REPORT

Is local government fiscally responsible?

NZIER report to Local Government New Zealand

11 September 2012

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About NZIER

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Each year NZIER devotes resources to undertake and make freely available economic research and thinking aimed at promoting a better understanding of New Zealand's important economic challenges.

NZIER was established in 1958.

Authorship

This paper was prepared at NZIER by Peter Nicholls & Derek Gill

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The assistance of Sarah Spring is gratefully acknowledged.

Key points

"My other piece of advice, Copperfield, you know. Annual income twenty pounds, annual expenditure nineteen six, result happiness. Annual income twenty pounds, annual expenditure twenty pounds nought and six, result misery." Mr Micawber from David Copperfield. Charles Dickens. (1850)

This report addresses the question 'is local government fiscally irresponsible?' In brief it concludes that it is not clear that rates revenue or expenditure are too high. The result according to Mr Micawber should be 'happiness'.

Better Local Government, the government discussion document and relevant documents back-grounding the first and second local government reform bills, argued that rates revenues have increased relative to the CPI. The paper also argues that labour costs, capital spending and debt have grown too much.

This report focuses on the key measures of revenue, expenses, debt and debt servicing at the aggregate level. The analysis is simple due to time restrictions. More time and detailed analysis would answer a broader array of issues.

We find that, while revenue and spending have increased, these by themselves do not present a problem. The increases are contained when compared against measures of wealth like property values and income measures like GDP.

Local government has an obligation to rate payers to make sure that spending is warranted and provides value for money. Given that local government is a community democracy process, the rates and expenditure choices should be seen in that political-economy context, even if democracy is not foolproof.

Capital spending is between 3% and 5% of total assets. This is consistent with the level of investment required for long lived asset bases. There is no clear evidence of excessive capital expenditure at an appropriate level.

Debt and debt servicing measures are at prudent levels. Debt to assets, a commonly used measure has risen only modestly and interest payments are at a prudent level of incomes.

There is no consistent evidence that local government as a whole has been fiscally irresponsible in New Zealand over the last two decades. In the face of turbulence following the global financial crisis and longer term demographic pressures, there may be other arguments for strengthened fiscal responsibility. But local government's track record over the last two decades does not provide the basis for that argument.

Note: This paper is a slightly amended version (to update for some recently released data) that was submitted to the Local Government and Environment Select Committee.

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1 The issue

Local Government New Zealand (LGNZ) has commissioned NZIER to provide an independent review of recent trends in local government statistics.

Our report provides an independent review of the trends reported and the conclusions drawn in three papers:

- the Better Local Government discussion document (NZ Govt. March 2012)
- the Cabinet paper
- the accompanying Regulatory Impact Statement (RIS) for Better Local Government (dated 16 March 2012).

These three papers conclude that the local government (LG) sector has been fiscally irresponsible since the local government reforms of 2002. This is based on five main issues:

- rates have increased much faster than general inflation
- local government labour costs have risen rapidly
- local government expenditure has risen as a proportion of the economy
- local government capital expenditure has risen rapidly
- local government debt has quadrupled over the past decade and is projected to rise further.

Table 1 summarises the key issues, the metrics used, followed by what we believe are the appropriate metrics and the interpretations. We agree with some of the trends identified, but we do not find these evidence of fiscal irresponsibility.

In particular, while rates have risen, they remain contained relative to the rating base – the value of property – and some measures of income. Capital expenditure, debt and interest cover are all at prudent levels.

The Better Local Government reform programme should be based on robust statistical evidence, using the appropriate metrics and in the appropriate context to answer the question posed.

Table 1 Five key issues

#	ISSUE	MEASURE USED	PROPER MEASURE	RATIONALE	CONCLUSION
1	**Rates have increased at double the rate of inflation**	1) Average annual increase in CPI (2003-2010) 2) Annual % change: 1993-2011	1) Real rates revenue per household 2) Rates revenue as a share of property values and an income measure (such as GDP)	1) Rates are charged per household 2) The value of properties is the local authority's rateable base 3) The income measure signals affordability and demand for services	Rates have increased, but are contained relative to property values and incomes
2	**Significant increases in LG labour costs**	Labour Cost Index comparing LG with core state sector	1) Index of LG real wages compared to central government and overall economy 2) LG sector employment growth compared to core state sector and overall economy	1) Indicate if LG wages are growing faster than other sectors 2) Identify if the growing wage spending is a function of LG simply employing more people	LG wages have by and large grown in line with economy-wide measures Employment has grown faster, particularly since the private sector slowed during the recession
3	**Total LG expenditure has increased as a proportion of GDP**	Ratio of LG expenditure to GDP grew from 3.1% (2002) to 4.0% (2011)	Comparison of spending/GDP ratio with central government	See if local government spending has increased in general and relatively more than the central government sector	Spending ratio has increased in recent years, but this is in the context of a weak economy
4	**Capital expenditure has increased by 154%**	Quotes numbers and graph, but no data source given	Ratio of capital expenditure to assets	This is a relative measure that puts capital expenditure in context of the asset base	Capex is lumpy, but not clear whether deficient or excessive relative to the asset base
5	**LG debt has quadrupled over the past decade & is expected to continue to grow**	Debt ($m) from Local Authority Financial Statistics and analysis of 2009 LTCCP	1) Real debt per household 2) Debt/asset ratio 3) Interest paid on debt to revenue ratio 4) Debt/GDP ratio	1) How much real debt is LG holding when you take into account the number of households 2) Indicates the amount of assets pledged against debt 3) Indicates cost of debt servicing 4) Indicates a broad measure of debt serviceability	Debt and gearing is low, and interest costs are at a prudent level relative to incomes and quoted benchmarks

Source: NZIER

2 Rates revenues

Local Government in New Zealand is funded through a variety of means. These include:

- rates on property values (the primary source of revenue)
- the national road tax (in the case of road construction and maintenance)
- development contributions (capital spending forecast to be increasingly funded by this).

In this section we compare trends over time in local authority rates with the number of households and property values. We also consider the local government operating balance.

The key issue

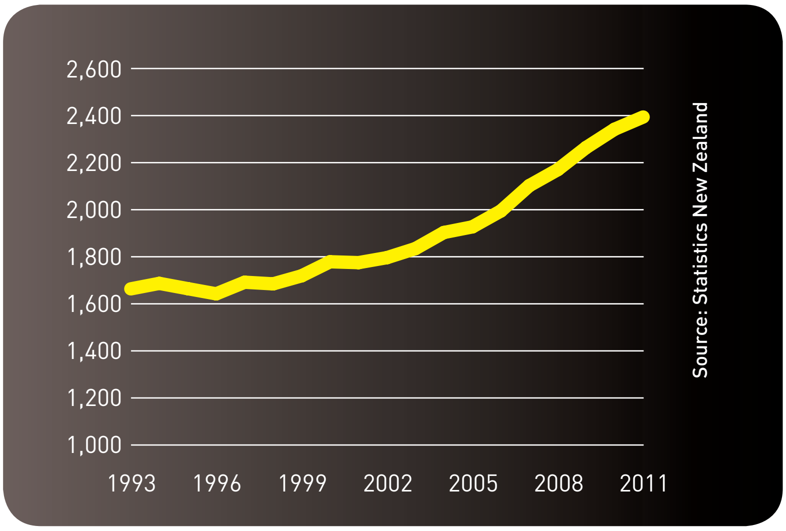
The RIS and the discussion document compared the Consumer Price Index (CPI) with the rates component of the CPI. This showed that rates had increased relative to the CPI; since 2003, rates had increased 6.8% compared to a 3% increase in the overall CPI.

Rates have increased, but it is not clear that this is a problem. Increases in rates (and expenditure) may be the choice of local communities, and should be considered relative to measures of income and wealth.

Real rates per household

The data show rates have increased in real terms and on a per household level.

Figure 1 Real rates per household[1]



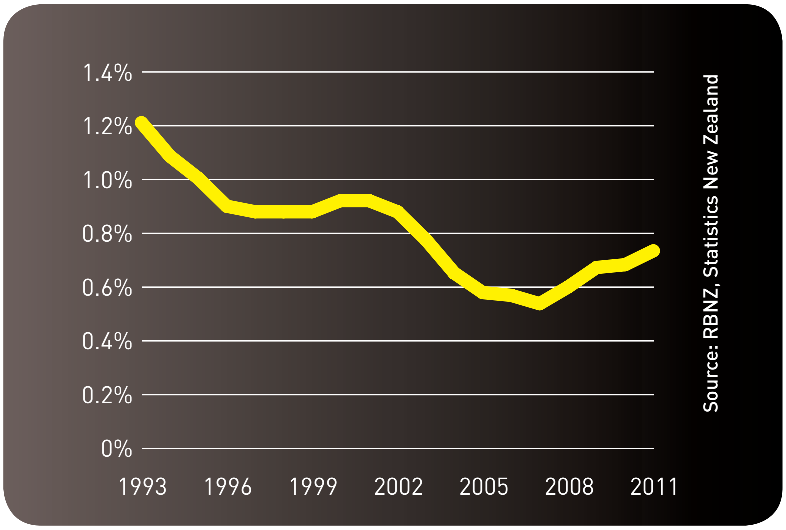
1 *Real rates calculated by deflating rates revenues by annual averages of the CPI index. The number of households is taken from Statistics New Zealand's population data.*

Rates relative to property values

Relative to property values, which is a measure of wealth and the rateable base, rates have been contained.

Figure 2 Rates contained relative to rateable base

Rates revenue divided by total housing stock value



Why use rates relative to property values?

The revenue stream for local government is underpinned by property values, which is a measure of wealth (and therefore affordability).

What does it show?

Figure 2 shows that rates have fallen, and then remained contained relative to property-based wealth since 1993.

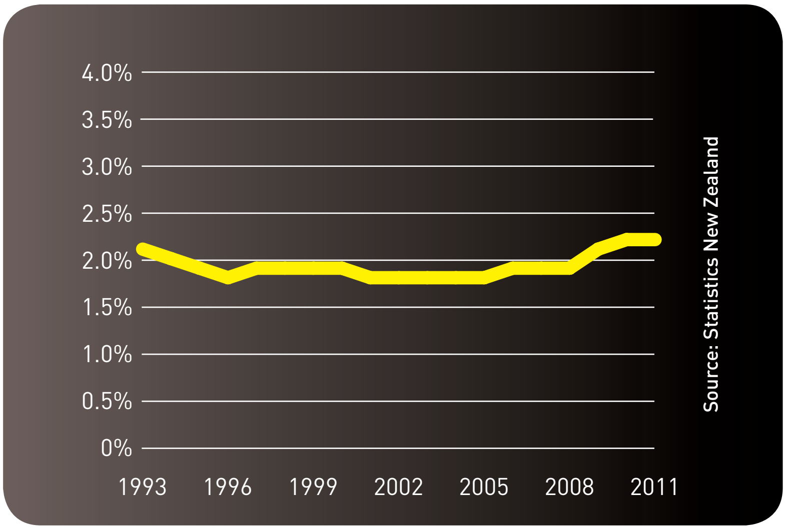
This trend only reversed as property prices flattened after 2007.

Rates as a proportion of GDP

Figure 3 shows that rates have risen modestly relative to GDP.

Figure 3 Rates contained relative to GDP

Rates revenue divided by GDP



Why use rates to GDP ratio?

The ratio is an economy-wide measure of affordability. GDP also captures the change in the demand for services.

What does it show?

Rates have risen modestly relative to GDP. This measure, by itself, is not evidence that rates are too high. The increase in rates needs to be compared with provision of services and the desire and ability of rate payers to fund these services.

3 Labour costs

In this section we compare trends over time in local and central government median wages and employment numbers.

The key issue

The RIS suggested that labour costs in the local government sector have increased beyond both the private sector and the public service. This used percentage changes in the Labour Cost Index (LCI) for 2005 to 2008, and 2008 to 2011.

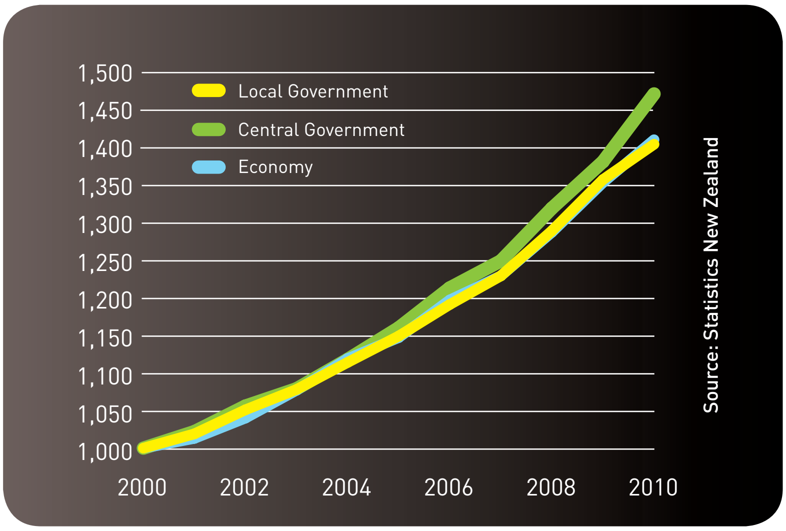
This is a reasonable measure, but we can see a longer history using median wage and employment numbers from the Linked Employer-Employee Dataset (LEED).

Longer history

Figure 4 shows an index of the level of median wages in local government, central government and the wider economy.

Figure 4 Median wages in line with economy

Index, base = year 2000



Why use a longer history of wages?

The 2005-2008 period saw a very tight labour market and high wage inflation. There was some catch-up of wages in sectors that had grown by less in earlier periods. Because labour market adjustments take time, a longer timeframe gives a more accurate picture of wage trends.

What does it show?

The longer history of wage data shows that over the decade to 2010 Local Government wages moved largely in line with the broader economy.

4 Spending to GDP

In this section we compare trends over time in local and central government expenditure relative to GDP.

The key issue

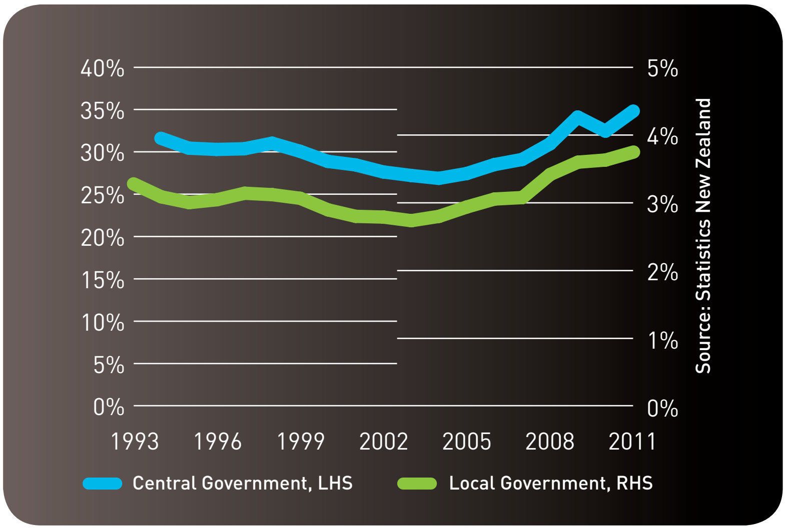
The Better Local Government report and the Cabinet paper both suggested that local government expenditure as a percentage of GDP increased since the passing of the Local Government Act in 2002. The ratio grew from 3.1% of GDP (in 2002) to 4% (in 2011).

Spending to GDP

LG spending to GDP ratio has increased (as has central government spending). By itself it is not clear that this is a problem. Note that spending on government services tends to be less cyclical than GDP. The recession and subsequent weak economic growth since 2007 partly explains the rising spending to GDP ratio.

Figure 5 Similar trends in spending to GDP ratio

Operating expenditure to nominal GDP



What does it show?

- Local government has increase from 3% in 2002 to 3.9% of GDP in 2011 – this is an average annual percentage change of 2.7%. The faster increase since 2007 reflects a period of slow growth in the economy or GDP.
- Central government has increased from 29.7% in 2002 to 36.2% of GDP in 2011 – this is an average annual percentage change of 1.6%.

5 Capital spending

Local government spending is dominated by roading, and the three waters (water supply, waste water and storm water) – in particular, spending on infrastructure maintenance and depreciation.

In this section we compare trends over time in local authority capital spending.

The key issue

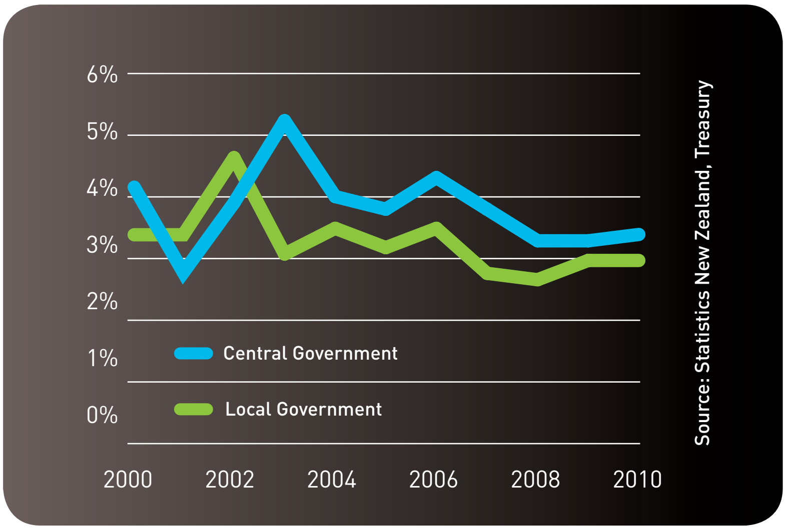
The RIS suggested that local government capital expenditure had increased by 154% between 2002 and 2012. The RIS notes that the major drivers of the capital expenditure included constructing new and maintaining existing infrastructure, and building new facilities and amenities. It was suggested that the large increase in capital expenditure was a key factor behind the increase in local government debt.

Capital spending to total assets

Figure 6 shows the ratio of capital spending to total asset ratios for both the central and local government.

Figure 6 Capital spending similar to central government

Capital expenditure to total assets



Why the capital spending to asset ratio?

This indicates how much investment is being made relative to the asset base.

What does it show?

The local government is investing between 3-5% of its total asset base. This is slightly higher but in the same vicinity as the central government.

With long term infrastructure assets with 20 year, 30 year or longer lives, a 3-5% investment rate is consistent with a natural depreciation rate.

These measures do not tell us if the spending is appropriate or good quality. These should be seen as providing context for the size of capital spending relative to assets.

6 Debt

Local government is generally obliged to balance their budget so debt is not used to fund operational expenditure. This is underpinned by the 'Golden Rule' of fiscal policy.

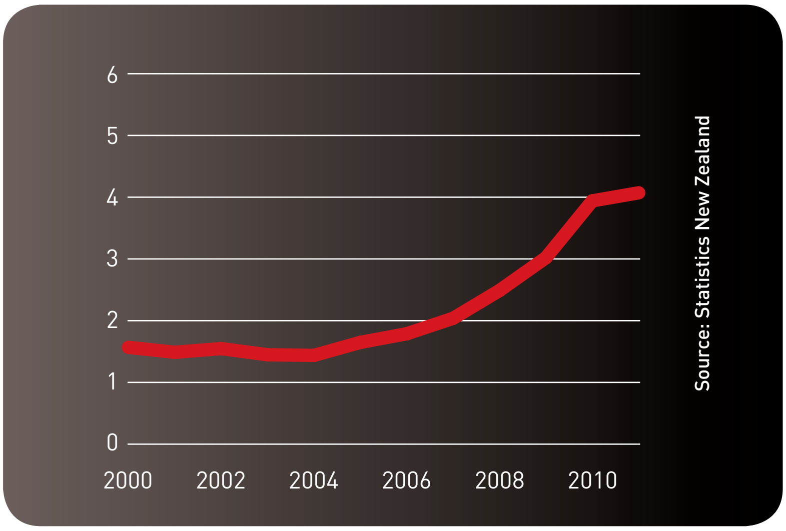
The Golden Rule suggests that Government should only borrow to invest and not to fund current spending. This is consistent with intergenerational equity in that any debt inherited by future generations is matched by assets passed on. Debt can be used by local government to spread the cost of long lived assets across generations.

The 2007 Rates Inquiry indicated that local government could make increased use of debt. In part this is because debt can used to enable projects to be undertaken earlier than they could be if they were to be funded from general revenue.

As a result of the sharp increase in capital spending since the mid-2000s, the sector is making more use of debt. This is shown in Figure 7. The level of real local government debt per household has increased, particularly since 2004.

Figure 7 Local government debt increasing[2]

Dollars in real terms



The key issue

The Regulatory Impact Statement, the Better Local Government paper and the Cabinet paper all flag the increase in local government debt as a concern. Local government debt is said to have quadrupled over the past decade and is expected to continue growing. It is also pointed out that the local government sector has not pulled back on increased debt in response to the global debt crisis.

2 *Local government debt stock is deflated by the CPI to transform it to real debt. The number of households comes from Statistics New Zealand's population data.*

The level of debt is not the problem though. The problem is whether or not the local government sector can deal with the amount of debt it has. To get an understanding for that, two measures can be used:

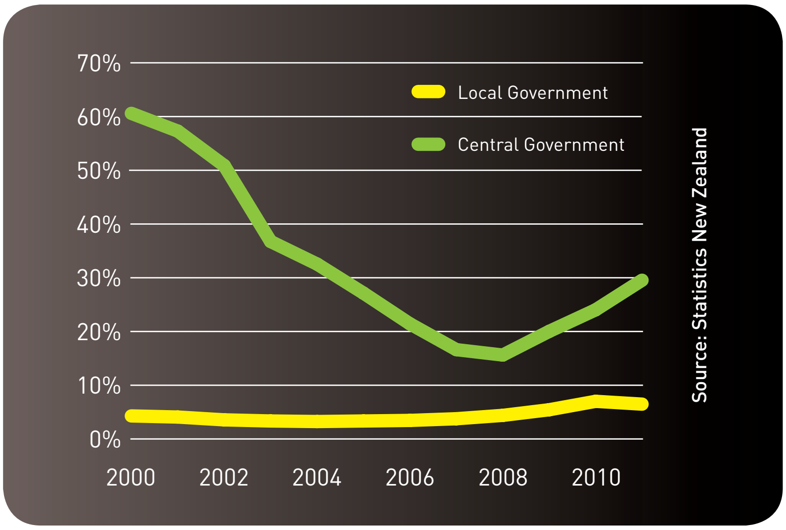
- the Gearing ratio – comparing debt to total assets
- the Interest Cover ratio – comparing the interest being paid on debt with the revenue stream.

Debt to asset ratio

Figure 8 shows the gearing ratio for central and local government.

Figure 8 Gearing ratio rising but still modest

Debt to total assets



Why use the gearing ratio?

The ratio indicates the percentage of local government assets that are provided via debt, and enables comparison with the central government. As the ratio increases so does the level of risk, as it reflects a greater level of financing by debt.

What does it show?

The gearing ratio has trended slowly upwards since 2000. As of 2010, the local government gearing ratio is at 6.8%.

This compares to 30% for central government. The level of local government financed by debt does not appear worryingly high from this data.

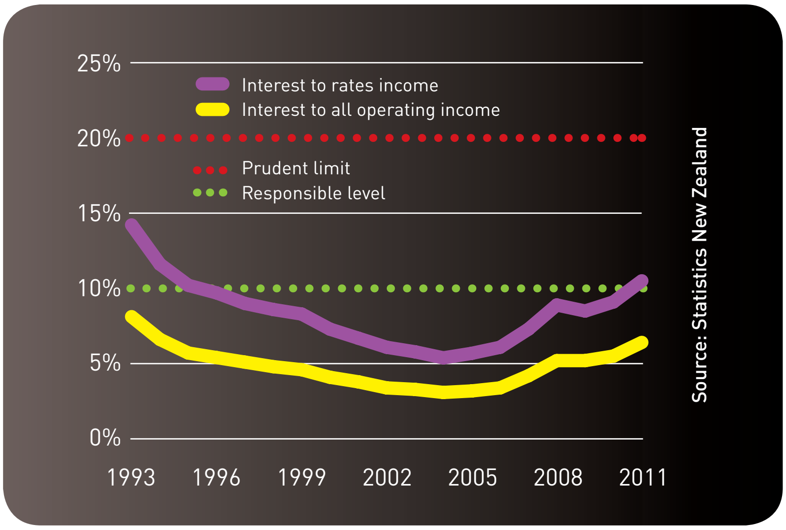
Such a gearing ratio also does not look high compared to, say, the NZX-listed property sector (also carrying long term physical assets), which typically have a gearing ratio of around 30%.

Ongoing debt servicing

Using debt to fund quality capital spending is consistent with the Golden Rule of fiscal policy discussed above. However the local authority has to be able to service the debt over time. Figure 9 summarises the debt servicing costs as a proportion of income since 1993.

Figure 9 Debt servicing costs responsible[3]

Interest paid on debt relative to income



Why use the debt servicing costs ratio?

The cost of servicing debt as a proportion of the local government's revenues indicates the ability to service debt from current income.

What does it show?

The ratio of revenue being spent on debt servicing is at 6.4% in 2011. The ratio is higher when compared to only rates revenue. Is this level prudent?

Different benchmarks exist for what constitutes a prudent level of debt servicing. According to Reid (2012), the internationally prudent benchmark is that debt servicing should be below 10% of all operating income. The DIA (2011) in their paper on local government debt suggested that "20% was generally seen as being the prudent limit".[4]

The level of local government debt servicing is well within the responsible and prudent levels suggested by Reid and the DIA (2011).

3 *Debt servicing costs are the ratio between interest payments on local government debt and rates revenues.*

4 *Quote from DIA (2011 p65): "the forecast increases in debt are generated by a much larger increase in fixed assets. As a sector, the forecast peak interest costs/rates ratio is 12% in 2016, well under the average 20% ratio generally seen as being the prudent limit. While Auckland councils are forecasting a peak interest costs/rates ratio of 17%, many local authorities still have very low levels of debt relative to assets and income"*

7 A wider range of functions

A final discussion point arising from the Regulatory Impact Statement, the Cabinet paper and the Better Local Government paper is the range of functions being provided by local government.

The key issue

The Regulatory Impact Statement proposes that "there is no clear quantitative evidence to suggest that the LGA02 has resulted in a proliferation of new activities, or that local government is undertaking a wider group of functions." This was drawing on findings from a joint 2006 Central Government and Local Authority Funding Project team.

A lack of data

The claim in the RIS goes beyond what the data can inform. There is no local government activity spending data before 2002, so it is impossible to make comparison and see if the LGA02 has had any effect. Since 2003, data has been collected on activity but not at the level of disaggregation that is required to make an informed decision on whether or not local government are spending resources on a wider range of functions.

Appendix A: References

Local Government Rates Inquiry Panel (2007) Funding Local Government: Report of the Local Government Rates Inquiry; at *http://ndhadeliver.natlib.govt.nz/ArcAggregator/arcView/*

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