SUBMISSION TO THE INTERNAL AFFAIRS AND LOCAL GOVERNMENT COMMITTEE

ON THE

LOCAL GOVERNMENT LAW REFORM BILL

NEW ZEALAND BUSINESS ROUNDTABLE

MARCH 1995

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Summary of Recommendations

Overview

Part I of the Bill is an excellent initiative for improving the focus of local government and its accountability to ratepayers. The New Zealand Business Roundtable (NZBR) supports all its important features.

The specific recommendations in this submission reflect two dominant concerns:

(1) the monitoring and enforcement aspects of the Bill are relatively weak; and

(2) most local authorities may not be able to comply with the Bill satisfactorily in the first few years. Transitional arrangements need to be carefully considered.

Our emphasis on strengthening these features of the Bill also reflects our view that it is desirable to allow local authorities to use risk management techniques to manage existing liabilities prudently rather than just at the time of borrowing.

A Financial Management and Borrowing and Security

Compliance Considerations

The NZBR recommends that the government makes a transitional task force or agency responsible for:

- ensuring that local authorities are aware of, and understand, the requirements of the Local Government Law Reform Bill (the Bill);

- monitoring, at least for a transitional period, the steps being taken by local authorities to comply satisfactorily with the requirements of the Bill;

- reviewing the first plans produced by each local authority under sections 122B-122K of the Bill and publicly reporting to the minister for local government and to the local authority on the areas in which those plans fall short of the required standard of compliance; and

- publicly recommending to the minister any steps which central government should take in order to improve the quality of compliance with the requirements of the Bill. This would include consideration of the need for ongoing monitoring and compliance arrangements beyond the transitional period.

Financial Delegations

The NZBR recommends that further thought be given to the need to better protect ratepayers, at least for a transitional period, against the risks of financial losses arising from either inadequate financial policies or inadequate policy implementation. The degree of financial discretion which should be exercised should be consonant with the ability of the authority to manage those discretions competently.

Local authority asset and liability, risk exposure and risk management plans could be required to be critiqued by an agency (such as the New Zealand Debt Management Office or an internationally-reputed credit rating agency) before they are put to the general public for submissions and approval. The reports from the relevant agency could then be published along with the vetted plans.

Authorities would not be permitted to implement their proposed liability management plans until they had passed public scrutiny. A more cautious approach would not allow liability management plans to be implemented unless they had been approved by a reputable authority as determined by the implementation agency suggested above.

Perhaps an exception could be made for authorities whose debt is already rated by a reputable rating agency – although requesting that agency to contribute an assessment of the initial liability management plan would still appear to be necessary in order to allow ratepayers to make a reasonably informed decision.

Regardless of the above considerations, the NZBR reiterates its earlier view that external monitors, for example credit rating agencies, should be utilised and councillors should be personally liable for reckless borrowing. Loan poll arrangements would be retained at least for a transitional period for local authorities which do not have an external credit rating.

In any case, the NZBR strongly recommends that the New Zealand Debt Management Office's views be requested on this matter and that substantial weight be put on them.

Fiscal Principles

The NZBR recommends that the principles in the proposed section 122B of the Act be respecified so that they cater for a wider range of circumstances. The NZBR recommends in this respect that the principles of financial management required under section 122B should be expanded so as to be more in accord with those embodied in the Fiscal Responsibility Act. In particular each local authority should:

- set a target for net worth which would provide an adequate buffer against adverse shocks and should specify in its long-term financial strategy statement its policies and timetable for achieving and maintaining that target;

- similarly determine prudent levels for its total liabilities and specify how those levels are to be achieved and maintained;

- comprehensively list its fiscal risks, including off-budget risks, and put in place policies for prudently managing those risks; and

- be required to have regard to policies which provide a reasonable degree of predictability and stability concerning local government tax burdens.

To assist local authorities to determine their optimal net worth and debt and to reduce the costs faced by external monitors, the Bill could be amended to require local authorities to set debt targets which are based on keeping their marginal cost of borrowing within some target margin above central government debt. The larger authorities could be required to have their term debt rated by a credit rating agency. All authorities with term debt could be required to publish each year information about their cost of borrowing relative to that of central government (or against a group of the highest rated local authorities). Where this information is not available, dealers in local authority debt could be surveyed (perhaps quarterly) for an expert opinion on the margin at which the authority's debt would have traded. The task of undertaking these surveys could be contracted out, for example to a rating agency or the Reserve Bank.

Core Activities

The NZBR recommends that subsection 122D(5)(b) be expanded so as to require the long-term financial strategy to state:

- the principles, or criteria, which the authority has used to determine the activities in which it engages;
- the reasons for any changes in those principles or criteria since the previous strategy statement, if there is one;
- the specific reasons, in terms of these principles or criteria, why the activities giving rise to the expenses listed in 122D(5)(b) are to be engaged in, incorporating an explicit discussion of the reasons for rejecting options involving a greater degree of user pays and/or private provision.

Other Recommendations

Section 122B(1)(a)

The NZBR considers that local authorities should primarily act in the interests of their ratepayers. It suggests that the words "in the interests of the district of the local authority or of its inhabitants and ratepayers" should be replaced by "primarily in the interests of the ratepayers of the district of the local authority".

Section 122D

The *long-term financial strategy* should identify any foreseeable build-up in capital expenditure and debt repayment obligations and require explicit policy statements on the major expenditure and revenue aggregate targets and the measures planned to achieve them rather than detailed 10-year forecasts in relation to each and every major activity.

Section 122F

This section should be renamed "Asset Management Policy" with consequential word substitutions throughout the section's subsections.

Specific provision should be made requiring local authorities to take urgent corrective action if debt reaches imprudent levels.

Section 122G

This section should be renamed "Liability Management Policy" with consequential word substitutions throughout the section's subsections.

Section 122O

Permitting local authorities to actively manage their liabilities would require allowing them to manage their risks continuously, rather than just at the time of borrowing. Changes in section 122O and in other sections may be required in order to confer this power on local authorities.

Section 122P

The prohibition on borrowing in foreign currency should be dropped from the Bill and section 122G should be amended to include a requirement to state the proposed foreign exchange exposure policy. Valid concerns about the degree to which local authorities might get into financial difficulty should be tackled by more general measures such as those discussed in section 3.1 of this submission.

Section 122Q

Lending of local authorities to LATEs should be permitted where the local authority can demonstrate that the terms are no more favourable than those which the LATE could obtain independently in the market place.

Registry Services

The Reserve Bank's registry services should not enjoy any special status (refer to the discussion in section 2 of this submission).

B Land Drainage and Water-Race Issues

The NZBR recommends that section 517J be clarified to make it explicit that adequacy of consideration is a factor which the Commission must consider and that section 517I which specifies the duties of local authorities be expanded to include a requirement to obtain and publish an independent valuation of valid proposals.

C Waste Management

The proposed subsection 538(2) in clause 15 of the Bill should be reworded to require each territorial authority to have "regard to the economic (including environmental) costs and benefits ... ".

Paragraph (a) in clause 19(1) of the Bill requires the relevant agency to ensure that minimum prices can be charged to consumers of water and sewerage services in the Auckland region. This minimum price formulation should be removed; prices should be set in accordance with the principles provided in section 122B.

All local authorities should be permitted to use water meters to recoup the costs of providing sewerage services, where this is the most efficient approach. A section clearly permitting this activity should be included in the proposed Part XXXI of the Act.

1 Introduction

This submission on the Local Government Law Reform Bill ('the Bill') is made by the New Zealand Business Roundtable (NZBR), an organisation of chief executives of major New Zealand business firms. The purpose of the organisation is to contribute to the development of sound public policies that reflect overall New Zealand interests.

The NZBR is taking a close interest in the activities of local authorities because of their size and significance. The spending, taxing, borrowing and regulatory policies of local authorities have a large effect on the economy and the welfare of the community. It is important that local government carefully identifies and efficiently performs its role in the economy. Reflecting this view, our submission addresses Part I of the Bill. Within this part, we focus particularly on clause 3 which will amend the Local Government Act 1974 ('the Act') by inserting new parts VIIA and VIIB covering financial management and borrowing and security issues.

Centralised decision-making is often inefficient because information is widely dispersed and is costly to collect. Thus the moves in the last decade to reduce the role of central government in decision-making through deregulation, privatisation and lower government expenditure.

By the same logic, the NZBR supports consideration of the scope for delegating greater autonomy to local authorities. Local communities may be in a better position to find local solutions to some problems than central government.

Local government, like central government, is potentially subject to principal/agent problems and the problems arising from voting behaviour. Thus elected governments and the agencies of government may put their own interests ahead of the interests of voters (their principals) and some groups of voters may be able to use the branches of government to benefit themselves at the expense of less organised groups.

The statutory framework within which local authorities operate is central to the establishment of incentives which promote efficiency and inter-generational equity. The proposed amendments to the Act should be evaluated from this perspective. The NZBR submitted its initial comments on the government's proposals to the Department of Internal Affairs on 28 October 1994. It welcomes the opportunity to make this submission directly to the select committee.

The NZBR supports the broad thrust of the proposals. The emphasis on greater transparency and accountability is welcome. We support the replacement of the Local Authority Loans Board by more decentralised, transparent and flexible borrowing arrangements and the concept of imposing new financial management requirements which incorporate principles of fiscal responsibility.

Greater delegation of authority to local authorities does not free central government from ultimate responsibility for the performance of local authorities. Local government is a creature of central government in New Zealand, as the powers of local government are only those conferred by parliament.[1] In the event that any local authority got into severe financial or other difficulties there would be great pressure on central government to act. An illustration of this point is the pressures on central government during the water shortage problem in Auckland in 1994.

Ratepayers may not be well placed to protect themselves against the financial risks arising from the greater delegation of financial management responsibilities to local authorities, particularly in the initial years when many ratepayers and their elected representatives may fail to appreciate the potential costs of management failure. They would seek redress from central government to the extent that they felt that central government had delegated authority without giving adequate consideration to the competence of all local authorities to cope with that level of responsibility.

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1 1994 Official Yearbook, page 38.

The Bill appropriately imposes significant disclosure and reporting requirements on local authorities. Local governments must prepare and publish a long-term financial strategy and funding, investment and borrowing management policies. Section 122B establishes some principles of financial management.

The proposals are generally well crafted and well thought through, but they demand a high level of sophistication from local authorities. This creates significant transitional risks for ratepayers and therefore potential political difficulties for central government. These difficulties are not such as to warrant any change to the thrust of the Bill, but they imply that central government must pay careful attention to compliance considerations.

The NZBR considers the Bill's approach to be weakest in respect of external monitoring and compliance arrangements. The NZBR supports the view embodied in the Bill that central government needs to mandate the powers of local authorities in a manner which efficiently balances the benefits of decentralised decision-making and the risks of sub-optimal outcomes from principal/agent and voting behaviour problems. Determining how prescriptive an approach is optimal requires a careful balancing of the potential costs and benefits of alternative constraints.

Section 2 briefly reviews the Bill in the context of the NZBR's initial comments on the earlier proposals. Section 3 comments on the proposals in clause 3 of the Bill. Section 4 comments briefly on other sections in Part I of the Bill.

2 Review of the NZBR's Earlier Recommendations

The NZBR's 28 October 1994 submission to the Local Government Group of the Department of Internal Affairs on the proposed legislative provisions relating to local authority borrowing and financial management supported the general thrust of the proposals and suggested modifications to specific provisions. In particular, the submission:

(1) cautioned that the *cost-benefit analysis* requirement not be made unduly onerous;

(2) suggested that the drafting of the requirement for *adequate financial and accounting provision* for expenditures should be related to the costs of meeting such needs;

(3) questioned a number of aspects of the requirement for a *balanced budget* on a year-by-year basis - for example, surpluses might be appropriate when debt is excessive and economic cycles might lead to deficits in some years and surpluses in others;

(4) opposed proposals drafted around the concept of *speculation*;

(5) suggested that the *long-term financial strategy* might require an estimated balance sheet for each forecast year, but that requiring a *detailed* 10-year plan every three years might be too onerous. It also argued that the focus should be on identifying any foreseeable build-up in capital expenditure and debt repayment obligations and on requiring explicit policy statements on the major expenditure and revenue aggregate targets and the measures planned to achieve them;

(6) suggested strengthening the use of external monitors, for example through the use of *credit rating agencies*;

(7) recommended specific provisions in respect of *debt reduction* where debt is too high;

(8) questioned the consistency of prohibiting local authorities from borrowing in foreign currencies;

(9) suggested that any *lending of local authorities to LATES* should be at commercial rates;

(10) favoured retaining *loan polls* if mandatory credit rating or similar external monitoring arrangements are not put in place;

(11) recommended that elected officers should be *personally liable* for reckless borrowing and that consideration should be given to requiring the chairperson and chief executive to include a signed statement in the annual report that all statutory requirements relating to borrowing and financial management have been complied with; and

(12) recommended against conferring special status on the *Reserve Bank's registry* services.

In January 1995, the NZBR published *Local Government in New Zealand*. This report provided an overview of economic and financial issues and reiterated many of our October 1994 comments.

The Bill now under consideration largely or entirely meets the NZBR's concerns in respect of (1), (2), (4) and (10). In respect of point (11), the personal liability provision has not been taken up, but the concept of a compliance statement has been accepted in clause 122K of the Bill.

We have not changed our views in respect of the suggestions made in (3), (5), (6), (7), (8), (9) and (12) above.

In respect of personal liability, the NZBR is struck by the disparity between the personal liability exposure of company directors and the dropping of the earlier proposal to hold a member of a local authority personally liable for up to $10,000 where a Court decides that the member acted recklessly in approving loans. There are good grounds for imposing sanctions on those who act recklessly and the penalty proposed was not a high one. This provision could be reinstated, but there are grounds for going further. Under the Companies Act 1993, directors may be personally liable for losses incurred through reckless or negligent trading leading to insolvency, or if a company that is insolvent continues to trade. It could be argued that councillors should face personal liability for unauthorised expenditure or neglect of statutory duties equivalent to that borne by company directors.

The issue of personal liability of councillors for reckless actions does not arise solely in respect of borrowing activities and consideration should be given to addressing this issue through the Public Finance Act 1977 as part of the ongoing reform of local government.

In 1989 section 66 of the Local Authority Loans Act, which made the Reserve Bank the registrar of all local authority loans raised by the issue of stock, was repealed and replaced by a requirement that each local authority appoint a person to be the registrar of stock issued by that authority. However, other legislative provisions (for example, sections 66, 80 and 84 in the Local Authority Loans Act, sections 81 and 84 in the Public Finance Act and section 35 in the Reserve Bank Act) arguably undermine the clear intent of government policy to remove any special status enjoyed by the Reserve Bank.

3 Financial Management and Borrowing and Security Issues

3.1 Compliance and Enforcement Considerations

As illustrated in the following table, the Bill has many features in common with the Fiscal Responsibility Act ('the FRA'), but there are also some significant differences.

Comparison of the Fiscal Responsibility Act and the Local Government Law Reform Bill

Requirement	Fiscal Responsibility Act	Local Government Law Reform Bill
1. Regular, explicit reporting	4 (Annual & 6 Monthly)	4 (Annual only)
2. Prescribes Benchmarks	4 (5 principles)	(Prudent debt, operating balance)
3. Parliamentary Review	4	6 (No equivalent)
4. Compliance Statements	4 (Ec. & Fiscal Update)	4 (Annual Report)
5. Pre-Budget Strategy Statement	4 (Budget Policy Stat't)	6
6. Annual Self-Evaluations	4	4
7. Semi-annual Evaluations	4 (Ec. & Fiscal Update)	6
10. Two-Yr Projections	4 (Ec. & Fiscal Update)	4 (Annual Report)
11. 10-Yr Projections	4 (Fiscal Strategy Report)	4 (Long-Term Financial Strategy)

Differences are notable in respect of the prescribed benchmarks (row 2 in the table) and in the absence of any equivalent to the parliamentary review and scrutiny of local government statements (rows 3 and 5). Section 3.2 discusses the benchmark differences.

The remainder of this section considers the implications for the likely effectiveness of the proposed measures in the absence of parliamentary scrutiny and in the light of other significant differences in constraints applying to central and local government. To be effective, the provisions in the Bill must be observed by all local authorities. This raises questions of competence to observe the Bill's provisions; monitoring and enforcement mechanisms; and incentives. Related questions arose in respect of the FRA.

Conceptually, the Bill follows the FRA quite closely in that both presume that the required level of competence to comply can readily be achieved and rely for their efficacy on the disciplines imposed by public disclosure and precedent. The FRA is not entrenched and contains no penalties for

inadequate compliance. However, the existence of a parliamentary opposition and the relatively intense media attention given to central government probably ensures that a reduction in the quality of compliance would attract considerable public attention.

Competence and Independence

In respect of the FRA, there could be little doubt about the ability of the Treasury and the minister of finance to comply competently with the FRA's requirements in respect of judgments about prudent levels of debt, cost-benefit analysis and financial management. In respect of advice concerning the role of government, the Treasury is clearly independent of spending departments and has a long tradition of giving advice to politicians which may conflict with the advice of those departments. This independence ensures that politicians receive accountable and contestable advice concerning matters such as which activities should properly be undertaken by the government.

Local government will, however, have less economic expertise than the Treasury and will generally not be as technically competent to perform such functions as cost-benefit analyses of proposals or to provide advice on the prudent level of debt. While expertise can be hired on such matters, local government officers need to be able to assess the quality of the expertise hired.

At the technical level, local government advisers will need to understand the distinctions between a commercial analysis and a national cost-benefit analysis and to balance the risks of market and government failure. Considerable confusion could arise in respect of the economic analysis of the costs and benefits of various options. Two examples: employment generated by a project is a cost, not a benefit, in the standard national cost-benefit analysis; and a dollar of housing assistance for a target group paid for out of general rates is a transfer rather than a cost to ratepayers or a benefit to the target group. In economic terms, a transfer is neither a cost to ratepayers nor a benefit to the recipient. The economic cost of a transfer is measured by the direct compliance and administrative costs and by the so-called deadweight costs which arise from the way in which it distorts behaviour and induces wasteful rent-seeking activities.

Designing prudent liability management procedures may also be a highly technical task if a local authority's treasury department is given the ability to alter the risk structure of the authority's balance sheet. It is crucial that councillors and management understand the need for very prudent policies, rigidly-enforced management controls and the employment of competent staff if financial disasters are to be avoided. There are potentially major risks here for local authorities – as the Orange County fiasco illustrates.

In central government, the New Zealand Debt Management Office is well aware of the importance of these factors; no comparable centre of expertise resides in local government. We understand, for example, that the quality of the early response of local authorities to the 1989 Act which required local authorities to consider cost of capital issues was decidedly mixed. Some approached accountant advisers who treated it as an accounting rather than an economic issue. In this case we understand that the Audit Office was able to detect the problem and assist some local authorities to understand it as an economic issue.

While local government may well achieve the required standards of analysis and assessment in time, the delay could be costly if it takes some financial disaster to alert ratepayers to the potential for things to go wrong. Thought should be given to arrangements which could reduce such costs without unduly losing the benefits hoped for from decentralisation. In section 3.2 we make some suggestions as to how central government may be able to assist local authorities to set prudent targets for their debt and net worth.

Monitoring and Enforcement

Elected office-holders in both central and local government are constrained in many ways by laws and regulations. For example, audit and disclosure requirements expose elected officials to scrutiny by the media and the wider public and decisions may be subject to judicial challenge.

Such similarities should not be allowed to obscure consideration of the significant differences between the constraints facing central and local governments. Local authorities are compelled to hold council meetings in public. Notwithstanding its positive aspects, this feature may create a politicised environment in which it is difficult to analyse contentious matters (such as the proper scope of local authority activities or the appropriate policy on risk management techniques) objectively. Local government councillors do not face the considered scrutiny of a full-time official opposition. Nor does local government provide the same opportunities for intense nation-wide media and select committee scrutiny as occurs in central government. Select committees allow elected politicians, including opposition MPs, to cross-examine those who have made public submissions, officials, and even the proposing minister, and they report back to parliament rather than to the governing elected officers.

Central government is also intensely monitored by financial markets and by rating agencies. The very liquid markets in government bonds and the New Zealand dollar rapidly convey information to the wider public about the market's changing assessment of New Zealand's economic prospects and the quality of the government's policies.

The proposals currently embodied in the Bill do not appear to give adequate consideration to the greater risks of inadequate compliance which appear to arise from the above considerations. In the NZBR's view this omission is a potentially serious threat to the Bill's efficacy. We have put considerable thought into identifying practicable and realistic options for reducing this threat.

Options for Improving Outcomes

Outcomes from the Bill are likely to be improved if, during the implementation stage, processes are put in place to:

(1) assist local authorities to determine the standard of analysis which is necessary in terms of such technical areas as cost-benefit analysis (subsection 122B(1)(b))) and the standard of competence which must be achieved in respect of risk analysis and management of investment and borrowing policies;

(2) encourage local authorities to ensure that they have a core of staff who are competent in the required skills; and

(3) monitor and review the performance of each local authority in meeting the requirements of the Bill, at least during the learning stages.

Clearly it would be efficient for individual local authorities to pool resources in obtaining assistance in the technical analysis of these issues. Staff training, recruitment and the preparation of manuals could be necessary. Much of the technical expertise in these matters is in central government departments and it may be efficient for local government to tap into that expertise.

The NZBR strongly recommends that the government make a transitional task force responsible for:

- **ensuring that local authorities are aware of, and understand, the requirements of the Bill;**

- **monitoring, at least for a transitional period, the steps being taken by local authorities to comply satisfactorily with the requirements of the Bill;**

- **reviewing the first plans produced by each local authority under sections 122B-122K of the Bill and publicly reporting to the minister for local government and to the local authority on the areas in which those plans fall short of the required standard of compliance; and**

- **publicly recommending to the minister any steps which central government should take in order to improve the quality of compliance with the requirements of the Bill. This would include consideration of the need for ongoing monitoring and compliance arrangements beyond the transitional period.**

One option would be to locate the task force within the Department of Internal Affairs, since this department is responsible for Vote: Local Government. Probably Internal Affairs would need to assemble a task force incorporating the necessary expertise for the role envisaged. This could be inter-departmental in nature and could involve an outside consultant. Consideration should be given to the powers of inquiry that should be provided to the department in respect of this monitoring role.

Making the Department responsible for managing the transition is not the only option and the NZBR does not have a firm view about the optimal institutional arrangement.

In undertaking this implementation, monitoring and reporting role, the task force would liaise with the Audit Office which would have an ongoing role of reporting on the degree to which individual authorities have complied with the Bill.

One important role for this implementation agency would be to ensure that local authority asset and liability risk exposure and risk management plans are critiqued by a reputable agency (such as the New Zealand Debt Management Office or an internationally-reputed credit rating agency) before they are put to the general public for submissions and approval. The reports from the relevant agency could then be published along with the vetted plans. A more cautious approach would be not to allow liability management plans to be implemented unless they had been approved by a reputable authority as determined by the suggested implementation agency. Perhaps an exception could be made for authorities whose debt is already rated by a reputable rating agency – although requesting that agency to contribute an assessment of the initial liability management plan would still appear to be necessary in order to allow ratepayers to make a reasonably informed decision.

Our concerns arise here in part because the proposed subsection 122O(1) permits local authorities to enter any arrangement or contract in connection with the borrowing of money. This allows local authorities to use derivatives and other arrangements to manage their risks at the time of borrowing. Borrowing is defined in section 122M, and appears to refer to the act of borrowing rather than to the subsequent management of existing borrowings. However, there is a clear incongruity in allowing the use of risk management arrangements at the moment of borrowing, but not allowing those arrangements to be subsequently modified and managed in the light of changing circumstances. The NZBR favours allowing local authorities to take full responsibility for liability management, subject to tighter arrangements for vetting plans and reducing the risk that local authorities will confer more discretion on staff to actively manage financial risks than is warranted by the quality of their management control systems.

Some of the disclosure requirements suggested in the next section for assisting external monitors to assess the appropriateness of local authority net worth and debt adequacy would serve to increase the disciplines applying to local authorities.

3.2 Statement of Fiscal Principles

As indicated in the above table, the Bill requires local government to maintain debt at prudent levels in accordance with its borrowing management policy (subsection 122B(1)(e)) and to ensure that operating revenues cover identified operating expenses (subsection 122B(1)(f)), subject to the exceptions listed in 122B(2). These two principles were incorporated into one in the FRA.[2] In addition, the FRA set out four further principles, namely that:

- debt be reduced to prudent levels;
- net worth be moved to, and subsequently sustained at, a level which would provide a buffer against future adverse shocks;
- fiscal risks be managed prudently; and
- policies be consistent with a reasonable degree of predictability about the future level and stability of tax rates.

Generally local government balance sheets are far stronger than the Crown's. This may explain the omission from the Bill of the first of the principles listed above. However, the principle that operating revenues cover operating expenses implies that local government net worth is not currently larger than is optimal. We consider this issue below.

Sections 122F(2)(c) and 122G(3) of the Bill incorporate risk management concerns in respect of investment policy and borrowing management policy respectively. This is a narrower risk management specification than that embodied in the FRA.

In our view more thought needs to be given to the statement of fiscal principles embodied in the Bill. Critical issues for central and local government are:

(i) what are the proper activities of local government?;

(ii) which assets should be owned by local government or its agencies?; and

(iii) how should those assets be funded?

In considering these issues it is important to be aware that local government is in a stronger position financially than central government. Currently local government is characterised by relatively low levels of debt in relation to very significant and diverse assets. Debt dropped 38 percent in real terms in the 13 years to 1988. Local government net worth is currently around $26 billion while total assets are approximately $30 billion. In contrast total assets for central government were $56 billion at 31 December 1994 against total liabilities of $59 billion.

While being a welcome contrast to excessive Crown indebtedness, the view that debt is currently too low must be considered. For example, the president of the New Zealand Local Government Association commented in 1994 that:

> Given the intergenerational benefits in such local government assets such as roads, sewage, and water systems and institutional buildings (art galleries and museums) and the fact that they average 70-80% of asset values in the accounts, local government debt can be described as far too low.

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[2] The principle stated in section 4(2)(b) of the FRA required that prudent levels of debt, once achieved, be maintained by ensuring that over reasonable periods of time the total operating expenses of the Crown do not exceed its total operating revenues.

The asset rich nature of local government is also indicated by the simple calculation that, at a 10 percent cost of capital, the capital charge on an equity investment of $26 billion would, at $2.6 billion, be over 3 percent of GDP. Total local government spending is around 3 percent of GDP. If local authorities were to undertake a programme of privatisation and wider use of user charges, perhaps in conjunction with contracting out or franchise arrangements, the result would be very large free cash flows. Such cash flows would create well-recognised incentive problems.

The Bill will rightly require local authorities to explicitly consider their optimal level of debt. This is a complex matter to address. The current low levels are not necessarily optimal and no doubt reflect a combination of factors – past funding constraints, the effect of inflation on the real value of the debt, a period of relatively low spending on infrastructural assets, the release of cash from special funds as part of the restructuring in recent years and the use of some of that cash to repay debt, and cash received from the sale of works divisions and properties.

To illustrate the first factor, local authorities could only borrow for infrastructural assets for a finite term, which was often much shorter than the economic life of the asset. Once that term was up the loan had to be repaid. In the absence of a rigorous accrual-based user-pays charging system, such a situation could cause local authorities to rate and/or charge too heavily early in the life of new infrastructure, so as to ease the cash flow problems associated with heavy loan repayments, and to rate or charge too lightly when debt repayment burdens were low. Charging too low a price for the service towards the end of its economic life would inflate demand and could induce uneconomic, premature investment in additional capacity.

Conceivably the response by local government to the Bill would be to increase user charges and asset sales and to seek to borrow to fund new capital projects. The net funds generated could be used to expand local government expenditures – or to reduce rates with the net effect of returning net worth to ratepayers. The latter option could mean running an operating deficit on an accrual basis which was funded by asset sales and increasing debt, until net worth and total assets had been reduced to optimal levels. Such a response would violate the proposed section 122B(1)(f) of the Act. If so, this section would inhibit an optimal reduction in the size of the local government sector.

The NZBR has criticised local authorities in recent years for investing in questionable activities, such as the ownership of car park buildings, and for being slow to sell assets and reduce rates. At the same time it has supported the greater use of user pays mechanisms so as to reduce the likelihood of premature investments in additional capacity.

For these reasons it seems particularly undesirable to impose on local government a requirement that it run operating surpluses when ratepayers may prefer that net worth held in the local government sector be reduced. Rather than prejudge the issue of optimal net worth in each local authority, **the NZBR recommends that the principles in the Bill be respecified so that they cater for a wider range of circumstances. The NZBR recommends in this respect that the principles of financial management required under section 122B should be expanded so as to be more in accord with those embodied in the FRA. In particular each local authority should:**

- **set a target for net worth which would provide an adequate buffer against adverse shocks and should specify in its long-term financial strategy statement its policies and timetable for achieving and maintaining that target. Clearly this would imply fiscal balance over the economic cycle once the target level had been achieved;**

- **similarly determine prudent levels for its total liabilities and specify how those levels are going to be achieved and maintained;**

- **comprehensively list its fiscal risks, including off-budget risks, and put in place policies for prudently managing those risks; and**

- **be required to have regard to policies which provide a reasonable degree of predictability and stability concerning local government tax burdens.**

Local authorities may not find it easy to determine their optimal net worth and debt once the borrowing traditions and habits associated with the Local Authority Loans Board are removed. These are complex issues about which experts might disagree. It would be a great pity if the removal of the statutory constraints which have existed for over a hundred years saw a move in the next decade or two to excessive levels of indebtedness and/or an unjustified expansion in local authority activities.

Given the difficulties which local authorities could face in determining optimal debt levels, some guidance from central government could reduce transitional costs and the risks of excessive indebtedness. For example, central government could assist local authorities to determine their optimal debt burden, at least initially, by requiring them to set debt targets which are based on keeping their marginal cost of borrowing within some target margin above central government debt. The larger authorities could be required to have their term debt rated by a credit rating agency. All authorities with term debt could be required to publish each year information about their cost of borrowing relative to that of central government (or against a group of the highest rated local authorities). Where available this information might be the spread above government stock at which the authority's debt traded during the year on the secondary market. Commonly the market in an individual authority's debt will be too thin for this purpose, in which case dealers in local authority debt could be surveyed (perhaps quarterly) for an expert opinion on the margin at which the authority's debt would have traded. The tasks of undertaking these surveys could be contracted out, for example to a rating agency.

3.3 Core Activities

The NZBR remains concerned by the tendency of local authorities to neglect core activities and to undertake risky investments in peripheral activities. For example, many would regard core responsibilities of local government as being to ensure that the local community has adequate roads, water supplies and waste disposal services. Yet there is considerable evidence that local authorities find it difficult to avoid pollution of our beaches by sewerage and to maintain urban sewer, drainage and reticulated water pipeline networks adequately. Water supply loss rates are high in some places and it is clear from the Wellington and Auckland experiences with sewage treatment and water supply respectively that local authorities find it difficult to make major capital expenditure decisions. At the same time, local authorities appear to be constantly exposed to pressure to engage in fiscally risky extraneous activities for town planning, employment, tourist or business promotion purposes.

For this reason the NZBR welcomes the many features in the Bill which will assist local authorities to determine their proper sphere of activities and to resist pressures to spread themselves too widely. These features include:

- subsection 122B(1)(d) of the financial management section which establishes important user-pays principles. This should reduce the incentives of narrow groups of ratepayers to lobby for council expenditures on activities in the hope that the costs will be spread more widely than the benefits;

- subsection 122D(5)(b) of the three-yearly long-term financial strategy which requires local authorities to provide the reasons for an activity;

- subsection 122E(2) which requires the proposed allocation of costs across groups to be detailed for each separate function as part of the funding policy statement in each annual report. This supports the user-pays principles listed above;

- subsection 122F(3)(b) which requires any policy of the local authority on its investment mix to be included in its investment policy statement which must be outlined in each annual report; and

- subsection 122J(2) which requires variations between plan and outcome to be explained in each annual report.

The NZBR considers that these provisions should be strengthened. Local government bureaucracies are likely to have an inherent bias in favour of local government provision. To the extent that those bureaucracies do not embody significant commercial expertise, they will find it difficult to determine the extent to which private provision could genuinely add value. Specifying the contracts for private provision could be time-consuming, even though it would be beneficial. These information and incentive problems create a conflict of interest for local authorities between their interests as providers and their responsibility to ensure that the community gets the optimal quantity, quality and reliability of services at least cost.

Central government has recognised this conflict by requiring local authorities to give explicit consideration to competitive provision. The NZBR supports this approach, while recognising that it needs to be balanced by due recognition that in some areas (for example, perhaps in respect of small, isolated rural communities) local authority provision may be the most efficient and that disclosure provisions, if taken too far, could undermine the commercial competitiveness of a government-owned entity.

The NZBR does not favour any attempt to define within the Bill the list of core activities which should properly be within the domain of local government. The scope for greater private sector involvement is now more widely appreciated but opinions on its applicability are still evolving. It would be premature to attempt to prescribe the appropriate balance between government and private sector provision. However, it is very important that local authorities are clear about the appropriate role for local government.

For this reason the NZBR recommends that a more explicit direction to this effect should be incorporated in the Bill in order to further induce local authorities to define their core activities for themselves and to constrain them from too readily indulging in extraneous activities. This could be achieved by an additional clause in section 122B on fiscal principles and/or by an additional clause in section 122D on the long-term financial strategy. The three-year financial strategy document provides a reasonable opportunity for local authority representatives to review their existing activities to determine if they are still a valid local government function.

We recommend that subsection 122D(5)(b) be expanded so as to require the long-term financial strategy to state:

- **the principles, or criteria, which the authority has used to determine the activities in which it engages;**

- **the reasons for any changes in those principles or criteria since the previous strategy statement, if there is one;**

- **the specific reasons, in terms of these principles or criteria, why the activities giving rise to the expenses listed in 122D(5)(b) are to be engaged in, incorporating an explicit discussion of the reasons for rejecting options involving a greater degree of user pays and/or private provision.**

3.4 Funding Considerations

The NZBR strongly supports the user-pays principles embodied in section 122B(1)(d) and applied in section 122E on funding policy. The business community has long been concerned about the lack of a sound basis for determining the balance between rates levied on residences and rates levied on businesses. Often discussions on this point do not appear to distinguish carefully between benefits which accrue to employees or customers of a business and the benefits which accrue to the owners of the business. These provisions should do much to oblige local authorities to clarify their thinking on this important issue.

3.5 Other Considerations

Section 122B

Subsection 122B(1)(a) requires every local authority to act "in the interests of the district of the local authority or its inhabitants and ratepayers". This phrase invites confusion. Only people have interests; districts do not have disembodied interests. In terms of people, the clause invites confusion as to how local authorities should trade-off conflicts between ratepayers and individuals. Ratepayers are the residual risk bearers in relation to local government activities. When a local government makes commitments it makes those commitments on behalf of ratepayers. Therefore it must hold itself accountable primarily, if not solely, to ratepayers for any decisions it takes with potential financial consequences for ratepayers.

We recommend that the words "in the interests of the district of the local authority or its inhabitants and ratepayers" be replaced by the words "primarily in the interests of the ratepayers of the district of the local authority".

Section 122F

This section should be renamed "Asset Management Policy" with consequential word substitutions throughout the section's subsections.

Section 122G

This section should be renamed "Liability Management Policy" with consequential word substitutions throughout the section's subsections.

A critical point in relation to the requirements of sections 122F and 122G is what management controls and processes are put in place to ensure that policy is rigidly adhered to – and to take corrective action in the event that these arrangements fail. The less able is an organisation to understand, monitor and control its liability and investment exposures, the more conservative should be its operating restrictions. This point was discussed more fully in section 3.1.

Section 122O

Permitting local authorities to actively manage their liabilities would require allowing them to manage their risks continuously, rather than just at the time of borrowing. Changes in section 122O and in other sections may be required in order to confer this power on local authorities.

Section 122P

The prohibition on borrowing in foreign currency is inconsistent with optimal risk management considerations and with the general philosophy of the Bill. Nor are foreign currency exposures notably more risky than other instruments in which local authorities could borrow and invest. **This section should be deleted from the Bill and section 122G should be amended to include a**

requirement to state the proposed foreign exchange exposure policy. Valid concerns about the degree to which local authorities might get into financial difficulty should be tackled by the more general measures discussed in section 3.1.

Section 122Q

The intent behind the prohibition on local authority lending to LATEs is laudable to the extent that LATEs should not be permitted to derive a competitive advantage on the basis of a local authority's coercive powers of rating. However, the proposals are likely to be difficult to enforce in practice since they will require debt to be distinguished from equity. There is a further problem that equity may be invested in LATEs on a non-commercial basis.

On balance the NZBR considers that this prohibition should be replaced by a requirement that all funds invested by local authorities in LATEs should be charged for on a full commercial basis which is commensurate with the risk class of that investment. Possibly an independent opinion could be required on that point.

Section 122V

Loan polls are an accountability mechanism which should be retained, at least as a transitional measure, given the weakness of the monitoring and compliance mechanisms currently in the Bill.

Sections 122ZE and 122ZF

These sections require both local authorities and the registrar of companies to maintain a register of charges over local authority assets. The case for this duplication of expenses is not clear.

4. Comments on Other Clauses in Part I of the Bill

Land Drainage and Water-Race Schemes

Clause 14 of the Bill provides for the transfer of land drainage and water-race schemes from local authorities. Users who account for at least 75 percent of the rateable properties serviced by a drainage or water-race scheme may petition to have that scheme's assets and liabilities transferred to them.

The NZBR supports the thrust of these provisions which allow local authorities to divest themselves of an activity which may be undertaken more efficiently by those who are most directly affected.

However, the current provisions in the Bill do not appear to adequately protect ratepayers against the risk that these schemes could be transferred to existing users too cheaply. No tender mechanisms or bargaining process appear to be envisaged. Section 517J does not give ratepayers the right to object on financial or any other grounds – only other users of a local authority can object. Even if the local authority does object on the grounds of price, none of the four criteria provided in section 517S which the Local Government Commission must use to determine the issue is explicitly financial. Possibly criterion (b) which requires the Commission to consider the likely effects of any transfer on any local authority could come under this heading, but it is surely too vague to constitute adequate protection for ratepayers.

Normally when valuable assets are being transferred in a non-arms-length, non-contestable transaction an affected party would request an independent valuation of the assets being transferred. The publication of such a valuation would inform public debate and increase public confidence in the integrity of the process.

The NZBR recommends that section 517J be clarified to make it explicit that adequacy of consideration is a factor which the Commission must consider and that section 517I which specifies the duties of local authorities be expanded to include a requirement to obtain and publish an independent valuation of valid proposals.

Waste Management

Clause 15 of the Bill inserts a section 538(2) into the Act which requires each territorial authority to have "regard to environmental and economic costs and benefits for the district's inhabitants". Economic costs should encompass all costs, so this terminology could cause confusion.

We suggest that this be reworded to require each territorial authority to have "regard to the economic (including environmental) costs and benefits for the district".

Paragraph (a) in clause 19(1) of the Bill requires the relevant agency to ensure that minimum prices can be charged to consumers of water and sewerage services in the Auckland region. It is not clear what is meant by minimum prices, but this section could conflict with the user-pays principles provided in section 122B. Clearly the latter principles are to be preferred.

All local authorities should be permitted to use water meters to recoup the costs of providing sewerage services, where this is the most efficient approach. A section clearly permitting this activity should be included in the proposed Part XXXI of the Act.

5. Concluding Comments

Part I of the Bill is an excellent initiative for improving the focus of local government and its accountability to ratepayers. The NZBR supports all its important features.

In the previous sections of this report we have identified many areas in which we believe the Bill can be improved. These sections reflect two dominant concerns:

(1) the monitoring and enforcement aspects of the Bill are relatively weak; and

(2) most local authorities may not be able to comply with the Bill satisfactorily in the first few years.

The Bill rightly requires a high level of sophistication from local authorities. It requires them to assess the rationale for getting involved in activities and to determine the proper basis for funding activities, prudent balance sheet ratios and sound risk management strategies. The last will require a sophisticated understanding of the problems of management control.

As such the Bill is likely to eventually require local authorities to significantly upgrade staff skills in these areas. This will take time. Ratepayers could be at risk during the transitional period and central government, having created this situation, must give it due consideration in advance.

In our view the transitional risks are sufficiently high as to warrant setting up transitional arrangements which will reduce those risks and assist local authorities to achieve a satisfactory standard of compliance with the Bill's provisions from the outset.