



**Reading Room:** [Local Government](#)

# Local Government Into The Future

## *An Overview*

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### Introduction

My brief for this paper is to give a personal overview of the future of local government. In doing so I have been asked to consider a number of specific issues including the legislative framework, ownership, regulatory powers, rating, infrastructure and the role and functions of local government.

Such an overview is timely. Local government is coming under more scrutiny, from more directions, than at any time since the 1989 reforms. The major initiatives underway include:

- Scenarios for local government to 2010; a joint venture between government and local authority organisations to bring local government into the *foresight project* which is developing a set of scenarios for New Zealand as a whole.
- Revision of the Resource Management Act.
- Rooding reform with a discussion paper to be released at the Local Government New Zealand rooding seminar on 8 December.
- A first principles review of water and wastewater.
- A rewrite of the Rating Powers Act
- The Local Government Forum is about to release a major discussion paper on the role and functions of local government entitled "Refocusing the Role of Local Government"

Central government is experimenting with greater involvement of local government in co-ordination and, possibly, delivery of social services through initiatives such as "Strengthening Families". The Inland Revenue Department is yet again rewriting the definition of Local Authority Trading Enterprises as part of an attempt to protect the revenue against the opportunities for creative tax planning which exist when the same group is a mix of taxable and essentially non taxable entities.

Central to all of this activity is what the role and functions of local government should be. Resolving this, as we shall see, is far from being an easy task. It will, however, be the main theme of this paper with the detail of specifics such as rating powers, ownership, legislation and so on used for illustrative purposes rather than treated as themes in their own right.

## Constitution

I begin with the constitutional position of local government. New Zealand lacks both a written constitution and any coherent expression of the relationship between central government and local government.

Historically, local government evolved for quite pragmatic reasons, principally to help meet the infrastructure and service needs of newly established European settlement. Local authorities in various guises (roads boards, counties, boroughs, cities) evolved to handle core local services - primarily roading in rural areas with the add on of water and wastewater, street lighting and recreational and cultural services in larger settlements.

The somewhat ad hoc nature of the way local government developed was in the wide range of special purpose authorities which grew up over the years including harbour boards, drainage boards, power boards, pest destruction reserve boards and a number of others.

The 1989 reforms sought both to impose a degree of rationality on local authority structure and, for the first time, set out a general statement of the purposes of local government. Section 37K, which was inserted in that year, declares the purposes of local government as including such things as:

- Recognition of the existence of different communities in New Zealand.
- Recognition of the identities and values of those communities.
- Scope for communities to make choices between different kinds of local public facilities and services.
- Recognition of communities of interest.

Debate continues as to whether local government is simply a creature of central government or whether it should be treated as having an independent existence of its own.

The formal legal situation is that local government owes its existence to statute and Parliament has the theoretical power, at any time to amend that statute. However, the same could be said of limited liability companies which also can only exist because of the provisions of the Companies Act which, again, Parliament can change whenever it sees fit.

An alternative way of looking at local government is to regard it as an expression of the collective will of the community facilitated by statute and with somewhat more restrictive provisions than, for example, the Companies Act because local authorities have the power to tax. But even this power should not be seen as necessarily implying that local government is purely subsidiary to central government. Central government has also passed the equivalent of taxing powers to commercial interests where the same free rider and transaction cost issues as justified giving taxing powers to local authorities arise. The best known example is the Commodity Levies Act.

Both for companies and for local authorities the role of Parliament can be seen as one of facilitating collective endeavour through the provision of the needed legislative framework, with no necessary implications that the resulting bodies are merely creatures of statute.

The debate is an important one. To assert that local government is no more than creature of statute existing at the whim of Parliament is to assert that decisions local issues are properly the domain of Parliament simply devolved for the time

being as a matter of convenience.

To take the alternative view, that local government is an expression of the collective purpose of providing a means for the community (at least in the geographic sense) to address issues of common concern is to recognise that the locus of decision making, together with the question about what kinds of decisions on what kinds of issues, properly belongs at the local level and that central government's role is to facilitate this including (as with the company example) ensuring a proper degree of transparency and accountability and a clear definition of the rights and responsibilities of the parties involved with or effected by local government.

## Legislation

As most of this audience will know, this confusion is amply reflected in local government legislation including both the Local Government Act and the Rating Powers Act. Large parts of both of these Acts are highly prescriptive. They read as though they represent explicit devolution to local authorities of a narrow power handed over on the presumption that, unless it is very carefully detailed, local authorities are likely to abuse the power they have been given. A good example from the Local Government Act is the power to lend money or provide guarantees for housing.

Thus, section 563 of the Act authorises a council, where any person approved by it is desirous of erected or purchasing or improving or converting a house upon land... to advance money to a financial institution for on-lending to that person. The institution must lend at least two thirds of the value of the house and land and the borrower contribute at least 10%. The council's advance is limited to 25%. Repayments of interest and principal received by the financial institution are to be apportioned between it and the council as the two may agree. Effectively the section authorises a council to provide the equivalent of a second mortgage but through the medium of a first mortgage held by a financial institution.

Section 564 gives a council power to guarantee a loan from a financial institution for the purpose of purchasing or erecting or improving or converting a house. Again the borrower must contribute at least 10% and the financial institution's loan must be not less than two thirds of value. The council's guarantee is limited to one third of the total principal monies and once again application of any monies is a matter of agreement between the council and the financial institution.

Section 565, "for the purpose of enabling any person to obtain funds required by that person for the erection or improvement of residential flats or the conversion of any building into residential flats", gives the council power to guarantee repayment of part or whole of the money borrowed and of any interest. In contrast to the provisions dealing with housing, there are no limits on amounts as a proportion of value and the loan may come from any source, not simply from a "financial institution".

On the other hand, other parts of the Act are extremely wide in their drafting. They reflect the more purposive approach of modern legislation which is to give broad general powers recognising that with statutory corporations such as local authorities, there is an overriding legal constraint from the Common Law that such powers can only be used for a proper purpose consistent with the statutory purpose of the organisation. This sees such extremely wide powers as section 598 of the Act which allows a local authority to "either singly or jointly with any other local authority or any other organisation or group or body of persons (whether incorporated or not), undertake, promote, and encourage the development of such services and facilities as it considers necessary in order to maintain and

promote the general well being of the public and may promote or assist in promoting co-operation in and co-ordination of welfare activities in the district". These provisions would enable a council, as an example, to promote a housing trust, or housing co-operative free from any of the restrictions in the detailed sections dealing with specific housing powers.

This includes power to "make grants of money, or make advances on such terms and conditions as it thinks fit (including, if a council thinks fit, a condition that the advance is to be free of interest), or grant leases of land at such rental and for such term and on such conditions as it thinks fit, to any organisation or group or body of persons (whether incorporated or not) whose object or principal object is conserving or promoting the welfare of the community or of any members of the community". There is also a broad power to guarantee.

One emerging view, which I share and have done something to promote, is that the Local Government Act should be substantially rewritten giving local government a power of general competence but subject to appropriate transparency and accountability, something which we now virtually have through the provisions of Part VIIa which sets out the current financial management provisions.

An alternative argument is that the modern approach to the development of legal frameworks may render the debate about powers of general competence irrelevant. A legal framework based on:

- A statement of purpose
- Broadly specified powers
- Accountability mechanisms which are local

although not a power of general competence as technically defined may produce much the same result so long as the legislation covers those areas which you would wish local government to be involved with.

This approach does depend on the local accountability process working effectively. As I argue elsewhere in this paper, there are some concerns about this. Each new initiative is placing further burdens on current accountability mechanisms, such as section 716A, at the same time as there is growing scepticism regarding their effectiveness.

This also places an added burden on local government itself to ensure that compliance with the provisions of Part VIIa is in substance as well as in form - I discuss these issues further below.

## **Role and Functions**

In my view it is pointless to discuss the role and functions of local government without also considering those of central government. Both are in the business of governance; of ensuring access to those goods and services the delivery of which we have as citizens decided is best facilitated through an entity with the characteristics of a government (specifically, the power to tax and the power to coerce).

The roles and functions of the two need to be considered together for reasons which include the increasing limits both on the power of central government and on its ability to deliver outcomes at a community level.

Whether we like it or not, globalisation is steadily eroding the sovereignty of

national governments. For example, we are bound by a set of rules regulating how we may trade which substantially prevent us from imposing many of the restrictions which were a characteristic of the New Zealand economy of 20 or more years ago, thus exposing virtually all of our authorities to international competition. One consequence is that our cost structures need to be internationally competitive - and this applies to both the tradable and non tradeable sectors - if we are to be successful. This erodes the power of governments to intervene in the market through means such as subsidy or through favouring particular industries, regions or activities. Increasingly, to do so is to trigger market responses which effectively penalise the intervention and make it counterproductive.

This is compounded by the fact that, in an open economy, taxation is one of the most important costs faced by business. All of us here should know that the modern business targets post-tax profit, not pre-tax profit, treating tax as a cost in much the same way as it treats any other business expense. The implication is that increasingly New Zealand governments face tradeoffs which effectively restrict their ability to tax and therefore to use income distribution or central government financed interventions as a means of dealing with social concerns.

The effect can be seen in the shift from open ended funding of government institutions (particularly in education and health) to an entitlement based approach. The universal tertiary training allowance in education is effectively a voucher. Measures in the just released tertiary white paper make it clear that government is moving to quit the role of risk bearer. In the health sector, funding is strictly limited on a population related basis and government management of its major institutions has made it clear that restructuring, downsizing or closure are seen as options for institutions which cannot manage within their budgets.

One immediate result has been a de facto expansion of the role of most local authorities to include a significant research/policy/advocacy function around core social services.

Longer term, the implications are more profound. Central government policy may comfortably accept the closure of a local polytechnic or hospital so long as residents still have access to equivalent services within standards acceptable to government.

The reality is much different at a local level. Consider the impact of the closure of a local polytechnic. From government's perspective as owner of the system, this may be a perfectly sensible rationalisation, reducing overall costs without unduly restricting access.

From the perspective of the local community the issue is quite different. A major undertaking has closed. There is significant loss of employment and of the flow of expenditure into the local community. Of perhaps equal importance, the locality can no longer boast a tertiary institution. The impact on the ability to attract and retain skilled workers may be significant. So may be the impact on local property values and on local businesses which no longer have direct access to locally based training opportunities for their staff.

In this situation it may be perfectly rational for the local authority, considered as the manager of the community as a business enterprise, to want to intervene to try and find a way of maintaining the local institution in existence. The value equation is quite different from that facing central government.

I give this example not to argue that local authorities should be getting into the education business but to highlight the kinds of changes likely to take place in the

relative roles and responsibilities of central and local government. Increasingly, I believe, local government will be pulled into a significant governing role in areas which formerly were the prerogative of central government.

There is a different but equally important force at work. It is increasingly common to recognise the complexity of local communities and the differences between them even in such an apparently homogenous society as New Zealand. Europeans use the term subsidiarity. This is the principle that acts of governance, including the delivery/facilitation of social services, should be the responsibility of the lowest level of government able to discharge the role effectively. It is essentially an empirical test. If national standards and consistency are important, then the role may be one for national government. If local knowledge, networks, connections, understandings and so on matter then delivery by local institutions is indicated (and this does not mean the local office of a central government agency).

Section 37K (f) includes as one of the purposes of local government "for the delivery of appropriate facilities and services on behalf of central government". Expect to see increasing use made of this, especially in social services and employment.

At the local level, there continue to be good reasons for maintaining the ability to act, collectively, on behalf of the community. I have already referred to research/policy/advocacy issues around social service delivery. The rationale here is that the needs and circumstances of each community differs and cannot be properly served if the principal input to policy making comes either from Wellington or from some government outlier in a major metropolitan centre.

Equally, when you look at issues in development of the local economy, there is a clearly definable role which it is rational for a local authority to perform. Soft issues such as promotion and harder issues such as local economic development are areas where there is a case for collective action which needs to be supported by a taxing power.

So far what I have done is make the theoretical case for a strong governing role, at the local level, on the part of local government. I now want to consider what is required in order to get there.

Currently, for a variety of reasons, local government is not held in particularly high regard. A number of factors contribute to this, some well founded some less so. They include:

- The way in which the media reports local government which, all too often, focuses on dissent and the occasional instance of poor performance, rather than on reporting on constructive performance - unfortunately, stories of competent people doing a good job are not usually headline material.
- The fact that most people hold views of local government reflecting what it used to be rather than what it is - this is still the case within much of central government.
- The still variable quality of much of local government performance and the obvious difficulty which many local authorities are still having in getting to grips with a dramatically changed operating environment.

Overriding all of these, at least from the perspective of the business community, is a strongly held view that local government is the last of the dinosaurs. Typically criticism includes:

- That in an environment where private firms need to reduce their operating

costs year on year in real terms local government sees it as an achievement if rates rises do not exceed inflation.

- The apparent willingness of many local authorities, through the use of differential rating, to charge the business community in order to deliver services to the residential ratepayers who elect them to office.

Much of this criticism is unfair, based on misinformation, outdated understandings of local government, or misinterpretation of information, sometimes assisted by local authorities themselves. I am constantly puzzled, for example, why local authorities in reporting on rates increases fail to distinguish between that portion of rates which goes on operating expenses and that portion which goes as capital investment (debt repayment or asset acquisition). Certainly, if I were a financial manager or an elected officer in a local authority I would be at pains to draw the distinction; in most local authorities this would show rates tracking beneath the level of inflation even after allowing for the shift between rates and user charges.

The main point which I really want to make in this paper is that local government is at something of a turning point. It has the potential to complete the shift from its old "roads, rats and rubbish" stereotype to becoming quite genuinely the government of the local community. Achieving that will, though, require an increased level of confidence both within central government and within key stakeholder groups, especially the business community, if it is to happen. Building that level of confidence is very much in the hands of local authorities themselves although some assistance will be required from central government where legislation is involved. In my judgement, getting there will require from local government:

- An improved performance on governance
- Better compliance with accountability requirements, especially those spelt out in Part VIIa
- A greater willingness to apply market tools where they are appropriate

Let me deal with these in turn.

## **Governance**

There is still much confusion, both within the legislation and within individual councils, over the different roles of governance, representation and management.

Section 119D of the Local Government Act makes the chief executive responsible for implementing the decisions of the local authority and ensuring the effective, efficient, and economic management of its activities and planning. Section 119C makes the chief executive officer responsible for the employment of all staff (except in any particular case where the local authority has designated some senior executive as the employer).

This was intended to promote the same separation of policy and implementation as characterises central government. In practice, many elected members still act as though they were elected to manage the local authority rather than to act in a governing role.

The problem is compounded by the large size of many councils and the perverse incentives in the remuneration structure through the payment per meeting component.

There is a growing view, shared by many within Local Government New Zealand,

that there is a need to clarify the roles of elected members, downsize councils, and change the remuneration structure. The rough parallel being adopted is with the role and remuneration of a public company director.

Such a change would significantly improve the quality of governance and, in all likelihood, the standing of local authorities in the eyes of their community. It would need to be accompanied by a specific emphasis on representation. Local authorities are inherently democratic bodies accountable to their communities. Any change in governance arrangements needs to recognise this.

In my view, it also needs to recognise that representation is most often not about conditions in the local authority as a whole but about what is happening in my street or my locality. Downsizing of elected councils and an emphasis on their governance role could well be accompanied by greater reliance on community boards or their equivalent as the representative arm.

## **Accountability**

It is in this area that perhaps the greatest tensions currently exist between local government, some of its major stakeholders, and much of central government. It is a problem compounded by the archaic nature of the Rating Powers Act and the incompatibility between that Act and Part VIIa of the Local Government Act.

Part VIIa is based on the principle that the costs of activities should be borne by those individuals or groups who benefit from them. Realising this goal requires at least two things:

- A genuine and informed endeavour by local authorities to understand the nature of the services which they provide (or facilitate), how those benefits arise and the appropriate tools for recovering costs.
- The existence of a set of funding tools with the flexibility to match decisions on how costs should lie.

We are, admittedly, still in the early stages of transition to a new environment. Elected members did not stand for office in order to become instant experts in public economics. Not all local authorities had at the time the legislation was passed or yet have the inhouse capability needed for the kind of rigorous analysis which the legislation requires.

All too often the result has been poor quality analysis which can look very much as though the decision was taken first and the justification sought afterwards with a substantial emphasis on maintaining the status quo.

In some respects, I do not personally have a problem with the fact that a funding policy and long term financial strategy may support broadly the expenditure and funding patterns which local authorities already had in place. We should not assume that applying a public goods framework to local authority activities would necessarily find that many local authority decisions, in previous years, were poorly informed and lacking proper justification. If we have been well served by elected members (and council officers) of past years, then we could expect to find their judgements had a modicum of good sense about them.

This, however, begs the question of why the legislation was passed at the first place. It reflected a very real concern within both central government and the business community that local authorities were prone to get into activities which they should not really be undertaking and to spend business dollars for the benefit of residents and ratepayers.

Accordingly, it mattered to ensure that the quality of analysis and the rationale put forward showed an understanding of the legislation and its intent. Too often this has not been the case even where sound arguments actually existed.

Libraries are one of my favourite examples. If you take what is sometimes characterised as the "new right" approach you argue that library services are a private good little different from the local bookshop and should be entirely paid for by users.

You can, however, find an alternative rationale within public economics. Most councils and their communities, if reaction to attempts to increase library charges is anything to go by, take the view that we have a collective responsibility to ensure a minimum level of access to quality information and reading and other materials. In practice, what those councils and communities are saying is that libraries, or at least their core services, are what economists term a "merit good". This is a good which is commonly traded in private markets but where, under purely market arrangements, the level of demand will be less than optimal. In essence, the community is saying that it wishes to support a minimum level of access greater than would be the case if left to the market and is prepared to pay for doing so because of a belief that there are commensurate community benefits.

That said, there will clearly be areas where the principles of Part VIIa will put pressure on current activities and lead to the downsizing or withdrawal from some accompanied by changes in funding policies (that is in terms of whom the council believes ought properly pay for the service and how they should pay).

We can expect this set of issues to be addressed in the rewrite of the Rating Powers Act. It is recognised that both the processes and the tools under that Act are incompatible with Part VIIa. Why, for example, should a council be required to strike a rate with the use of the special order procedure under the Rating Powers Act when it has already gone to public consultation through its annual plan/funding policy?

More importantly, the Rating Powers Act does not provide the range or flexibility of tools needed to reflect the kinds of funding and other decisions now required under Part VIIa. Expect that the rewritten legislation will both provide the additional flexibility needed and tie the use of those tools back to proper compliance with Part VIIa.

In turn, local government should also be ensuring that the rewrite of the Rating Powers Act applies the same rigorous policy framework to central government as it does to local government. Specifically, there is now no good argument in support of continuing the rating exemption for health and education property. That exemption is an anomaly from a bygone age. Today, it is a central principle of public policy that activities should bear their own costs. Effectively, these exemptions are a random tied tax requiring particular groups of ratepayers to subsidise education and health services which they are already paying for through their taxes. The exemption should be scrapped and the cost meet through Vote: Education and Vote: Health.

The other accountability issue which central government will need to deal with if it is to claim the governance role, is the issue of public consultation. Section 716A was a well intentioned attempt to allow greater public involvement in decision making on important issues. Experience has shown that, if anything, it is almost counterproductive. Local authorities take proposals to their communities only once they have been relatively well developed and, typically, when they are effectively a fait accompli creating a concern that they are just "going through the motions". Again and again the courts have held that section 716A consultation is not the

equivalent of a poll or referendum and that local authorities are free to ignore public views if they consider it proper to do so.

Other means of consultation need to be found. Experimentation with things such as customer advisory boards, advisory boards, citizens juries and other means of public input are worth exploring.

## **The Use of Market Tools**

A concern both for central government and for the business community has been the apparent reluctance of many local authorities to use more commercial means of managing what are regarded as business activities producing essentially private goods.

From central government's perspective, the issue is one of microeconomic reform. The emphasis is on ensuring that, throughout the economy, goods and services are produced at the least possible cost consistent with the performance standards required and with appropriate principles for efficient resource allocation.

We are familiar with what central government has done in respect of its own activities. There has been significant corporatisation and privatisation and those elements of the state which still remain as part of the core public service have increasingly been restructured to operate on a quasi commercial basis.

The business community argument has echoed the central government one maintaining, not always with any good analytical support, that private provision is inherently superior to public provision.

Amongst the concerns which critics of traditional local government arrangements have had are:

- Monopolies, whether in the public or the private sector, are inherently inefficient unless very deliberate attempts are taken to encourage efficient operation and these steps must include placing the activity within a commercial framework.
- Failure to take proper account of the cost of capital means that local authorities underestimate the true economic cost of their activities and significantly distort investment decisions. This is particularly the case with high capital intensive activities such as water and wastewater as currently managed.
- More from sectors of the business community than from government, a criticism that local authorities in practice treat their ratepayers as captive investors, requiring them to invest substantial capital in assets which they may prefer not to own.

Behind all of this there is a combination of a lot of political point scoring and ideological rather than analytical perspectives. However, there is also some substance in the argument that local authorities have, generally, been reluctant to embrace more commercial approaches, especially to the management of large scale infrastructure. A number of factors have accounted for this. The first is that putting a commercial structure in place really requires the use of a company form which appears to have a number of drawbacks including:

- Companies undertaking trading activities are by definition Local Authority Trading Enterprises and as such both their income and any income which a local authority receives from them is taxable.

- The use of a company form carries with it its own cultural baggage. It is often understood as a device for maximising charges and seen as a precursor to privatisation.
- It will often be seen by local authorities as representing a loss of control, particularly if elected members and/or officers do not understand the nuances of governance and how to maintain influence over those matters which may particularly concern the local authority.

The second factor, related to the first, is that too many advocates of the adoption of a more commercial form really mean privatisation and are not prepared to engage in a constructive debate about how to optimise performance within a publicly owned structure. This was understandable 10 or 15 years ago when the track record of public ownership of commercial enterprise, world-wide, was relatively poor. It is less understandable today when a number of countries, including New Zealand, have transformed our understanding of how to manage public enterprises efficiently.

A third factor, which should not be overlooked, is that legislation dealing with major infrastructure such as water and wastewater was written on the assumption that the infrastructure would be local authority owned and operated. Thus local authorities have powers of entry on private land for the purpose of carrying out work which is not available to private operators. They have bylaw making powers covering the charges which they set and regulating access. They have the power to charge property owners simply because infrastructure passes their gate.

The two major remaining areas of local authority infrastructure, roading and water and wastewater are both undergoing review. Roothing is more complex than water and wastewater for a variety of reasons including both the mix of state and local authority ownership and the pattern of demand.

Forecasting what may actually happen with roading reform is difficult at best. The present government has already found that roading is an extremely sensitive and that reform without at least the acquiescence of local government may prove extremely difficult. The possibility of a change of government within the next year increases the uncertainty surrounding implementation of whatever may come out of the next set of reform proposals.

On the other hand, the difficulties now faced in some of our urban centres, especially Auckland, make roading reform an absolute priority. Furthermore, it seems clear that reform will have to mean more than simply building additional roads. Instead, it means moving more in the direction of charging for use with, if needs be, quite draconian charges for the most heavily congested roads/times of use. This in turn points towards a commercial model and to shifting away from rates towards a variant of user pays. Despite uncertainty, my prediction is that we will see quite major organisational reform for the ownership and management of New Zealand's roads. Whether we get roading companies or some form of standalone roading authorities is less certain but what does seem clear is that within the next 2-3 years roading will cease to be a local authority function but under a set of arrangements which will still give the local community significant influence over the corridor.

Water and wastewater presents a different set of issues. At the moment we have a system which is biased strongly towards:

- Public ownership and provision
- The use of large capital intensive options rather than smaller onsite options.

On the assumption that we continue to treat water and wastewater services as major capital intensive infrastructure, guesstimates of the amount of investment required to bring existing systems up to acceptable standards and for new investment range upwards of \$6 billion. The costs for many local authorities, especially smaller rural authorities with environmentally sensitive areas, are horrendous.

The search is on, as I believe we all know, for alternative means of funding. Papakura District Council has already experimented with the use of a franchise arrangement. Other authorities, such as Wellington, have accepted a build own operate transfer option.

In a sense, these are ad hoc responses. It is by no means sure that they represent the most efficient response from the perspective of the local ratepayer. Personally, I am sceptical, that some of these solutions represent the best option. I find it hard to believe that a commercial entity, whose debt has a risk weighting of 100%, can borrow more cheaply than a local authority whose risk weighting is 20%. Current signs are that the

water and wastewater review will concentrate on creating a level playing field rather than as (say) with electricity reform, forcing corporatisation. My personal expectation is that the outcome of the review will be:

- A rewriting of the regulatory framework for water and wastewater services to put local authority owners/providers on an equal footing with other potential providers so that each has the same rights in respect of the construction and operation of services and each is required to establish charges through contract rather than, as at present, through the use of rating powers.
- A requirement that water and wastewater activities be taxable regardless of how they are operated (in a parallel with the provisions introduced prior to the Energy Companies Act 1992, for making local authority owned electricity activities taxable).
- A requirement that pricing for services include an appropriate allowance for cost of capital.

This last one may seem a little "off the wall"; why should a local authority not be able to charge its ratepayer owners on a break even basis? I believe there are several good reasons why a cost of capital requirement should be mandatory. They include:

- It is a prerequisite to creating a level playing field. Private operators will be required to seek a market return on the capital they invest. If local authorities are able to operate on a break even basis, then the idea of effective competition between different providers becomes a nonsense.
- In the absence of a cost of capital, services will be underpriced. There is quite good evidence that this has a very real impact on demand. The question is particularly important when the environment is under pressure as it is in many parts of New Zealand. Indeed, it often seems to me that one of the most important pro environment measures we can take is to make sure that services such as water and wastewater are charged for on the basis of full economic cost.

Two other changes are desirable. Customers should have a choice as to whether or not they wish to be connected to a system and, if they decide not to, should be required to meet charges for the foregone service (an exception may properly arise where a reticulation system has been built to a higher capacity in order to

meet firefighting requirements). There should be regulatory changes supporting the appropriate recycling of grey water.

This set of changes will have a number of impacts. First, it will turn what have traditionally been cost centres into major profit centres. A number of local authorities may find that earnings on their water and wastewater businesses are well beyond what can reasonably be recycled within the authority (more of this below).

It will make corporatisation, or at least the creation of inhouse business units at arms length from the rest of the council, the natural option for operating water and wastewater services which remain in public ownership.

It will encourage local authorities to look at the costs and benefits of different means of owning and operating these services.

Over time, it could see a significant shift away from our preoccupation with capital investment in infrastructure. With technology now available, it would be possible for many if not most residential properties to detach themselves from water and wastewater systems. It will be interesting to see how this plays out in practice.

## **Implications For the Role of Local Government**

The changes likely to happen in the ownership and management of major infrastructure foreshadow major changes in the nature of local government. For many local authorities, roading is their most significant activity with water and wastewater not far behind.

Loss of the roading activities to a roading company or standalone roading authority would take away a major part of their current business.

Placing water and wastewater services on a more commercial basis would have a somewhat similar impact. There is a world of difference between operating this kind of infrastructure as an integral part of core council activity and doing it through a standalone business unit or LATE.

Some observers have predicted that these changes will lead to a further round of local authority amalgamations - indeed I have heard some people query why it is the Ministry of Transport rather than the Department of Internal Affairs which is driving the restructuring of local government.

This response overlooks one factor; the governing/representation role of local government. I believe that there is actually quite a good case for further rationalisation of local government but I expect this to happen more at the operational level rather than the political level. For example, in anticipation of water and wastewater reform, numbers of local authorities are looking at the establishment of operations which cover the territory of two or more authorities.

My view is that this next round of infrastructure reform may have the effect of freeing up local authorities to see themselves as being much more in the business of governing, and of facilitating access to services (including monitoring quality and performance) and much less in the business of physical provision (there are parallel arguments, which would lengthen this paper unduly, which support shifting much of the recreational and cultural activity of local authorities into trust structures where the benefits are also potentially quite major).

The other impact, which is also potentially significant, is what happens as local

authorities start moving into surplus. The question this begs is the one of ownership. I do not subscribe to the simplistic view that local authorities should be treated as the equivalent of companies, ratepayers as the equivalent of shareholders, and any surpluses returned as some form of special dividend. The issues are far more complex and beg very real questions of community capital - what are the entitlements to it, how should it be used, how should the managers be held accountable.

I believe the tools exist for striking an appropriate balance between the claims of current ratepayers and the claims of the community in a way which is entirely consistent with both the claims of economic efficiency and the claims of community interest. Again, going into the detail of this is beyond the scope of this paper; for the moment I simply make the point that treating the ownership of local authorities as a form of community capital is an issue which we now confront but one for which there are sensible solutions.

## Getting There

As I noted earlier in this paper, public attitudes towards local government are still not entirely positive. I have canvassed some of the major problems and pointed to possible solutions. I believe that these issues present local government with the opportunity to take the initiative and demonstrate that local authorities are perfectly capable of playing a responsible role both within their communities and as key players in the national economy. The way to do this is to be proactive in dealing with the challenges currently facing local government. This does not mean accepting that local government is simply some form of business which should be run commercially. It does mean understanding and being comfortable with the use of market tools knowing both when they are appropriate and when they are not.

It means being prepared to address the question of governance and achieve a consensus on the changes required to improve what we now have (I make this comment knowing that Local Government New Zealand has been actively leading an initiative on governance but has not been able to achieve consensus amongst its members).

It means taking questions of accountability seriously. This includes mastering the requirements of Part VIIa and finding better means of managing public consultation.

## Conclusion

In a very real sense, local government is at something of a cross roads. My own view is that it is shifting towards becoming truly the government of the communities it serves but that this cannot yet be seen as a foregone conclusion. Achieving that outcome will require the respect and trust of central government and of key stakeholders. My assessment is that, despite much of the public rhetoric, the ground is shifting in local government's favour. However, this is not the time for complacency. Local government holds its future in its own hands but I am not yet sure that the grip is as firm as it needs to be.

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