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Local government funding and financing inquiry  
New Zealand Productivity Commission  
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Infrastructure New Zealand is the peak industry body for the infrastructure sector and promotes best practice in national infrastructure development through research, advocacy and public and private sector collaboration. Infrastructure New Zealand members come from diverse sectors across New Zealand and include infrastructure service providers, investors and operators.

This submission represents the views of Infrastructure New Zealand as a collective whole and may not necessarily represent the views of individual member organisations.

## Infrastructure New Zealand submission to the Productivity Commission on the Local Government Funding and Financing Inquiry: Issues Paper

### Introduction

Infrastructure New Zealand agrees that a wide number of factors have in recent times been placing upward pressure on local government costs, and thus funding and financing resources. The Commission, in the Issues paper, canvasses a number of these drivers, including:

- Population growth
- Tourism growth
- Higher standards from Government
- Climate change

We agree that each of these, and other factors, are increasing local government costs, but we wish to stress that increasing costs are more a *symptom* than the cause of local government funding and financing challenges.

Cost drivers are causing significant disruption to the existing system of local government decision making. However, this system does not work and it is the fact that it does not work which sits at the heart of local government funding and financing challenges.

Under New Zealand's current system of funding and financing public services – both central and local – the allocation of costs and benefits from public investment is distorted, leading to incorrect price signals to users, beneficiaries, residents, councils and the Government.

Accurate price signals are critical to containing costs, by preventing investment in services which are not valued in proportion to the investment required, and “maximising utility”, by allocating resources to services which are valued.

The impact of New Zealand's misfiring system of funding and financing public services is spending and investment decision-making which is short-sighted and inefficient. Weak decisions are directly contributing to poor infrastructure investment prioritisation, house price inflation, inequality and low productivity growth across the country.

A fundamental realignment of who pays, when and how for public services – both central and local – across New Zealand is required.

We consider that this realignment should happen in conjunction with other reforms, particularly to national, regional and local planning as well as restructuring of the entities responsible for delivering public services to ensure they are fit for purpose.

## Part I:

### **Public service costs, benefits, funding and decision making are misaligned**

Rising costs for local government, including from growth, tourism and higher standards, are severely disrupting the existing system of local government decision making.

However, more resourcing for local government will only address the problem if the system of funding and financing is working efficiently, that is, if resources are directed towards activities which are valued by the communities funding those activities.

If resources are not efficiently allocated, there is no limit to the amount of resourcing required to meet public and political demands.

We emphasise here the importance of “price” signals. If either public entities, like councils, or the general public is able to transfer the cost of an activity they value to another party, then they lose the connection between the cost of that activity and the benefit. The benefitting party is likely to call for ever-increasing investment to realise the benefit, even when the cost of that investment exceeds the benefits gained.

Likewise, if the benefit of a costly activity is realised by a portion of society without a concomitant requirement to pay, then the party that is carrying the cost will be misinformed regarding the true costs and benefits of that activity. A risk then emerges that the party paying will decide that the costs outweigh the benefits (which may be true for that affected party, but may not be true for society as a whole), leading to the decision to stop the activity, making society worse off.

Signals in cost and benefit establish a system of relationships which inform both public entities and the general public of the impacts of their decisions and demands.

The problem of weak and misdirected price signals is the real issue sitting at the heart of not only local government funding and financing challenges, but wider public service delivery, which is also under pressure.

We agree that more resourcing (i.e. funding and financing capacity) is required for critical public services – central and local – across New Zealand.

However, our view is that if more money is allocated to the existing system, this funding will be misallocated, outcomes will not improve in proportion to expenditure and further reforms will be required.

A fundamental revision of New Zealand’s system of responsibilities for delivering public services is required before further resources are committed.

## **Transport: A Case Study in system failure**

To demonstrate why more resourcing will not necessarily lead to better outcomes, it is useful to examine the case of transport.

Land transport in New Zealand is funded from fuel levies, road user charges and vehicle licensing fees, as well as local government rates (with some periodic injections from the consolidated account). The majority of this funding comes from fuel levies, road user charges and licensing fees paid for by “users” of the system and is fully “hypothecated” to transport.

This makes New Zealand’s transport funding system one of the most direct in the world. In most cases globally, transport levies, such as fuel taxes, are channelled into a government’s consolidated account and transport funding decisions are balanced against other needs, such as health and education.

Theoretically, New Zealand’s system should be more efficient. Users fund the network, an independent agency (the New Zealand Transport Agency) allocates funding to greatest need, based on Government priorities set out in a Government Policy Statement, and all transport charges are returned to transport activities.

However, after several decades of this model, New Zealand boasts some of the worst transport outcomes in the developed world, despite some of the highest levels of spending.

Fuel levies have doubled since 2002, moving from 33 cents per litre to 66 cents per litre.<sup>1</sup> This has seen the revenue the Government obtains from fuel levies exceed inflation by a considerable margin, albeit offset to some extent by improving fuel economy.

The combination of high tax and distance from major markets means that New Zealand now has one of the higher fuel prices in the world.<sup>2</sup>

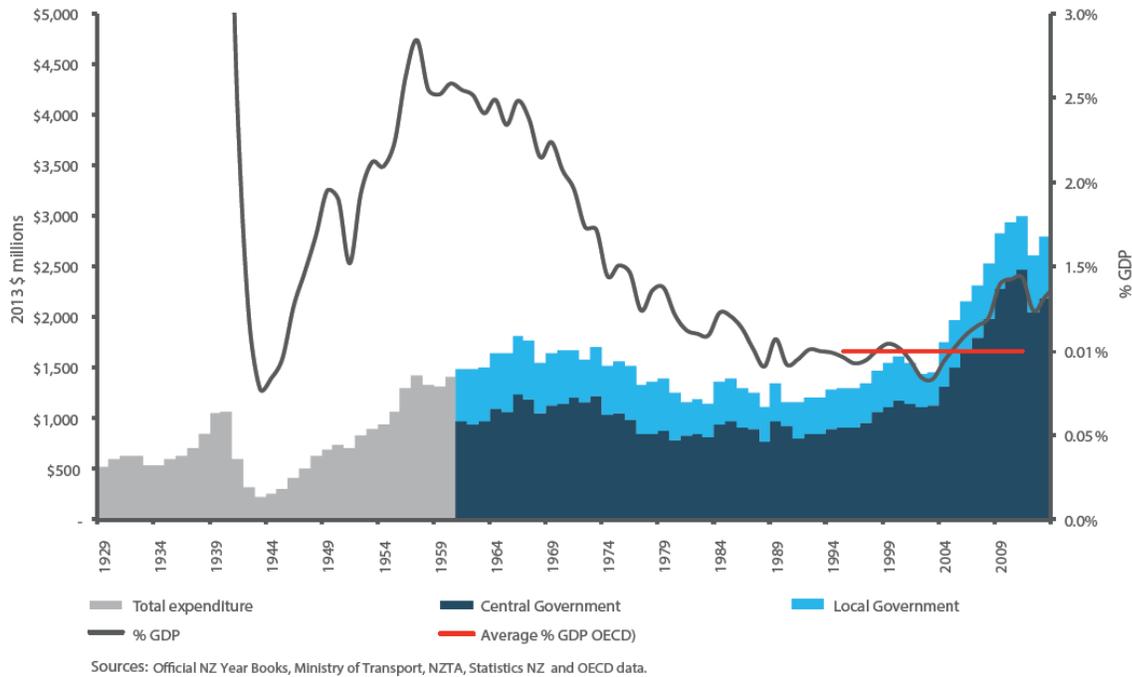
The full hypothecation of this revenue to transport has at the same time lifted New Zealand’s total transport investment to an internationally very high level. Figure 1 below shows that the average annual investment in transport across the OECD is around 1 per cent of GDP, with New Zealand now spending consistently above 1.5 per cent of GDP.

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<sup>1</sup> <https://www.transport.govt.nz/assets/Uploads/Land/Documents/3a6bfcc315/RIS-Funding-the-Government-Policy-Statement-on-land-transport-2018-SIGNED.pdf>

<sup>2</sup> [https://www.globalpetrolprices.com/gasoline\\_prices/](https://www.globalpetrolprices.com/gasoline_prices/)

**Figure 1: Total Public Investment in New Zealand Transport<sup>3</sup>**



However, far from delivering one of the better transport systems in the world, the two key outcomes of importance to private vehicle users who majority fund the transport system – safety and congestion performance – are extremely poor and deteriorating rapidly.

TomTom is the only objective and consistent comparator of congestion performance across the globe. TomTom technology monitors vehicle speeds in a large number of cities, measuring the amount of delay experienced at peak versus off peak times.<sup>4</sup>

TomTom finds that Auckland’s travel time delay is the 40<sup>th</sup> worst in the world across all major monitored cities. Drivers in Athens and Hong Kong experience less travel time delay as a proportion of travel than drivers in Auckland, despite those cities having vastly greater populations and much greater land use challenges.

Across Australasia, 4 of the 7 most congested cities, as measured by TomTom, are in New Zealand. Both Auckland and Wellington experience more travel time delay than Melbourne – a city approaching 5 million people.

Drivers in small, slow growth Dunedin experience more travel time delay as a proportion of travel than fast-growth Brisbane’s 2.5 million residents.

<sup>3</sup> Ministry of Transport, Briefing to Incoming Minister, 2014.

<sup>4</sup> TomTom, Traffic Index. Data available to Productivity Commission upon request.

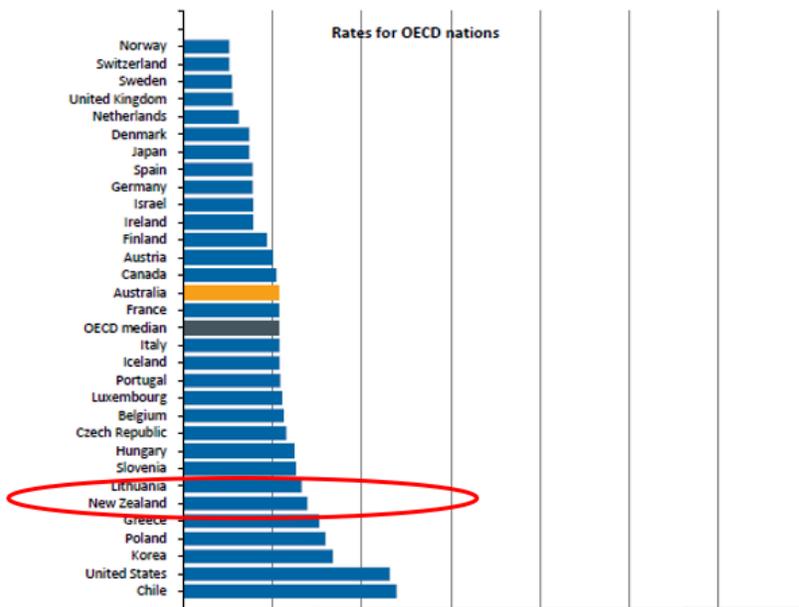
Congestion can be measured in different ways but even official data shows that congestion in our growing cities is getting worse, not better, notwithstanding current levels of investment and record levels of taxation. Between 2014 and 2017 alone, arterial congestion in Auckland worsened by 30 per cent.<sup>5</sup>

Findings are saying, unequivocally, that congestion in New Zealand is comparatively bad. Other systems and other cities are managing congestion better and New Zealand’s system of transport management is not working for road users.

It’s not just congestion.

New Zealand has some of the most dangerous driving conditions in the developed world (Figure 2).

**Figure 2: OECD Road Deaths per 100,000 population<sup>6</sup>**



And things are getting rapidly worse, not better.

In the last five years in Auckland, for example, there has been a near-doubling of road deaths and serious injuries.<sup>7</sup>

**How is this possible?**

The answer is that the system for funding (including taxing) and financing transport services is broken.

<sup>5</sup> Auckland Council, Long Term Plan 2018-2028.

<sup>6</sup> Australian Government Department of Infrastructure and Regional Development, [https://bitre.gov.au/publications/ongoing/international\\_road\\_safety\\_comparisons.aspx](https://bitre.gov.au/publications/ongoing/international_road_safety_comparisons.aspx)

<sup>7</sup> Auckland Council, Long Term Plan 2018-2028.

In transport, as in other areas, misallocated investment due to weak or distorted price signals is increasing costs and decreasing user benefits. Beneficiaries are increasingly not the people who pay but those who do not pay.

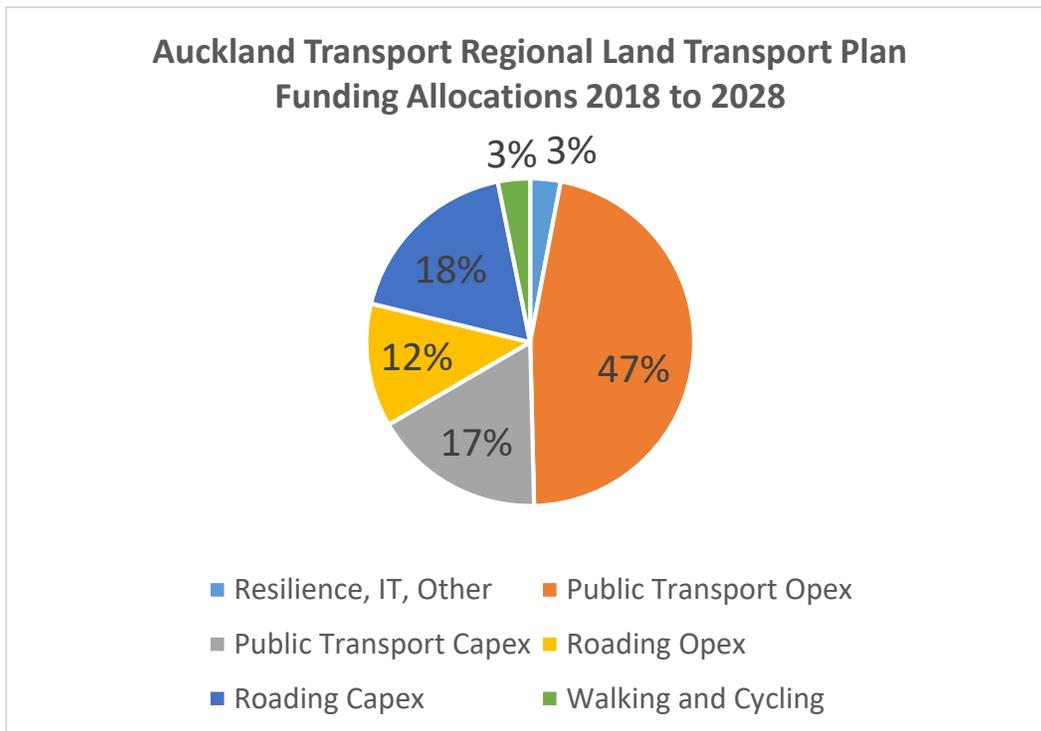
Pedestrians, cyclists and public transport users have benefitted significantly from funding from private vehicle users through the National Land Transport Fund (NLTF), without a firm requirement to demonstrate proportionate benefit to the funders (private vehicle users).

The lack of price signals is leading to greater calls from those who do not pay for additional services, because they are free, depriving private vehicle users of more efficient investments of capital, which could otherwise be lessening congestion and improving safety.

This issue is compounded by the concurrent reallocation of rates, the other major source of transport funding, across many large council areas from roading investment to alternate modes.

For example, as the following pie chart shows, Auckland Transport is allocating 67% of its income over the next decade to public transport, walking and cycling and 30% to roads<sup>8</sup> even though cars, vans and trucks carry 90% of distance travelled mode share and account for 83% of overall trip leg mode share.<sup>9</sup>

**Figure 3: Auckland RLTP Ten-year funding allocations**

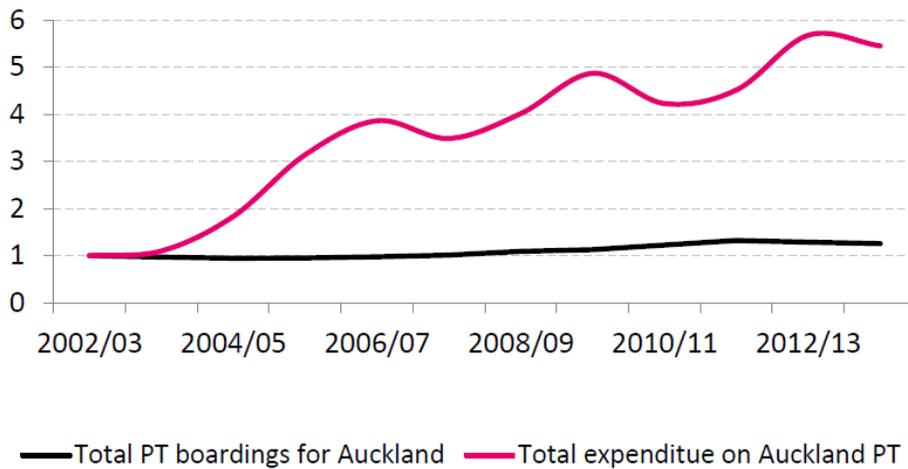


<sup>8</sup> Infrastructure NZ analysis of Auckland Transport’s Regional Land Transport Plan 2018 to 2028

<sup>9</sup> Ministry of Transport Household Travel Survey available at <https://www.transport.govt.nz/mot-resources/household-travel-survey/new-results/>

Figure 4 below demonstrates that, in Auckland at least, a much greater investment per user was required over the decade following 2002 to achieve each additional passenger on Auckland’s buses, trains and ferries. Transport investment has become lower value, achieving less for each dollar spent.

**Figure 4: Index patronage and public transport expenditure growth in Auckland<sup>10</sup>**



**Source: NZIER & NZ Transport Agency**

Over the next three decades, around half of all transport investment in Auckland is expected to be directed towards public transport investment.<sup>11</sup> This is not an issue in itself, but does require patronage to rise in response, and in some reasonable proportion, to additional investment. If it does not, then this is a signal that public investment is not being directed to services that the public is in practice demanding.

Unfortunately, 2018 Auckland Transport Alignment Project (ATAP) evidence has not been released publicly. However, earlier ATAP evidence signalled that, with a high and arguably punitive direct charging mechanism in place, public transport mode share would increase from 7 per cent to 16 per cent.<sup>12</sup>

Doubling public transport mode share to 16 per cent is a significant achievement of policy, but it is not nearly proportional to half of all transport investment over 30 years. This provides a strong indication that transport pricing, funding and investment are misaligned leading to overinvestment in activities which are not, in practice, desired and lower levels of investment in activities which are desired. The result is a high cost of service provision and poorer outcomes.

To be clear, we are not suggesting that public transport investment should thus be reduced. What we are saying is that there is compelling evidence that price signals are weak leading to investment in services which do not maximise transport benefits.

<sup>10</sup> Aaron Drew, NZIER, Presentation to the Auckland Transport Infrastructure Conference, September 2015.

<sup>11</sup> Auckland Transport Alignment Project 2018.

<sup>12</sup> ATAP, Recommended Strategic Approach, 2016.

Public transport provides numerous other benefits – environmental, social and economic – but these do not accrue to funders of the transport network. They are felt across the environment, society and the economy.

Their funding stream, therefore, should be linked to revenue tied to these general benefits. The fact that they are not is having undesirable impacts. Most notably, the benefits of public transport investment, particularly in Auckland, is materialising not transport benefit but as largely untaxed land value benefit.

Quality public transport investment, especially in a context of increasing congestion, delivers benefits not just to public transport users, but to property owners proximate to stations who benefit from new amenity.

Property value improvements are material and could provide a revenue stream to fund investment. In 2010, for example, Motu found that property values around Auckland’s western line rail stations benefitting from new services increased by around \$600 million – the same approximate cost of the upgrade.<sup>13</sup>

However, the method of calculating property taxes in New Zealand (in particular, the sharing of charges across a rateable area) means that these and other properties benefitting from transport investment have paid a tiny fraction of the capital gain they have experienced and no discernible price signal has alerted property owners of the highest and best use of their land.

Increasingly across New Zealand, direct “user” charges for transport are being directed into projects which inflate property values, providing a transfer of wealth and benefit from users and funders of a service to local property owners.

The situation is perpetually worsened when higher land values push up project costs (almost all new transport projects require land purchase). Higher individual project costs mean less money is available across the network, reducing the ability for sound investment to mitigate transport pressures. As travel speeds and access deteriorate in the face of lower effective spending, land values in accessible areas increase.

In practice, there is no amount of money that road users can pay under the current system which can improve congestion outcomes because each additional dollar is absorbed into property values.

It is not just transport which has been affected by this cycle of distorted funding. All public activities which consume land have been equivalently impacted by rising land values. The Auckland Council recently paid, for example, the equivalent of almost \$11 million per hectare for land for a park.<sup>14</sup>

### **How did we get here?**

The underlying principal behind New Zealand’s theoretically efficient transport funding model was quite simple – and narrow. Road users would fund the road network through user charges, providing a revenue stream to fund new roads (and maintain existing roads). New travel on new roads would add to the revenue stream, providing for the next increment in funding.

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<sup>13</sup> Arthur Grimes and Chris Young, Motu, Anticipatory Effects of Auckland’s Rail Upgrades, 2010.

<sup>14</sup> [https://www.nzherald.co.nz/nz/news/article.cfm?c\\_id=1&objectid=11891303](https://www.nzherald.co.nz/nz/news/article.cfm?c_id=1&objectid=11891303), see Upper Harbour investment of \$4.9 million for under half a hectare.

Conceptually sustainable, three major issues have over time become evident which have undermined this approach.

Most obviously, public transport was largely ignored. Public transport effects tend to be felt over the long term as land use change evolves in response to greater accessibility. Technical features like high discount rates have meant that public transport has struggled to demonstrate value to transport users, meaning projects never received funding. A further conflict is that any public transport investment which removes cars from the road actually reduces transport revenue so that the more successful public transport is the less revenue there is available for funding transport.

Secondly, the user-based approach fails to account for wider economic benefits from transport. Transport is a key tool for governments to facilitate and generate economic activity by increasing social interaction, reducing the costs of production, improving competitiveness and increasing access to labour, among others. These benefits materialise as higher wages, greater profitability, improving land values and greater tax revenue, as well as travel time savings for users. That is, transport benefits are not limited to users of the transport system, they are felt across the economy and limiting funding to users has weakened New Zealand's economic growth, lowering wages and increasing the cost of business.

Third, social impacts from transport have been ignored. Most obviously, the focus on transport as a service independent of land use has meant that projects providing benefits to users have been prioritised over projects providing wider social benefits – most notably housing. New Zealand's housing crisis is in large part due to inadequate funding and financing of transport infrastructure to support new development. Under the transport user approach, the costs and benefits of travel to and from a new development are measured but not the costs and benefits of the development itself. This had led, particularly in Auckland, to planning decisions which restrict development in an effort to contain transport costs, but which materialise as land price inflation exceeding by orders of magnitude the transport costs.

The response of successive governments has not been to address the deficiency in funding and financing caused by the well-intended yet misdirected attempt to link transport users to charges (although there have been some minor changes to NZTA borrowing and small capital injections from the consolidated account).

Instead, successive governments have sought to address transport issues by increasingly infringing upon NZTA prioritisation methodology. In one case, the Government elevated major road projects above other priorities as a means to better incorporate the wider economic impacts of major strategic investment. In another, the Government reprioritised spending to public transport to achieve, among other things, social and wider environmental priorities.

Both political priorities can – and should – be easily justified, but they are both political priorities, not, strictly speaking, the priorities of the users and funders of the system.

The attempt to fund wider economic, social and environmental benefits from what is otherwise a direct user charge has distorted the efficiencies which direct pricing should have provided and left the transport sector chronically underfunded.

If that wasn't enough, politicisation of the investment programme has seen the sector become more risky and expensive to operate in. Project cancellations and reprioritisation has created uncertainty and reduced investment by suppliers, lowering the capacity of the industry and increasing project costs.

### **It's not just transport: system failures in water**

Similar distortions can be found in the system for funding and financing water services, leading to underinvestment and social, economic and environmental costs.

In the water supply sector, only a small proportion of councils across New Zealand meter water and charge for it on a volumetric basis. The rest provide water free of direct charge, with the costs of provision covered by rates or fixed charges

Much has been written, including by the Commission, on this issue. We are comfortable that it will be discussed in detail, but will highlight one particular system-issue resulting from common existing arrangements for water supply.

Small councils across New Zealand have proven remarkably resilient to water sector reform, despite significant ongoing issues across the sector.<sup>15</sup> The reason for this is that the revenue from water enables a wider range of council services to be provided. Councils have opposed demonstrably superior water service provision, generally because it is feared that the loss of water would undermine other council services and local decision making more broadly.<sup>16</sup>

The result is that, across much of New Zealand, depth in water service provision capability is sacrificed for scope in the range of council services provided.

This approach increases the risk of both public health crises and structural undersupply of new services to meet growth in order to protect other council functions, without analysis of what delivers the greatest benefit to communities.

In wastewater, many of the same issues are present, including the funding of services through rates and the distortionary effect this has on local decision making. However, the major observed impact of a dysfunctional system relationship between the funders, users and beneficiaries of wastewater provision is higher environmental costs.

Small council areas with low populations have in a large number of cases failed to make necessary investments in wastewater treatment in order to keep rates low. The result has been severe underinvestment and environmental degradation.

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<sup>15</sup> For extensive and growing evidence on water sector challengers, see <https://www.dia.govt.nz/Three-waters-review>

<sup>16</sup> Waipa District, for example, opposed shared services with Hamilton despite all available evidence showing a strong net benefit to users and the district, see Cranleigh, Business Case for Water Services – Delivery Options, 2015.

For example, Greymouth, with a population of 10,000 sits either side of the mouth of the Grey River. The town had been discharging untreated sewage into the Grey River for over 100 years. With the advent of the Resource Management Act (1991), it was apparent that things must change. However, it wasn't until 2015, that the District was finally able to complete investment in a separated waste water treatment system and deliver significant improvements to the quality of discharges made to the Grey River.<sup>17</sup>

Declining freshwater quality across New Zealand, often disproportionately blamed on intensive farming, is in part due to poor wastewater treatment.<sup>18</sup> Recent analysis suggests some \$2 billion is required to bring wastewater disposal up to standard across New Zealand.<sup>19</sup>

Stormwater services are difficult to price so are, and in general agreement should be, funded through taxes. The existing means of funding stormwater – rates and development charges – are in our view the best mechanism because they carry the least distortions to behaviour.

However, like wastewater, there does appear to be some evidence that councils are trading off environmental outcomes for stormwater cost savings.

The stormwater impacts of land use change, in particular urban intensification, are significant. Greater urban infill reduces permeable surface coverage, increasing the need for stormwater infrastructure. The runoff from higher density development, including roads, dwellings and other components of the built environment, contains heavy metals and other toxins, requiring treatment.<sup>20</sup> Where wastewater and stormwater pipes are combined, greater density development can have major impacts on receiving environments and should therefore be adequately accounted for in planning decisions.

We have not seen sufficient analysis of the impacts of intensification on stormwater and the affected environment.

In a context where resource-constrained councils favour intensification as a means to avoid new greenfield capital expenditure, there is a high risk that the environmental impacts of stormwater are overlooked, resulting in net lower public outcomes.

We encourage the Commission to look into this issue further.

### **It's not just local government service system failure: A case study in housing**

We stress that the system failures affecting local government service provision also affect central government service provision.

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<sup>17</sup> 20 YEARS IN THE MAKING – CLEANING UP GREYMOOUTH, Simon McAulay Project Manager, MWH Global & Assets & Melvin D Sutherland, Engineering Manager, Grey District Council Dunedin, NZ Greymouth, NZ

<sup>18</sup> Parliamentary Commissioner for the Environment, Water Quality in New Zealand: Land use and Nutrient Pollution, November 2013.

<sup>19</sup> GHD and Boffa Miskal, Cost Estimates for Upgrading Wastewater Treatment Plants to meet Objectives of the NPS Freshwater, September 2018.

<sup>20</sup> For a detailed investigation into stormwater's impact on the aquatic environment, see Auckland Regional Council, The Impacts of Stormwater in Auckland's Aquatic Receiving Environment, 2008.

However, central government has broader and more comprehensive funding (and to some extent, financing) resources which have concealed the true extent of system misalignment.

Nowhere is this misalignment more evident than in housing.

In New Zealand, the Government has primary responsibility for meeting the needs of those residents who cannot for any reason be serviced by the private housing market.

Through its ownership of Housing New Zealand, central government is by far the dominant provider of public housing services. It's 65,000 homes nationwide comprise over three-quarters of social homes, or a little under 5 per cent of all occupied dwellings.<sup>21</sup> In addition to the direct provision of housing, the Government also subsidises market housing.

The combination of all housing related provision and subsidies is now a very significant Government expenditure item, comprising around \$4 billion and 15 per cent of all social welfare expenditure in the 2018 Budget.<sup>22</sup>

However, responsibility for enabling the supply of market housing is principally delegated to local government. It is local government which zones new land and carries the majority of public sector cost and risk for servicing that land.

This contrasts with the economic benefit and taxable revenue from new development, which is overwhelmingly captured by central government.

Thus, in terms of overall housing, responsibility and cost for enabling housing supply sits with local government, while the benefits of efficient, as well as the costs of inefficient, housing supply sit with central government – and “users”.

These users – new and prospective homeowners – have increasingly found housing to be less affordable as supply has failed to keep up with growth.<sup>23</sup>

Work by the Commission has found that that the infrastructural costs of new development to be in the vicinity of \$50,000 per dwelling.<sup>24</sup>

It is clear that in growth centres like Queenstown and Auckland, where house prices have doubled from around \$500,000 to around \$1 million in recent years, the infrastructural costs of growth are minor in comparison to land price inflation from undersupply of developable land.

However, because councils themselves largely carry these infrastructural costs, while the benefits are society-wide, lack of critical investment in growth has been allowed to materialise.

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<sup>21</sup> Salvation Army, Taking Stock: The Demand for Social Housing in New Zealand, August 2017.

<sup>22</sup> <https://www.interest.co.nz/news/93812/budget-2018-social-welfare>

<sup>23</sup> Productivity Commission, Housing Affordability Inquiry, 2012.

<sup>24</sup> Productivity Commission, Using Land for Housing, 2015, Ch. 8.

Compounding the issue further is that “non-users” of growth infrastructure investment, i.e. existing home owners, benefit from housing supply shortages via a surplus of demand and according house price inflation.

These “non-users” are the group principally responsible for funding growth infrastructure via council rates.

The asymmetry of benefits in the wider housing-infrastructure-decision making discussion has been described by the Commission as a “democratic deficit”, as existing homeowners with a direct link to local politics through annual rates discussions have wielded greater influence in council decision making processes.

In short, new homeowners who stand to benefit most from council activities do not vote because they do not own homes and existing homeowners who do vote have deprioritised growth investment.

The result is misallocation of public resources, an overinvestment in unproductive housing speculation and increasing inequality.

### **It’s not just local government service system failure: A case study in irrigation**

Irrigation is a fourth water service, usually treated separately from the other three waters due to its different ownership and user base.

Historically, investment in irrigation was promoted by central governments. This makes sense because the benefits of irrigation are economic: better access to water allows greater farming productivity, increasing the amount produced per hectare of land and in turn generating employment and investment.

However, central government has hesitated to fund irrigation amid perceptions that the beneficiaries are farmers (who should therefore pay). The previous Government’s Irrigation Acceleration Fund failed to allocate its resource due to the reluctance of Government to carry the risk of regional irrigation projects through their formative stages.

The result has been that a number of irrigation projects which would have delivered permanent economic uplift and opportunities to many challenged rural communities have not proceeded. The failure of irrigation projects to move forward, has seen local government become more involved, with the Hawke’s Bay Regional Council recently committing some \$20 million to the failed Ruataniwha project.

However, it is not clear that there is a significant rates benefit from local government participation in irrigation.

What is very clear is that the beneficiaries of irrigation include affected farmers and their communities.<sup>25</sup> Wider economic benefits are significant and this regard central government, through GST, income and corporate taxes, should be taking a more proactive stance.

However, because irrigation’s impacts are also inherently “local”, investment from central government is vulnerable to accusations of “backing winners” and has been stymied.

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<sup>25</sup> NZIER, The Economic Impacts of Irrigation, 2010.

At the same time, without economic tax income (i.e. GST, income and corporate tax), local government has no real incentive or means to fund these otherwise intrinsically “local” projects.

Adding to the complexity, and misalignment, of the irrigation issue, are debates over environmental costs and benefits.

Irrigation can and does provide environmental benefits, such as guaranteeing minimum river follows, as well as costs, if land use change is not managed appropriately. Where irrigation delivers net environmental and resilience benefits, it is not appropriate that local farmers carry all project risks and costs, yet this is in many cases what has happened.

The overall result of misaligned funding and financing arrangements across the irrigation sector has been that beneficial projects have not moved forward and New Zealand’s rural communities are poorer and more vulnerable, while freshwater environments are worse off.

### **Is the problem funding or financing?**

Although the greater part of New Zealand’s challenge funding and financing public services is due to system failures resulting from poor price signals, we also agree that inadequate resourcing is an issue.

There is much discussion, and at times debate, within the infrastructure sector over whether the primary “resourcing” challenge is rooted in funding or financing limitations.

The debate tends to revolve around whether, if local authorities were not effectively restricted to borrowing “caps” by rating agencies of approximately 2.5 times revenue, they could then finance the infrastructure they need. This borrowing would allow them to invest, in turn providing a revenue stream to repay the debt. For some industry experts, the constraint on borrowing – i.e. financing – is the limiting issue preventing councils from investment. Other experts, conversely, question whether the future revenue stream ever truly develops or can be captured, meaning councils in fact have a funding problem.

While it is clear both remain issues, it is our emerging view that the principal challenge is funding.

We draw this conclusion by comparing public infrastructure providers to private.

Attachment 1 to this submission sets out the debt to asset and debt to EBITDA<sup>26</sup> financial figures for three UK private utility providers. In each example, debt to assets is around 45-60 per cent of total assets and debt to earnings around 5.5-7.5 times EBITDA.<sup>27</sup>

This level of borrowing can be compared to New Zealand’s most high profile local infrastructure provider, the Auckland Council.

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<sup>26</sup> Earnings before interest, tax, depreciation and amortisation.

<sup>27</sup> We have not examined the service performance of these three companies, but as regulated entities we consider it probable that their service performance is at least comparable to, if not better than, New Zealand public infrastructure providers.

Calculating the Auckland Council's EBITDA and assessing its public assets is subject to some assumptions, but we do note that the latest Long Term Plan (2018-2028) signals roughly \$9 billion of group debt in 2019.

This compares to assets of around \$50 billion, giving the council a gearing of 18 per cent – much lower than the three UK private utilities.

The Auckland Council's revenue in 2019 will be approximately \$4 billion. Less core direct expenditure, this results in income of \$1.5 billion, meaning the Auckland Council is currently borrowing six times a figure broadly comparable to EBITDA.

The Auckland Council is, on this basis, borrowing roughly the same in terms of income as a private utility might, but materially less in comparison to its total assets.

What this suggests is that the Auckland Council does not earn the return on its assets that might be expected for a well-regulated utility provider. That is, the Auckland Council has a funding problem.

To understand why the council does not adequately fund its asset base, it is instructive to look at how infrastructure monopolies are regulated.

Regulation of entities like the three UK examples in Attachment 1, or indeed local examples like Vector and Chorus, is based on the value of their assets and the cost of operating these assets safely and effectively.

The regulator does not regulate based on user ability or willingness to pay.

This is the opposite to how public infrastructure providers are “regulated”.

Public infrastructure operators, most acutely those reliant upon fixed charges such as council rates and fuel taxes, are “regulated” by voters based on willingness to pay (or, at least, politicians' interpretation of what the public is willing to pay).

The cost of operating effective networks is subordinate to the amount of revenue voters, as an imperfect proxy for users, wish to pay.

Voters regulate public infrastructure operators on revenue, professional regulators regulate infrastructure operators on performance.

The effect materialises as a financing constraint because the total amount a council is able to borrow is dependent on permitted revenue generating activities (such as water and transport). When councils invest in (core) services like local parks, which generate no revenue, capital is consumed which otherwise would be available to meet growth in revenue generating activities. However, the origin of the issue is that councils are structurally undercharging residents for the provision of services as evidenced by the much smaller return on investment (i.e. assets) they receive.

A similar issue can be identified in transport, where the revenue generating activities of the New Zealand Transport Agency (i.e. road operations) are limited by wider transport activities with lower or no revenue

generating capacity.<sup>28</sup> The affordability crunch is perpetuated when the costs to operate non-revenue generating infrastructure consume future resources, amplifying funding constraints.

The use of rates and transport levies as both a user charge and a more general taxation mechanism breaks the price signal relationship between supply and demand, leading to structural under delivery of critical services.

Since service failure is a materially more significant (i.e. politically charged) issue than failing to provide for growth, public infrastructure operators tend to underfund growth in proportion to limitations in their revenue.

This structural underfunding has had a long term, deleterious effect on the supply of new services, directly contributing to the housing and congestion crises facing our growth centres.

## **Part II: Fixing the system**

New Zealand's public services are underperforming, with some notable infrastructure services, in our view, failing.

Well-publicised reporting on chronically weak asset management, including, but not limited to, leaky hospitals, damp and cold homes, boil water notices, sewerage overflows, severe congestion, unsafe roads and productive water shortages all demonstrate issues with the delivery of public services.<sup>29</sup>

It is noteworthy that failures are not limited to local government services, but are much more common to public service provision. Private sector service provision in energy and telecommunications is not affected by these issues to anywhere near the same extent.

As discussed above, the principal reason why issues are found in public and not private sector infrastructure provision is that public services are "regulated" by voters via revenue and private infrastructure operation is regulated by specialised institutions based on service need.

The reason revenue has been regulated down is that the different parties which comprise the public service funding, financing and delivery system have become detached from the costs and benefits of provision:

- "Users" are paying for services they are not using
- Beneficiaries are not paying for services they benefit from
- Central government is delivering services to local communities
- Councils are paying for services which deliver benefit to central government
- Central government is pushing costs onto councils
- Councils are pushing costs onto central government and communities
- Community costs are materialising as increased social costs to central government.

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<sup>28</sup> NZTA is also subject to restrictions on its borrowing.

<sup>29</sup> Infrastructure New Zealand considers these issues to have been well publicised and not in factual dispute, so will not detail issues further. We are happy to provide evidence should the Commission require.

Public service funding and financing incentives which drive institutions and voters are severely misaligned. Until they are corrected, more resources to deliver public services will be required than New Zealand can afford and limited public spending will not find its way to the highest and best use.

### **Costs and benefits are realised at different scales**

To successfully allocate the costs and benefits of public services, different scales of government are necessary.

In a context where national resources are limited (and they are always limited), not all national priorities will benefit local areas equally.

For example, the decision to invest in a state highway upgrade in the south island today and defer investment in the north island until tomorrow may carry net costs for the north island, even if national benefits are maximised.

Likewise, a decision at a regional level to defer development into a future decade may assist in the maximisation of limited regional resources, but may not maximise the benefits of development for a local community.

There is thus a strong and critical role for smaller government in the delivery of public services.

The opposite is also true.

Communities can make decisions which result in net costs at a regional level and regions can make decisions which result in net costs at a national level.

The value of lower levels of government is that local interests can be promoted where they do not conflict with higher level interests.

The value of higher levels of government is that the bigger picture can be surveyed and benefits maximised for all.

The key factor in all arrangements is that the costs of decisions lie with the parties making those decisions and the benefits remain with the parties who pay.

### **Incentives must be realigned**

The demands and priorities of each party in the wider system of public service provision and consumption – government, councils and residents – are informed by what they can afford.

The tension between affordability and benefit provides an “incentive” to each party in the system to pay and demand as much as they value.

To know how much benefit is achieved from each investment decision, “price signals” are required which allocate the costs of decisions to the parties who benefit.

The price signals indicating to different parties in New Zealand’s system for funding and financing public services are distorted and misaligned leading to poor investment prioritisation and excessive demand for services which are comparatively undervalued.

To realign price signals, the following changes are required:

Users must, to the greatest extent possible, pay for the services they receive. The direct connection between the price of a service and the payment ensures the correct balance is struck between demand for more or less of the service.

Professional, expert regulation based on the cost of maintaining an identified level of service is required to ensure the overall cost of service provision for non-competitive services (like infrastructure) is fair.

But, there must be recognition that in many cases users are not the only beneficiaries. Beneficiaries must pay their fair share or distortions will appear in the system for resourcing services; “payers” will underinvest because the costs are too high and beneficiaries will demand more because the costs are too low.

Payments on behalf of users and beneficiaries will need to be made by public bodies when either affordability challenges or complexities in identifying beneficiaries are evident.

These public bodies must receive the taxation revenue most closely tied to these activities:

- If one unit of government is required to invest in activities where the benefits accrue to another, investments will be deprioritised even when there is net benefit to New Zealand.
- If one unit of government picks up the social cost of investment decisions from another, investment decisions will be made which result in a net cost to New Zealand.

If costs and benefits are correctly allocated to the party which pays, each member in the system will be incentivised to maximise their activities. This encourages capital efficiency, but also innovation and discipline in expenditure.

### **Fixing the system: recognising that not all taxes are equal**

It must also be recognised that not all public revenue streams (i.e. taxes) are equal. A dollar of additional income tax is, politically, superior to a dollar of rates. Income tax comes out of “pre-tax” earnings, is usually collected “stealthily” as wages and salaries are paid and is rarely felt by voters.

Rates come out of “after-tax” earnings and must be actively paid by a voter who otherwise thought that money was theirs.

Central government revenues, which exceed by a factor of more than ten local government revenues, are only the subject of political contention when new taxes, such as a capital gains tax, are debated. Local government rates are relitigated every year.

There can be little doubt that the form of local government funding – property rates – is both resulting in uncomfortably low perceptions of local government performance<sup>30</sup> and lower than needed investment in critical services, despite the total revenue obtained being comparatively small.

As long as local government institutions are dependent upon an after tax property rates charge, relitigated annually, and have no recourse to more subtle economic taxes which rise with good investment decisions, councils will be incentivised to underfund critical services and reduce New Zealand’s economic potential.

## **PART 3:**

### **A proposal for an efficient public infrastructure funding and financing structure**

Part 1 of this submission explained why New Zealand’s system of funding and financing public services was under pressure.

Part 2 set out conceptually what needs to happen to ensure a functional system allocates costs and benefits across society to maximise public welfare.

This Part sets out Infrastructure New Zealand’s proposal to realign public service funding, financing and delivery so that services are provided efficiently and in proportion to need.

#### **Reassigning responsibilities for public services in New Zealand**

Figure 4 below sets out an alternative high level delivery structure for major infrastructure services.

The key feature of this structure, which differentiates it from the existing framework, is the establishment of a new empowered layer of government – regional “government”.

New Zealand does not currently have a “regional” level of government. Regional councils are part of local government and exist “alongside” not “above” territorial authorities in the structure of government. They are poorly resourced, dependent upon rates and focused on environmental management.

The effect is that there is no authority representing regional economic progress and development beyond poorly resourced regional economic development agencies (which, due to resourcing, tend to focus on events, not investment). Regional economic growth is a “top down” priority from central government, not an inherent characteristic of regions.

Regional economic development is subordinate to national, and in instances local, development, without a balancing argument for regional investment. This stifles competition for talent and investment, undermining innovation and growth.

Our proposal delegates central government’s spatial priorities which impact at the regional level to new empowered, resourced regional governments.

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<sup>30</sup> See, for example, LGNZ, New Zealand Local Government Survey, 2017.

Consistent with the Terms of Reference given to the Commission, we have avoided any changes to local government boundaries, though we do think that this would add significant benefit

**Figure 4: A national infrastructure system aligned with planning and funding**

	Activity						Funding
<b>Central government</b>	<b>Transport</b> system regulation and funding	<b>Water</b> system regulation and funding	<b>Public housing</b> regulation and funding	<b>Hospital</b> infrastructure regulation and funding	<b>School</b> infrastructure regulation and funding	Other central functions	GST Income tax Corporate tax
<b>Regional government</b>	<b>Transport</b> planning and delivery	<b>Irrigation</b> planning and delivery	<b>Public housing</b> planning and delivery	<b>Hospital</b> planning and delivery	<b>School</b> planning and delivery	<b>Regional spatial planning</b>	GST Land tax Road charges
<b>Local government</b>	Local streetscapes, community services and facilities, local parks, events, local consents, growth finance						Property rates

### Central government

Aside from (in fact because of) the creation of a new layer of government, one of the most significant changes in our proposed structure is the general withdrawal of central government from infrastructure delivery.

Central government instead becomes a regulator and policy-setter, monitoring lower levels of government and administration to ensure services meet demand and support national direction.

Central government will, in a country of New Zealand’s size, always play a role in infrastructure policy and funding and would continue to lead delivery on major national initiatives and manage a competitive system of transfers to successful regions.

This is essential for three reasons.

First, some projects are simply too large or comprehensive for any sub-division of government. Ultra-fast broadband or an additional Waitemata Harbour Crossing in Auckland would be examples of projects not appropriately delegated to regions.

Second, central government will continue to experience the benefits of infrastructure delivery via improved economic performance, and therefore tax revenue. If it does not have proportionate responsibility for funding new services, then these services risk becoming underfunded even when benefits exceed costs.

Third, central government will continue to incur the costs of social dysfunction resulting from service deficiencies so it must have the ability to respond positively to reduce costs on its services.

However, under this model, responsibility for planning, funding, delivering and operating health, education and public housing infrastructure (as distinct from non-infrastructure operations, such as teaching and pharmaceuticals) would shift to regions.

Central government would largely promote its infrastructure policy agenda through transfers to regions and regulation, rather than through government departments.

The use of transfers as an incentive for promoting central government policy is common overseas and can be effective at small levels.

In the USA, for example, federal fuel excise revenue is distributed to states based on a variety of factors important to the federal government, including effectiveness, value for money and deliverability. Often the amounts transferred to states to support projects is small – as little as 10 per cent of a project cost. Yet the availability of “free” money to state governments encourages project development consistent with national priorities.

The general principle guiding which level of government funds infrastructure and in what proportion should always seek to mimic identified benefits. Since most infrastructure costs and benefits are experienced regionally, it is appropriate that the majority of funding comes from local and regional sources.

Central government’s role would not be made uniformly smaller. It would increase its interest in service regulation and spatial planning, for example, and we would envision that environmental protection responsibilities would shift from regional to central government.

All regional spatial plans developed by regional government would require sign off by the responsible Minister, contracting the Government and regions to fund and deliver on the plans.

Municipal water service regulation, something the Government is now investigating, would also become a new function. Central government and its delegated regulatory agency would agree prices and standards and ensure those standards are being met by corporatised regional public water providers. Water providers may deliver the two or three waters, depending on funding, would be structurally separate from central or regional government and funded through water charges.

Transport performance regulation could also become a new activity. A transport regulator could, for example, set congestion and safety requirements and, under a road pricing scenario, regulate dynamic charges.

Separating infrastructure delivery from central government would allow national authorities to focus much more heavily on ensuring that services are provided to a desired level across the country.

Through the new Infrastructure Commission, Commerce Commission and other entities, the appropriate focus of government would be ensuring the economy, society and system as a whole functions efficiently.

The absence of central government in this wider system observer and “regulator” role, because it is so involved in delivery, is a major reason why infrastructure and related services, including housing, are not meeting need.

### **Regional government**

Under our proposal, general infrastructure planning and delivery would be delegated to regional governments where the spatial impacts of infrastructure investment – both positive and negative – can be planned, captured and managed.

Consistent with Scottish, Australian, American and Canadian delegated authority (albeit without law making powers), regions would become competitive infrastructure entities, balancing the benefits of scale with the inherently local impacts of infrastructure.

Their responsibilities could potentially include all those major fixed investments which serve regional communities, including transport, public housing, hospitals, schools and productive water, as well as regional spatial planning.

Urban water, either the two (water supply and wastewater) or three waters (including stormwater), would be delivered separately from regional governments. Consistent with other utilities like electricity, gas and telecommunications, municipal water services do not shape place and are technical activities with their own, potentially, fully sustaining revenue stream.

The presence of a fully sustaining revenue stream is critical to financing “lumpy” infrastructure investment, making water supply and wastewater ideal for management by specialised water operators, structurally separate from wider government bodies, either public or privately owned.

The factor determining which services should be performed by which level of government would, and should, be spatial.

For activities which deliver services independent of the local communities where they are located, for example, defence, their management should be/remain centralised.

For activities servicing networks or large communities at a subnational level, operations should be regional, linking both scale and local understanding to affected areas.

For activities which affect the look, feel and identity of local communities, and where scale does not deliver efficiencies, local government is the appropriate delivery arm.

Regions are much better placed than central government to balance local concerns with wider economic and social benefits, which in most cases are felt at a regional, rather than national, level.

Regions, properly configured and with adequate resourcing and/or transfers from central government, would have the scale to manage transport, public housing, health and educational infrastructure.

Scale is critical to efficiently allocating capital, maintaining and fostering expertise and achieving economies in the provision of investment-heavy services.

Also notable under a revised regional government structure is the potential for regional spatial planning.

As infrastructure entities, regional governments will orient around place and the spatial impacts of investment, leaving central government to focus on broader, non-spatial effects.

Spatial plans, agreed between central and regional government, would confirm growth projections, investment priorities and funding arrangements to deliver plans.

This arrangement would not only improve forward visibility of the project pipeline, enabling the supply sector to invest long term, it would operate as the first step in approving major projects.

That is, under a reformed system based around spatial planning, the RMA would be separated into an environmental protection Act and a planning Act which moved away from effects-based planning.

Spatial plans would be the first and main opportunity for communities to engage with, comment on and inform long term plans, front-loading consultation rather than litigating national and regional priorities through the later environmental consenting process.

### **Local government**

Local government would remain in much the same state under this proposal as it does currently, with the exception of changes to water and roading.

There would be no requirement for boundary changes and local councils would continue to levy rates to promote the interests of their communities.

The key purpose of local government would be to represent their local communities, support democratic decision making and promote local identity.

Their functions would reorient away from major investment decisions to support economic development and instead focus on environmental and social amenity.

For example, responsibility for 'local' roading would, as part of a regional network, sit with the regional transport agency. The regional agency would prioritise safe movement of people and goods, with local government investing above and beyond the basic service to deliver an outcome supported by local residents. Street-scaping, activation and local feel would be among the transport priorities for local government.

We consider there may be further opportunities to expand the role of local government into the delivery of social services where economies of scale are not significant and where integrating services around place may result in benefits. For example, some functions performed by local offices of Work and Income, the Ministry of Business, Innovation and Employment and the Ministry of Social Development may benefit from local knowledge if delivered at a different level of government.

At all times, local councils would retain the right to invest in additional infrastructure and services, for example, to meet growth earlier than anticipated through regional spatial plans.

The flexibility and capability for local councils, or special purpose entities similar to the special district structures common in the USA, to levy a rate to fund infrastructure which enables land development (and thus greater rates) is critical to balancing regional planning objectives which may otherwise overlook relative local benefits.

Local government would, under this model, become a lot more flexible and capable of evolving in response to community needs.

The presence of larger, scale regional governments would enable smaller local councils to be accommodated, with community support. A closer and more representative relationship between local residents and government could develop without compromising infrastructure and other services dependent upon scale and capacity.

### **Funding and financing under an incentivised model**

The overriding purpose of resetting the functions of different levels of government is to better link public service funding and financing to communities affected by those services.

The tension between greater taxation and user charges, on one hand, and service delivery, on the other, needs to remain as direct as possible to ensure the right levels of investment.

Table 1 sets out general taxation capability across central and local government currently. It indicates that total government taxation revenue is around \$80 billion, or \$73 billion if only the main taxation tools – income, corporate and GST – are included. Local government rates revenue of \$5.5 billion is around 7.5 per cent of general central government’s main tax revenue.

**Table 1: Existing tax revenues across government**

	Crown revenue 2018 (\$m) <sup>31</sup>	Local authority rates (\$m) <sup>32</sup>
Individual tax	36,000	
Corporate tax	13,500	
Other income tax	2,500	
GST	21,000	
Other indirect tax excl. transport	4,000	
Transport levies	3,000	
Total	80,000	5,500

The following sets out an indicative proposal to improve efficiency and effectiveness of taxes to fund and finance public services.

<sup>31</sup> Treasury, Half Yearly Update December 2018.

<sup>32</sup> Statistics New Zealand, Local Authority Financial Statistics, 2017.

## Land/property tax

The most substantive change New Zealand could make to redress imbalances in the tax system which lead to misalignment of investment is the implementation of a land (or property) tax.

Current comparatively high taxation on labour is offset by comparatively low taxation on capital, but this is having the effect of undermining social capital, increasing inequality and creating a sense of “unfairness” in the taxation system.<sup>33</sup>

The recent Tax Working Group report found a capital gains tax and environmental taxes as the preferred tools to redress imbalances, however, the Working Group was also explicit in noting that its recommendations were restricted by the Terms of Reference.

Most notably, the proscribing of taxation on primary residences was identified as a major issue in promoting any land tax.<sup>34</sup>

This is unfortunate as a land tax is both a capital gain and environmental tax, resolving the two primary concerns the Working Group had with the existing system.

In fact, a land tax is a more efficient and accurate tool for capturing the changes in value of land, something which is of great importance to public service delivery, in particular, transport, water and zoning activities.

It can, furthermore, be applied only to land receiving public services, like roads or development zoning, and can be extended to reflect water rights, resolving another outstanding issue in New Zealand’s taxation system (and one very relevant to irrigation). Unimproved farmland and Maori-land can, and arguably should, be exempt.

This makes a land tax an ideal tool for funding infrastructure because infrastructure gives value to land. Land tax is also comparatively dynamic, changing annually as factors like supply and demand for housing as well as local improvements take effect.

Critically, the dynamism in a land/property tax (versus a one-off capital gains tax) provides an ongoing price signal to property owners regarding the highest and best use of their land.

The lack of such a signal has been at the forefront of New Zealand’s housing and infrastructure crisis. Existing property owners have not had the benefit of price signals to indicate failings in the housing and infrastructure system, creating a two speed society: increasingly wealthy property owners benefitting from housing undersupply and increasingly pressured tenants subject to increasing rents.

A land tax price signal would have informed property owners and voters of issues arising in the housing market as and when they occurred.

Importantly, rising land values would have increased revenue to public authorities providing a mechanism to fund infrastructure needed to unlock land.

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<sup>33</sup> Tax Working Group, Future of Tax: Final Report, February 2019.

<sup>34</sup> Tax Working Group, Interim Report, September 2018.

This is of immediate importance as investment shifts away from major roading initiatives designed to open land for development, and moves towards rapid transit, which is designed to open “height” for development.

Without some form of dynamic land charge, development will not occur around rapid transit at the speed required to maximise new accessibility and increases to property values will not be captured (although if, as proposed, a capital gains tax is introduced, it will capture a portion of the capital gain on non-primary residences).

Land taxes have been investigated by Infrastructure Australia to be the most efficient form of value capture<sup>35</sup> and could be used to greatly simplify the tax system; development levies, zoning and rates could all be simplified with a land or property tax.

To be clear, a land/property tax is not without costs. Its implementation would require, but also enable, a “tax-swap”, substituting tax on labour for tax on capital.

It would also need to be effected over the long term, with Westpac estimating a 10 per cent impact on property prices from a 0.5 per cent property tax or a 1 per cent land tax.<sup>36</sup>

Nevertheless, over time such a tax on New Zealand’s approximate trillion-dollar housing market would enable around \$5 billion per annum to be removed from income and corporate taxes.

Fifty billion dollars over ten years is equivalent to central government’s capital investment programme set out in Treasury’s most recent Capital Intentions Plan.<sup>37</sup>

This revenue could be passed through to regional governments, who would take control of the majority of this investment.

### **“Economic” taxes**

A key structural deficiency which undermines New Zealand’s productivity and economic potential is the absence of domestic competition. More precisely, competition among councils is for money from central government, rather than competition against each other to attract skills, investment, employment and economic growth.

The lack of revenue and community benefit from prudent, proactive investment has instilled an attitude and culture across New Zealand’s local government sector which is less innovative and more risk adverse, contributing to a reluctance to employ all tools to effect policy.<sup>38</sup>

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<sup>35</sup> Infrastructure Australia, Capturing Value, December 2016.

<sup>36</sup> <https://www.westpac.co.nz/rednews/property/capital-gains-tax-would-reduce-house-prices-westpac-economists-estimate/>

<sup>37</sup> Information last updated in 2016. The Labour-led Government has since signalled a higher investment programme, see <https://treasury.govt.nz/information-and-services/nz-economy/infrastructure/ten-year-capital-intentions-plans>

<sup>38</sup> Infrastructure New Zealand, Enabling City Growth: Lessons from the USA, 2018.

Further, by monopolising economic taxes, central government takes from regions doing well and gives to regions doing less well. This is equitable, but can starve local economies of capital when growth prospects are high, only for that revenue to be channelled into local economies where growth prospects are low.

Regional governments with revenue tied to growth – GST, income or corporate tax, either directly levied or transferred from central government – will be incentivised to compete, innovate and go for growth.

Infrastructure New Zealand does not hold a firm position of whether a proportion of GST could be allocated to regions to fund new regional governments, or whether income tax provides a more accurate gauge of economic performance.

We are also open to whether transfers are made from central to regional government, essentially rewarding regions for implementing national policy, or whether regions receive a direct proportion of the, for example, sales tax generated within their boundary.

The priority for any new regional authority function is that a sufficient revenue stream is available to regions which incentivise investment in sustainable economic development.

The most efficient funding mechanisms will depend on the number of regions (their scale and capacity) as well as the range of services covered. (It may not, for example, be necessary to include hospitals as a regional government activity given the generally low spatial impacts of health infrastructure.)

### **Road charges and financing**

In time, dynamic road charging will replace fuel excise and conventional road user charges.

Vehicle charging by distance travelled and time of day will more accurately reflect the true costs of utilising road infrastructure and should be adopted in the medium term.

Regardless of whether current mechanisms are used or more modern methods, the primary challenge facing transport is the allocation of user charges to wider public objectives.

There is a high risk that without changes to transport funding, that road users will be charged more than it costs to provide the services they consume, with ever increasing amounts committed to services not equivalently valued.

For this reason, our evolving view is that road funding and operation should be delivered separately from wider transport activities.

It may already be possible today to separate road funding and investment from wider transport activities, including rates charges.

That is, if 100 per cent of the National Land Transport Fund was committed solely to road operation, with active and public transport funded out of rates, it is possible that the road network would be close to self-sustaining.

Structurally separate regional road authorities borrowing against the revenue they receive in fuel levies, road user charges and vehicle licensing may be sustainable.

Such an approach would tie users to funders, limit investment in services which are of low value and allow for better management of capital.

It would not be without its challenges. The transport system would be viewed less as a “system”, with some risk of competition between modes cannibalising demand. The place-making aspects of road delivery would be challenging to align. Effective, collaborative integrated planning would be critical.

However, this level of planning and coordination is no less critical in an environment where “mobility as a service” depends on full system operability and integration.

Importantly, the people funding road operations would benefit from road operations and the people benefitting from public transport investment (property owners) would fund public transport operations.

In our view, the appropriate mechanism to top up activities would not be higher fuel levies, but allocations from economic taxes which recognise the economic development benefits of public transport (agglomeration) and new roading (land development and business competitiveness).

### **Urban water services**

Urban water services should be structurally separated from local, regional and central government (with an option for stormwater to remain with local or regional government).

Wastewater and water supply can, and should, be volumetrically charged, providing a revenue stream to finance debt off wider governmental balance sheets.

The absence of strong place making or spatial impacts strongly suggests these services can be delivered by special purpose bodies, structurally separate from political decision making processes.

The large and lumpy nature of investment, long life of assets and technical nature of service delivery all point to at-scale special purpose water delivery bodies as the optimum delivery agencies.

Separating water charges from rates will more clearly align the costs of both water delivery and other activities to payment, and benefits to investment.

Significant international evidence, highlighted in past inquiries by the Commission, all suggest major efficiencies and even larger improvements in service quality are attainable from corporatised, professional water service delivery.

### **Rural water services**

Rural water services, particularly productive water – irrigation – is appropriately delivered at a regional scale. Irrigation projects are large, their economic benefits felt regionally and social and environmental costs and benefits concentrated across large, but localised areas.

Regional governments, with land tax revenue, would be in a position to charge beneficiaries of irrigation, fund environmental mitigation and, with economic tax incentives, take into consideration wider economic impacts.

Central government, as the environmental regulator, would monitor regional council decisions to ensure there is no net environmental degradation.

### **Regulation**

Regulation would become a major activity of central government to achieve not only good environmental outcomes, but social and economic as well.

Central government, through its principal environmental regulator, would monitor freshwater, the marine environment, air quality and other indicators to ensure regions were balancing economic with wider objectives.

Through the Infrastructure Commission it would monitor overall investment priorities and assist in the formulation and delivery of agreed plans.

Economic regulation, either through the Commerce Commission or independent water and roading regulators, would ensure minimum national standards were met for infrastructure.

Transfers and other central government contributions to infrastructure would be used as both “carrot and stick” to encourage and enforce decision making in the national interest.

In doing so, higher standards would be expected than today in terms of environmental performance, the cost of public services and the fairness of investment priorities.

It is extremely difficult to achieve optimum levels of service under the existing approach as long as central government in particular plays such a significant role in delivery and overall system monitoring.

### **Local government growth financing**

Local government activities under a revised model focused on aligning system incentives would remain similar in nature, though different in scale.

The reassignment of the two main local activities – water and roads – would mean that councils were smaller, but also more focused on genuine community activities.

Through successive amalgamation discussions, it has been the community identity and representation issues of greatest concern to local communities.

The creation of regional governments accentuates the community strengths of local government.

In fact, without major infrastructure responsibilities, local councils would not require scale, allowing them to separate more freely to bring local democracy closer to affected communities.

Local government would still be funded by rates, with the advantage that these rates would be employed for fewer activities, improving transparency.

The combination of smaller and more flexible local government would also allow councils to reoccupy the growth funding and financing space, which has been compromised by a broken system of funding and financing general governance activities.

Special purpose local government bodies, once the primary enablers of local infrastructure delivery through roads, water and electricity boards, would be re-energised.

Communities collectively deciding to levy an additional rate to develop land, could fund local infrastructure along similar lines to the Milldale pilot in Auckland.

The employment of such tools is critical to providing a “circuit-breaker” when higher levels of planning fail to deliver on local needs.

Without the large overhang of existing water and transport operations, local councils will become more flexible and responsive to growth desired by local communities.

This, in tandem with greater scale at the regional level, and superior oversight at the national level, will ensure New Zealand’s infrastructure needs are met in proportion to real demand.

With revenue tied to the activities of different levels of government, all parts of the public service funding and financing system will be better aligned to need and more appropriate allocation of scarce national resources will lead to improved economic, social and environmental outcomes.

We thank the Commission for this opportunity to submit.