the future (also known as the sustainable development principle).

Neither this nor any other section of the Act says much about why local government rather than the private sector (comprising individuals, firms and voluntary organisations) should be involved in particular activities. However, the underlying purpose of local government is to facilitate the well-being of communities. (This purpose is also reflected in the Resource Management Act 1991, section 5.) From this, we can infer its intermediate functions, such as providing individuals with security for themselves and their property so that they can invest in productive wealth-creating activity and ensuring the quality of infrastructural amenities, such as local flood control, roads, water supply and waste disposal.

Except in highly decentralised and federal constitutions, local authorities are statutory creations exercising the local and special-purpose functions delegated to them by central government legislation. This view has been reiterated in court rulings over the years in New Zealand and Britain as is evident in the comment that a local authority “is not to be viewed in high policy terms as the alter ego of central government”<sup>2</sup> and that:

A local authority, although democratically elected and representative of the area, is not a sovereign body and can only do such things as are expressly or impliedly authorised by parliament.<sup>3</sup>

In the past, statutory restriction has not stopped councils from devising policy on matters over which they have neither jurisdiction nor power of enforcement, such as the declaration of nuclear-free zones. However, statute constrains councils’ powers to raise and apply funds to activities, thus circumscribing their freedom of action.

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<sup>2</sup> *Mackenzie District Council v. Electricity Corporation of New Zealand* [1992] 3 NZLR 43.

<sup>3</sup> *Hazell v. Hammersmith and Fulham Borough Council* [1991] All ER 545.

The key questions for all governments in determining their activities are:

- What activities are to be undertaken and what services are to be provided?
- How can these activities and services be provided? Broadly, the choices are:
  - providing services directly through taxpayer-funded (or ratepayer-funded) operations,
  - encouraging or discouraging privately provided services by providing subsidies or imposing taxes respectively,
  - promoting changes of behaviour in the community through taxpayer-funded promotional and educational activities,
  - regulating private behaviour in the community for a common good with taxpayer-funded monitoring and enforcement;
- Who benefits from these activities and services, and who should fund their cost?

Economic analysis provides a framework (of comparative advantage) for assessing whether government action might be likely to do more good than harm. This framework applies to local as well as central government.

## 2

# ECONOMIC FRAMEWORK

In mainstream economics, there is a strong presumption that individuals know their own tastes and preferences best and pursue diverse goals of their own choosing. By ensuring people and their property are secure, governments provide the conditions that are necessary for individual creativity, productive work, the raising of families and voluntary collective action. This presumption of general self-competence and individual autonomy parallels the English common law tradition in favour of the liberty of the individual citizen.<sup>4</sup>

As the Local Government Forum's 2007 report *Democracy and Performance: A Manifesto for Local Government* noted, this framework accords government a critical role in providing for the security of citizens and their property and in ensuring that a community's infrastructure and legal framework foster community welfare.

The ubiquity of government laws, regulations and taxes makes the common concepts of 'market failure', 'government failure' and 'non-intervention' somewhat contrived.<sup>5</sup> The relevant policy issue is usually whether some change in a government regulatory, spending or tax measure could improve outcomes overall from a community perspective.

In evaluating this issue, economic analysis stresses the importance of incentives. The behaviour of individuals, households and firms is affected by the incentives they face, including those arising from government decisions. It is necessary to take account of the possible unintended and undesired consequences of government action on behaviour. For example, most taxes distort behaviour in costly ways, so a dollar of additional spending funded from taxes will cost the community a lot more than a dollar and possibly as much as two dollars. Council rates also entail economic or deadweight costs. Public spending funded by taxes or rates, therefore, needs to yield benefits at least equal to these costs otherwise the money is better left in the hands of those who pay the costs.

Furthermore, even when a tax- or rate-funded activity appears to produce net benefits, it is not necessarily the case that the activity is best undertaken by a public body. Private firms, perhaps in conjunction with regulatory reforms (for example, to facilitate public-private partnerships), may be able to undertake it more efficiently.

The role of incentives is relevant in its application to politicians and bureaucrats as well as to citizens. Much writing about the case for government intervention to correct so-called

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<sup>4</sup> See Legislation Advisory Committee (2001), 'Guidelines on Process and Content of Legislation' and amendments, <http://www.justice.govt.nz/lac/index.html> (last accessed October 2008).

<sup>5</sup> See Friedman, D (2004), *Private and Political Markets Both Fail: A Cautionary Tale about Government Intervention*, New Zealand Business Roundtable, Wellington.

market failures rests on the assumption that politicians and bureaucrats are invariably disinterested, omniscient and act only in the overall interests of the community. This is known as the public interest theory of government.

Politicians may indeed act in the overall interest of the community – sometimes at the expense of their own political interests – simply because they want to ‘do the right thing’ in a particular situation. However, they have to get votes and build constituencies in order to obtain office, and this may lead them to make compromises with different interest groups in order to win support for a programme. Political processes can be unpredictable and even chaotic. These factors militate against governments acting solely in the public interest. A leading textbook reports that the public interest theory of government action, as a general proposition, has lacked supporters for decades because so much evidence refutes it.<sup>6</sup>

An alternative view stemming from public choice theory recognises that politicians and bureaucrats are self-interested, just as consumers, workers and employers are self-interested. They have other incentives and objectives besides serving the public interest. These include gaining and retaining power and expanding the budgets and influence of agencies by increasing the range of interventions they oversee. Competing political parties may use other people’s money to buy votes or tax a majority to favour a well-organised minority.

Economic analysis also suggests that there is a supply and demand for government regulations (this is known as the economic theory of regulation) and spending programmes. The demands are most apparent in public or media pressure on governments to be seen to be taking action over particular events, and politicians respond by supplying an intervention. Special interest groups exploit ‘rent seeking’ opportunities to obtain benefits at the expense of dispersed and unorganised consumers and taxpayers. For example, businesses commonly lobby for government regulations that reduce competition, and trade unions lobby for union privileges. Capture theory postulates that regulations may serve partisan interests that have captured the regulator.

None of these theories is complete. While the public-interest approach provides a rationale for appropriate government action, alternative theories caution against naïve assumptions that the results will automatically be beneficial for the community as a whole. The bottom line is that government regulatory or spending proposals should be evaluated to identify the risks of undesired outcomes as well as the potential for outcomes that would improve community welfare. This ‘comparative institution’ framework for public policy is favoured in contemporary economics. The ‘private interest’ theories of government also underlie the case for constitutional-type constraints on governments to help align their decisions with the overall public interest.

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<sup>6</sup> Viscusi, W Kip, Vernon, John M and Harrington, Joseph E Jr (1995), *Economics of Regulation and Antitrust*, The MIT Press, Cambridge, Massachusetts, p 326.

# 3

## PUBLIC AND PRIVATE GOODS

### 3.1 Public goods

'Public goods' is a technical term that has a narrower meaning than the 'public interest' and is defined by the characteristics of services that private providers are likely to under-supply because they cannot recover their full costs. Public goods have two distinctive features:

- Once a public good is provided, it is difficult to exclude non-payers from receiving the related benefits because there is a 'free rider' problem. This is known as non-excludable consumption.
- Once a public good is provided, one person's use of it does not limit its availability for use by others. This is known as non-rival consumption.

Given these characteristics, a private supplier may find it impossible to recover the costs of providing a public good because too few people would be willing to pay for the service and too many would try to free ride on it. In that situation, the service may not be provided at all unless government intervenes and subsidises the private supplier or directly provides the service itself, recovering its costs by taxing the community that benefits.

A rough practical test to determine whether a service is a public good is to ask whether it is cost-effective to charge directly for it. If it is, the service is not a public good. However, services that cannot be charged for directly (for example, free-to-air broadcasting) can sometimes be indirectly funded (for example, through advertising).

Examples of genuine public goods are national defence and local street lighting. These both provide an indivisible collective benefit to their respective communities and do not have their availability varied by the number of people receiving their benefit. Additionally, it would be difficult to exclude people from receiving the benefit once provided. For such public goods, private supply (other than by government contract) is infeasible and funding must come from taxing the communities that benefit.

The non-excludability and non-rivalry characteristics of public goods provide a key two-part test for determining whether local government supply of goods and services should be considered. A 1988 government discussion paper proposed that the key role of local government should be to provide local public goods that could not be more efficiently provided by the private sector.<sup>7</sup>

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<sup>7</sup> Officials Co-ordinating Committee on Local Government (1988), *Reform of Local and Regional Government*, Discussion Document, Government Printer, Wellington.

As shown in *Democracy and Performance* (2007), the technical definition of public goods is essential to a proper analysis of the role of government. Confusion arises because government goods and services are often described as public goods, or a widespread pattern of benefits is alleged (the goods and services are deemed to be good for the public in some sense) when a careful analysis would reveal that they have few or no public good characteristics.

The term 'public transport' is one such example. Users are charged when they get on a bus or train, and once a seat is taken, it is not available for another potential passenger. Public conveniences are another example. The term public good used loosely becomes no more than an assertion that the government should support a particular activity.

Public goods can often be provided privately. For example, property developers may provide 'free' roads and public spaces to help sell their developments. Supermarkets provide 'free' car parks to attract customers. The Internet provides a vast number of 'free' goods and services. Philanthropists, churches and friendly societies may provide social services. It should be noted that the absence of private provision is not necessarily proof of the desirability of public provision. Some goods and services are simply uneconomic to supply and do not justify their costs because too few people want them. Such goods and services cost more than the value they provide to the community, and to subsidise them would simply compound the problem by increasing the opportunity costs of the resources used to produce them.

### 3.2 Quasi-public goods

Apart from defence, street lighting, flood control, footpaths, civil defence and arrangements for communicable diseases, such as foot and mouth disease or bird flu, the list of pure public goods provided by government at any level is not extensive. However, there is a variety of goods that fall between pure public goods and private goods. These have some excludable or rivalrous characteristics and are termed non-pure or quasi-public goods.

Some of them are also referred to as club goods, which are amenable to various forms of charging. Others are congestible in that they are public goods that become crowded at some level of use so that consumption becomes rival. Further rises in their use impose additional costs, either through increased congestion among users or the need to provide additional capacity (for example, public road networks).

Public libraries, museums and swimming pools are examples of non-pure public goods. They do not fully satisfy the principles of being non-excludable and non-rival. Charging arrangements are feasible and are sometimes employed in all cases. Users of libraries could be excluded if they did not pay a subscription or borrowing fee, and when a book is lent to one borrower, it is not available to another. The benefits of reading a book are largely enjoyed by the borrower, not by other people. Alternatives to public libraries, such as bookstores, second-hand book shops and DVD and video stores, illustrate the point that similar services can be provided privately. Likewise, barring congestion, visitors to museums are not rivals in consumption.

Similar points apply to swimming pools. It is more economic for hotels and gymnasiums to supply swimming pools when local authorities charge for theirs on a user-pays basis. A vast array of alternatives to swimming as a form of exercise are provided privately, for example through ski clubs, ice-skating and roller-skating rinks, and indoor cricket, soccer and ten-pin bowling venues.

At the same time, it can be argued that there is a public good element in the provision of all such services. Library services may contribute to literacy, which may benefit the community at large by helping people become functioning members of society (just as education has a public good element, especially at the elementary levels). Private and public museums may be of value to the community by contributing to a national identity and culture.

Such public good elements may or may not provide a justification for some local government involvement in such services. Councils should be mindful that they compete with similar private sector businesses and that charging for some services is possible and desirable on level-playing-field and beneficiary-pays grounds.<sup>8</sup>

A club is a voluntary association made up of members who derive mutual benefit from sharing a collectively consumed good or service.<sup>9</sup> At its simplest, it can be a group of like-minded individuals who share their knowledge, skills and equipment in pursuit of a common interest (for example, a tramping club). Where activities require more elaborate facilities that are beyond the reach of most individuals (for example, tennis courts or golf courses), these can be provided through the members combining resources in a more formal society.

Such facilities are excludable at reasonable cost, so although they are jointly provided by the collective of members, their use need not be free of charge. For instance, sports clubs commonly recover the fixed costs of facilities through membership subscriptions paid by all, but they recover the variable costs of maintenance through some form of user charge. Therefore, the amount each member pays towards maintenance is in proportion to their use of the facilities.

The technical feasibility and cost of identifying and charging individuals determine whether it is efficient to have such two-part charges. Where the transaction costs of so doing are high, it may be more efficient not to charge for use, for example by providing a season ticket allowing unlimited use.

Many local government activities resemble club goods as localised supply confers a degree of excludability on the consumption of public services. This can be reflected both in decisions on what services to provide and how to fund them. A council can be viewed as presiding over a 'club of clubs' in which natural constituencies may be at ward level

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<sup>8</sup> Of course, it might be politically difficult to effect change if those benefiting disproportionately from current services protested vigorously while the great majority that subsidised them was relatively passive. Such situations illustrate how poor quality spending can be perpetuated by creating an entrenched privileged group in the community.

<sup>9</sup> Cornes, R and Sandler, T (1986), *The Theory of Externalities, Public Goods and Club Goods*, Cambridge University Press.



rather than district-wide. The provisions in the rating-powers legislation for targeted rates reflect this, and such rating instruments (formerly known as special rates and separate rates) have long been used for funding area-specific public works, such as flood banks and road-seal extensions.

A local authority has one critical difference from a true club and this is that 'membership' is not voluntary: ratepayers cannot opt out of contributing to the services of their regional and territorial authorities. Even if individual ratepayers relocate to another region or district in protest at the level of rate liability, they remain liable for rates on any property they retain.

For this reason, and the difficulty of defining the boundaries between the various clubs or collectives of beneficiaries, local authority services can be susceptible to cross-subsidy, both deliberate and inadvertent. Cross-subsidy is signified not only when one group of constituents pays more than another for the same service but also when a particular group pays more than it could reasonably expect to pay if the same service was provided on a stand-alone basis.

A cross-subsidy in a local government setting where political power amongst constituents (votes) is distributed differently from the value of rateable property creates an incentive for interest groups to obtain services for their own benefit while the costs are borne by others. Although this may be sustainable for a while, in the longer term it provides a spur for those paying more than the value of the services they use to relocate to other jurisdictions with lower rates and charges.

Excludability of collective services is largely determined by technology, so over time the list of public goods will change as new charging mechanisms become feasible. For instance, roads have long been provided as if they were public goods, but in some locations the technology and level of use now makes it feasible to apply direct charges for the use of road space (for example, urban congestion charges in London, Singapore and some Scandinavian cities).

### 3.3 Private goods

Most goods and services consumed or enjoyed by the community are private goods. These can be supplied and charged for directly by private enterprises on a for-profit or not-for-profit basis. Competitive markets for private goods, supplemented by regulation where necessary, help ensure that economic resources are directed to the production of goods and services that consumers value most.

A large body of empirical research over the past 25 years has found that private goods are best supplied by the private sector. The evidence that, on average and over time, private enterprises are more efficient than publicly owned enterprises has motivated a worldwide shift of activities from the public to the private sector.

Local government in New Zealand is engaged in a large array of private good activities. These range from ports and airports to public transport, parking facilities, farming, forestry, pest-control operations, commercial property, portfolio investment, marinas,

holiday accommodation, cinemas and Lotto shops. The related investments form part of the \$75 billion of ratepayers' equity in councils in 2005/06, an average of around \$48,500 per household. This level of equity would exceed the net worth of many households. Total ratepayer equity exceeds the current market capitalisation of public companies listed on the New Zealand Exchange (around \$50 billion).

It is not appropriate for councils to undertake these private good activities. Politicians are commonly not experts in investing in businesses and managing them. Ownership interests, as a provider and employer, conflict with councils' broader responsibilities to the community. For example, it will be easier for a council to ensure that piped water meets quality standards if it is not also a provider that has been effectively captured by its employees.

Public sector enterprises are less efficient, on average, than private enterprises because of flawed, politicised incentives and inadequate information. Council ownership of ports, for example, is generating low rates of return on investment and frustrating industry rationalisation because parochial considerations override commercial considerations. Such waste of resources constrains economic growth and increases in living standards.

As noted in *Democracy and Performance* (2007), there is no compelling strategic or public policy reason for councils to be engaged in such private good activities. The argument that they produce income through dividends or other returns that helps keep rates down is invalid. The sale of commercial businesses would in fact strengthen the financial position of councils relative to continued ownership because the price received could be expected to reflect the efficiency gains that private owners would hope to make.

Exiting from private good activities would also allow councils to focus more intensively on their important public good roles and perform them better. Such a strategy would be one of the most important ways of improving the contribution of the local government sector to the economy.

### 3.4 Overlapping hierarchies of local public goods

The analysis of local public goods differs from the theory of general public goods because goods and services that are specific to a particular geographic location may be excludable by virtue of distance. Also, by moving between locations, consumers can exercise some choice over the quantity and type of public goods they receive.

The polar expression of this notion is the Tiebout hypothesis,<sup>10</sup> which states that if there were enough communities, people would reveal their true preferences for local public goods by relocating to those that offered the particular mix of public goods they preferred. In reality, location choices may not be so flexible as they involve transaction costs, and choices are limited to each locality's packages of attributes. However, the ease of mobility of capital and people between regions and districts, as opposed to countries,

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<sup>10</sup> Tiebout, C M (1956), 'A Pure Theory of Local Expenditures', *Journal of Political Economy*, vol 94, pp 416–421.

does mean that local government operates under constraints that differ from those of central government.

The smaller the community, the more feasible it is for residents to relocate to an area with the levels of services and taxes they prefer and the more likely it is that the community's services will conform with the wishes of its constituents. This constrains a local body from raising revenue from all ratepayers to supply services that benefit a minority of residents.

It can, therefore, sometimes be efficient for a higher-level authority to provide local public goods and services that spill over local boundaries. With open-access public facilities, such as parks, it is possible for local councils to free ride on the more generous provision of neighbouring authorities and provide fewer facilities in their own districts. The expectation is that residents will boundary hop to use facilities elsewhere.

Rather than one council bearing disproportionate costs for its facilities, it may be more efficient to internalise this spillover effect by having parks provided by a higher authority. This is a role filled by regional parks in metropolitan areas such as Auckland and by national parks and reserves managed by the Department of Conservation.

Central government can achieve economies of scale and scope in raising revenue from mobile taxpayers, such as labour and businesses, so there are situations where it is efficient for central government to collect revenues and return them to local government through grants and subsidies.<sup>11</sup> This is most apparent in the system of road funding in New Zealand. Through this, central government collects fuel taxes and road-user charges and channels these revenues to the provider of state highways and to local councils to assist with ratepayer-funded local roads.

The mobility of taxable entities such as labour and businesses is one reason why local bodies often use land taxes (such as property rates) to fund pure public goods. As land is immobile, taxing it is administratively simpler and yields more predictable revenue. This makes it better suited to local government applications than other forms of tax.

While some countries do have local income and sales taxes, these are usually collected as adjuncts to the national taxes and leave local authorities less accountability in setting their own rates. (If councils remain in the business of providing private goods, user charges should generally be applied, and in the case of quasi-public goods, mixed sources of funding will often be appropriate.)

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<sup>11</sup> Rubinfeld, D L (1987), 'The Economics of the Local Public Sector', in *Handbook of Public Economics*, vol 2, eds A J Auerbach and M Feldstein, Elsevier North Holland, Amsterdam.

## 4

# EXTERNALITIES

An externality arises where costs and benefits are not borne fully by the decision maker.<sup>12</sup> Such costs and benefits accrue, in part, to third parties who are not directly involved. Proximity effects (such as the noise of a neighbour's car, stereo or lawnmower) are commonly not externalities. This is not just because anyone could get rid of them (for example, by buying the neighbour out). It is also because the costs of such inconveniences are compensated for by the same freedom of action (in this case, to use one's own car, stereo or lawnmower).

Further, such costs will be reflected in the price of the goods in the first place. For example, when someone buys a property close to an airport, the price paid should reflect the disadvantage of airport noise on the one hand and the convenience of ready access to air travel on the other. In contrast, a decision to establish a new airport could impose costs and benefits on people in the vicinity who had bought their properties in the expectation that the affected land would, for instance, be farmed.

Some environmental effects may not be satisfactorily reflected in the prices that decision makers face. For instance, pollution such as smoke discharges from multiple factories may be illegal, but it is impossible to stop by common law processes because of the problem of proving which chimney caused which illness or what property damage. In these cases, the products of such factories may be oversupplied, from a community wide perspective, in the absence of further government action. The economically efficient solution depends on whether living with the adverse effects, reducing the discharges by installing filters or taking other remedial measures would impose a lower overall cost on the community.

Some externalities can be resolved by private negotiation or legal proceedings. Even if it were less costly to reduce the smoke discharge in this way, private negotiation may fail. Many of those who would benefit may be unwilling to contribute to the negotiation and prefer to free ride on the efforts of others, or negotiations may entail excessive transaction costs. In such circumstances, intervention by a public agency may be efficient as it could overcome free riding and extract contributions from all who benefit.

Much local government activity can be described as dealing with externalities. New Zealand's local government owes many of its characteristics to developments in Europe during the Industrial Revolution and the responses to the environmental pressures and health risks created by rapid urbanisation and the concentration of population and

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<sup>12</sup> Externalities are unintended effects that arise either because the relevant property rights have not been well specified or because the costs of contracting to address the unintended effects are too high.

industry. The town planning that emerged following World War II can be viewed as an extension of local government's sanitation activities and as a pre-emptive move to control the creation of neighbourhood externalities. Its advocates expected this action would be less costly and socially divisive than the alternative of private solutions using social sanctions and common law.

In contrast to earlier legislation, the Resource Management Act 1991 has an externality approach and focuses on controlling "adverse environmental effects". However, the Act rejects the common law notion that objectors to a land-use change should have to demonstrate standing (for example, a demonstrable harm to their person or property). It also rejects the economic proposition that those who seek to obtain a benefit for themselves should be confronted with the costs to the community of achieving it.

To some degree, this new 'progressive' view reflects the dominant economic theory of externalities that pervaded much of the twentieth century. New Zealand's 1953 planning legislation went substantially further than its British counterpart in extending authority over rural land and using prescriptive zoning aimed at achieving wise use of resources. However, as a central planning approach, it could not succeed in ensuring that private owners would put land to its highest value use.

More recently, externalities have been invoked as a reason for other economic interventions, such as council involvement with conservation, tourism promotion, stadiums and major events. These may sometimes be justified, as in the case of rates relief for owners of private properties that provide significant community benefit, such as conservation of historic sites or public access to open spaces. In such circumstances, though, it would be better for councils to provide grants that are transparent and subject to spending reviews. This approach is very similar to council provision of some services, indicating that some local public goods are simply a positive externality provided by council activity.

On the other hand, some of the supposed benefits for councils from being involved in stadiums and events are spurious.<sup>13</sup> Such projects can often be supported privately through ticket sales, advertising, sponsorship and broadcasting fees. Additionally, those who are likely to receive spillover benefits (for example, sporting clubs, retailers, transport operators and restaurants) should be seen as potential sources of funding. Any ratepayer funding should be a last resort and subject to a referendum of ratepayers.

A contemporary economic approach acknowledges that externalities are ubiquitous, and many do not warrant a government response. Because the risks of government failure are at least as large as those of market failure, greater reliance should be placed on private solutions to externality problems today than was the case during much of the last century.

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<sup>13</sup> See Cowen, T (1999), *Should Governments Subsidise Stadiums and Events?*, New Zealand Business Roundtable, Wellington.

## 5

# DIVISION OF RESPONSIBILITIES

There are various scales of public goods and externalities, so the optimal size of public agencies to deal with these is likely to differ. Originally, New Zealand had a multiplicity of such agencies – boroughs and counties, catchment, pest destruction and harbour boards, united councils and so forth, but such proliferation can be administratively cumbersome and costly. There is a trade-off between vesting authority in appropriately sized jurisdictions and minimising administrative costs by consolidating powers in a larger body that may exploit economies of scale and scope.

The 1989 reform of local government in New Zealand exhibited this trade-off at two levels. First, it amalgamated smaller local authorities and joined rural counties and boroughs into larger district councils. Second, it consolidated the functions of various special purpose authorities with those of regional councils. Now, district and regional councils' functions mostly complement, rather than duplicate, each other. In broad terms, regional councils are mainly responsible for region-wide regulatory and planning activities while districts are responsible for service delivery and regulatory activities at the local level.

Sometimes, however, this is an awkward division of functions. For instance, to coordinate upstream and downstream uses of watercourses, it is logical to organise catchment management along natural watersheds. For pest control purposes, though, it can be more effective to have unified management spanning more than one watershed (for example, controlling possums or goats over an entire mountain range rather than through separate catchments on either side of it).

For similar administrative reasons (and to reduce tax-induced distortions), a mix of local and national funding of some activities may be more efficient than relying solely on local resources. In such cases, it is usually efficient to have some local contribution (as with the financial assistance rate on local roads) so that local authorities explicitly consider the value they will receive from the spending. In general, however, there are strong grounds to require local authorities responsible for spending also to be responsible for raising the revenue needed. This requires councils to assess the costs and benefits of spending proposals and furthers their autonomy.

The ease of mobility between districts suggests the following division of government roles:

- Local or neighbourhood public goods and externalities can be managed at local level where councils set rules and by-laws over certain territorial functions (for example,

resource use), but general economic rule-setting and market regulation are better handled at national level.

- The larger and more heterogeneous the local authority's constituency, the more likely it is that any set of public services will not match the expectations of all constituents. In these circumstances, there will be some redistribution of resources within districts as some ratepayers contribute a disproportionate level of funds to collective services compared with the benefit they receive.
- Redistributive policies that raise local taxes above the level of neighbouring jurisdictions may prompt flight to lower taxed districts and are best managed at the national level.<sup>14</sup>

Such division of responsibilities on economic grounds is consistent with the principle of subsidiarity, which requires that decisions be devolved to the lowest level of collective authority capable of dealing with the characteristics and scale of the particular activity.

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<sup>14</sup> A historical example is the Speenhamland System, which was instituted in parishes in eighteenth century England and taxed local residents to provide top-up incomes for the poor. This proved unsustainable as it attracted vagrants from less generous districts and suppressed the wages paid by local employers. As the costs of moving between countries generally exceed those of moving within countries, central government has a comparative advantage in providing such income support. However, with increasing globalisation and international mobility of people and capital, even central governments are constrained by the possibility that high taxation may provoke flight to another country.



# 6

## FUTURE DIRECTIONS

### 6.1 The theory

Economic analysis suggests that local government is likely to have a comparative advantage in providing services that:

- have public good characteristics in that consumption tends to be non-rival and non-excludable across the community that benefits (although, where appropriate, local negative externalities need to be addressed and positive externalities provided for);
- are best provided at the local rather than the national level; and
- conform with the wishes and preferences of the local communities they serve, as demonstrated by their willingness to pay.

It also suggests that:

- externalities and public goods occur on a variety of different scales, so the optimal size of jurisdictions to deal with each is likely to differ;
- there is a trade-off between providing services through an agency of optimal size, from the point of view of residents, and an agency that can realise economies of scale and scope:
  - localised effects can effectively be dealt with by local bodies, but such bodies face resource limitations that may affect their efficiency,
  - larger bodies may be more efficient and able to spread risks across a wider base, but they are also more likely to generate cross-subsidies as some constituents contribute to services but derive no or limited benefit from them;
- central government may be able to raise revenue and subsidise some local services efficiently, particularly where such services meet a nationally set level of benefit; and
- councils are less well placed than national government to redistribute income because of their narrower tax base, greater susceptibility to people relocating to lower-taxed jurisdictions and their limited information on the income and wealth of ratepayers and residents. More generally, it is doubtful whether councils should engage in income or wealth distribution.



## 6.2 The implications

The figure below categorises services commonly provided by local government according to their varying degrees of excludability of and rivalry in consumption. Those towards the bottom right-hand corner of the figure are close to private excludable goods, and there is little economic basis for their provision as public goods. Those towards the top left-hand corner have more of the collective characteristics of public goods, such as street lighting and parks and reserves.

In between these two extremes are activities with some public good features. Some of them, such as local roads, have high rivalry that creates congestion, but it is not currently technically feasible to charge for them at a reasonable cost. In other cases, funding via a mix of user charges and rates is appropriate. A fuller (but not exhaustive) list of activities currently undertaken by councils is contained in the appendix.

Another dimension in considering local public good provision is the extent to which the service would lead to positive externalities (or avoid negative externalities). For instance, it is sometimes argued that waste collection should be subsidised to avoid littering and illicit disposal of bulk waste materials on another's property. It is also said that public transport should be subsidised to reduce car usage and congestion.

Figure 1: Characteristics of local government services – rivalry and excludability

		Rivalry in consumption <span style="float: right;">→</span>		
		<i>Public goods</i>		
Excludability of consumption		Low	Medium	High
		Low	Street lighting, street and traffic signs, parks and reserves, civil defence, public health and safety (eg security cameras), and democratic, representative and regulatory functions	Low-use roads, footpaths and cycleways
Medium	Flood protection	Sports grounds, public conveniences and bus ways	High-use roads, tourism promotion, economic development	
High	Museums and galleries	Public libraries, swimming pools, indoor recreation facilities and public venues	Ports, airports, public transport, water and waste water, rubbish disposal, cemeteries, car parks, cinemas and housing	
				<i>Private goods</i>

The merits of these arguments vary with particular circumstances, but they are not public good arguments. For instance, subsidising public transport changes the relative price and attraction of private and public transport. This reduces or removes a distortion in transport choices where there is no direct road pricing. However, subsidising public transport would not be economically justified if a more efficient means of pricing road space was in place.

Situating commercial structures at arm's length from direct political control is an important means of achieving economies of scale and scope in the case of utilities and improving incentives for more efficient operation, investment decision making and pricing. These structures could operate on a regional basis or serve larger areas. For example, some industry experts have suggested that three water utilities (two in the North Island and one in the South Island) may be optimal for New Zealand. Councils could retain ownership of these utilities although private sector involvement in various forms should not be ruled out. Public-private partnerships in utility operations are commonplace in many countries.

Categorising local services and drawing a line between public and private goods may be a difficult exercise at the margin. Even if services can be identified as non-rival and non-excludable, they can still be provided inefficiently if the funding mechanism used obscures the community's true willingness to pay.

As long as there is a reliance on revenue mechanisms that separate users of services from contributors to funding, there will be public debate about what goods and services to provide, how to provide them and who benefits from them. Councils do not have to provide a service simply because it is shown to have public good characteristics. Such provision is inefficient unless it passes a cost-benefit test and provides net social benefits.

### 6.3 The practice

The 2007 Local Government Rates Inquiry<sup>15</sup> considered that the Local Government Act 2002 had not resulted in an expansion of activity into new areas as the previous legislation also granted councils wide powers and discretion in promoting community well-being. The Local Government Forum has disputed this finding and argued that the Act, especially through its wider purposes section and the granting of powers of general competence to councils, has encouraged expansionary behaviour. The inquiry did find that local government planning needed more rigorous assessment, expenditures needed to be prioritised and more use of existing revenue tools was needed to improve the pricing of local services and reduce reliance on general rates.

Although councils may have greater discretion and powers because of recent changes to local government legislation, their greater activism has less to do with improving efficiency in local services than with favouring influential groups, including central

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<sup>15</sup> Local Government Rates Inquiry (2007), *Funding Local Government – Report of the Local Government Rates Inquiry*, [www.ratesinquiry.govt.nz](http://www.ratesinquiry.govt.nz) (last accessed October 2008).

government. If councils are tempted to pursue redistribution by targeting the deeper pockets of those who generate wealth disproportionate to their local voting power, they may eventually see the departure of productive activities and enterprising people that bring wealth to the locality.

Local government democracy, like its national counterpart, is not a costless activity, with its potential for long deliberations, indecision and delay. It is also, typically, weaker than national government in that voters often cannot identify candidates on the ballot paper, are unaware of candidates' policy views, do not have the benefit of close media scrutiny of council activities and have few ways of holding councillors to account for their decisions. Businesses, which pay around 50 percent of total rates, are particularly disenfranchised (and are thus often the target of rating differentials, which the Rates Inquiry recommended should be abolished).

There are more short-term political rewards in local government from spending than from not spending ratepayers' money. To restrain councils' expenditure, ratepayers need more in their toolbox than consultation processes and the three-yearly accountability at the ballot box.

Improving the connection between service costs and those that benefit would ensure council expenditure is more tightly scrutinised and more closely aligned with value to residents as expressed through their willingness to pay. It would reduce the cross-subsidies that may encourage businesses and residents to relocate to lower-rated areas. It would also focus attention on the changing boundary of local public goods as technology allows more direct charging for services provided.

There is also a case for stronger constitutional constraints on councils. Low-cost ways of minimising poor decision making could include influencing behaviours and structures at the local government level. Some constraints exist in legislation although they are not used effectively at present. These include alternatives to rates for charging and pricing of local services (as identified in the report of the Rates Inquiry) and the Local Government Act 2002 section 77 requirement for cost-benefit assessments to be made of decisions affecting the community.

Behavioural measures include such steps as:

- more consistently and frequently assessing the costs and benefits of major decisions to identify the likely net benefits, the public good element, and those who benefit and contribute;
- undertaking independent checks of the level of spending and value for money achieved from local public services in different council areas to compare their relative efficiency; and
- strengthening the role of the auditor-general or empowering an agency to evaluate completed local government activities and comment on adherence to process and the match between outcomes and expectations (providing a performance measure).

The Local Government Forum proposed a number of structural measures in the report *Democracy and Performance* (2007). These comprised:

- enumerating the core public good activities of local government in an amended Local Government Act. Other activities could be undertaken provided that more than a simple majority of ratepayers approved of such activities in a referendum;
- limiting the rate of growth of council operational spending to the rate of increase in population and inflation unless ratepayers approve higher increases in a referendum;
- abolishing business rate differentials; and
- applying stronger constitutional constraints to councils' regulatory activities so that regulatory taking of property results in appropriate compensation, as is the case with the taking of land under the Public Works Act.

Other possible constraints include:

- providing mechanisms for voter recall of decisions made by a council that have created more than a threshold level of dissatisfaction among voters (similar to the rights to stage public referenda on contentious issues found in Swiss cantons and US states); and
- prohibiting ratepayer subsidies, through grants or rates relief, to private commercial enterprises other than on valid public good grounds.



# APPENDIX: CATEGORISING COUNCIL ACTIVITIES

## Regulatory activities

- Resource management (plans and consents)
- Building consents and inspection
- Land transport planning
- Regional council discharge/activity consents
- Civil defence and emergency management
- Hazardous substances and biosecurity
- Public health and safety
- Public nuisances

## Provision and/or funding of activities

- Roading, footpaths and related services
- Storm water collection and disposal
- Waste water collection, treatment and disposal
- Water supply
- Rubbish collection and disposal
- Parks and recreation facilities
- Libraries, museums and galleries
- Public halls and venues
- Cemeteries and crematoria
- Public conveniences
- Flood protection
- Public transport
- Car-parking facilities
- Economic development and tourism promotion
- Community activities and housing







