SOLGM

NZ SOCIETY OF LOCAL GOVERNMENT MANAGERS

DEVELOPING LOCAL AUTHORITY REVENUE SYSTEMS – AN UPDATE

Produced in association with:

Local Government New Zealand

te pūtahi matakōkiri

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FOREWORD

This Guide is an update of *Local Government New Zealand's* 1993 publication *Principles and Guidelines for Local Authority Revenue Systems* (those with longer memories of local government may remember this as 'the Green book').

The guide draws together all of the aspects that go into designing a good local authority funding system. In this guide you will find the following:

- an explanation of the law (including both the statute law and case law)
- key economic concepts that are useful in the design of funding systems
- an assessment of the advantages and disadvantages of the existing set of funding tools
- some guidance – largely replicated from *Dollars and Sense* – on putting a revenue and financing policy together.

The original guide was produced at a time when local government was facing significant legal challenges to their rating decisions on grounds of unreasonableness (in the administrative law sense). At the time local authorities had few statutory signposts as to the factors that should be considered when making funding policy. The original guide addressed this deficiency by introducing a largely economic framework for local authorities to use when making funding decisions.

Of course, since that time the landscape has changed somewhat:

- a statutory funding policy process was introduced in 1996 and amended by the present Local Government Act
- the Rating Act widened the kit of rating tools (especially for regional councils) and redefined basic concepts such as primary liability for rates
- local government has been provided with a new tool – development contributions under the Local Government Act
- the so-called *Woolworths* case settled upon a concept of unreasonableness that attached proper weight to local democratic process.

This guide is designed to assist local authorities in evaluating the impact of the policy options available to them, and in communicating that to the community. While *Dollars and Sense* covered the revenue and financing policy in some detail, discussion of the revenue and financing tools was beyond the scope of that Guide.

This is a product of the SOLGM Financial Management Working Party. I thank the members of the Working Party for their efforts in producing this Guide. I also want to thank:

- Keith Miller, Department of Internal Affairs for supplying the statistics used in this guide
- Janice Nadew, SOLGM, for proofreading and editorial services and
- Jonathan Salter, Simpson Grierson, for the legal review and discussion of the case law.

This is the first of a new series of publications designed to enhance day to day financial management in local authorities. As these guides build on the practice in the Dollars and Sense publication, the series will be known collectively known as the *Dollars and Sense Guidance*. Future publications in the series will look at development contributions, pricing and (potentially) accessing the debt securities market.

I commend the Guide to you.

Steve Parry
President
SOLGM
November 2008

Disclaimer

This Guide has been compiled to assist local authorities in using the suite of tools in the Local Government Rating Act to the advantage of the local community.

This Guide is not intended to be a substitute for the legislation, or for the policy judgements of elected members backed by appropriate policy, legal and other advice from their officials. In the final analysis, it is the elected member who bears the ultimate accountability for funding decisions.

Every effort has been made to ensure that the document is as accurate as possible. However, the Courts are the final arbiter of what the law actually means.

For this reason, neither SOLGM, *Local Government New Zealand* nor any of the other individuals and groups involved in the preparation of this Guide accepts any liability for any loss or damage arising to any organisation from the use of the material contained herein.

The examples presented in this Guide are examples of the ways powers in the Rating Act might be used. They are presented for the purposes of illustration only, and are in no way a statement of how local authorities "must" deal with particular rating issues.

Reading or using the material beyond this point constitutes acceptance of the contents of this disclaimer.

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Summary: Funding Tools for the Time Challenged

Local government funding sits at the heart of the relationship between local councils and their communities. Local government funding decisions involve balancing political considerations and financial need backed with economic and legal advice.

Some Key Economic Concepts

Some useful economic concepts to keep in mind are:

- *incidence* – the distribution of the burden of rates. Two key things to distinguish are the legal incidence of the tax (who gets the bill) and the economic incidence (from whose pocket the money eventually comes)
- *the difference between income and wealth* – income is a flow concept. It measures the amount of money an individual receives from work or investment over a set period of time. Wealth, on the other hand is a stock concept and measures the level of financial and non-financial assets an individual has. Rates are a tax on one element of wealth
- *affordability, ability to pay, and willingness to pay* – this is the difference between 'can't pay' and 'don't want to pay'. Affordability is a measure an individual's true capacity to meet their contribution to community services. Willingness to pay relates more to the value an individual thinks they receive from council services
- *efficiency* – the degree to which local authority funding requirements affect production and consumption decisions
- *equity* – very much a subjective concept, equity relates to the 'fairness' of certain decisions
- *public/private goods* – a *public* good is an activity or service that is both non-rival (my consumption does not interfere with yours) and non-excludable (I cannot be prevented from consuming the service). Common examples in local government are civil defence and various planning functions. A private good is both rival and excludable.

The Legal Framework

Local government funding decisions are subject to judicial review on grounds of error in law, or unreasonableness in the administrative law sense. Case law around unreasonableness starts from the premise that funding involves the weighing of considerations best undertaken by those elected by the community to making decisions on its is behalf. Judicial intervention in these cases is justified only where the decision is 'perverse', 'irrational', 'outrageous in its defiance of logic' and 'so unreasonable no reasonable local authority would have made it'. The leading case law authorities in funding in this country that go to unreasonableness are *Wellington City Council vs Woolworths and Others(1996) and ECNZ vs Mackenzie District Council (1991)*.

Errors of law may occur in cases where a local authority has acted ultra vires (outside its legal powers), has failed to follow the statutory procedures or has failed to take relevant matters into account when making decisions (or taken irrelevant matters into account).

So what are these procedural requirements? The LGA requires that local authorities adopt the following set of funding and financial policies:

- a revenue and financing policy
- an investment policy
- a liability management policy
- a policy on development contributions or financial contributions
- a policy on public-private partnerships, and
- a policy on remission and postponement of rates on Maori freehold land.

There are also two optional policies – a policy on remission and postponement of rates on categories of land other than Maori freehold land.

At their most basic level, funding and financial policies show who pays, for what, when. They are part of the package of material that supports the right debate and need to be transparent.

The most important of this group of policies is the revenue and financing policy. This is a device for recording and justifying the policy decisions local authorities have made regarding the funding of activities. Transparency in this document is especially important to demonstrate the link between dollars and value to the ratepayer.

Much of the revenue and financing policy will refer to the considerations in section 101(3) of the Local Government Act, and your local authority's application of those considerations. The analytical process is a sequential two step process. The first step includes consideration at activity level of the rationale for service delivery, beneficiary pays, exacerbator pays, intergenerational equity, and the costs and benefits of separate funding. The second step of the analysis involves consideration of the results of the first step and their impact on community well-being. A clear rationale for service delivery is a vital piece of information to have when working through the section 101(3)(a) analysis. Knowing why you are delivering the service can help sort out who benefits, when they benefit, and who any of the exacerbators are, as well as obtaining some idea of what impacts on well-being might arise from the way you fund a service.

Although not a funding and financial policy as such, the funding impact statement (FIS) is a device for implementing the revenue and financing policy. Effectively the FIS acts as a link between this policy and the annual setting of rates and charges. The FIS should contain all of the information relating to the factors and matters that will be used to set rates. An irregularity in your FIS could invalidate your rates strike – resist the temptation to 'cut corners'.

Rating Tools – The General Rate

The general rate is a tool for funding those activities where your local authority has decided that all or part of the cost of a particular activity should be funded by the community as a whole. Local authorities may use either or both of a uniform annual general charge (UAGC) or a valuation based rate.

The UAGC is a flat dollar charge per property, or separately used/inhabited part of a property. The UAGC is a device for mitigating the impact of high property values. It is a regressive tax (you pay the same amount regardless of income or wealth) – this is one reason why the Rating Act caps the use of this tool.

Local authorities have the choice of one of three bases for setting a value-based general rate. These are land (unimproved value), capital value (land and improvements) or annual value (either rentable values or 5 percent of the capital value). Capital and annual value tend to be better proxies for ability to pay and use of council services than unimproved values. Capital and annual value data tends to drawn from a much larger set of data than is the case for unimproved values - although a recent review of valuation data has found no inherent measurement bias in any of the systems. Capital and annual value are thought to be less prone to sudden swings than unimproved values as location-based factors play a lesser role. On the other hand, to the extent that rates are a part of business cost structures, rating based on unimproved values can be more of an incentive to development. Annual value needs a large and active rental market to work effectively.

Local authorities can use differential powers on their value-based rates i.e. charge one category of property a higher rate in the dollar than another. Differentials are a tool for altering the incidence of rates, they do not release new revenue in and of themselves. Use of differentials will create 'winners and losers' – it is therefore important that these policies are based on robust criteria. A useful set of criteria to keep in mind are:

- levels of service
- ability to pay
- willingness to pay
- cost.

Rating Tools – Targeted Rates

Targeted rates are devices for funding those activities where your local authority has decided that:

- all or part of the cost of a particular activity should be met by particular groups or ratepayers or
- there is some other advantage in funding the activity outside of the general rate or
- both.

Local authorities have access to a wide range of targeted rating powers including: property values (unimproved value, capital value, annual value and the value of improvements). Local authorities can also set a targeted rate based on one or more of the following:

- a flat dollar charge
- the number of separately used or inhabited parts of a rating unit*
- the number of water closets and urinals within the rating unit*
- the number of connections the rating unit has to local authority reticulation*
- the extent of provision of any service to the rating unit by the local authority (where this is capable of objective measure and independent verification)*
- the total land area of the rating unit*
- the total land area within the rating unit that is sealed, paved or built upon
- the total area of land within the rating unit that is protected by any facility provided by a local authority
- the total area of floorspace within the rating unit.

In addition to these powers, a local authority can set a targeted rate for water consumption based on the volume of water consumption (often called water metering).

In the 2007/8 rating year approximately 40 percent of the total rates assessed will be targeted rates of one form or another. There are two local authorities that rely entirely on targeted rates and set no general rate at all, while at the other extreme one local authority collects around 92 percent of its rate revenue via the general rate.

Local authorities can set:

- more than one targeted rate to fund a particular activity (for example, many rural local authorities with more than one water or sewage scheme set a rate for each scheme, some city councils charge a base water supply rate and an additional fire protection rate to fund water supply) or
- a targeted rate to fund more than one activity (targeted works and services rates are a common example of this)
- a targeted rate over only some defined categories of property (such as CBD rate for security patrols, streetcleaning or development or a tourism rate over commercial property). The basis for constructing the categories are defined in Schedule Two of the Rating Act.
- a differential targeted rate – provided that the basis for constructing the categories is one of the matters listed in schedule two
- targeted rates using combinations of factors (a not uncommon use is to set a flat dollar charge and a value based rate)
- including a rate that uses different factors for different categories of property (so for example a targeted rate that is set on the basis of a flat dollar charge for residential property, a value based rate for commercial property and an area based rate for rural property)

The targeted rating mechanism is a potentially very powerful tool that local authorities are only now beginning to use, some five years after the powers were extended to local government. A targeted rate is a good mechanism for tailoring liability to perceived benefit from council activities and for demonstrating value for money, they do, however come at a cost.

Non-Rate Funding Tools

Local authorities also have the following non-rate funding tools available to them:

- *user charges* – a variety of powers exist, some set maxima on the levels of fees, others prescribe charging methods
- *development contributions* – a tool for recovering the capital costs that are imposed by growth from development. These too are very tightly constrained in terms of the recoverables and the methodology
- *debt* – this is more of a device for spreading the costs of activities over time
- *revenue from investments*
- *asset sales*
- *funding from third parties* (including but not limited to central government).

1.0 Introduction

1.1 What is this Guide?

This guide is a revision and update of *Local Government New Zealand's* 1993 publication 'Principles and Guidelines for the Development of Local Authority Revenue Systems'. Those readers with longer memories of local government may remember this as 'the Green book'.

The guide provides an objective discussion of the merits and disadvantages of the different types of funding instruments (both rating and non-rating) that are available to local authorities at the time of writing (September 2008). The aim is to provide for better informed debate about funding options within local authorities and in the public at large. This document will be made freely available on the SOLGM and Local Government New Zealand websites, and copies will be made available to sector groups.

This discussion takes place against the context of the wider legal background governing the making of funding policy – both in statute and case law. This guide also introduces some of the key economic concepts that can assist in making funding policy.

The guide explores each of the funding options which are *currently* available to local government. It is not intended to, and does not, discuss the merits of alternative tax bases for local government (income tax, GST etc).

The guide also avoids discussion of two instruments that are sometimes thought of as funding tools:

- *lump sum contributions* – these are a payment option for rates, rather than a funding mechanism in and of themselves
- *so-called private public partnerships* – at the current time there are limits on the use of these tools both in water services and land transport that essentially constrain their usefulness.

The guide is intended to provide an objective discussion of the options – it does not advocate for any particular option or options. The comments and analysis in this document is based on fact or objective theory rather than advocacy as such. Nothing in this document should be read as endorsement of, or rejection of, any particular funding option.

Nor is this guide a treatise on the wider financial management obligations of the Local Government Act, such as the so-called 'balanced budget' clause. Readers looking for a discussion of those issues are referred to the publication *Dollars and Sense*[1].

1.2 Why a Guide?

An analysis of many of the submissions that went to the 2007 *Independent Inquiry into Rates* revealed a general lack of understanding of rates on the part of the general public. Comments such as 'the value of my property went up, so my rates must be about to go up', 'I oppose capital value because its higher than land value, so my rates will go up' and the like are common threads throughout the discussion. Some sector groups appear to

[1] SOLGM et al (2007), Dollars and Sense: Financial Management Under the Local Government Act, a copy can be accessed by clicking here.

advocate solutions that may run counter to their members' interests due largely to this kind of misunderstanding[2].

Secondly, with the passage of time the original Green book has become progressively more dated. The legislation that governs the making of funding policy has been subject to two rewrites – both of which incorporated ideas from the original Green book. Rating legislation has been rewritten largely 'from scratch':

- the basic presumption of occupier liability has now been turned largely 'on its head'
- new rating tools such as improvement value and various modifications of land area have been added to the toolbox. In particular, regional councils have had their kit considerably expanded.

In the period 1999-2006 the environment in which funding policy was made was a relatively benign one. As we shall see in the next section the Woolworths decision clarified that courts would intervene only in cases of non-compliance with the legislation or on grounds of unreasonableness (in the administrative law sense). Funding legislation was redrafted to (in the view of the then Minister of Local Government[3]) remove any perception that the benefit principle was the primary consideration.

The advent of development contributions as a funding tool has also provided fresh impetus for challenge to funding decisions both at the technical implementation level, and the policy level.

The pressures that led to the Independent Inquiry into rates, and the Inquiry's finding that local government affairs are not well understood suggests there is a need for a 'refresher' for the sector and some degree of education for those outside the sector. Since 2005 various reports have suggested that the local government sector has been slow to take up some of the options available to it[4].

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2 *The classic case was the residents group in a coastal part of a large metropolitan authority that argued for the removal of the UAGC, apparently not realizing that this provided what are very high valued properties with a degree of protection from a rate based solely on property value!*

3 *Hon Sandra Lee.*

4 *For example, see Central/Local Government Funding Project Team (2005), Local Government Funding Issues, and Covec (2007).*

2.0 Some Useful Economic Concepts

In this section we introduce a number of economic concepts that underpin a principled analysis of funding decisions. Many of these have fed through directly or indirectly into the legislation. Others are useful things to keep handy as you think about your funding system.

2.1 Incidence

Incidence refers to the distribution of the 'burden' of tax among the community.

The *legal* incidence of a tax (who you send the bill to) and the *economic* incidence of a tax (out of whose pocket the money finally comes) can be quite different things. Why is this? Businesses (including landlords) do not simply absorb rates into their cost structures, all or part of the tax is ultimately passed onto the consumer through the prices they pay. This is why the argument that rates are unfair because people who rent property do not pay does not stand up to scrutiny – landlords are not philanthropists, rates are passed on (although usually there is some time lag between the point when rates are increased and prices adjust, and economic theory tells us that in most markets landlords will absorb a portion of the cost).

The distinction between the legal and the economic incidence of rates is a useful concept to keep in mind when thinking about tools (such as differentials and fixed charges) that purport to redistribute the burden of rates. It is useful to keep thinking about who ultimately pays the bill.

2.2 Income vs Wealth

Wealth is the sum total of an individual's stock of assets such as their property (both real and personal) and their income-producing capability less their liabilities. Income, on the other hand is the amount of money an individual receives during a period (usually a year) from work, investments and the like.

Rates are a funding mechanism that tailors an individual's liability according to the amount of a single component of wealth[5] they own (land) rather than income, and thus there are so-called 'asset rich, income poor' ratepayers. One needs to treat these claims with some caution; an individuals' wealth is a function of their income over their life span, and often individuals with a high degree of wealth in the form of land have other assets as well[6].

Nevertheless the distinction between income and wealth does have implications for your rating system such as the mix of fixed and value-based charging that your local authority employs, and the design of any remission and postponement policies.

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5 *To be strictly accurate rates are based on gross rather than net wealth (i.e. the value of assets held rather than assets less liabilities). To illustrate the difference, in a purely value based rating system a family of five paying off a mortgage would ceterus paribus be paying the same as a couple who held the property mortgage free, but no-one would argue that these two owners have the same ability to pay.*

6 *Some, particularly elderly, ratepayers will claim they have "sunk all of their resources" into purchasing a property (e.g a home in a retirement village). But the prudent investor should be considering all of the costs involved in making an investment before making a decision. Placing too great a weight on this kind of circumstance encourages one type of asset ownership over others – local authorities should not be in the business of what is effectively an underwriting a property investment decision.*

2.3 Affordability vs Ability to Pay vs Willingness to Pay

In 2006 there was a great deal of speculation about the 'affordability' (or otherwise) of rates both from local authorities and from ratepayers. Some of that discussion appears to confuse genuine affordability issues (or ability to pay) with issues around the ratepayers willingness to pay.

Ability to pay is a measure of an individual's actual capacity to meet the cost of their contribution to community services. The public tend to link ability to pay with an individual's income, but considerations of ability to pay should also take account of ratepayer wealth (as ratepayers can liquidate some assets, particularly those of a financial nature).

Willingness to pay is a completely different concept and perhaps can be best illustrated by this comment from a local authority submission to the 2007 Rates Inquiry:

'our rates are unpopular rather than unaffordable'.

Willingness to pay is, simply put, a measure of how much people 'want' to pay their rates/charges – or in economic terms, the degree to which they place a value on the services they receive in return. The difference between ability to pay and willingness to pay can also be thought of as '*can't pay*' as opposed to '*won't pay*'. When viewed in these terms it becomes clear that often when local authorities refer to affordability they are in reality referring to willingness to pay, or to be more accurate the local authority's perception of the ratepayer's willingness to pay.

It is important to distinguish between the ability to pay and willingness to pay as the options for resolving issues can be different. Both can be resolved through reducing service levels and hence the overall funding requirement.

Willingness to pay is closely related to perceptions of 'value for money'. Resistance to paying rates often reflects a lack of awareness of the services being provided and the cost of providing them. Options for addressing willingness to pay issues therefore tend to involve better promotion of the package of services being offered to the community (in other words, selling the benefits that come from rates[7]).

A genuine ability to pay issue might be handled with:

- a remission or postponement policy
- encouraging ratepayers to take up weekly or fortnightly payment options
- pointing ratepayers to the Rates Rebate Scheme
- referral to Work and Income (a ratepayer who genuinely cannot afford rates is also likely to have difficulty meeting other costs as well).

2.4 Efficiency

Efficiency is one of the most misused and misunderstood economic concepts – partly because it is often associated with particular political/philosophical viewpoints, or because people associate the concept with one of the aspects of efficiency.

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[7] *Some tips for using your performance management framework to demonstrate value for the community can be found in Performance Management Frameworks: Your Side of the Deal, which is available here.*

Efficiency in the economic sense has three aspects:

- *allocative efficiency* – relates to the distribution of resources in a way that maximises society's wellbeing, in its purest sense allocative efficiency implies that the design of funding systems would minimise distortions between differing types of activity [8]
- *dynamic efficiency* – or the efficient allocation of resources over time i.e. funding systems should not be designed in such a way as to move production and consumption decisions from the present into the future (or from the future into the present)
- *productive efficiency* – or, broadly speaking, efficiency in the accounting sense of the word, involves doing things at the least cost. This is the aspect of efficiency that people are most familiar with. Applying this aspect of efficiency to the design of funding systems would see policy-makers looking for options that have the lowest cost of collection and enforcement within the local authority, and the lowest cost for those paying the tax (in terms of the way they arrange their affairs). This is a particularly relevant consideration when determining whether to fund a particular activity via a targeted rate. Note that achieving productive efficiency in the short-term does not necessarily mean that allocative or dynamic efficiency will be achieved in the long-term.

2.5 Equity

In its broadest sense, equity as a concept is largely about the distribution of rates (incidence) among groups in a way that is perceived to be 'fair'. Equity or fairness are often quoted by individuals and groups. Equity/fairness are very much in the eye of the beholder – and in practice there will be a large degree of political judgement in the consideration of equity.

As with efficiency, giving due consideration to equity may well necessitate considering various aspects:

- *horizontal equity* is the idea that like should be treated alike, those in similar circumstances should be treated in a similar way
- *vertical equity* is the idea that those who have a higher income should be treated differently. This is often linked to the concepts of progressive, regressive or proportional tax systems[9]
- *intergenerational equity* – relates to the treatment of individuals over time, all other things being equal, today's residents and ratepayers should not subsidise the consumption and production decisions of future ratepayers and vice-versa. This is often linked to the concept of dynamic efficiency (see section 2.4).

2.6 Public Good/Private Good

These two concepts are familiar to many local authorities through the 1996 financial management reforms. A public good is an activity or service that is both non-rival (my consumption does not interfere with yours) and non-excludable (I cannot be prevented from consuming the service). Common examples in local government are civil defence and various planning functions. A private good is both rival and excludable. Of course most activities will sit between these two polar cases.

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[8] *We say in the pure sense because the design of funding systems takes place in a wider policy environment. The way your local authority chooses to fund something can be a policy instrument for achieving other objectives, for example encouraging or discouraging development.*

[9] *In a progressive tax system, the share of an individual's income taken up by tax increases as their income increases (as is the case with our system of income tax). In a regressive tax system, the share of an individual's income taken up by tax increases as their income decreases (as is the case with GST – lower income people spend a higher proportion of their income and thus pay more in percentage terms than an individual with sufficient income to save – something supporters of a local GST should bear in mind). In a proportional tax system shares do not change as income changes.*

3.0 Funding and the Legal Framework

This chapter discusses the legal framework as it applies to the making of funding policy in general. While the funding and financial policies receive some attention – this guide does not provide an in-depth description of every one of these policies, it focuses on the revenue and financing policy as the key instrument.

Other parts of this chapter will focus on the statutory requirements for implementing funding policy decisions. Including the:

- funding impact statement – both as it appears in the LTCCP and annual plan
- the rates resolution.

In the last part of this section we turn to case law and trace the development of the thresholds at which the courts will intervene. The lesson from this is that although the courts have shown an unwillingness to intervene in funding decisions except in cases of non-compliance with legislation, or unreasonableness – there is little room for complacency or arbitrariness when making funding decisions. Decisions must be supported with the types of analysis envisaged in section 101(3) of the Local Government Act.

Funding decisions take place within the context of statutory requirements for:

- the types of analysis that take place when making funding decisions – the section 101(3) Local Government Act requirements
- the requirements to document that process in a set of funding and financial policies – the requirements of sections 103 -110 of the Local Government Act
- processes for implementing funding decisions – the Funding Impact Statement (FIS) of schedule 10, clauses 10 and 13 of the Local Government Act and the rates resolution of section 24 of the Rating Act.

3.1 Funding Policy: The Analytical Process

3.1.1 Why are the Funding Principles and Process Important?

When making funding policy your local authority will need to work through the process and matters set out in section 101(3) of the LGA, while having regard to the section 101(1) obligation to act prudently and in the interests of the community. These requirements provide local authorities with a list of matters to consider as part of the development of a transparent revenue system. The section 101(3) requirements recognise that funding policy is more than just a device for raising revenue, but subject to the prudence test, is also one of the instruments that your local authority may wish to use to promote community well-being. While the results of section 101(3) analysis are presented in the revenue and financing policy they apply equally to other policies.

Section 101(3) analysis also features strongly in:

- *the revenue and financing policy* – this document basically sets out your local authority's policies on, and selection of funding sources for capital and operating expenditure and the rationale for that selection of tools
- *the policy on development contributions or financial contributions* – must explain the impact of development, how growth-related capital expenditure will be funded and explain the rationale for those choices in terms of section 101(3), and
- *the LTCCP disclosures at groups of activity levels* – the so-called 'schedule 10 disclosures' require a statement of estimated revenue levels, other sources of funds and explanation why these have been selected, using the section 101(3) analysis as a base.

Section 101(3) analysis is therefore critical to the success of your local authority as it provides the basis for your funding – including the annual rates collection, all of your borrowing, and the assessment of development contributions. A successful challenge to this analysis could potentially invalidate any or all of these decisions.

3.1.2 Step One Analysis

Section 101(3) analysis is basically a two-step process. The first step requires consideration, *for each activity* (this is one of the few LGA disclosures required at this level) of each of the following:

- community outcomes - the community outcomes to which the activity primarily contributes (in other words your rationale for service delivery)
- the user/beneficiary pays principle – the distribution of benefits between the community as a whole, any identifiable part of the community, and individuals
- the intergenerational equity principle – the period in or over which those benefits are expected to accrue
- the exacerbator pays principle – the extent to which the actions or inaction of particular individuals or a group contribute to the need to undertake the activity, and
- the costs and benefits, including consequences for transparency and accountability, of funding the activity distinctly from other activities.

These five matters are a 'menu' of considerations, no single criterion has greater weight in law than the others. Your local authority might decide to attach more weight to some criteria over others, but your policy will have to demonstrate that all have been considered. A failure to do this can cause problems in the event of challenge.

The community outcomes to which the activity primarily contributes

This is a statutory signal that your local authority should be considering its rationale for service delivery[10] (although the Local Government Act only requires consideration of community outcomes good practice suggests consideration of the other priorities of your local authority). The rationale for service delivery is an important piece of information.

Example: Swimming Pools

In 2006-16 LTCCPs, many of the local authorities that spelt out rationale for the provision of swimming pools tended to do so as either or both of promoting community health or widening the set of leisure opportunities available to the community. If this is the objective then a selection of funding instruments that applies a '100 percent user pays' policy may not be consistent with the rationale for service delivery.

The distribution of benefits between the community, identifiable parts and individuals

This is the 'user/beneficiary pays' principle that local authorities became accustomed to applying in the mid-late 1990s. Activities that predominantly benefit the community as a whole are generally good candidates for funding mechanisms that are levied on the community as a whole (such as a general rate). Activities that benefit particular individuals or groups tend to be better candidates for mechanisms that direct the costs to those individuals or groups (such

[10] *Indeed its one of the 24 Steps to a Great LTCCP described in the summary to Piecing it Together. Further information about developing robust rationale for service delivery for your activities can be found under 'Linking Activities and Outcomes' in that Guide and also in section six of the Performance Management Frameworks: Your Side of the Deal.*

as targeted rates, fees, and charges). Many of the activities provided by local authorities tend to fall somewhere between these two 'poles' in which case – depending on your other analysis your local authority might apply a mix of tools, or might make a judgement to use a single funding mechanism.

Your rationale for service delivery may well highlight a number of different aspects of a particular activity and their different mixes of public and private good may feature in your local authority's thinking. There is no uniform technical answer to these questions.

Example: Libraries

Generally speaking, library functions can be grouped into three main categories – lending services, reference services and preservation of heritage.

Lending services might well be viewed as having a large amount of private benefit in that the good is both rival in consumption (if I'm reading a book you can't) and excludable (that's what a library membership does). However, if your rationale for service delivery is focussed around educational benefit your local authority might well consider promotion of reading to be desirable. In this case lending services might then be viewed as having an element of public benefit.

Based purely on a consideration of benefit, your local authority might then decide that a mix of funding from the general rate, and from some form of fee or charge (such as borrowing fees for paperbacks and/or CDs) might be applied.

Period over which benefits occur

The 'intergenerational equity' principle is one of the least understood and well-applied of the funding principles. Many of the activities provided by local government are either network or community infrastructure, which have long service lives. Benefits from these services can be expected to accrue over the entire life of the asset. This requires consideration of how benefits are distributed over time and the merits of applying funding sources that achieve a spreading of the cost over time.

The main tool for ensuring intergenerational equity is the use of debt, and then rating future ratepayers to service the debt. A decision not to borrow for new capital is effectively a decision that current ratepayers should meet the cost of services future ratepayers will consume, and should be made as a conscious policy choice.

The extent to which actions or inactions contribute to a need to undertake the activity

This is the so-called 'exacerbator pays' principle and holds that those whose actions or inactions give rise to a need to undertake a particular activity should meet part of the cost of that particular activity.

Example: Flood and River Control

The exacerbator pays principle has been used by regional councils for many years as part of the basis for flood and river control rates. A strict application of the beneficiary pays principle would tend to suggest that the ratepayers who live on hillsides should pay comparatively little in these sorts of rates (perhaps only to cover the fact that property access and other facilities used by these ratepayers are protected). However the rainfall on hillside properties tends not to be absorbed by the ground to the same degree and thus tends to result in water 'running off' to the land below and adding to the volume of water in the catchment. The extension of flood control rates to the hill country properties can be justified using this type of rationale.

Costs and benefits from funding the activities distinctly from other activities

This is a requirement to consider whether there is any advantage to funding the activity separately from others – in other words is this an activity that could be funded from a general funding source (such as rates) or a targeted source (such as a targeted rate, fee or charge etc). The legislation specifically requires consideration of 'consequences for transparency and accountability', some useful things to consider would be:

- *the financial scale of the activity* – the smaller the activity is the less likely it is that separate funding will be economic
- *what administrative costs would be involved in funding the activity separately* – for example the cost of creating the information necessary to administer a targeted rate on the rating information database and adding extra information to the invoice, invoicing and collection of a fee or charge etc
- *legal requirements* – occasionally the law may require you to 'ring-fence' an activity. For example, if your local authority is contemplating some capital work, and it wishes to offer ratepayers a lump sum contribution option then it must apply a targeted rate (at least for the capital component)
- *the distribution of benefits among the community may aid in your decision* – for example, something that is of benefit to a subset of the community may be a stronger candidate for separate funding than something that benefits the community as a whole, and
- *promotion of value* – separating some activities, especially those to be funded from rates, may assist your local authority in its promotion of value for money. This is particularly relevant for some of the utility based activities such as water, refuse collection, and sewage disposal. There may also be other activities where your local authority may see a benefit in the community clearly being able to see what it is 'getting for its money'
- *other benefits* - for example to the environment.

3.1.3 Step Two Analysis

Once you have given consideration to how the matters in section 101(3)(a) apply to each activity you can move to the second step of the process. By now you will have some indication of the funding sources that you might use to fund each activity, and thus an indication of what the overall call on each source is likely to be.

Your local authority must then consider the impact of the cumulative results of step one on the current and future well-being of the community. This consideration may lead to some alteration to your results from section 101(3)(a). This process of consideration and modification *cannot* be done as part of the first step of the process.

The following are some examples of things that your local authority might consider in its section 101(3)(b) analysis. This is presented as a starting point to stimulate thinking and is not intended in any way to be an exhaustive list (nor is it a checklist of the things that must be considered):

- what is the likely impact of the mix of funding sources on the elderly and others on fixed incomes or low incomes (in other words is there a genuine affordability issue)?
- will the policy act as a barrier to the accessibility of some services (such as cultural and recreational facilities)?
- what implications does the policy have for community groups?
- what implications does the policy have for business in your local authority – are particular activities unduly penalised
- is the policy likely to have any effect on people's participation in community activities?
- what is the size of changes in funding arrangements – is some sort of transitional process necessary?
- is the mix of funding sources financially sustainable ie is the likely borrowing level one that is feasible
- what effect is the mix of funding sources likely to have on any particular sectors of your community?
- what are the current economic conditions and projected conditions over the life of the policy?
- what incentives will the policy have for development in the district?
- how is the burden of funding distributed across differing sectors of the community?
- what incentives does the policy provide to conserve scarce resources?
- does the policy provide incentives for people to avoid environmentally 'unfriendly' activities?
- what incentives does the policy provide for the preservation of natural heritage?
- what impact might the policy have on people's participation in sporting and cultural activities?
- does the policy provide any incentives for the preservation of historical and other cultural heritage?
- are there particular community or cultural groups that will be advantaged or disadvantaged by the policy?

3.1.4 Documenting Your Funding Policy Process

It is important that you document the entire process of analysis. Documenting the process provides protection in case of challenge, so that you can demonstrate both that the process has been undertaken and that your local authority has considered everything. Documenting the process also provides a helpful 'safety check' that everything has been considered and seeing things 'in black and white' can also be a useful quality assurance tool.

For *each activity* your documentation should clearly record:

- how each of the considerations in section101(3)(a) were applied and how your local authority reached that decision (including supporting evidence if relevant), and
- the results of your consideration in terms of an indication of the funding sources that emerged from the step one analysis

For the *total set of activities* documentation should include:

- a description of the matters taken into account when assessing the impact on well-being and how they applied, in other words what modifications you made to the step one results and why, and

- the final selection of revenue and financing mechanisms both across the local authority, and for each group of activity (although not an explicit requirement of section 101, you will need this information to comply with the requirements of section 2(2)(d) schedule 10).

A wide range of answers are both possible and legitimate, but your decisions need to flow logically from your section 101 analysis.

3.2 The Revenue and Financing Policy

3.2.1 The Legal Requirements

The revenue and financing policy sets out your policies on why and how funding sources are used to fund operational needs (revenue) and capital needs (finance) e.g. why did your local authority choose capital value rating etc.

This is an area where special care is needed to ensure your policy is transparent and helps support the right debate rather, than merely complying with the legislation. This is the policy that the interested ratepayer will go to, as it is intended to show who pays for what, and when. Ideally your revenue and financing policy should provide an aid to understanding your financial statements, both at (groups of) activity level, and at local authority level. Without a focus on transparency your revenue and financing policy becomes an exercise in compliance, with minimal usefulness to the ratepayer.

The actual legislative requirements for such a policy are not particularly complex or lengthy. The requirement is firstly to set out any policies your local authority has on the funding of operating and capital expenditure from the following sources:

- general rates (including the choice of valuation basis, differential rates and the use or otherwise of uniform annual general charges)
- targeted rates (but noting that the LGA does not specify any further disclosures – in other words, the revenue and financing policy need not disclose the basis on which the rates are set, and the basis for any differentiation)
- fees and charges
- interest and dividends from investments
- borrowing
- proceeds from asset sales
- development contributions
- financial contributions
- grants and subsidies
- any other source.

The second part of the requirement is that the policy must also show how the selection of funding sources in your policy complies with the funding policy process in section 101(3).

The revenue and financing policy is the place to disclose any policies your local authority may have regarding selection of particular funding instruments. For example why do you go to the legal maximum on uniform annual general charges and what do you use it to fund, why do you borrow for some capital works but not for others. It is also the best place to explain the construction of any differential rating policies or targeted rating policies and your local authority's rationale for these (which might, for example, be based on robust assessments of differences in levels of service/benefit, ability to pay, willingness to pay, and cost).

The disclosure requirements apply to both operating and capital expenditure. However, the funding sources for capital expenditure are sometimes quite different from those that apply to operating expenditure. Mixing the two will have the effect of distorting the overall picture, especially if your local authority has a sizeable capital works programme perhaps associated with a large borrowing requirement. Disclosure of capital expenditure sources becomes especially important if your local authority intends to use either development contributions or financial contributions[11].

Your demonstration of how your local authority applied section 101(3) is likely to change between long-term planning processes as:

- your local authority starts or ceases activities
- the policy rationale for undertaking activities changes, or
- some external change forces a reconsideration of the second step of the process e.g. a change in economic conditions, population composition etc.

The implication of this is that a revenue and financing policy is not something that can be merely rolled over from one LTCCP to the next – while the preparation of a policy need not be done from a 'zero base' there will be changes from plan to plan.

Your revenue and financing policy has logical linkages to each of the following that should not be neglected:

- *cost of activity statements and forecast financial statements* - the revenue and financing policy should aid in the readers understanding of the financial information in the cost of activity statements (especially) and the forecast financial statements
- *Schedule 10 disclosures* – the results of your section 101(3) analysis and an explanation of the results must be shown at group of activity level. Some of this analysis will also feature, at a higher level, in your revenue and financing policy
- *funding impact statement (FIS)* – the FIS is the mechanism for implementing the revenue and financing policy. In effect, the FIS is the linkage between the revenue and financing policy and the actual setting of rates and charges. This is the document that provides the majority of the detail as to how rates will be set - not the revenue and financing policy.

3.2.2 Good Practice for Revenue and Financing Policies

Principles for a Revenue and Financing Policy

The following are useful principles to keep in mind when developing a revenue and financing policy:

- *transparency* – the over-riding purpose of a revenue and financing policy is to show who pays for what and why. The content of your policy should be tailored in such a way as to meet the legislative requirements and this test. A policy that does not do this cannot provide the predictability and certainty described in section 102
- *easy to understand* – avoid the use of terminology if you can. If you need to use terms such as 'marginal cost pricing' define these in everyday language. Thresholds and percentages may also be useful to make the policy concrete
- *robust* – the policy should be based on a clean set of funding/financial principles and sound underpinning analysis and documentation. Policies that can demonstrate this are more likely to withstand legal and ratepayer scrutiny. An example of a set of funding and financial principles is shown below

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[11] *It is worth noting however that the central plank of this judgement Neil Construction and Others vs North Shore City Council related to deficiencies in the revenue and financing policy in the treatment of capital expenditure rather than the development contributions policy per se.*

- *fair and equitable* – the policy is your local authority's opportunity to explain what it considers to be 'fair and equitable'. Without this fairness and equity remain a concept that is ' in the eye of the individual ratepayer'
- *durable* – the policy should retain relevance in spite of day to day changes in the environment
- *realism* - like the remainder of the LTCCP, the revenue and financing policy represents a commitment to the community by your local authority and in particular elected members. A document that is 'aspirational' but sets results that are not 'feasible' is unlikely to survive an LTCCP cycle. The obvious implication of this is that elected members must be involved in the development of the revenue and financing policy.

Specification of the Policy

The revenue and financing policy was not intended to, and need not, provide a detailed description of every fee and charge. Remember the intent of the revenue and financing policy is to show what, why and how. The rest is implementation detail. Describing exactly how each rate is set adds considerably to the length of the revenue and financing policy and may have the effect of reducing rather than enhancing transparency. An over-specified revenue and financing policy is unlikely to have any durability and will require frequent amendment.

In some cases some level of detail is prescribed. The most obvious of these is that the revenue and financing policy must identify your choice of valuation basis, whether you use differentials and the use of uniform annual general charges. Your disclosure of this in a revenue and financing policy would then be something like:

'General rate – ABC district council levies the following general rates:

- *a uniform annual general charge* (if this local authority had a policy of going to the maximum it would then follow this with some form of disclosure along the lines of *'this charge is set at a level such that x percent of the rate revenue will be generated by this charge'* and explanation of why the policy is in place)
- *a rate per dollar of rateable capital value, differentiated on the use to which the property is put and the location of the property.* This would then be followed by a rationale for the use of both the valuation system and differentials. Simple statements along the lines that *'the council considers the capital value system produces the fairest allocation of rating liability'* go some way towards providing a rationale but need further explanation as to why that judgement was made.

Your disclosure for targeted rates need only specify that a targeted rate will be used to fund a particular activity or activities and briefly explain why. You do not need to disclose the basis on which the rate will be calculated (but you will need to disclose this in the FIS).

Capital Expenditure

Many local authorities take something of a 'pooled' approach to funding capital expenditure and might make one disclosure for their entire capital programme in the revenue and financing policy. This is an acceptable approach if your rationale for selecting particular funding sources over others is clear. A disclosure might take the form of a hierarchy of sources or clear descriptions of when funding sources would be used.

You may need to set out clearly any differentiation in funding sources for renewals, changes in levels of service, and the costs attributable to growth. While each is capital expenditure your selection of funding sources is often quite different for each. For example, renewals tend to be funded from rates and reserves whereas new assets are often funded from borrowing (and those to service growth may also be funded via development contributions). This sort of disclosure provides further support for your policy on development contributions or financial contributions (and will be something developers will be looking at).

Percentages and Thresholds

The revenue and financing policy is a particularly important policy for the readers of your LTCCP – the more understandable it is, the better. Readers should be able to understand your intentions and gauge the likely impact of the policy upon them.

This does not mean that your revenue and financing policy needs to be specified with military precision – in fact too great a level of precision is probably spurious. A high level of prescription is also likely to create a need for frequent amendment (that is a policy that is neither robust nor durable). Rather than a set percentage your local authority may find that specifying a range of percentages or thresholds may provide more transparency without too much detail.

One of the things to watch out for if you move to including percentages in the revenue and financing policy is that these do not become an end in themselves (these can be popular with the community as they are readily understandable). The percentages and thresholds you include in the revenue and financing policy should be linked in some way to service delivery objectives (including the rationale for service delivery).

This is where your section 101(3) analysis can be especially helpful. For example in the case of a library where there may be wider education objectives, your discussion of community outcomes will have highlighted this. It would then logically follow that your local authority might set user fees at or close to marginal cost ie a low-moderate percentage of revenue for recovery.

Showing Compliance with Section 101(3)

The 2006-16 revenue and financing policies generally took one of two approaches. The first approach was to list the matters in section 101(3) and state that these had been considered in developing the revenue and financing policy. The second was to include something approaching the full set of documentation in the policy (thus there were some revenue and financing policies that were 30-40 pages long).

The first approach may not comply with the legislation (merely saying that you have considered something is marginal in terms of actually showing 'how' you complied). Such a document is not useful document for readers trying to determine how the section 101(3) matters applied to any particular activity or group.

The second approach demonstrates a more certain level of compliance with the legislation (depending on how well the consideration of section 101(3) matters has been documented). The issue with this approach is more the additional content in the LTCCP and the ease with which the reader can locate information regarding a particular activity (although careful structuring and signposting in the document can resolve this).

Figure 3.1 (page 29) below represents a 'halfway house' for considering the 101(3) matters ie those matters that apply at the level of an individual activity that attempts to compromise between too much detail and too little. Impact on well-being is not included in this table as this is done globally when the results of section 101(3)(a) have been tabulated.

You would then append a narrative describing:

- any impacts on well-being that your local authority took into account
- why those matters were important
- how those matters influenced your local authority's selection of funding sources.

The provisions of your revenue and financing policy will then flow through into some of the other funding and financial policies – in particular the borrowing management policy (for decisions about intergenerational equity) and the policy on development contributions/ financial contributions.

So to this point you have undertaken a process of analysis, documented that process and prepared a set of funding and financial policies. How do you go about moving from these policies to actually setting fees and charges?

There are three steps. These are (in chronological order):

- the LTCCP FIS
- the Annual Plan FIS
- the rates resolution.

3.3 Funding Impact Statement

3.3.1 Legal Requirements

As it appears in the LTCCP, a FIS is a ten year statement that sets out the revenue and financing mechanisms that will be used in each year, and an indicative level or amount of funds to come from each mechanism. The Annual Plan FIS must meet the same tests, but applies only to the year covered by the Annual Plan.

The LTCCP FIS should contain enough detail to:

- support the revenue and financing policy in providing predictable and certain estimates of future funding requirements
- help your residents and ratepayers understand the implications of the revenue and financing policy 'for them' ie what are the rates and charges they are likely to have to pay, and
- demonstrate that you have complied with your own revenue and financing policy.

Figure 3.1: Documenting Section 101(3) Analysis in a Revenue and Financing Policy

This summary is intended for the revenue and financing policy, and is not intended to replace the fuller documentation of the section 101(3) matters. The last two columns reflect a policy decision this particular council has made and should not be taken as any indication that this service 'must' or even 'should' be funded in this way.

Activity	Community Outcomes	Who benefits	Period of benefit	Whose acts create a need	Separate Funding	Funding Sources	Rationale
Aquatic Services (You might state the level of cost of the activity – separated into the operating and capital elements).	Active City – this activity provides the community with an opportunity to participate in active leisure.	The users benefit from personal fitness and competition. However there is also a community benefit in providing options for people to exercise and relieve pressure on the health system. The aquatic facilities can also be used to attract regional and national sports events.	The central pool facilities have a service life of 50 years. The proposed western suburb pool is expected to have a similar life. Council has borrowed for the central pool and is currently repaying the loan. The council also proposes to borrow for the western pool	Growth in the western suburbs has exacerbated demand for a second facility.	Funding the growth component by development contribution will require separate attribution of drivers and a separate mechanism. Large degree of private benefit makes user charging feasible.	**Operating** General rate 30-40 percent. Fees and charges 60-70 percent **Capital** Borrowing 75-85 percent General rate 10-20 percent Developer contributions 1-10 percent	**Operating** Although there is a large degree of private benefit, the council's rationale for service delivery (promoting active leisure) means full recovery from fees and charges is inappropriate. **Capital** This asset has a long life –borrowing enables council to spread costs evenly between current and future users. Growth in the west suburbs has added to demand it is by no means the only driver underpinning the need for the second facility. Only a small level of development contribution is appropriate.

The FIS is the place to put the mechanical detail on the rates strike that some local authorities previously placed in the revenue and financing policy. The required disclosures around rating mechanisms literally require all of the information you would put into a rates resolution except the actual level of the rate (the 'rate in the dollar', 'per property' and the like).

So for a general rate the information includes:

- the valuation basis (land, annual, or capital)
- differential categories (if any) a precise definition of their construction and either the revenue sought from each category or an explanation of how the level of the rate that each category pays differs from the others (so, for example if your council has a target differential such as the commercial sector paying twice the rate in the dollar that the residential sector pays you would state that here), and
- details of how any uniform annual general charge will be calculated (that is on a one per property or one per separately used or inhabited part of property, and if the latter then your definition of separate use or inhabitation).

For a targeted rate the information includes:

- the activity or activities that the targeted rate will fund
- the categories of property that will be liable for the rate
- how the targeted rate will be calculated (which of the matters from schedule three of the Rating Act will be used as the basis for the rate, noting that there may be more than one, and there may even be different bases for different categories of property)
- if differentials are being used, then the basis for the differential (from schedule two) and a statement of the relationships between the categories.

Your local authority is also required to disclose the level of every other revenue and financing mechanism it intends to employ in the FIS – including the non-rate mechanisms. This does not mean the FIS need identify every fee and charge separately, a single fees and charges disclosure is sufficient (although those that are significant such as water meter revenue should probably be separately disclosed).

Your FIS needs to state 'the relationship between each mechanism and the sources of funds described (in the disclosures) under clause 2(2)(d) (of schedule 10)'. It is not clear exactly what this means, as the 2(2)(d) disclosure is pitched at group of activity level while the FIS is corporate. A single paragraph to the effect that the FIS represents the aggregation of the funding sources described in the groups of activity statements is all that is required.

Where your local authority is intending to use a mechanism in more than one year (as typically it will with most mechanisms), then the mechanics of the rates, and the information relating the mechanisms to clause 2(2)(d) need only be disclosed once (provided you specify the years in which your local authority will be setting that rate). If your local authority intends to change any of the mechanics for either a general or a targeted rate during the life of the plan (such as switching from land value to capital value or changing a differential) you will need to disclose that.

Doing the FIS well is vital as your rates must be assessed in accordance with the factors and matters set in the FIS. A deficient FIS creates a potential procedural matter which could be used to invalidate one or more of your rates and charges.

3.3.2 Good Practice for the Funding Impact Statement

Your FIS will contain a mix of financial information and non-financial information. There is no single 'right' way to present this information in the FIS, but many of the better FIS tend to take the following structure:

- general rate disclosures
- targeted rate disclosures, and
- other disclosures – borrowing, asset sales, development contributions, fees and charges.

This is accompanied by a table that lists each of the sources and the indicative level of funds in each year (in a format similar to the way that most local authorities presented their forecast financial statements). It is good practice to separately disclose each rate.

The ideal FIS would show not only the money 'coming in', but also the money 'going out' (the expenditure requirements). Most of the general public have a good understanding of movements in cash, thus such a FIS can be a useful communications aid. We would be seeing examples from local authorities which have done this.

3.4 The Rating Resolution

Up to this point in the process, your local authority will have been communicating its intentions around its funding decisions. With some funding instruments such as development contributions and borrowing, the adoption of a policy and if need be supporting delegations is all that is required. Rates are different – up to this point the policies and documents are notices of an intent to set rates in a particular way that do not create a legal liability to pay.

It is the act of setting rates that gives your rating decisions legal force and allows you to begin the collection process (not covered in this guide). Rates can only be set by resolution of the local authority. The power to set a rate cannot be delegated to a Committee of Council, to a Community Board, or to a member of staff. Rates can only be set in accordance with the provisions of the LTCCP and the FIS for the relevant year.

The rates resolution must state:

- the financial year
- the date or dates (where rates are payable by instalments) on which rates must be paid.
- each of the rates to be set by the local authority, together with any relevant details such as the basis of calculation (section 16(4) or 18(2)), the factors that will be used and any differential categories
- any delegations that will be operative (if not made elsewhere)
- any penalties that will be operative.

3.5 The Case Law

Local authority decisions can be challenged for non-compliance with the legislation but can also be challenged on administrative law grounds. The courts do not view local authorities as the alter ego of central government in 'high policy' terms.

3.5.1 The grounds for challenge of funding decisions

Local government funding decisions are subject to judicial review. Judicial review is concerned with the exercise of public power and the need to limit its excessive or improper use by public bodies.

There are three main grounds of judicial review:

- Illegality
- Procedural irregularity
- Unreasonableness

Illegality

Illegality arises where a decision was based on an error of law, contravenes legislation, or the empowering legislation does not authorise it. In the rating context, this could occur where the council purports to set and assess a rate that has no basis in the Rating Act.

Procedural impropriety

Because rates are a form of mandatory tax imposed on ratepayers, the law requires strict compliance with the statutory procedures for authorising, setting and assessing rates. Where these processes are not correctly followed rates will likely be invalidated.

Administrative authorities are also bound by procedural requirements known as the rules of natural justice (or fairness). The two key principles of natural justice are that the parties be given adequate notice and opportunity to be heard and that the decision-maker be disinterested and unbiased.

Unreasonableness
A reviewable decision can be challenged on the ground that it is irrational or unreasonable. Unreasonableness is the most problematic ground of review as it can be difficult for Courts to maintain the distinction between the legality of a decision, which is reviewable, and its merits, which are not reviewable.

The leading case concerned with unreasonableness in the context of local authority decision-making is an English case known as the Wednesbury case[12]. Wednesbury, and the case law that has followed it, use terms such as *'perverse'*, *'irrational'*, *'outrageous in its defiance of logic'* or *'so unreasonable that no reasonable decision-maker would have made it'* as their standard of unreasonableness. The test is intended to provide a high threshold. The burden of proof in these cases is on the plaintiff to prove the decision is unreasonable, not on the defendant to prove it acted responsibly. The law around unreasonableness starts from the premise that funding involves the weighing of considerations best undertaken by those elected by the community to make decisions on its is behalf.

3.5.2 Rates challenges in the 1990s

In the 1990s there were a series of cases challenging council rating decisions on the grounds of unreasonableness. The first was *Electricity Corporation of New Zealand (ECNZ) v Mackenzie District Council (1991)*. This case revolved around a challenge to a council decision not to grant a differential on two hydroelectric dams. In the year that ECNZ dams became fully rateable under the Rating Powers Act 1988, Mackenzie District Council set its general rate on the basis of undifferentiated capital value. As a result ECNZ's dams became liable for approximately 78 percent of the total rate take of the district. The increase in ECNZ's rates

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[12] *The full citation for this case is Associated Picture Houses Limited vs Wednesbury City Incorporation (1948).*

would have provided Mackenzie District Council with a $1.9 million unallocated surplus. This was roughly the same amount as the Council's usual rate take. The Court of Appeal held that:

- local authorities are an administrative body and courts therefore do have jurisdiction to investigate and overturn decisions on administrative law grounds
- the rates set by Mackenzie in respect of the hydroelectric dams bore practically no relationship to the degree of benefit that these properties would enjoy from council services. Although the linkage between rates payable and degree of benefit under the Rating Powers Act 1988 did not contemplate exact and direct relationships between the two, the difference between the rates payable and benefit in this case was so extreme that the court considered the level of rates unreasonable[13].

This judicial reasoning was further applied in *ECNZ v Waimate District Council* [14]*(1991)* and *ECNZ v South Waikato District Council*[15]*(1994)*. Both of these cases also involved the rating of hydroelectric dams. The latter case represented the highwater mark of this line of judicial authority. As with the previous cases it involved a failure to grant a differential to hydroelectric dams in the district, however, in this instance South Waikato District Council was only using the general rate to fund roading, regulatory services and the costs of democracy[16].

Wellington City Council v Woolworths

In 1996 the Court of Appeal heard the case *Wellington City Council v Woolworths and Others*. This was an appeal from a High Court decision striking down Wellington City Council's commercial differential. Wellington City Council had a policy of setting its differentials in such a way as to collect a set percentage of the rate take from commercial property (at the time around 66 percent). A revaluation had seen suburban commercial property increase in value at a much faster rate than commercial property in the CBD, thus suburban commercial property had experienced a significant increase in rates. The Court of Appeal upheld the appeal, finding that:

- the rating legislation has been designed in such a way as not to require any clear and direct correspondence between rates and levels of benefit received[17]
- local authorities have a wide discretion in the design of funding systems and can apply anything ranging from something akin to a taxation system to systems closer in spirit to user pays
- decisions of this nature should be made 'in the round' by those elected to make such judgements and courts should intervene only in cases of error of law or clear and extreme unreasonableness
- benefit does not lend itself to objective, accurate determination – indeed there is no uniform technical answer as to whether a particular service generates benefits of a public or private nature.

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23 *The Court of Appeal also noted that Mackenzie had not followed statutory procedures when setting the rate in that the council had not determined what its expenditure requirements were and then set the rate. In effect the council had set the rate, noted it would be left with a surplus, and decided it would (unlawfully) make supplementary estimates. It is likely that this alone would have invalidated the rate.*

24 *In this case, the High Court found unreasonable Waimate's decision to impose a land value general rate differentiated on the hydroelectric dams in such a way as to recoup an equivalent amount of revenue to that which they would have collected under the capital value system.*

25 *There was also the case Howick Engineering and Others vs Manukau City Council (1993) in which the High Court found that a commercial differential of 3 was not unreasonable in the circumstances. It found the council was entitled to take ability to pay and the policies of other councils into account in the process. However, the rate was still invalidated on grounds of non-compliance with the rate-setting procedures of the time.*

26 *There has always been a strong suspicion that the decision in this case may well have been overturned on appeal, as the council had gone to some lengths in its assessment of benefit, and in the design of the rating system.*

27 *In his judgment in the case Richardson P held that "it is implicit in the scheme of the legislation that the rating system in all its diversity remains primarily a taxation system and not a system inherently based upon a principle of user pays …"..*

This judicial reasoning has been invoked in favour of local authorities in: *Lovelock and Others v Waitakere City Council (1996)*[18], *Visser and Others v Whangerei District Council* [19] *(1998), and Telecom NZ Limited v Auckland City Council* [20] *(1998)*.

3.5.3 Changes to the Statutory regime since 1996

Part VIIA of the Local Government Act 1974

The cases discussed above were decided before the financial management provisions of the Local Government Act took effect (from 1 July 1998). The provisions of Part VIIA of the Local Government Act 1974 gave local authorities a set of principles, considerations and matters to apply, a process for applying them, and a requirement to document their consideration in a funding policy. These more detailed requirements suggest opportunities for challenges based on the failure to take relevant considerations into account rather than unreasonableness.

The first challenge under Part VIIA of the Local Government Act 1974 was *Brocklesby and Others v Waikato Regional Council (1999)*. This was a case involving the setting of a land drainage rate in the Piako community and in particular the council's decision to apply the 'exacerbator pays' principle to a group of ratepayers who owned properties in the Central Waikato Hills from which water run-off was contributing to flooding downstream. The court held that the exacerbator pays principle was relevant to funding this activity, and that the council had considered other relevant considerations. The court also held that the importance the council attached to each was a matter for it to determine, provided the council could demonstrate it had followed the funding policy process.

Local Government Act 2002

The requirements to consider patterns of benefit (both in the present and in the future), exacerbators, and the costs and benefits of separate funding were included in the Local Government Act 2002. However, both the process for considering these matters and the requirements to document the policy were changed subtly.

In *Paekakariki Informed Community Incorporated v Kapiti Coast District Council* (2004), the High Court considered a challenge to the Council's rate setting. It was argued that the council had failed to take account of relevant considerations (which related to particular circumstances in the district which might affect rating decisions). The court held that section 101(3) set out mandatory relevant considerations, and that it could not be implied from this that certain other particular considerations (for example, the increase in the burden to Paekakariki ratepayers) were mandatory.

Neil Construction and Others v North Shore City Council, involved a challenge to the council's policy on development contributions. The main elements of the challenge were directed against the council's revenue and financing policy and in particular the compliance of the council's documentation in respect of the Northern Busway project. Relying heavily on the exacerbator pays principle the council had decided to recover 95 percent of the cost of this project through development contributions. The court held that while exacerbator pays was relevant, the council should also have considered patterns of benefit. The Court held that the factors in section 101(3) must be considered, weighed and evaluated in reaching funding determinations in respect of each activity. A council may not "consider" then

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28 *This case involved a challenge by a group of residential property owners in a high-value area to a council decision not to adopt the so-called stepped or value-based differential. This challenge was initially upheld by the High Court, but overturned in the Court of Appeal.*

29 *This case involved a challenge by a group of owners of small rural blocks in a coastal area outside of Whangarei, that had recently experienced significant increases in valuation.*

20 *This case was part of a multi-headed challenge to the rates the council levied on phone lines and phone booths in the city.*

reject or exclude a factor completely. The council's revenue and financing policy could not demonstrate that such consideration had occurred, and although the Judge made no specific orders, the decision anticipated that the Council would redraft its policy to give effect to the court's finding (and leave was reserved for the parties to apply for further direction or orders, if necessary). .

The *Neil* case signals something of a shift in the grounds on which the judicial review of funding decisions are being brought. There have been no successful challenges to a local authority rate on the ground of unreasonableness since 1996. It appears challenges to development contributions may be this decade's equivalent.

Neil is also representative of the shift from challenging the substance of a policy to the policy process itself. North Shore City Council's decisions were found to be invalid due to a failure to demonstrate that it had considered all the statutory matters.

3.5.4 Consultation

Consultation is not usually a stand-alone ground for review. However, from time to time funding decisions are challenged on the basis that the consultation process was defective in some way, or that insufficient weight has been attached to the results of the consultation process.

The leading case law authority on consultation in New Zealand is *Wellington International Airport v Air New Zealand* (1992). Although not involving a local authority, the principles in this case have been applied by the courts to local decision-making (most notably in *South Taranaki Energy Users Association v South Taranaki District Council*). The key principles in the Wellington Airport case are:

- consultation is an exchange of information, it is not a process of negotiation towards an agreement[21]
- the organisation consulting is obliged to consider any feedback received in the consultation with an open mind and, if need be, demonstrate a willingness to change
- sufficient information should be provided to the parties being consulted so that they can make intelligent and informed decisions.

Many of these considerations now have statutory recognition in the principles of consultation in section 82 of the Local Government Act 2002. The South Taranaki case noted that mere numbers for or against a particular proposition are not, in themselves, determinative[22].

More recently, in *Willowford Family Trust v Christchurch City Council*[23], a majority view of respondents to a form of public consultation in relation to a new bylaw expressing a preference for a particular form of bylaw, was not enough to save the bylaw from being held to be invalid.

21 *Or as the learned judge in Greensill vs Waikato Regional Council (1995) noted "Consultation is a two way process. It is not intended to mean having deliberation with any party and abandoning the project if those deliberations do not appear fruitful.*

22 *In this particular case the council had decided to sell shares in an energy company, when consulting some 95 percent of submissions received (mostly coupon style submissions) had been against the sale.*

23 *[2006] NZLR 791*

3.5.5 Funding Challenges and the Case Law: The Key Lessons

The lessons that can be learned from this are:

1. local authority funding decisions may be challenged not only for failures to adhere to the law, but also on grounds of unreasonableness. While policy-making is a role that is best left to those elected by local communities to make these kinds of judgements, councils do not have a licence to act unreasonably or arbitrarily;
2. the revenue and financing policy and associated documentation is central to being able to demonstrate compliance with the law and the reasonableness of a decision. A revenue and financing policy that is deficient could potentially invalidate any or all funding decisions made in reliance on that policy including the setting of rates, development contributions and borrowing;
3. the matters in section 101(3) of the Local Government Act are not a 'menu' – a local authority cannot simply 'pick and choose' the matters it wishes to consider, but rather must be able to demonstrate it considered them all;
4. while the rating system is not, and never has been, intended to be a user-pays mechanism, the matters listed in section 101(3) of the Local Government Act 2002 will involve consideration of benefit as well as the other matters listed in that section;
5. the law around consultation does not require negotiation towards agreement, the obligation is to consider feedback with an open mind;
6. it is essential to comply with the statutory process and content requirements for the revenue and financing policy, funding impact statement and rates resolution (and for rates assessments and invoices).

4.0 The Funding Tools

This section turns to the actual set of funding tools available to local government and their merits and disadvantages. We begin with a discussion of the various options around setting a general rate (including a thorough discussion of the land, annual and capital value systems). This is followed with discussion of the options available for targeted rates and last, but not least, non-rate funding mechanisms.

A rate is a charge levied on the owners of property[24] to fund community services. Most, though not all rates mechanisms[25], do not show a direct relationship between the level of use/benefit and the amount of the charge. This gives rise to the 'debate' as to whether rates are a tax or a charge for services. SOLGM et al (2007)[26] has this to say

> *"We are aware that some commentators have suggested that the very nature of the rating mechanism is unclear. No lack of clarity exists, rates are a system of tax used to fund local goods and services, in much the same way as income tax and GST are used to fund nationally provided services. However, local authorities do have the discretion to tailor rating systems in such a way as to more closely approximate "user pays".*
>
> *One need only look at the scheme of the funding parts of the Local Government Act 2002 to see that rates are not intended to be a user charge. The main section dealing with funding policy (section 101(3)) requires local authorities to give consideration to the distribution of benefits among the community, but also to consider:*
>
> - *the objectives the local authority has in undertaking the activity;*
> - *intergenerational equity;*
> - *any exacerbators;*
> - *the practical implications of funding the activity separately from other activities;*
> - *the impact on wellbeing.*
>
> *Had Parliament intended that rates were to be solely a user charge it would not have enacted a policy-making requirement that takes in such broad considerations.*
>
> *The concept of rates as a tax has received judicial recognition on several occasions. The root of this line of jurisprudence is the decision of the Court of Appeal in Woolworths and Others vs Wellington City (1996) where the judgement of Richardson P commented that:*
>
> *" … it is implicit in the scheme of the legislation that the rating system in its diversity remains primarily a taxation system and not a system inherently based on a principle of user pays".*
>
> *Finally, any standard economics textbook includes property within its standard definition of tax. Economists refer to the "tax-like characteristics of rates" which are generally referred to as:*

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[24] *Where owner and occupier are different people on a block of general-titled land, it is only in rare circumstances that the occupier can lawfully be assessed the rates. (On Maori freehold land it is more common for the occupier to wind up being defined as the ratepayer).*

[25] *The closest direct mechanism to a user based charge in the present set of rating tools is the ability to meter water consumption.*

[26] *SOLGM et al (2007), Getting Real – Funding the True Cost of Local Communities, pp11-12.*

- universality
- coerciveness
- independence from levels of benefit received
- public accountability on the part of the agency levying the tax.

GST on rates is sometimes raised as an argument in support of rates being a user charge. This is something of a 'red herring'. In fact, the reason GST is applied to rates is more to preserve competitive neutrality between providers[27] and to ensure a broad and "tidy" revenue base (i.e. the more exemptions, given the more "grey areas"). "

4.1 General Rating

A general rate is a tool for funding those costs that your local authority has decided should be met by the district as a whole. With the exception of the so-called 30 percent cap on uniform charging – there is no restriction on how much or how little the revenue raised from a general rate can be, or how these revenues can be used.

Local authorities currently have two general rating tools available to them – the value based general rate and the uniform annual general charge (or UAGC). For general rates local authorities have the choice[28] of three valuation bases – the land value system, the capital value system and the annual[29] value system.

Local authorities can use a combination of the UAGC and valuation based general rates (and many do) but cannot use combinations of valuation bases (e.g. 50 percent land and 50 percent annual) for the general rate.

It is important to recognise that the tools for general rating are devices for allocating liability, no matter which set of tools in which combination, the overall revenue-raising potential within your community remains the same. The UAGC, the three valuation bases, and differentials on value based rates are devices for sharing the cost of rates out amongst the different sectors of your community, rather than for releasing whole new pockets of rating potential.

4.1.1 Land Value

Key Features

Land value is based on the value of the bare (unimproved) value of the land.

In the 2007/8 rating year 34 of the 73 territorial authorities and one regional council set their general rates on the land value system.

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[27] *For example, if GST were removed from rates, those whose water is funded through rates would pay no GST, whereas those Auckland, Papakura, and Manukau residents would pay GST on the water they receive from CCOs. There are similar examples across the entire ambit of local government activity.*

[28] *This degree of choice is uncommon in overseas jurisdictions, many of whom rely on capital value (or close derivatives of that system).*

[29] *Also sometimes (incorrectly) referred to as the rental value system.*

Things to Remember

Land value generally provides a poorer reflection of benefit than the other two valuation bases. To take a simple example, assume there are three different rating units side by side. They are similar in every respect except one is unimproved, one has a two bedroom house, and one has a five story residential apartment complex. All other things being equal the three have the same value under the land value system. But no-one would argue that the degree of benefit is the same - they make quite different use of local authority services.

Historically property values, especially land values, have been seen as poor indicators of ability to pay. Covec 2007[30] plotted a single metropolitan local authority's land and capital values (at meshblock level) against meshblock income. Unsurprisingly they found a positive relationship, that is as income increases so does the capital value. However Covec also found that a surprisingly high degree of relationship between unimproved values and income[31]. While this is far from conclusive evidence, if translated across local authorities of different sizes, and mixes of land use, it might suggest land value is a better predictor of ability to pay than has been previously assumed.

It has been claimed that unimproved values tend to fluctuate more than capital values between revaluations. Although we are unaware of any systematic New Zealand evidence to support or refute this, it intuitively rings true. Swings in valuation are driven off sales information which are driven by market demand. One of the major factors in demand is location – certain suburbs or 'school zones' become sought after, urban growth fuels demand for land on the urban/rural fringe, zoning changes manifest themselves in sudden shifts in demand for different categories of property. It is the site that is the determining factor, it then follows that this would be reflected in valuation.

Partly because of the fluctuation, there tend to be a greater number of 'outliers' (i.e. properties with high values relative to the rest) and sudden swings in valuation. Calls to resolve these tend to point local authorities towards greater use of the UAGC and/or differentials to deal with the impact.

By ignoring improvements, the land value system takes no account of the state of development of the land. To the extent that rates form a significant part of cost structures this may, at the margin, encourage development of vacant land and or more intensive development of developed land. All things being equal, those who use or develop land intensively pay the same rates as those who do not develop land at all. This was historically seen as a strong argument for land value.

It has been argued that rating on unimproved values tends to favour residential ratepayers. Rates are apportioned where unimproved values are highest which will tend to be in central business districts, or near a body of water (or with a view of water). SOLGM (2008)[32] found that a shift to capital value would result in some shift in incidence into the residential sector in eight of the nine land value councils in the study sample.

The market for unimproved land is much smaller than that for improved land. With less transactions data to rely on there is the potential for lower data quality (for example, one or two significant sales of unimproved land could potentially skew results).

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30 *Covec (2007), Trends in the Use of Rating Tools Nationally to Fund Services. This report was one of the background reports requested by the 2007 Independent Inquiry into Rates.*

31 *For those readers with knowledge of statistics the R^2 of this simple one variable and an intercept model was 0.75 (statisticians tend to find a model with a result of 0.6 or better useful).*

32 *SOLGM (2008), No Magic Answers - An Analysis of the Impact of the Recommendations from the Independent Inquiry into Rates on Rating Tools.*

4.1.2 Capital Value

Key Features

Capital value is based on the value of the land and improvements. This includes fruit trees, nut trees, vines, berryfruit bushes, or live hedges. Network infrastructure is legally regarded as an improvement, therefore it has a capital value and can be legally assessed for all value-based rates[33].

The average capital value across all property types is around 2 – 2.5 times higher than land value.

In the 2007/8 rating year 36 of the 73 territorial authorities, and all but one regional council set their general rates on the capital value system. This percentage has been slowly increasing over the past ten years.

Those overseas jurisdictions that use property taxation as a means of funding local government tend to rely on capital value as the rating base.

Things to Remember

Capital value tends to have access to a greater volume of transactions and hence richer sales information. Covec (2007) cites the experience of two Auckland city councils where there have been approximately 50 sales of dwellings for every sale of land. Values under this system are likely to a more accurate set of data than that generated under the land value system. Covec also notes that:

> *"even in areas with a higher number of land sales, land transactions tend to concentrated in the peripheral (greenfields) areas. The value of land in these cases may not be representative of the values elsewhere in the district.[34]"*

Capital value targets intensity of use/intensity of development. The higher the intensity of development the greater the capital/land value ratio is likely to be and the higher the share of rates any given property will pay. For example, properties such as hydroelectric dams, dairy factories, and other capital intensive properties can expect to pay especially high levels of rates[35].

Intuitively one would expect capital value to show a closer correlation[36] with ability to pay than land value, especially noting the earlier discussion about land values and ability to pay. Covec (2007) found a very high degree of correlation between income and capital values within the local authority that they surveyed. However land and capital value were much closer in their relationship than many might expect.

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33 *There is a long line of judicial authority that holds that such infrastructure is both an interest in land and has a capital value. The most recent case law is Telecom NZ Limited vs Auckland City Council (1998). Note also that regardless of the valuation system, a local authority is required to value such infrastructure and place it on the district valuation roll. Once on the roll that land becomes liable for the UAGC and any fixed targeted rates, irrespective of the valuation system i.e. every local authority should either be assessing rates on phone boxes and lines, gas pipes and the like or remitting them as part of a remissions policy.*

34 *Covec (2007), Trends in the Use of Rating Tools Nationally to Fund Services, page 35.*

35 *It is no accident that many of the early challenges to rating systems came from a single high capital/land value property owner, the then Electricity Corporation of New Zealand.*

36 *The R^2 for that model was 0.81.*

Supporters of capital value argue this system tends to bear a better relationship to benefit than unimproved values. Intuitively you would expect that this would be the case – a developed property is likely to be making heavier use of the road network, the occupiers of the property make heavier use of water, refuse collection, community infrastructure and the like. This is one reason why differentials in councils on the capital value system tend to be fewer (both in terms of the number of councils using differentials and the number of differentials in those councils that do use them) and smaller (although there are exceptions among some metropolitan local authorities.

Opponents of capital value argue that this system discourages development. There is little systematic evidence to support this claim. Intuitively, rates are such a minor part of most industrial cost structures that in reality any development that has become uneconomic through rates was marginal, at best, before the change in systems[37]. Again, the one exception where there may be more of an argument lies with capital intensive industrial projects.

Capital value tends to be a slightly more buoyant base than unimproved value i.e. it expands more as development occurs. In addition to the price effects on unimproved land noted in the discussion of land value, as land is developed more intensively the value of improvements rises, hence the overall capital base.

4.1.3 Annual Value

Key Features

Annual values are based on the greater of:

(i) five percent of the capital value of the rating unit or

(ii) the rent at which the unit would be let, less twenty percent for houses and buildings and ten percent for land

In the 2007/8 year only two local authorities (Auckland City and Manukau City) use the annual value system as the basis for the general rate and one or more value-based targeted rates.

Things to Remember

Supporters of the annual value system tend to argue that annual value is a better reflection of the income-producing capacity of a particular property than land or capital value. This may be more true where the annual value is based on rental, but is perhaps less so where the annual value is based on a percentage of capital value.

In a similar vein, the correlation between annual value and ability to pay may be closer. Particularly in the residential sector, affordability issues mean that the higher the rental, the higher the income of the residents[38].

Annual value tends to bear a closer relationship to degree of benefit than is the case with the other systems, especially land value. For residential property, rentals are often determined by the number of bedrooms (in other words, the number of people who can be accommodated on the property)[39]. All other things being equal, the greater the number of people on a property, the greater the use it is likely to make of both network infrastructure (more people driving on the roads, greater water use) and community infrastructure. While a similar argument can be made for commercial/industrial property it can also be argued there that

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37 *This may also have implications for the design of remission and postponement policies to "attract business".*

38 *Noting that, again, above a certain point, the rental value ceases to dominate and the rating value is based on 5 percent of the capital value.*

39 *Although there are also strong location related factors as well.*

rentals are closely linked to potential profitability, and that this tends to be related to intensity of use.

As a general rule rental yields tend to reduce as property value decreases, thus as value increases it becomes more likely that the annual value will be based on the former of the two components. Covec (2007)[40] shows that in one of the above two local authorities – above a capital value of around $300K the capital value component begins to dominate. In a market where sale prices are rising rapidly this can cause annual value to default to the capital value basis – in 2007 Manukau City Council noted[41] that growth in property prices in greater Auckland meant that approximately two-thirds of residential properties at the time were being rated on the '5 percent of capital value' rule. This is why some opponents of annual value sometimes refer to this system as being 'capital value in drag'.

Annual value requires a significant and active rental market to maintain accurate quality valuation data. This means that annual value is either not going to be a viable option for most rural local authorities or the adoption of annual value would create an incidence of rates little different from capital value.

Those local authorities that have the large and active rental markets to support a rental based value, may also find that the robustness of their valuation data improves. Market rental data tends to be available at more frequent intervals (rental tenure tends to be far shorter in duration than ownership tenure) and at higher volumes then property sales.

4.1.4 Differentials on General Rates

Key Features

Differentials to general rates are not a separate tool in and of themselves, but rather are means of modifying the incidence of the valuation based rates described earlier.

Differential powers enable local authorities to charge different levels of valuation based general rate on different categories of property. Property can be categorised using one or more of the following[42]:

- land use (far and away the most common use of these powers – when your council sets a commercial differential or a rural differential it is using these powers)
- location
- land area
- value – either land, annual or capital (some local authorities set a differential where the rate reduces as the value of the property increases[43])
- the activities that are permitted, discretionary or controlled in the location under an operative district plan or regional plan.

The most common uses of differentials at the present time are to:

- increase rating loads on commercial/industrial properties
- decrease rating loads on rural properties

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40 *Covec (2007), pp 35-36. We understand Covec based their research on values in the Manukau City Council.*

41 *Manukau City Council (2007), Manukau City Council's Submission to the Local Government Rates Inquiry, pp 6-7.*

42 *Schedule Two of the Rating Act.*

43 *Local authorities wishing to make use of value as a basis for a differential should take legal advice before setting rates.*

- decrease rating loads on 'stand out' high-valued properties (e.g. particularly high-valued residential properties, capital intensive properties such as hydroelectric dams and dairy factories).

Things to Remember

The differential is first and foremost a tool for altering the incidence of rates. Setting a differential rate does not release new revenue in and of itself, it merely allocates the revenue requirement in a different way from that which a pure value-based system would. Differential rating is therefore bound to create 'winners' and 'losers'[44] – and therefore require a sound policy rationale.

Poorly justified differential policies may create the perception that the rating system is arbitrary or set for political purposes (or both). Ultimately a poorly justified policy rationale is at severe risk in the event of judicial review.

The 2007 Report of the Independent Inquiry into Local Government Rates suggested that an appropriate rationale for differentiation should be based on differences in:

- *levels of service* - if one group receives a higher level of service, or a higher share of benefits then it should be charged more. This is one of the main reasons that section 101(3) requires a consideration of benefit
- *ability to pay* – if one group has greater means from which to pay rates, then all things being equal it should pay more.
- *willingness to pay* – if one group is willing to pay more than another group, it should pay a higher proportion
- *cost* – if the cost of providing a service to one group is higher than for others, they should pay more.

Two other grounds that are sometimes used to justify the imposition of differentials on business, are:

- businesses receive favourable tax treatment on the payment of rates
- businesses are able to pass on their rates to the customer.

It is true that business is able to treat rates as an expense and 'write off' 30 percent of this for taxation purposes. It is also true that business is able to claim back GST paid on rates as part of the normal processes through which GST is confined to the sale of final goods and services.

Those who consider the tax treatment irrelevant for the setting of rates point out that owners of rental residential properties <u>also</u> have an ability to claim rates as an expense. Other taxation (e.g. various types of duties) are not set on the basis that business should pay more because of its different status for income tax and GST purposes. Others point to local government's claim that income distribution is a matter for central government, and then question whether basing a differential on the basis of perceptions of inequity in tax treatment (and therefore disposable income) are consistent with that line.

Turning to the ability to pass-on argument – it is argued that firms trade in competitive markets and therefore have only limited scope to pass on higher costs in their pricing structures. It is also argued on occasion that a differential policy of this sort ignores the differences between the legal incidence of rates (the person to whom they bill is sent) and the economic incidence)of rates (whose pocket the money actually comes out of). In other words that it is ultimately the residential ratepayer who bears the impost. Finally, and more related to GST, it is argued that GST is a tax on final consumption and that input credits are to ensure that the correct rate is applied at the actual point of final sale. The owners of profitable businesses pay GST when their income is spent.

On the other hand economic theory tells us that even in the hypothetical 'perfectly competitive' market, business owners will pass on a majority of their costs. Many customers are located outside of the district in which business is located and are therefore not always residential ratepayers to the same local authority. GST is a tax on value-added – all things being equal, the profitability of a business increases as its GST refunds increases.

The validity of these arguments is well and truly open for debate, most local authorities have moved away from using these as justification for their policies. SOLGM Financial Management Working Party believes these arguments are an irrelevance. These arguments have not been tested in court since the introduction of the section 101(3) process in 2002. Local authorities are advised to engage robust legal and economic advice before attempting to construct a differential using these as arguments.

Many of the objectives of a differential general rate could theoretically be achieved more transparently through the use of a targeted rate. For example, differences in levels of service tend to manifest themselves in particular services, and a targeted rate might serve to make those differences more apparent than if they are 'hidden' in a differential on the general rate.

4.1.5. The Uniform Annual General Charge

Key Features

The key features of a uniform annual general charge (or UAGC) are:

- it is a fixed dollar charge per rating unit or per separately used or inhabited part of a rating unit. The ability to charge per separately used or inhabited part of a property is an especially useful tool for local authorities that have significant numbers of multi-unit residential properties (blocks of flats, retirement villages etc) or commercial development (shopping malls, office blocks etc). Local authorities are able to develop their own definitions of 'separately used or inhabited parts of a rating unit. The definitions must be disclosed in the relevant funding impact statements (i.e. both the LTCCP and the relevant annual plans).
- revenue raised from the UAGC may be applied to any lawful purpose of the local authority, that is the revenue is not tied to any particular activity or activities.
- as with fixed targeted rates (FTR) a UAGC is currently subject to the so-called '30 percent cap' imposed by section 21 of the Rating Act. The total revenue raised from the UAGC and all FTRs (other than those for water supply or sewage disposal) may not exceed 30 percent of your local authority's rate revenue.
- a UAGC may not be differentiated.

In the 2007/8 rating year approximately $439 million (or 11 percent) of total local authority rate revenue will be raised in this way.

Things to Remember

The UAGC is primarily a device for altering the incidence of the general rate. By reducing the amounts of value-based general rate collected the UAGC shifts the incidence of rates from higher valued properties to lower valued properties. The UAGC therefore provides an element of 'protection' to ratepayers in coastal properties, on the fringes of urban areas, or in areas which have experienced large increases in valuation, or are in the central business district.

Many rural local authorities also find that changes to a UAGC tend to shift rates between the urban and rural parts of the district. For example, the introduction of a UAGC (or increase in an existing charge) tends to shift the incidence of rates from the rural sector into the urban sector[45].

The UAGC is a *regressive* form of taxation. As a flat dollar charge irrespective of circumstance lower-income ratepayers pay a proportionately higher share of their income to meet this charge than a higher income ratepayer. For this reason, the UAGC is often criticised as being regressive, especially by some senior citizens and beneficiary groups not necessarily aware of the impact that full value-based rating may have. The UAGC is independent of property value and therefore bears little relationship to ratepayer *wealth*.

A UAGC may be tougher on residents who live alone than on families.

A UAGC can be a useful tool for funding those activities where your local authority has decided that all properties in the district benefit uniformly. For example, the costs of democracy are often funded wholly or partly out of the UAGC. Beyond this, the linkage between benefit and a uniform charge is more tenuous.

Do not underestimate the difficulty of defining the term 'separately used or inhabited portion' and the day to day application of the concept.

4.2 Targeted Rates

A targeted rate is a rate set by local authorities:

- over one or more categories of property and/or
- to fund one or more identified activities.

Targeted rating powers are an amalgam of a variety of rating powers that existed prior to 2002 (known collectively as 'separate rates'). The range of powers has been considerably widened. In addition to the three bases for valuation described under general rates and a flat dollar charge per rating unit, targeted rates can be set on:

- the improvement value of the rating unit (i.e. capital value less unimproved value)*[46]
- the number of separately used or inhabited parts of a rating unit*
- the number of water closets and urinals within the rating unit*
- the number of connections the rating unit has to local authority reticulation*
- the extent of provision of any service to the rating unit by the local authority (where this is capable of objective measure and independent verification)*
- the total land area of the rating unit*
- the total land area within the rating unit that is sealed, paved or built upon
- the total area of land within the rating unit that is protected by any facility provided by a local authority
- the total area of floorspace within the rating unit.

In addition to these powers, a local authority can set a targeted rate for water supply based on the volume of water consumption (often called water metering). Funding water supply is the only activity that can be funded in this way under the Rating Act[47].

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45 *Some rather striking instances of the effects of removing a UAGC can be found in SOLGM (2008) No Magic Answers (available here) in some cases shifts of up to 30 percent into the rural sector were reported*

46 *Those powers marked thus * are currently in use in one or more local authorities.*

47 *At the time of writing the Government was considering proposals to widen this particular power to allow for volumetric charging for wastewater disposal.*

In the 2007/8 rating year approximately 40 percent of the total rates assessed will be targeted rates of one form or another. There are two local authorities that rely entirely on targeted rates and set no general rate at all[48], while at the other extreme one local authority collects around 92 percent of its rate revenue via the general rate[49].

Local authorities can set:

- more than one targeted rate to fund a particular activity (for example, many rural local authorities with more than one water or sewage scheme set a rate for each scheme, some city councils charge a base water supply rate and an additional fire protection rate) or
- a targeted rate to fund more than one activity (targeted works and services rates are a common example of this)
- a targeted rate over only some defined categories of property (such as CBD rate for security patrols, streetcleaning or development or a tourism rate over commercial property). The basis for constructing the categories are defined in Schedule Two of the Rating Act.
- a differential targeted rate – provided that the basis for constructing the categories is one of the matters listed in Schedule Two
- targeted rates using combinations of factors (a common use is to set a flat dollar charge and a value based rate)
- including a rate that uses different factors for different categories of property (so for example a targeted rate that is set on the basis of a flat dollar charge for residential property, a value based rate for commercial property and an area based rate for rural property)

The targeted rating mechanism is a potentially very powerful tool that local authorities are only now beginning to use creatively, some five years after the powers were extended to local government. Within the constraint that rating is based on taxation of properties (as opposed to people), the above serves to demonstrate that targeted rates are a very flexible tool[50].

A targeted rate is a device for achieving the following policy objectives:

- more closely tailoring the level of rates to perceived levels of benefit – the above tools enable those local authorities that use them to more closely target the funding of activities to those characteristics that drive cost or benefit from the service. The counter to this objective is of course that the further a council travels down this path the more the rating system begins to look like a user charge and the less it looks like a tax
- greater transparency and better demonstration of value for money to the ratepayer – targeted rates and what they fund must be separately disclosed in accountability documents and on rates assessments and invoices. The more people can 'see what they're paying for' the more acceptance there is likely to be of the overall rate (or alternatively the better the debate about the services the council provides). This is why many of the targeted rates currently in existence are set for utility services such as water, sewage disposal, refuse collection etc. Of course, there is something of a saturation point – beyond which adding further targeted rates creates additional detail and obscures rather than aids transparency and policy simplicity[51].

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48 *Masterton District and Northland Region.*

49 *Hamilton City Council.*

50 *Some revenue managers disagree with this. Covec (2007) claims that some revenue managers feel that targeted rates do not for example, allow for capturing revenue from absentee ratepayers or those who benefit from tourism initiatives. Rating is a property based tax, it is difficult to see how for example, a local authority could use that tool to generate revenues directly from tourists (though it can be used to recover revenues from business servicing tourists).*

51 *It can also be argued that targeted rates provide nothing that an itemized rates assessment could not also provide.*

The policy objectives need to be evaluated against the transactions cost of the rate. Although some of the mechanisms listed above draw on information that comes from the valuation roll (and thus is already paid for in the fee paid to the council's valuation service provider), the council may need to collect other information itself, maintain that information and deal with objections to that information. There is both an initial cost and an ongoing cost to collecting this information. In addition, introduction of new targeted rates may potentially involve a change to a council's revenue and financing policy and trigger requirements for consultation and audit.

The targeted rating mechanism is another option for sharing the costs of particular activities amongst different sectors of the community. Targeted rating tools are not devices for tapping new pockets of revenue raising potential in and of themselves, any increase in the overall base of revenue would be marginal.

4.2.1 Improvement Values

Key Features

Improvement values are defined by legislation as the capital value of a property less the annual value of the property. Improvement value is unique among the valuation bases in that it is <u>only</u> available for targeted rates i.e. this system cannot be used as the basis for a general rate. In the 2007/8 rating year we are aware of only two district councils using improvement values as the basis for a targeted rate – both being very small amounts of money[52].

Things to Remember

Improvement values could be a useful tool for targeting rates where the intensity of development is a key factor in patterns of benefit, exacerbation etc. Building regulation is an obvious example, where the amount involved in the inspection increases as the complexity of the building project increases, and this is pretty much unrelated to unimproved values. Improvement values may also be a useful tool for various types of rates such as fire protection or flood protection.

Improvement value has many of the same advantages and disadvantages of capital value. Being based on improvements alone it may be less volatile than capital value (the land component is removed so location as a factor is largely removed). That same factor means that improvement values can be said to target intensity of land use/development to a greater extent than capital value.

4.2.2 Fixed Targeted Rates

Key Features

Fixed targeted rates (FTRs) are analogous to the UAGC except that the revenue raised may only be applied to the activity or activities specified in your funding impact statement.

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[52] *Southland District Council uses improvement values as the basis for a targeted rate for building control, and Thames-Coromandel District Council uses improvement values as one of the factors in its targeted rate for economic development.*

Like the UAGC, FTRs can be assessed on a 'one per property' or 'one per separately used or inhabited part of a property' and are also subject to the 30 percent cap[53].

In the 2007/8 financial year 75 of the 85 local authorities set one or more FTRs. In aggregate these rates accounted for 21 percent of the total local authority rate take.

Historically, FTRs were used primarily as a means of charging for water and sewage disposal (and even today two thirds of the revenue from FTRs are raised for these purposes). However a much wider range of activities are funded in this way – everything from roads to medical buildings and pool safety.

Things to Remember

Except as noted above an FTR is subject to all the same merits and disadvantages as a UAGC.

Setting FTRs on a one per separately used or inhabited portion of a property can be used a method of targeting properties where large numbers of people reside or where multiple shops and offices are located.

4.2.3 Land Area

Key Features

Rates are set on the basis of a charge per area of rateable land (most commonly per hectare).

In the 2007/8 rating year less than one percent of the sector's total rate revenue is collected in this way. Most regional councils set one or more rates in this way, and thus around 4 percent of their revenue comes from these charges. Although 18 territorial authorities set area based rates many of these are for quite small land drainage schemes inherited from their predecessor county councils.

The use of area rating today is largely the result of historical legislation and the way that these sometimes dictated approaches to funding solutions (such as the Soil Conservation and River Control Act 1941 and the Land Drainage Act 1908). Those statutes were concerned largely with infrastructure and services benefiting rural land and contained procedures for rating by what were known as 'classifications' which parcelled land into categories based on presumptions of benefit or exacerbation. This was an early forerunner of differential rating – some schemes are still in place.

Things to Remember

Area rating is best used in circumstances where patterns of benefit and/or causation of costs are generated by the size of a property, or in circumstances where the size of a property is the best proxy for the driver of the allowable bases.

Targeting property size means that these rates are likely to favour residential and small commercial ratepayers and disadvantage farmers and larger industrial and residential properties.

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[53] *In practice, the 30 percent cap is actually a great deal less restrictive than it first appears. Section 21 puts charges that are calculated as a 'fixed amount per rating unit or separately used or inhabited part of a rating unit'. This wording excludes targeted rates where different categories of property are assessed different levels of flat dollar charge. For example a targeted rate made on the basis of $100 per residential rating unit and $110 per commercial rating unit would not come within the scope of these charges. When taken together with the water and sewage disposal FTRs some local authorities find they can raise up to 65 percent or more of their rates revenue in this way.*

As the supply of rateable land is relatively fixed, area-based rating is unlikely to exhibit much buoyancy. The only times the area of rateable land within a local authority will change at all are when property moves from non-rateable to rateable status or in rarer instances such as boundary changes, reclamation of land from the sea and the like. The revenue base for this type of rate is likely to change very little as the level of development in your community increases.

Area has often been used as a proxy for biosecurity and pest management rates (in theory the greater the area of land the more pests there are on the land) and land drainage rating (the greater the area of land the more water needs to be removed from it). Some flood and river control rates are also set in this way.

4.2.4 Other Area Based Tools

Key Features

There are two other tools that rely on area as the basis of a targeted rate:

- the area within the rating unit that is sealed, paved or built on
- the area of floor space within the rating unit
- the area within the rating unit that is protected by any amenity or facility provided by the local authority.

These three tools were both introduced in the Rating Act 2002. Some local authorities use the area paved or built on as a proxy for charging for stormwater (on the assumption that water falling onto a paved area will not soak into the ground and is disposed of via the stormwater system).

Things to Remember

These three tools appear to have been intended as slightly more targeted options for area rating. We shall soon see an example of the kind of issue that the area protected could be used to resolve.

Valuation rules require the valuers to include area of floor space in their field notes where the local authority is maintaining capital or annual values on their database. A local authority that is using only unimproved values is not obliged to maintain annual or capital values and may find they have to recreate the dataset.

Area built on and area of floor space are more buoyant tools than total area, in that as development expands theoretically there may be some increases in the built area or area of floor space.

Floor space will tend to target rates towards multi-storey developments (both residential and commercial), caution may need to be taken if your intent is to avoid targeting the average residential home.

Area built on will still target large properties, but by comparison with total land area the incidence of this tax would be more likely to shift from farms onto larger commercial and residential developments.

4.2.5 Pan Charges

Key Features

'Pan charges' is a colloquial term for charging based on the number of water closets and urinals on a property.

A property used primarily as a rating unit for a single household can only be rated for 1 water closet or urinal regardless of the actual numbers on the property.

Pan charges can be used as a targeted rate to fund any activity (legally speaking). In practice however the link between the number of water closets and urinals on a property and any activity other than wastewater may be more difficult to draw.

Things to Remember

Pan charges will target intensity of use, both commercial and residential. The greater the level of development on a property the more pans and urinals there are likely to be on the property. This can encourage some landlords to reduce the faciltites provided to the bare minimum.

The pan charge is a regressive tax, every residence, office, shop etc, needs at least one regardless of the level of income of the ratepayer.

Some Crown-owned properties (most notably schools) argue that the pan-tax in its purest form is inequitable. The design of schools is heavily regulated (one toilet per 20 pupils) and is designed around the peak capacity (i.e. intervals). The counter to this is of course, that like a school, a local authority has to provide for peak capacity[54]. Some local authorities have designed remissions policies to take account of this issue. For example, the sliding scale of charges so that say the first six pans are assessed the full charge, the next five a reduced scale of charge per pan, and any others at a still reduced charge[55].

4.2.6 Extent of Service Provision

Key Features

This particular tool is designed to allow for charging on measures that are proxies for the level of use of a service. After water metering, these are probably closest of the rating tools to a direct user charge.

In the 2007/8 rating year around 0.5 percent of the total rate take comes from charges set in this way.

Things to Remember

Whatever measure you are using as a measure of the extent of service provision must be capable of independent verification – which means record keeping procedures must be impeccable.

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54 *Don't forget some high schools can be the size of a small town.*

55 *Under section 25 of the Rating Act the Crown can make regulations governing how schools will be rated for sewage disposal. Before those regulations can be enacted the Minister of Education has to report to Parliament on the rating of school sewage disposal. These powers have not been used since they were enacted, but from time to time we become aware that this 'appears on the radar" at the Ministry of Education, and they begin doing research for the report.*

It is unlikely that many of the measures for extent of service provision will be items that the valuers would gather during the preparation of the district valuation roll. Some expense will be incurred in collecting these and dealing with objections (the process for dealing with objections is something that warrants further thought).

Those few local authorities who rate on the basis of per bin, or per container for refuse are using extent of service provision as a basis for rating. Some regional and unitary authorities use this as a basis for their Clean Home Heating rate

4.2.7 Water Metering

Key Features

In its simplest form, water metering is a charge per unit of water consumed or supplied. Water metering is the only power in the Rating Act that can truly be said to be a direct charge for service.

At the time of writing volumetric charging was available as a tool for the funding of water supply. Metered water cannot be used as a technique for funding other activities.

Your charges can be calculated as a fixed charge per unit of water or on a scale of charges (e.g. $1 per cubic metre supplied up to x cubic meters and $1.30 for each cubic meter thereafter).

Local authorities are not empowered to stop water supply for non-payment of rates, and may only restrict supply if the restriction is unlikely to create insanitary conditions on the property.

NB – local authorities also have the option of providing for water by meter as a contract for service under the general empowerment provisions of the Local Government Act. The main disadvantage of this as a tool is that the enforcement powers of the Rating Act cease to apply. Charges set in this way are excluded from the Rates Rebate Scheme.

Things to Remember

The introduction of water metering and changes to existing water metering has historically been one of the more contentious funding decisions many local authorities have taken.

When making a decision about moving water metering it is important to realise that it has an ongoing cost (reading of meters, separate billing, maintenance and repairs to meters etc) <u>not</u> just the capital cost of installing the meters.

Water metering creates a direct relationship between quantity used and cost to the user, therefore providing users with incentives to conserve. As examples:

- Rotorua District Council experienced a 35% reduction in average annual use and a 50% reduction in peak demand,
- Tauranga City Council experienced a 27% reduction in peak flows in 2002 compared to 1994-1998 average
- In Tasman District water consumption fell by at least 15 percent.

Reduced water usage also has the potential to delay infrastructure investment, including the development of new water sources. Reduction in consumption frees-up scarce water for other productive uses and saves energy.[56]

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[56] *Transporting and treating water and waste water are energy intensive operations that typically consume the largest part of a council's power bill.*

Metering of water in itself has further benefits of assisting in the identification of leaks, and allows for much more detailed data collection on water usage, which, in turn, allows for more appropriate management and policy decisions.

It can be argued that water metering is equitable in the sense that depending on the design of the charging structure, users pay for their consumption and only for their consumption. A single senior citizen will typically pay less than a family of six, or a ratepayer with a swimming pool or 'heavy water using' business.

This same argument is also used by critics of metering. Larger households will typically pay higher charges under a volumetric charging regime than they would under fixed non-volumetric-based rates. Other households that have higher water usage than average for other reasons, for example medical requirements, may also be impacted by increased charges. Careful design of the charging structures (e.g. the so-called reducing block tariff can help in these cases)[57].

The other argument that is sometimes advanced is that water metering somehow involves 'privatisation' of water services. It is hard to see any logic to this argument – how something is paid for, and who owns and operates the asset are clearly separable issues. Local authorities charge for borrowing of some types of collection items from their libraries and no-one suggests libraries are being privatised.

Design of the charge is critical to the achievement of efficiency and equity goals. A tariff structure that does not incentivise consumption will struggle to meet either.

Water metering is subject to the same disclosure requirements as other rates. It must be in the funding impact statement, rates resolution, rates assessment and the like. There are some special provisions that cover the unique collection procedures for metered water – sections 43(1)(c) and 46(5)(c).

4.2.8 Number of Connections

Key Features

This power allows for charging based on the number or nature of any connections from a property to any local authority reticulation system. For example, a charge could be based on factors such as the number of pipes or the size of the pipes.

While there are no limits on the activities that could be funded in this way – this is a proxy that appears to have been designed for water, stormwater, and wastewater.

Things to Remember

This proxy falls somewhere between water metering and targeted rating on the tax-charge scale.

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57 *Further information on charging for water can be found in Local Government New Zealand (1999) Water Utilities: Pricing and Funding.*

4.2.9 Use of the Targeted Rating Powers – Some Examples

Important – Read Before Proceeding

The examples presented in this section are presented as ways of resolving particular issues. The selection of funding tools are matters of policy judgement at local level. These examples are not presented as "the answer" to any particular issue.

Example A: Rating for Tourism Facilities and Promotion

Upper Creek is a small town in the Kiwi District Council. This township is situated on a State Highway approximately halfway between the metropolitan centre (Kakapo City) and a popular 'tourist town' in the Weka District Council. Kiwi District has long been concerned that tourist buses stop in Upper Creek to allow drivers to take lunch breaks, and for tourists to take a comfort stop at the public toilets. While resting it is common for the tourists to walk through town visiting various lunch bars, souvenir shops etc. The council has considered and previously rejected the option of pay toilets as being unfair on residents. When completing its last revenue and financing policy it decided that the provision of public toilets and other facilities were in part a public good (benefiting the whole community) and thus would be part funded by the general rate. But what about the remainder?

Weka District Council is undertaking a major tourism promotion campaign to remind visitors about the natural wonders and recreational opportunities that its main township Moa Point provides. The council considers that the benefits of this accrue mainly to the commercial sector, especially the accommodation sector. How might it use the targeted rating powers?

Kiwi District might approach its particular issue by using the schedule two powers to differentiate based on location and create an "Upper Creek Mainstreet Rate" to fund part of the activity.

Weka District Council could use a targeted rate for tourism promotion. Using the factors in Schedule Two it could resolve to employ property use as a basis of differentiation and assess this rate only on commercial property, if it desired it could segment this into different types of commercial use (e.g. accommodation, commercial, industrial etc). An obvious factor to use for this sort of rating might be capital, improvement or even annual value (thus recognising intensity of use). Alternatively, if the council knew that these properties were situated in one part of Moa Point it too could use the power to differentiate on location, and exclude all properties outside a particular area.

Again, it is worth noting that both these 'solutions' involve reapportioning rates revenue that would have been collected in some other way. Neither raises new revenue as such.

Example B: Rating for Refuse Collection[58]

Weka District Council has historically operated a "three bin" refuse collection policy. Ratepayers have an option of selecting a "standard size" bin or a "large" bin with different costs for each. While the service is primarily provided to residents of Moa Point, it is also provided to a small number of lifestyle blocks on the urban/rural fringe (the small numbers are higher cost to service). Historically this was collected as a user charge, but the council has recently become concerned at the level of non-payment and for sanitation and environmental reasons is unwilling to discontinue collection.

How might the council use the targeted rating powers?

This case lends itself well to using the extent of provision of service to the rating units. Both the size of the bins and the delivery of the bins are objectively measurable (provided the obvious steps are taken to record delivery) and can be independently verified if needs be. Recognition of the difference in costs between the urban area and the other people receiving the service could be made by differentiating based on location (for example, by defining an 'urban area' and differentiating the charge inside and outside the area).

Example C: Catchment Rating

Eastland Regional Council operates a very large catchment control scheme - the Huia River Scheme. The scheme runs across parts of the Kurikuri and Takahe District Councils, and also protects the large metropolitan Kakapo City Council.
In the past the scheme was based on classification lists developed under the authority of sections 41 and 51 of the Rating Powers Act. Eastland Regional Council is aware that these sections have been repealed. Although the power to set rates based on classifications has been "saved" in the Rating Act, the Council has decided that the classification schemes cost too much to maintain and wants to replace the lists with some form of differential scheme.

When the Council last reviewed its funding policy the Council took the view that rates based on *property value* are a fair means of charging for flood protection in urban areas, and rates based on *land area* are a fair means of charging in rural areas. Under the Rating Powers Act it found that rating in this way was, at the very least, problematic.
In one particular part of the Takahe District Council, the Huia River runs through a rural river valley, the Swallow Valley, which has a large number of river terraces which are well above the level of the river. Farmers in the Swallow Valley have argued for years that rates based on land area result in them being "overcharged" as significant parts of their properties are not really protected.

The Revenue Manager has been asked to develop a proposal for a new rating system that takes all of these issues into account.

Section 18(3) of the Rating Act allows local authorities making a targeted rate on a differential basis, to use different factors for different categories of rating units. In Eastland's case this means that the council could develop a differential rate based on location (from Schedule Two), with a rate based on capital value in some areas, and land area in others.

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58 *The solution to this particular issue is loosely based on a real council's rating policy.*

Local authorities can be very specific in its definition of properties by location. For example, the council might decide that the entire Kakapo City Council is on the flood plain and should pay a targeted rate, but provide a narrower definition of the parts of the Kurikuri and Takehe District Councils that pay the rates. In this case the council could decide to create a special area called the Huia Flood Plain (which takes in the entire Kakapo City and the parts of the Kurikuri and Takahe Districts) by drawing lines on a map and including that in the FIS. The Huia Flood Plain is split into two areas – "Kakapo" and "Eastern" to allow the council to use capital values in Kakapo City and land area elsewhere.

The particular issues in the Swallow Valley can be resolved by defining a particular area of benefit and making the rates on that category of property on the basis of the area of land protected.

Based on many years working with the old classification lists the Manager is well aware that some properties by the nature of their land use contribute more than others. This can be reflected by adopting a multi-layered differential which not only differentiates by location but also by use.

Putting all of these together, Eastland could adopt a differential targeted rate which looks something like the following:

- 0.01 cents per dollar of capital value for all properties used for ("use-category a") situated within the Kakapo section of the Huia Flood Plain
- 0.03 cents per dollar of capital value for all properties used for ("use-category b" – presumably a higher contributing category) and situated within the Kakapo section of the Huia Flood Plain
- 0.005 cents per dollar of capital value for all properties used for ("use-category c" – presumably the lowest contributing category) and situated within the Kakapo section of the Huia Flood Plain
- $1.50 per hectare of land protected by the flood control scheme, for all properties used for ("use-category A") and which are situated in the Eastern section of the Huia Flood Plain
- $2.25 per hectare of land protected by the flood control scheme, regardless of use category, for properties used for ("use-category b") and which are situated in the Eastern section of the Huia Flood Plain
- $1.00 per hectare of land protected by the flood control scheme, for properties used for ("use-category c") and which are situated in the Eastern section of the Huia Flood Plain
- $0.25 per hectare of land protected by the flood control scheme, regardless of use category, for land situated in the Swallow Valley

Example D: Using Rating As A Tool To Support Other Policy Initiatives

Eastland Regional Council[59] has a number of initiatives in place to improve air quality. It has passed a bylaw banning household fires as a means of generating heat. The council recognises that some low income earners may not be able to afford the capital cost of removing open fires and installing other 'clean heat' options. It has therefore started a scheme whereby the council loans money to the property owner. The council was concerned about potential non-payment and wants a greater degree of security over payment. Is there a rating option that could help?

59 *This example is also loosely based on the real rating policies of a regional council and a unitary council.*

Yes there is. The council could set a targeted rate on all properties whose owners have taken up the scheme using factor number five from Schedule Two of the Rating Act – the provision or availability of a service as the basis for differentiating between these and other properties. The choice of basis for calculation of the rate could be any of the bases listed in Schedule Three (but might well a fixed rate). As a rate, the council has all of the mechanisms available for recovery of rates available to it).

Example E: Funding a Regulatory Function

Kakapo City Council[60] has recently completed the section 101(3) Local Government Act analysis and reached the conclusion that the majority of its building inspection and regulation activity should be funded by a targeted rate. While the council considers that all rating units should pay the targeted rate, it is looking for a rating option that more closely tailors the liability to the level of development. What rating options may be available to Kakapo City?

There are several bases available to local authorities under Schedule Three of the Rating Act. Many local authorities would be tempted to base such a rate on capital values. However a closer approximation might be achieved by using improvement values (i.e. capital minus the unimproved value).

4.3 Non-Rate Funding Tools

4.3.1 User Charges

Key Features

The term 'user charges' is a catch-all for a wider variety of charges made directly to users of a service or facility. Common examples include so-called bag charges for refuse, entrance fees to community and recreational facilities, various fees for inspections and permits and the like.

There are a raft of specific powers contained in different pieces of legislation such as the Sale of Liquor Act, the Amusement Devices Regulations, the Resource Management Act and the like. A handful of these set prescribed fee levels (most notably the Sale of Liquor Act), other prescribe certain process for determining the charge, still others set the fee on the basis of 'actual and reasonable' cost[61].

In addition, local authorities are empowered to set fees for any service (not covered by other legislation) as one of the consequences of the level of empowerment provided in section 12 of the Local Government Act.

In 2005/6 (the latest year for which figures are available) around 18 percent of local government revenue came from sales revenue.

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60 *This example is based on a real rating policy in a district council.*
61 *Further guidance about actual and reasonable cost is to be included in the upcoming SOLGM pricing and charging guidelines.*

Things to Remember

User charges will only be viable for a service which is private good in nature, that is it is possible to prevent consumption of a service (e.g. if someone wanting an amusement device inspected doesn't pay the inspection doesn't happen and the amusement device cannot be used).

It can be argued that user charges are equitable, in the sense that they target cost to the user, and only the user. Others argue that user charging is unfair because the lower income individuals do not have the same level of access to services as others do.

As with development contributions below, user charges ensure that the users face the costs of their consumption, production or location decisions. Set at a proper level, fees can act as an incentive for users to modify behaviours, economic theory tells us that if faced with true costs users will only consume to the point where they truly value consumption.

In certain circumstances fee-setting powers can be used as one of a suite of tools for achieving a policy objective (or objectives). For example, prices can be raised to manage demand for a particular service or facility, different structures can encourage different sorts of behaviours. A low fee can be set to encourage use of a facility deemed to produce public benefits[62].

4.3.2 Development Contributions[63]

Development contributions are a statutory mechanism for raising capital to meet territorial authorities' growth-related costs of infrastructure and reserves. Territorial authorities are empowered to collect them under the Local Government Act 2002. They were developed as an alternative to the use of financial contributions under the Resource Management Act 1991, and are now often used in combination with financial contributions to ensure a more comprehensive collection of development-related costs.

Key Features

The High Court decision in *Neil Construction and Others vs North Shore City Council* held that development contributions are not tax, but are more in the nature of a charge that is tied to funding capital expenditure to support infrastructure incurred by development (although the Judge also commented that they fall short of specific cost recovery as in the case of user charges).

Development contributions may only be imposed in accordance with a "*policy on development contributions or financial contributions* ", which the territorial authority is obliged to adopt under the LGA. The policy may provide that no contributions will be sought.

Development contributions may be sought from a development at the time at which a resource consent, building consent or a service connection is granted. They can only be imposed if the effect of the development, either alone or in combination with another development, is to create demand for infrastructure or reserves, and the council therefore incurs capital costs to meet that demand (and where those capital costs will not be met from another source). The LGA also specifically allows the council to anticipate the demand, and provide the capital in advance of the development occurring and the contribution being sought.

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62 *Just as a fee set below true cost encourages more than the economically efficient use of the facility, a fee set above true cost may result in less than the economically efficient use of the facility.*

63 *There is also the option of financial contributions under the Resource Management Act.*

The contribution can be in the form of cash, land, or both.

The contribution can be applied to the provision of:

- network infrastructure (limited to roads or other transport and "three waters" collection and management);
- community infrastructure (an open-ended category for other infrastructure that provides public amenity); or
- reserves (often called the reserves contribution).

If development contributions are to be sought, the policy must set out:

- the growth-related capital expenditure which the territorial authority has programmed in its LTCCP for each of the service areas, and the proportion it expects to fund from development contributions and from other sources, and why those sources were chosen;[64]
- a schedule of development contributions payable in each district and/or each part of the district (if catchments are used) , in relation to each activity or group of activities for which a contribution will be sought, calculated in accordance with the statutory methodology in Schedule 13 of the LGA;
- the significant assumptions underlying the calculations (eg assumptions of growth levels and patterns; financial assumptions; and timing of infrastructure construction);
- the process that will apply to the grant of remissions and refunds (if any); and
- the time at which the obligation to pay will be triggered, that is, whether on issuing a resource consent, building consent, and/or granting an authorisation of a service connection.

There is a cap on the reserves contribution – either 7.5 percent of the value of additional allotments in the development or the value equivalent of 20 square metres of land for each household unit created by the development. The policy must also set out how land will be valued for the purpose of calculating this cap.

Things to Remember

The use of development contributions is constrained only to infrastructure and reserves needs related to growth. It will not assist the council to raise funds to meet infrastructure maintenance costs; to deal with historic under-funding; to improve deficient infrastructure; or to increase service levels to the existing community.

In any particular case, a contribution may only be imposed if the "threshold" is passed for that development, ie where the effect of development is to require council expenditure to provide new or additional assets or assets of increased capacity, which will not be funded from elsewhere.

Although imposition of development contributions cannot be challenged in the Environment Court (as financial contributions may be), they may be challenged by judicial review in the High Court. One risk is that, if such a challenge is successful, it could invalidate all collection of contributions under the policy (and therefore have a much wider impact than an Environment Court challenge to a particular financial contribution).

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[64] *The development of that explanation should involve elected members and needs to be linked back to the matters of section 101(3) and the revenue and financing policy.*

The benefits of continuing with financial contribution regimes are that it provides for a more inclusive opportunity for public participation through the RMA planning process. Although there are firm obligations to consult under the LGA, the RMA process provides more of an opportunity for interested parties to put their case through the RMA submission process, and where appropriate through the Environment Court appeal process. The historic concerns regarding delays in finalising financial contribution provisions are somewhat allayed by the 2003 amendment to the RMA allowing financial contributions to be based on proposed plan provisions.

A local authority that approaches the development contributions with a rating outcome in mind (ie seeking to raise enough funds to meet all applicable costs of the asset provision) runs a significant risk of non-compliance and challenge in the High Court.

The risk of challenge can be mitigated by:

- robust assumptions on growth both at a local authority level and at catchment level
- robust asset management information including levels of service and supporting programmes of maintenance, renewal, acquisition and replacement as well as an estimate of what is necessary to support growth (as opposed to level of service improvements and renewals)
- a revenue and financing policy (and supporting analysis for the development of the "*policy on development contributions or financial contributions*") that sets out how section 101(3) has been complied with (at activity level for smaller projects and individually for large items of infrastructure)[65].

If any or all of these are deficient, the likelihood of the development contributions policy standing up to a challenge will be greatly reduced.

The methodology for calculating a development contribution is tightly constrained to that set in Schedule 13 of the Local Government Act 2002.

If used correctly, development contributions are both efficient (in the economic sense) and equitable. The optimal (in the economic sense) development contributions policy is not a 'zero/low contribution policy'.

They are efficient because they make developers face the true cost that their activities impose on the community. Not recovering costs through development contributions means that there will be more than the economically efficient level of development (in effect either too much development occurs, or development occurs 'in the wrong places'). Non-economic considerations (for example, to encourage or target growth to particular locations for environmental or social reasons) may provide a valid reason to recover less than the full infrastructure costs of growth.

Recovering development contributions from developers also promotes equity for much the same reason. There are built-in limitations on the collection and use of development contributions to ensure that only growth-related costs are recovered from qualifying developments. In addition to those limitations, the Council must decide whether, and the extent to which, other sectors within the community should provide infrastructure which benefits developers. Properly undertaken, the process will ensure that developers make a fair contribution to the costs and effects of their developments.

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65 *It is worth noting that in challenging decisions around development contributions, the development community has been targeting the decisions taken under section 101(3) as much as the development contributions themselves.*

As noted above, territorial authorities have alternative options to the use of development contributions – one of which is financial contributions under the Resource Management Act. Provided your district plan is operative, financial contributions can be assessed for the *management of the environmental effects of a development* (which includes effects on infrastructure). Although a territorial authority cannot recover twice in respect of the costs of infrastructure provision to a development, its requirements for financial and development contributions can be designed to complement each other and ensure the best mix of tools is available to fund different types of infrastructure provision.

SOLGM is planning a guide to development contributions under the Local Government Act 2002.

4.3.3 Debt

Key Features

Subject to being able to meet the section 101 obligations of prudence, the only legal limitations on local authorities' ability to borrow are that:

- borrowing cannot be denominated in foreign currency
- a local authority may not borrow to on-lend to a council controlled organisation on terms more favourable than those that the organisation could have received itself.

There are also restrictions on local authorities use of water and wastewater assets as security for borrowing.

The only other limitations on a local authority's ability to borrow are those which it imposes on itself through its borrowing management policy (which forms part of an LTCCP).

Debt can be raised wholesale (from financial institutions) or retail (by issuing debt securities to the public).

Issuing debt securities to the public requires the preparation of an investment statement under the Securities Act 1978. Depending on the amount of time that has elapsed since the last balance date, a local authority wishing to issue debt securities may also need to issue interim financial statements to potential investors.

Things to Remember

Debt is not a revenue raising tool – it is tool for spreading the cost of acquiring major assets over time. This has two key benefits:

- debt provides for a closer match in the payment and receipt of revenues for the asset and
- debt spreads the responsibility for funding an activity across both today's and tomorrow's ratepayers/users ensuring that all of those who benefit make a contribution to the funding of a particular asset. This is sometimes referred to as intergenerational equity, and consideration of this aspect of local government funding is required under section 101(3) of the Local Government Act.

In other words, those local authorities who have no or very low levels of term debt are <u>not</u> necessarily managing their finances prudently – indeed such a policy may be asking today's ratepayers to pay too great a share and future ratepayers to pay too little. While public perceptions are otherwise, the local government sector as a whole is not currently heavily indebted and is expected to remain so until at least 2016.

It has sometimes been argued that borrowing and paying the interest on the debt makes a project more costly than paying "cash up front". While this argument may make sense to 'Joe Public' it largely ignores the concept of opportunity cost. The cash used to purchase the asset could have been deposited and earned a return – it is this return that is the opportunity cost. If the interest on the loan is less than the return on the deposit then it makes financial sense to borrow, deposit the cash and get a net return on the transaction. This is especially true for local authorities who have low risk premia on their debt and should also be able to gain access to the highest tier of interest rates on any deposits.

Local authority approaches to raising debt tend to fall into two camps. One camp takes the approach that debt should be raised at a 'corporate level', that is, debt is raised "to fund the balance sheet" and managed as a single consolidated amount or a small number of lesser amounts. The second approach is a more disaggregated approach where debt is raised in smaller tranches with each being tied to a specific project or projects. While the financial management[66] and borrowing aspects of the Local Government were designed with the corporate model of debt in mind, other considerations that might point a local authority towards a project level approach are:

- *legal* – for example a local authority that wishes to offer the option of lump-sum contributions to its ratepayers will be obligated to borrow at a project level, targeted rating systems similarly point towards this level for some projects
- *practical reasons* - some communities prefer that debt be managed in this way – usually this is linked to the presence of ward based rating and accounting systems.

Nonetheless, project by project borrowing may have additional costs involved in the additional resources needed to manage a larger number of loans, and (possibly) on the terms on which your local authority is able to borrow.

4.3.4 Revenue from Investments

Key Features

This is a catchall term for interest, dividends and any other payments received from financial assets such as financial instruments, holdings of equity in organisations and other assets of a financial nature.

Data from the 2006-16 LTCCPs suggested that the average council expected to receive around 6 percent of its income from this source. In some regional councils as much as 45 percent of the total revenue was coming in this way (mostly revenues from the local port company), a small number of local authorities earned less than one percent of their revenue from these sources.

Things to Remember

If your investments in equity assessments, either singly or jointly with other local authorities, are sufficient to make an organisation a Council Controlled Organisation then you are required to put performance targets for these into your LTCCP and report on the achievement (or otherwise) of these in the Annual Report. The SOLGM *Dollars and Sense* guide also recommends similar disclosures for other holdings of equity (where the rationale for holding these is in expectation of a return).

Your council's approach to making, managing and disposing of investments must be disclosed in your Investment Policy (which also forms part of the LTCCP). Although not a legal requirement, Dollars and Sense also recommends that local authorities should give some

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[66] *Section 101(3)(a) analysis does not require a local authority to undertake borrowing at an activity by activity level.*

indication of expected rates of return from investments in the policy – if only to balance the statutory requirements to disclose levels of risk.

Reliance on revenue from these sources can have its down-side – especially investments in organisations that are operating in a trading environment. If assets 'have a bad year' the ratepayer can end up subsidising the supposed revenue-producing investment. At the time of writing several local authorities were experiencing this difficulty with forestry assets, another with energy futures.

The above discussion has focussed on investments, but local authorities can hold assets for reasons other than for return (most often relating to service delivery objectives). On occasion these assets can also make a return (and in at least one case a local authority has explicitly budgeted for that). This can be an area of public concern – especially where the public views the return as excessive or unjustified.

Unless the flow of revenues is reasonably certain (as is the case with term deposits and the like) it would be prudent for local authorities to take a conservative approach when making assumptions about future revenue from investments and its use.

4.3.5 Asset Sales

Key Features

The previous section discussed revenues that flow from the ongoing ownership of assets, this section discusses those revenues that arise out of the disposal of assets.

Things to Remember

A saleable local authority asset, financial or non-financial is a finite resource in that the asset can only be sold once. The proceeds of asset sales should not be viewed as 'easy money' – proposals for the use of this money should be subject to the same level of scrutiny as any proposals funded from any other source.

Some types of asset sales (i.e. anything defined in the Local Government Act or in your significance policy as a strategic asset[67]) can only be made through the process for amending an LTCCP.

Asset sales can be a matter of significant community interest – be prepared for high volumes of submissions and for greater scrutiny of your decision-making processes. In some cases local authorities will come under pressure to give the proceeds of the sale 'back to the community' either directly or indirectly through holding down rates and charges.

4.3.6 Central Government/Other Party Funding

Key Features

Central government provides funding towards the cost of certain local government activities. At the time of writing the majority of funding from central government was via the New Zealand Transport Agency for land transport purposes. The other main streams of funding came via the Ministry of Health through the Drinking Water Assistance Programme (DWAP) and the Sanitary Works and Services Scheme (SWSS) – both targeting smaller less wealthy communities. There are other programmes that provide smaller scale assistance. And of

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67 *Among other things strategic assets include port and airport company shares and social housing.*

course, from time to time central government is persuaded to make one-off contributions to particular projects such as the Restoration of the Rotorua Lakes, works on Stewart Island etc.

At the time of writing around one dollar in seven of local government expenditure was funded by central government.

In addition, from time to time third parties provide funding for specified projects or for a specified project (with the community outcomes process, this type of arrangement may become more common).

Things to Remember

Central government grants are tied to a specific purpose or purposes. They will generally come with some form of reporting and audit requirement to ensure that funds have been used for this purpose.

The majority of central government funding is provided for capital works as opposed to the ongoing operational needs. So for example, both DWAP and SWSS clearly specify that they are for the costs of building/upgrading schemes rather than the operating costs. It is vital to establish clearly what the lifecycle costs of an asset are and not just build something because "the subsidy is there."

In past years, central government funding has been used as an incentive to encourage local authority participation in certain programmes, and once drawn in central government has then ceased the funding (e.g. Safer Community Councils). When making a decision whether to participate in such initiatives a local authority would be wise to consider whether funding streams are secure, and how it would cope with a sudden removal of third party funding. This is good practice both from a financial management perspective and from the perspective of taking a sustainable development approach to service choices (as required by the Local Government Act).

As a general rule, local authority autonomy and accountability to its community reduces as the volume of funding from central government increases[68]. With commenting on the rights and wrongs of the decision, the delivery of roading services underwent a fundamental shift in the period 1989-1996 largely because all state funded works had to be procured via central government set competitive pricing procedures.

When making an approach to central government for 'one-off' funding it is important to identify the national benefits that would arise from the proposal and base your case for funding on this. A case that appears purely self-serving is likely to be rejected[69].

Third party funding from other sources may potentially expose local authorities to a variety of financial and reputational risks (e.g a public backlash if one of the terms on which such assistance is made is the granting of 'naming rights'). Agreements need careful design and depending on the size and visibility of the contract may need the 'sign-off' of the full council.

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[67] *One need only look at jurisdictions such as the United Kingdom to see how emasculating large elements of central government funding can be to local autonomy.*

[69] *The days when local authorities in 'marginal seats' could use the electoral cycle to advantage are largely long gone!*