



Local Government New Zealand
te pūtahi matakōkiri

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Foreword

Local Government New Zealand is committed to promoting research about local government systems, to better understand what works and what doesn't, in order to raise our game.

The issue of local government funding is surrounded by myths and half-truths. Who likes paying taxes? The idea that a higher authority can limit rate increases while preserving service levels is simplistic at best, but what are the short- and long-term effects on community services and infrastructure?

Rate capping regimes of different kinds exist throughout the developed world and there is considerable interest in whether or not they work. *Local Government New Zealand* is equally interested and, as a result, commissioned this report from NZIER to better understand their implications.

The facts speak for themselves. While rates might rise less than they would without such constraints the impact is generally that costs are shifted on to future generations. Remember, council costs tend to rise at a higher rate than household costs. Any gap between income and expenditure is made up by reducing service levels and delaying required maintenance and renewal, particularly of those hard-to-see infrastructures such as drains and pipes.

Local Government New Zealand is pleased with the observation in this report that the internationally accepted best model for making decisions on these kinds of services is via elected representatives undertaking longterm planning in consultation with their citizens. This is recognition that New Zealand councils are regarded as among the world's leaders when it comes to planning and funding infrastructural services, which is the dominant role of our members.

Eugene Bowen
Chief Executive
Local Government New Zealand

Key points

- Views on rates capping and related mechanisms, such as citizens' referenda, cannot be divorced from underlying theories of local government and perspectives on the appropriate role for local government. The following table summarises (in a generalised form) the key differences identified in the report.

Differences in theories of local government and perspectives on the appropriate role for local government	
Support restricting local government revenue raising.	Oppose restricting local government revenue raising.
Tend to put more emphasis on <i>ratepayers</i> .	Tend to put more emphasis on <i>communities</i> .
Believe that local government, if unfettered, will not act in the interests of ratepayers and will grow excessively.	Believe that local government, if unfettered, will deliver a mix of services and rating levels appropriate to local circumstances and preferences.
Hold a "minimalist" view of local government – regulation as necessary and delivery of local public goods that the market would otherwise fail to provide – as assume that every dollar paid in rates above this would be better spent by the ratepayer privately.	Hold a "maximalist" and/or "optimalist" view of local government – delivering services within the context of fostering overall community wellbeing – and see "place-shaping" as a purposeful role. Service delivery would include but not be limited to local public goods.
View local democracy primarily as the means by which local citizens control their council to deliver services and regulation efficiently and keep rates as low as possible.	View local democracy primarily as the means by which local citizens engage with their council to set goals, determine priorities and influence others who have an impact on the goals.
View higher levels of government as protecting ratepayers from their councils.	View higher levels of government as partners in local and regional development.

- In New Zealand, work on rates setting since the introduction of the Local Government Act 2002 indicates that by and large local government does a good job of providing local services at reasonable cost and that councils are highly

cost-conscious. However, there is room to improve the rigour of prioritisation and the quality of citizen engagement in that process.

- Wanganui is an interesting case in New Zealand. Annual citizens' referenda over the past five years have provided guidance in decision-making that the Council finds useful and the citizens support. The latest referendum saw a 61% voter turnout. This is a voluntary undertaking and the Council has had freedom in how it has been implemented and how the results have been interpreted. It has evolved over the period as the Council has tried different ways of framing the key questions.
- A case study on the Wanganui experience noted the high level of local support for the process but identified two issues of concern. One was the inherent limits to communicating the complexities involved in major investment decisions. Clearly this is a significant challenge for local government with or without referenda. However, that challenge could be a knife-edge if a council is to be more or less bound by the results of a referendum. The other concern was that some projects, "back office" in nature, may not be able to get over the citizens' bar, even if the net benefits were compelling. This concern was echoed by officials' recollections of the old local government loans polls where "out of sight" infrastructure proposals were by and large less popular with citizens.
- The international experience with restrictions on local government revenue-raising indicate that they are effective in terms of the single objective of constraining rates increases, but the evidence is compelling that they fail to result in an optimal mix of local services and rates. On balance, rates capping in the jurisdictions studied has led to core expenditure being cut into the bone. Large infrastructure backlogs have been created. Local circumstances have not been well catered for and the evidence suggests that local choice has been denied.
- Moves to restrict local government revenue-raising are not only predicated on a lack of trust in local democratic institutions, they cultivate it. Higher levels of government in several overseas jurisdictions, and now New Zealand, actively undermine community trust and confidence in their local representatives. This is arguably feeding into negative perceptions of government more generally.
- Improving the quality of planning, reporting and citizen engagement is the alternative to rates capping most frequently proffered. A common concern in the literature is that restrictions on local government revenue raising have a disincentive effect in terms of robust, long term planning.
- If rates capping is instituted, there are a number of specific mechanisms that can be employed. Four key areas to consider are the choice of starting point, calculation of the limit, citizen involvement and making exceptions.

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1. Introduction

1.1 Purpose of the report

The possibilities of rates capping and/or the introduction of mandatory citizens' referenda are currently being explored in New Zealand following the appointment of Hon Rodney Hide as the Minister of Local Government. The Minister came to office with strong views on local government. The following excerpt from a recent speech summarises his perspective:

...I think of myself as the Minister for Ratepayers, not the Minister of Local Government...I want to keep rate rises down and encourage you to focus on core activities. On necessities, not luxuries. No one wants to pay more rates than they have to. And there can be no doubt that rates have been rising way beyond the rate of inflation for a good many years. As have other charges and fees. *So I'll be pushing for councils to accept that rates rises should be capped at the rate of inflation, or less. A council may have a good reason or need to increase rates faster than inflation but should get the consent of ratepayers first.* After all, it's their money. And it's a good test for a planned spend-up to get the agreement of those who are paying for it. [Emphasis added.]¹

The message is strong and clear and he has stated that he is considering options that would subject Councils to more than moral suasion from the Minister².

Local Government New Zealand (LGNZ) has commissioned NZIER to undertake a study of the international literature and experience with local government rates capping.

1.2 Approach

Our approach was to undertake a literature search to get an overview of what's been done where and what evaluative material is available, then select a small number of jurisdictions to study in greater depth. This is set out in section 4. The report first briefly traverses the wider context in terms of the theories of local government and views about the appropriate role of local government (section 2), then looks at current rates setting in New Zealand (section 3). The final section of the report draws together the findings of the study (section 5).

¹ Hon Rodney Hide, Minister of Local Government, Local Government Zone 3 Meeting, 2 March 2009

² Office of the Minister of Local Government 2009

2. Wider context

2.1 Underpinning theories of local government³

How local governments behave in relation to the interests of their constituents is a long-standing topic of debate in the literature. One perspective is that elected representatives provide public services in accordance with the preferences of the median voter⁴. In this view, there is no justification for fiscal controls. Another theory which suggests local government spending will be about right is the Tiebout hypothesis⁵. In this view, businesses and individuals choose amongst competing local jurisdictions which ensures optimal combinations of benefits and taxes.

There are two main schools of thought which suggest that local government will not naturally provide what the average voter would want. The first is the special-interest view⁶ which predicts that lobby groups will influence the provision of public services or concessions that are in conflict with the good of the community as a whole. The second is the Leviathan view⁷ which predicts that the behaviour of self-interested bureaucrats effectively exercising “monopoly power” will result in excessive growth. Both theories therefore predict that levels of local government spending will exceed what the average voter desires. Further, there is increasing concern that excessive taxation stifles economic activity⁸. In the special-interest and Leviathan views, there is a strong role for rules to restrain the growth of sub-national government.

Note that there is a close connection between these underpinning theories of local government and views about the appropriate role of local government (traversed in the next section).

2.2 Role of local government

It is difficult to separate consideration of the settings for local government from its role. The settings could look quite different depending on the prevailing view of what local government should be concerned about. In his 2007 report on local government, Sir Michael Lyons arrived at the same realisation.

During the course of my work on funding, I came to the conclusion that changes to the finance system could not proceed effectively without the role of local government being more clearly established. ...Ministers [then] asked me to extend my work to consider the strategic role of local government...and how pressures on local services could be better managed.⁹

³ This section draws predominantly on Krol 2007 p 432

⁴ Eg Downs 1957, referenced in Krol 2007

⁵ Tiebout 1956, referenced in Krol 2007

⁶ Stigler 1971, Peltzman 1976, Becker 1983, referenced in Krol 2007

⁷ Niskanen 1975, Brennan and Buchanan 1979, referenced in Krol 2007

⁸ Barro and Sala-i-Martin 1995 and Engin and Skinner 1996, referenced in Krol 2007

⁹ Lyons 2007 p 1

Professor Percy Allan, in his 2006 report for the independent inquiry into the financial sustainability of New South Wales local government¹⁰, also concluded that defining the appropriate role for local government is critical. The report describes conflicting views on this as follows:

Conflicting views on the role of local government¹¹

Minimalist	Councils are the body corporate for the local community and as such should look after the common property and regulate the usage of private properties....
Maximalist	Councils are the governments of their areas and as such should foster the welfare of the whole community ...They should undertake such services that local communities want and are prepared to pay for.
Optimalist	Councils are champions of their areas and as such should take a leadership role in harnessing public, NGO and private resources to promote particular outcomes...

Not all of these are mutually exclusive. For example, the Inquiry noted the possibility of councils facing “maximalist” expectations with “minimalist” resourcing, and the potential for “optimalist” approaches to make the most of all the players’ scarce resources in the pursuit of community wellbeing¹². In other words, the “minimalist” and “maximalist” roles are focused on the council’s own activities. The “optimalist” role is focused on leadership and how the council can influence others, which is not mutually exclusive with either of the other two. The Lyons report distinguished a role that is arguably a mix of “maximalist” and “optimalist”, which it termed “place-shaping”, being “...the creative use of powers and influence to promote the general well-being of a community and its citizens”.¹³ This is consistent with the approach of New Zealand’s Local Government Act 2002.

3. Current rates setting in New Zealand

3.1 Local Government (Rating) Act 2002¹⁴

Rates setting occurs under the Local Government (Rating) Act 2002 (LGRA). One of the prime objectives of the LGRA is to establish clarity, certainty, and stability in rating matters. It provides councils with the powers to set, assess and collect rates to fund local government activities. Provisions in the Act aim to ensure that rates reflect decisions made in a transparent and consultative manner.

¹⁰ Independent Inquiry into the Financial Sustainability of NSW local government 2006

¹¹ *ibid* p 98

¹² *ibid* p 100

¹³ Lyons 2007 p 3

¹⁴ [http://www.localcouncils.govt.nz/lqip.nsf/wpg_url/About-Local-Government-Local-Government-Legislation-Local-Government-\(Rating\)-Act-2002?OpenDocument](http://www.localcouncils.govt.nz/lqip.nsf/wpg_url/About-Local-Government-Local-Government-Legislation-Local-Government-(Rating)-Act-2002?OpenDocument)

Mechanisms are set out in the LGRA to allow local authorities to raise revenue from the community generally, specified groups or categories of ratepayers, and those who use or generate the need for particular services or amenities. The Act provides for processes and information so that ratepayers can understand their liability for rates.

3.2 Local Government Act 2002¹⁵

Deciding the local government activities to be funded by rates is predominantly governed by the Local Government Act 2002 (LGA). The Act aims to provide democratic and effective local government that recognises the diversity of New Zealand communities. It gives local authorities general powers [the “power of general competence”] to decide what they will do and how. To balance this empowerment, the legislation requires local accountability, with local authorities accountable to their communities for decisions taken¹⁶.

Councils are responsible for promoting the social, cultural, environmental and economic well-being of their communities. Local Government New Zealand sets out their obligations as follows:

A council must:

- provide directly or on behalf of central government, adequate, equitable and appropriate services and facilities for the community
- ensure that the services provided are managed efficiently and effectively
- exercise community leadership
- exercise its functions in a manner that is consistent with and actively promotes the principle of cultural diversity
- manage protect , develop, restore, enhance and conserve the environment
- account for and manage assets for which it is responsible
- facilitate involvement of councilors, members of the public, users of facilities and services and council staff in the development, improvement and co-ordination of local government
- raise funds for local purposes by way of rates, charges and fees and investments, loans and grants
- keep the local community informed about its activities
- ensure that in the exercise of its regulatory functions it acts without bias
- act as a responsible employer.¹⁷

¹⁵ http://www.localcouncils.govt.nz/lgip.nsf/wpg_url/About-Local-Government-Local-Government-Legislation-Local-Government-Act-2002?OpenDocument

¹⁶ It also requires councils to assess the costs and benefits of their expenditure.

¹⁷ <http://www.lgnz.co.nz/lg-sector/role/index.html>

3.3 New Zealand Local Government Rates Inquiry 2007

An inquiry into local government rates in New Zealand was initiated by the government following publication of the 2006 long term council community plans (LTCCPs). The projected rates increases were a source of concern. The Panel, chaired by David Shand, submitted its report in 2007¹⁸.

The Panel found that local government generally works well in providing a substantial range of network and community infrastructure and regulatory services at reasonable cost. It also put that cost into perspective – local government accounts for less than 5% of national expenditure.¹⁹

However, it also found that "...local government needs to show more restraint in its expenditures. It needs to give more rigorous consideration to the desirability and prioritisation of expenditures...".²⁰ It further found that local government is not adequately presenting key choices to citizens in LTCCPs and nor is it adequately considering the affordability of rates increases for some of their residents.²¹

The Panel assessed a number of ways to address these shortcomings and put forward several significant recommendations in that regard. It considered the option of rates capping but rejected it on the grounds that:

"...a cap on rates is too blunt an instrument to achieve restraint. It would not recognise the different financial position and expenditure needs of different councils and in any case would cover only the less than 60% of local government revenues consisting of rates. A cap based on the Consumers Price Index (CPI) would not recognise either growth pressures or that the price of most local government inputs is rising faster than the CPI. Rather, the Panel considers all councils should be required to adopt clear and honestly measured financial targets, which would be reflected in LTCCPs and a three-year indicative budget. These targets would cover proposed increases in operating expenditures as well as rates."²²

3.4 Analysis of main trends from draft 2009 Long-Term Council Community Plans

In May 2009, the Department of Internal Affairs released their briefing to the Minister of Local Government on the main trends from draft 2009 LTCCPs²³. It found that the forecast rates for the period of overlap with the 2006 LTCCPS was overall very similar²⁴ and that the capital programme was reduced²⁵.

¹⁸ Local Government Rates Inquiry 2007

¹⁹ *ibid* p 1

²⁰ *ibid* p 2

²¹ *ibid* pp 2–3

²² *ibid* p 3

²³ Department of Internal Affairs 2009

²⁴ *ibid* p 9

²⁵ *ibid* p 6

It reported a high level of awareness in LTCCPs of the need to constrain costs and evidence of deferred and cancelled projects accordingly²⁶. Projected cost increases were generally found to be in line with the combination of the national price adjuster for local government and population growth²⁷. The report did not comment on the relationship of local government expenditure (particularly but not solely in the area of infrastructure) to recovery from the recession or contribution to productivity in the economy.

4. Selected jurisdictions

This section of the report gives an overview of regimes in jurisdictions outside New Zealand, notes some cautions in making international comparisons and covers research into the following jurisdictions:

- Australia: New South Wales
- United Kingdom
- United States: Colorado, Massachusetts

We also look at the case of Wanganui District Council in New Zealand and previous experience with local government loans polls.

4.1 Overview of regimes in jurisdictions outside New Zealand

There are a number of rates capping regimes, with or without a referendum on voter preferences, operating internationally. Rates capping in Australia has been experienced in four states. It was temporarily in place in Victoria in the early 1990s, in South Australia in the late 1990s, in the Northern Territories for three years from 2007/08, and has been in place in New South Wales since 1977²⁸. New South Wales is by far the longest running and most studied Australian example.

Rates capping has been in place in the United Kingdom since 1984. Councils that are deemed to be rating excessively are given rate limits by central government, with rights of appeal and negotiation²⁹. In the Netherlands, rates increases have been pegged to the inflation rate since 2006, but with compensatory payments from a centrally-allocated “Municipalities Fund”. Sweden had two municipal tax freezes in the 1990s. Denmark has a system of centrally setting an overall cap, followed by negotiation (a) between central and local government on spending that will need to be funded by an additional grant and (b) among local authorities on how to allocate the total allowable rates take.³⁰

²⁶ *ibid* pp 8, 12

²⁷ *ibid* pp 4, 9, 12, 13

²⁸ Productivity Commission 2008 p 111

²⁹ Scotland is currently in the second year of funding councils who decide to freeze their taxes altogether as part of a package of recession-related measures.

³⁰ Gough 2009 pp32–33

Switzerland has mandatory spending referenda. Swiss citizens vote on new spending programmes whenever they exceed a predetermined spending threshold. In the United States, there are a variety of mechanisms used to limit the growth of state and local government, collectively known as tax and expenditure limits (TEs). By 1996, 30 states employed a TEL and, of these, 24 states and half of all cities employed citizens' initiatives (eg referenda).³¹ By 2006, 43 states had at least some limitation on property taxation.³²

4.2 Some cautions in making international comparisons

There are a number of substantial differences between New Zealand's local government system and that of other jurisdictions. There are two that stand out the most. First, the scope of local government activity varies enormously (eg the responsibilities of local government in the United Kingdom include education and social service delivery; the responsibilities of local government in the United States include police).

Secondly, there is significant variation in the overall funding systems. This is related to the first point, with a large proportion of funding often being provided by central government in some form or another (eg property taxes only account for approximately 30% of local government revenue in the United States and approximately 25% in the United Kingdom).

4.3 Australia: New South Wales

4.3.1 Context

The New South Wales (NSW) local government system is set by state government legislation (as is the case everywhere in Australia). There are 152 councils in NSW. The revenue base of local government in NSW is shown in the following table:

Revenue Base of Local Government in New South Wales³³

rates	36.7%
user fees and charges, waste charges, water and sewerage fees, regulatory fees and rental income	34.1%
other eg fines, contributions and donations	15.4%
grants and subsidies from state and federal government	8.6%
interest	5.1%

³¹ Krol 2007 pp 432, 439

³² Anderson 2006 p 685

³³ Independent Pricing and Regulatory Tribunal 2008 p 9

NSW has had a system of “rates pegging” since 1977. Each year, the NSW government sets a maximum amount by which Councils can increase their annual general income (largely revenue from property rates – excludes fees, fines, water and sewerage rates, and domestic waste charges). The peg is set at the projected annual increase in costs that a typical council would face (that is, not the CPI). Each council must then adjust its rates so that its general income increases by no more than this maximum amount. Councils may seek a special variation to the amount. In 2007/08 28 (out of 152) councils applied and most were successful.

Growth in NSW rates has been lower than in every other Australian state and has fallen well short of NSW economic growth rates. This is considered to be a result of rate pegging. Notwithstanding its restrictions on local government, the state government’s own tax revenues have grown broadly in line with gross state product (GSP).³⁴

The local government legislation in NSW was substantially revised in 1993 to provide for greater local autonomy balanced by greater accountability measures. Arguably, NSW reflects a “maximalist” view in their Local Government Act and a “minimalist” view in their rates pegging regime.

There have been a number of key studies which have examined the impact of rates pegging in New South Wales, outlined below.

4.3.2 Advancing Local Government: Partnerships for a New Century 2000

The UTS Centre of Local Government released this discussion paper in 2000³⁵. It puts the NSW rate pegging into an historic context, noting that in 1977 when it was introduced, inflation was high and taxes and charges were rapidly increasing. It was long before the spotlight turned on efficiency and cost cutting in the public sector. By contrast, in today’s climate, local government is highly aware of the need to contain expenditure and rates, even to the point of competition among Councils.

The paper finds that despite efficiency gains, the rate pegging limit has not allowed for adequate service levels or infrastructure maintenance in cases of rapid population growth or other special local circumstances. Indeed, the paper found evidence that rate pegging limits have been set below the cost increases facing even an average Council. In addition, local communities have in some cases wanted their Council to spend more for a particular purpose such as environmental management.

While the Minister has often agreed to higher rates increases in such cases, the paper notes that decisions are not always favourable and have been markedly inconsistent. Further, the process of making the case in itself is not costless.

³⁴ Independent Inquiry into the Financial Sustainability of NSW local government 2006 p 199

³⁵ UTS Centre for Local Government 2000

4.3.3 Rates and Taxes: A Fair Share for Responsible Local Government 2003

The Economics, Finance and Public Administration Committee, chaired by David Hawker, undertook an inquiry into local government and cost shifting in 2003.³⁶ One of the issues they considered was restrictions on revenue raising. The Committee found that rate capping in NSW has caused local government in that state to raise insufficient revenue. This was compounded by rising expectations and reduced grants. It also found a negative impact on strategic planning.

The Committee concluded that local government should be responsible for setting its own level of taxation, subject to “...the test of rate increases and of management of its fiscal position at the ballot box”.³⁷

4.3.4 Independent Inquiry into the Financial Sustainability of NSW Local Government 2006

The NSW Local Government and Shires Association (LGSA) established an independent inquiry into the financial sustainability of NSW local government, which reported in 2006.³⁸ A panel chaired by Professor Percy Allan was appointed to conduct the inquiry.

The inquiry recommended that rate pegging be removed. Key findings the inquiry took into account included:

- Rate pegging contributed to a significant “...mismatch between expenditure functions and revenue raising capacity”³⁹;
- Inadequate expenditure on asset renewal and replacement has created a large infrastructure backlog⁴⁰;
- Evidence that citizens would be willing to pay higher rates for more local services⁴¹;
- The system had used as its baseline whatever rates level was in place in 1997 – so the impacts were both less fair and less efficient if the rates were too low to start with⁴²; and
- the peg-setting is opaque and has often been below “generally accepted cost indices”⁴¹.

The inquiry considered (but didn’t recommend) the option of replacing rate pegging with a process of citizens’ referenda. Two advantages of this option were put forward. The first was that it would enable the ratepayers to set the rates and charges they would face. The second was that it would discipline councils to justify any proposed rises in rates and/or charges.

³⁶ House of Representatives Standing Committee on Economics, Finance and Public Administration 2003

³⁷ *ibid* p 45

³⁸ Independent Inquiry into the Financial Sustainability of NSW local government 2006

³⁹ *ibid* p 92

⁴⁰ *ibid* p116

⁴¹ *ibid* p 72–75

⁴² *ibid* p 209

A number of disadvantages were identified, including:

- Could make it difficult to raise rates for initiatives that are not visible (e.g. storm water drains) or whose benefits are not direct (e.g. back-office automation);
- Effective and unbiased communication to the electorate of the merits attached to rate increases could be difficult because a council financial plan and budget is extremely complex; and
- Such referenda could become political auctions with candidates promising rate reductions irrespective of actual council needs.⁴³

It was considered preferable to achieve direction as to community priorities in such decisions through ongoing engagement and consultation about council's budget in the framework of its strategic and management planning process.

4.3.5 National Financial Sustainability Study of Local Government in Australia 2006

In 2006, the Australian Local Government Association (ALGA) commissioned PricewaterhouseCoopers (PwC) to undertake an independent analysis of the financial sustainability of local government in Australia⁴⁴. It followed a number of state based studies, including one which was undertaken for NSW.⁴⁵ Consistent with other studies, the PwC report found that rate pegging prevented councils from setting rates at an adequate level. It also found that the objectives of rate pegging, constraining excessive growth and incentivising high productivity, should be met by improving asset and financial management, combined with the discipline of the ballot box.

Indeed, they considered that rate pegging acted as a *disincentive* to robust long term planning and financial analysis. Effectively the rate pegging limit sets the envelope and councils simply scale back infrastructure renewal spending until they hit the balanced budget point.

4.3.6 Assessing Local Government Revenue Raising Capacity 2008

In 2008, the Productivity Commission prepared a report for the Australian Government on local government's revenue raising capacity.⁴⁶ Rate pegging in NSW formed a small part of the overall scope of the report. The assessment considered the extent to which rate pegging had constrained the ability of councils to raise sufficient rates and whether this had been offset to any extent by higher fees and charges. Regarding the first question, the Commission drew on the Access Economics report to show the potential adverse impact of rates capping on financial sustainability, particularly where councils are serving a growing population.⁴⁷

⁴³ *ibid* p 93

⁴⁴ PricewaterhouseCoopers 2006

⁴⁵ Access Economics 2006

⁴⁶ Productivity Commission 2008

⁴⁷ *ibid* p 113

On the second question, the Commission found no evidence of *increasing* fees and charges to help meet the shortfall. It did find that fees and charges were already *high*⁴⁸ and that this mechanism may have been exploited in the earlier years of adjusting to the rates pegging regime. The Commission's overall finding was that "[r]ate pegging has dampened the revenue raised from rates from New South Wales relative to other States and there seems to have been little offset from non-rates revenue sources in recent years".⁴⁹ [p 117]

4.3.7 Revenue Framework for Local Government 2008

The Independent Pricing and Regulatory Tribunal (IPART) is a statutory body in NSW. In 2008, IPART was requested by the state government to review the revenue framework for local government.⁵⁰ IPART noted that the NSW Government has been committed to rate pegging because it is seen to impose fiscal discipline on councils.⁵¹ The report gives a good summary of the pros and cons of rate pegging that have been put forward in various debates as follows.

Those who favour rate pegging believe it:

- prevents the misuse of monopoly power in the supply of some basic community services
- helps to control cross-subsidisation and restrict council provision of non-core services and infrastructure that might prove to be unsustainable to rate payers
- manages the risk of poor governance in the local government sector
- limits the ability of councils to divert funds from essential infrastructure to other projects, and spend on marginal services that are better provided by the private sector

Those who oppose rate pegging believe it:

- limits councils' ability to provide local services
- prevents infrastructure backlogs from being addressed
- requires councils to consider higher user pays charges which could result in pricing inequities
- runs counter to principles of democracy and accountability of local government⁵¹

IPART found that local government in NSW is in an overall healthy position, but it found evidence of a mounting backlog of infrastructure renewals.⁵² It also suggested that more effective incentives for improved efficiency might be provided through planning and reporting mechanisms.⁵³

⁴⁸ based on a comparison with other states

⁴⁹ *ibid* p 117

⁵⁰ Independent Pricing and Regulatory Tribunal 2008

⁵¹ *ibid* p 55

⁵² *ibid* pp 38–43

⁵³ *ibid* p 60

4.3.8 2009 NSW Local Government Financial Sustainability Review

This report⁵⁴ was sponsored by Dexia Credit Local Asia Pacific Pty Ltd and commissioned by Review Today Pty Ltd as part of an annual series. The analysis was undertaken by FiscalStar Services Pty Ltd. Of the largest 100 local authorities in NSW, 16 were found to be “financially vulnerable” and a further 40 were found to be “financially unsustainable”, meaning that these Councils had operating deficits, infrastructure backlogs, and/or excessive net financial liabilities that would require “...substantial adjustments to [their] existing revenue-raising and/or expenditure.”⁵⁵ The least sustainable councils were found to be highly correlated with the fastest growing areas⁵⁶. In commenting on the report, the Research Director for Review Today, Professor Percy Allan noted that while worrying, the analysis indicated that the overall infrastructure backlog had reduced by about two thirds since the Inquiry in 2006 (see section 4.4.4)⁵⁷.

4.4 United Kingdom

Councils in the United Kingdom are responsible for setting their rates in accordance with their budget requirements but each year, in advance of that, the government sets its expectations as to maximum increases. It then has the power to cap rates for any council if a particular increase is deemed excessive. The government took such action against eight councils for 2008/09 and two councils for 2009/10. In announcing an increase in the average rates bill of 2.6% for 2009/10, the Local Government Minister also stated that with a large increase in funding from central government and significant planned efficiency savings, councils will be able to “...maintain both high quality public services and low council tax...”⁵⁸

In 2004, the government requested Sir Michael Lyons to undertake an inquiry into local government funding. This was expanded to include the role and functions of local government in 2005. An interim report *National Prosperity, Local Choice and Civic Engagement*,⁵⁹ was released in May 2006. Later that same year the UK government published a White Paper, *Strong and Prosperous Communities*⁶⁰ which incorporated the Lyon’s Inquiry concept of “place shaping” as a fundamental role for local government. The scope of the White Paper didn’t include a particular focus on rate capping but did reiterate that the Government “...wouldn’t allow excessive Council tax increases”.⁶¹

The Lyons inquiry final report was delivered in 2007.⁶² It did include a substantial section on funding, which covered the rate capping issue. The Inquiry found that

⁵⁴ FiscalStar Services Pty Ltd 2009

⁵⁵ *ibid* p ii

⁵⁶ *ibid* p 3

⁵⁷ http://www.reviewtoday.com.au/2009_FS_report.html

⁵⁸ <http://www.communities.gov.uk/news/corporate/1186287>

⁵⁹ Lyons 2006

⁶⁰ Department for Communities and Local Government 2006

⁶¹ Department for Communities and Local Government 2006 p 146

⁶² Lyons 2007

capping is inconsistent with local accountability and embodies a simplistic assumption that local government is inefficient unless forced otherwise. The report also concluded that rate capping had the perverse effect of weakening the incentives to better understand and manage underlying financial and service delivery pressures⁶³. Sir Michael's strong view was that "the solution to the rate of increase in council tax lies not in constraining local authorities' power to raise revenue, for example through capping, but in providing real flexibility to set spending plans in a way that reflects local choice about service provision and tax rates."⁶⁴

The government rejected this aspect of the Lyons report. When the report was released the junior local government minister reportedly "insisted that the government was duty bound to protect households from soaring bills"⁶⁵.

4.5 United States

4.5.1 Overview

There is some form of control on state and local finance in most states in the United States (US). These take a number of forms, such as limits on taxes, limits on overall spending (fiscal caps), or requirements to achieve a supermajority of the legislature or a majority of voters to approve an increase.⁶⁶ These are collectively known as tax and expenditure limits (TELs). Approximately 20 states have assessment limits which mean that the taxable value of any property may not increase by more than a stipulated percentage in any given assessment.⁶⁷

TELs are now generally considered to be effective in limiting growth of government at a sub-national level.⁶⁸ The key characteristics which distinguish different types of TELs include the following. Note that the italicised characteristics are considered the most effective in constraining growth⁶⁹:

- how the limit is approved, eg legislative action or *citizens' initiative*
- calculation of the limit, eg growth tied to personal income growth or *population plus inflation*
- what the limit is applied to, eg revenues or expenditures or *a combination of revenues and expenditures*

⁶³ Lyons 2007 p 6

⁶⁴ *ibid* p 246

⁶⁵ Mulholland 2007

⁶⁶ Resnick 2004 p2

⁶⁷ Anderson 2006 p 687

⁶⁸ Earlier literature found that TELs were generally not effective (see for examples Brown 2000 p 31), but more recent studies using advanced research methods concluded that they were generally effective (see for example McGuire and Reuben 2006 p 4 and Krol 2007 pp 433, 434). One large recent study was an exception. Kousser *et al* 2008, concluded that the "agent" (state government in this case) can and does always find a way to thwart the "principal" (tax payer) and grow excessively. This paper is not relied on for our report as it extends to cases where the taxpayer has willingly participated in such "thwarting" – in other words, it is simply inconsistent with any meaningful form of local democracy.

⁶⁹ Resnick 2004 pp 2–3

- how the limit may be waived, eg by legislative majority or *citizens' vote*
- requirements for setting tax increases, eg supermajority of the legislature or *citizens' vote*

A number of studies have found that there are significant variations in the distribution of the constraining effect of TELs. For example, one study concluded that "...TELs are most constraining on the ability of governments serving economically less prosperous and at risk populations to meet public service needs."⁷⁰

There is also evidence that while taxes have been constrained, there has been an increase in user fees and charges.⁷¹

4.5.2 Colorado

There is widespread agreement in the literature that Colorado's approach has been the most effective in constraining growth⁷². In 1992, a citizen-initiated constitutional amendment was approved called the "Taxpayers Bill of Rights" (TABOR). It strictly limits both revenue and spending. The limits apply to the state and all the local government bodies within the state. For municipalities, revenue and spending are limited to the previous year's level plus inflation plus the net percentage increase in the market value of all real property within the jurisdiction. For the state government, revenue and spending are limited to inflation plus population growth. Any amount collected above this must be returned to the taxpayers. Any increase in taxes (eg new tax or renewal of an expiring tax) must have majority approval from voters, as must any exception to the limit.⁷³

The impacts of TABOR have been studied comprehensively. Generally agreed conclusions are as follows:

- TABOR was successful in its purpose – growth of municipal governments was significantly curtailed⁷⁴
- Local government in smaller population areas has been more constrained than local government in larger population areas⁷⁴
- TABOR creates a "ratchet down effect" – in recessionary times with declining revenues the limit is adjusted downwards and future growth is from the lower limit⁷⁵

By 2005, state and local budgets were squeezed to a critical point with the implementation of major cuts in spending and the necessity of further cuts. "Referendum C", which created a five year time out for revenue to recover, was

⁷⁰ Mullins 2004 p 111

⁷¹ see for example Krol 2007 p 439

⁷² See for examples Bell Policy Centre 2003, Resnick 2004 and McGuire and Reuben 2006

⁷³ Brown 2000 p 30

⁷⁴ *ibid* p 46

⁷⁵ McCallin 2008 p 5

passed by the voters.⁷⁶ For proponents of TABOR, this was evidence of it working. For opponents, it was evidence of its shortcomings.⁷⁷

Studies that looked at whether moving tax revenue into individuals' pockets to such an extent contributed to economic growth in Colorado found no evidence that this was the case and some evidence that there was no such relationship.⁷⁸

4.5.3 Massachusetts

Massachusetts passed Proposition 2½ – a statute which limits property tax to 2.5% of total property values – in 1980. It also limits the annual increase in municipal taxes to 2.5%. “Overrides” may be permitted by specific exception if a majority of voters is in favour. Because the municipalities were rating at a variety of levels when Proposition 2½ came into effect, the immediate impacts also varied widely. Those that were rating above 2.5% of their total property values were required to reduce their taxes by 15% every year until they reached the limit. The areas affected in this way were predominantly the larger cities and towns. Overrides became more common over the course of the 1990s, particularly in the larger cities and towns, suggesting that communities felt that either Proposition 2½ had been a mistake or that its mission had been accomplished.⁷⁹ Evidence from a study into the effects of Proposition 2½ on house prices indicates that it “...prevented residents from obtaining services they desired and for which they would have been willing to pay.”⁸⁰ This result needs to be interpreted with some caution in the New Zealand context as the most affected component of total expenditure was education.

4.6 New Zealand: Wanganui

Wanganui is an interesting case. Since 2005 the Council has voluntarily undertaken an annual referendum on a number of key choices involved in setting the Annual Plan/LTCCP. The referenda are non-binding but the Council has abided by the results to date.

The format for the referenda involves sending descriptions, pros and cons, and costs of the proposals to ratepayers (also published on the Council's referendum website), followed by sending voting papers. The questions on the voting forms have usually been in the form of indicating the three most preferred choices, although on occasion the format has been yes/no. In 2005 there were a large number of topics (14), focused on service levels and capital projects. In 2008 five capital projects were put forward. In the other years, there has been a relatively small number of topics which have included questions of governance and local identity.⁸¹

The 2009 referendum included yes/no questions on a number of proposals including a major item of discretionary expenditure (the relocation of the Visitor Information

⁷⁶ Dusenberry 2006 p 10

⁷⁷ *ibid* p 12

⁷⁸ Bell Policy Centre 2003 p 6, McGuire and Reuben 2006 pp 10–11

⁷⁹ Cutler *et al* 1999

⁸⁰ Bradbury *et al* 2001 p 309

⁸¹ Department of Internal Affairs 2008

Centre). Notably however, it also included a question on the level of rates, with low, medium and high options put forward. The medium option equated to the proposed 2009/19 draft plan (therefore implicitly including the Visitor Information Centre). The high option added one major investment. The low option included the Visitor Information Centre but gave an indicative list of four other discretionary expenditure items (deferral of three of which is likely to lead to higher future costs according to the Council's information) plus a targeted amount for efficiency gains from an activity review (this review is being undertaken anyway). There was a further option to "leave this decision to the elected councilors".

Voter turnout for the referenda over the period has been:

Voter turnout in Wanganui District Council Referenda

2005	2006	2007	2008	2009
54.2%	55.4%	48.0%	46.3%	61%

The Council's rates increases over the period have been:

Rates increases over the period 2005/06 – 2009/10

2005/06	2006/07	2007/08	2008/09	2009/10
nil	3.0%	1.8%	4.7%	3.2%

The Department of Internal Affairs undertook a case study⁸² of the Wanganui experience as part of its Local Government Information Series. The case study covered the period to referendum 2007. DIA found considerable support for the Council referendum process as the major form of consultation on major issues. It was seen to engage and communicate effectively with the community. The process also brought Council and key stakeholders closer together.

Two problems with the referendum process were identified. The first was that some felt that the information provided to ratepayers did not fully communicate the trade-offs involved in the decision-making. Indeed, "...[t]hey questioned whether it was even possible to adequately inform the public to make complex decisions through a referendum process."⁸³

The second concern was that perhaps certain projects wouldn't be able to get over the bar of a referendum. An example was capital expenditure on the Council's IT system – it was felt that this type of project would be unlikely to gain sufficient community support through a referendum, even though it may generate considerable net benefits⁸².

⁸² Department of Internal Affairs 2008

⁸³ *ibid* p 22

4.7 New Zealand: previous experience with loan polls

Up until the 1996 financial reforms, local authorities in New Zealand were required to undertake loan polls if they wished to borrow to pay for capital investments. We were unable to obtain documentary evidence of this experience, but officials recall that polls for community infrastructure projects tended to be more successful than the network infrastructure (especially the “out of sight” infrastructure)⁸⁴.

5. Findings

5.1 Does rate capping work?

There is compelling evidence from the literature that rate capping can be highly effective against the single objective of constraining rates increases. In the United States, the most effective regimes are associated with citizens’ referenda. On the other hand, the New South Wales regime has been found to effectively constrain growth without this feature.

5.2 Does rate capping improve outcomes?

This is the harder and more crucial question. Is the result closer to an optimal package of services and taxes than would otherwise be the case? Do the restrictions prevent waste? Do they prevent funding of non-core activities or investments that the citizenry can’t really afford? Or do they prevent sensible decisions on local priorities by local communities and risk cutting core expenditure (eg infrastructure maintenance) into the bone?

The evidence in New Zealand and internationally is that local government is now highly conscious of the need to be efficient and keep costs to citizens as low as possible – without formal restrictions. The evidence from the US, and New South Wales in particular, points to the conclusion that rates capping has cut core expenditure into the bone, that a large infrastructure backlog has been created, that local circumstances have not been adequately catered for and that local communities are being denied local choice.

5.3 Nature of problem being addressed

Perhaps this simple quote sums it up best: “communities have increasingly resorted to [restrictions] when they do not trust their elected officials to serve their interests”.⁸⁵ In whatever form the restrictions take, this appears to be a fundamental issue.

Restrictions on taxation are not founded on increasing the level of trust and confidence in local government and appear more likely to perpetuate a low trust environment. Australia, the United Kingdom and now New Zealand provide examples

⁸⁴ New Zealand Society of Local Government Managers, 2009

⁸⁵ Cutler *et al* 1999 p 332

of higher levels of government actively undermining community trust and confidence in local government, as state or national governments paint themselves as the champion of the ratepayers, saving them from rampant local government excesses.

In the United States, proposals to institute Tax and Expenditure Limits (TEs) have often been presented as grassroots initiatives but this has also been challenged – another view is that TEL proposals in reality “...are championed at the state level ...[providing] little in way of local discretion in the application of their provisions to individual jurisdictions, and thus seriously limit local choice.”⁸⁶

All of this is somewhat of a two-edged sword of course. Central government in New Zealand as elsewhere has a long tradition of imposing stronger disciplines on local government than it imposes on itself. It's not obvious that citizens would have a higher level of trust in central government politicians. Indeed, the rhetoric of local government excess is arguably more likely to reinforce negative perceptions of government generally. Certainly in the United States, there have been calls for equivalent legislation at the national level since the proliferation of local and state TELs.⁸⁷

5.4 Relationship to planning and reporting

The literature suggests that high quality planning and reporting would be an alternative solution to the problem of low trust in local government to serve the community's interests. But this is not a costless activity for citizens, possibly requiring a great deal of time and effort – if local government fails to make such monitoring readily achievable by the citizenry, the appeal of a proxy mechanism such as rate capping is not hard to understand.⁸⁸ This highlights the role of high quality, accessible information, community engagement and ultimately community support for the direction and expenditure decisions of a local authority.

Note that if a restriction is applied and it involves citizens' referenda, this conclusion also holds. But a key point to note here is a common concern that a restriction on local government revenue raising, in one form or another, has a *disincentive* effect in terms of robust, long term planning.

This raises the possibility that an expenditure category could be created such as, say, “major, non-core” expenditure with that category being subject to a different approval regime (with or without an overall cap). This option isn't explored in this report as we found no examples of such a system in our research.

⁸⁶ Mullins 2004 p 114

⁸⁷ Cutler *et al* 1999 p 314

⁸⁸ Giertz 2006 p 704

5.5 Key mechanism issues

5.5.1 Choice of starting point

A theme within the literature is the arbitrary nature of whatever starting point is chosen for the application of rate capping. There is nothing to say, *prima facie*, that whatever rating level is currently applied in a particular local authority is the optimal level. It might be about right, too high or too low. It will certainly be different than what's applied in any number of other local authority areas. The literature suggests that using the levels and relativities that happen to be in place at a given point in time effectively sets historic inadequacies, inefficiencies and/or inequities in aspic.

5.5.2 Calculation of the limit

There are a range of ways that limits are calculated in the jurisdictions we studied. Examples of the factors employed in various formulae included income growth, population growth, property value growth, inflation and 'typical council costs'.

No basis of calculating the limit stands out as superior. While the literature finds problems with all the methods, the overriding issue is that while one factor might be the most relevant and sensible in a particular place at a particular time (eg population growth in a time of high population growth) in another place and/or time other factors will be the significant cost drivers. The key point is that a formal restriction limits the local authority from taking the key factors into account, including critical characteristics such as age and condition of infrastructure, demographic profile etc, in a way that is most relevant to its local area.

5.5.3 Citizen involvement

The systems in the United Kingdom and New South Wales do not include citizens' referenda. The caps are set by central and state government respectively and exceptions are granted (or not) by the same hand. The United States has a mix of legislature and citizen oriented mechanisms. A common arrangement there is a citizen-imposed formula which must be followed year by year unless a citizens' referendum either changes or removes the cap, or allows a specific exception for a particular year or period of years.

5.5.4 Making exceptions

Almost all of the regimes we studied had some provision for making exceptions, with decisions on this laying in the hands of either the government or the citizenry. These mechanisms are inherently problematic – too many exceptions undermine the provision itself but too much rigidity will override the merits of sound individual cases. The literature indicates that the processes for applying for exceptions are costly, and often generate arbitrary results.

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