Episode eighteen

TRANSCRIPT

NEW ZEALAND INFRASTRUCTURE COMMISSION
Te Waihanga

Unpacking local government debt

Infrastructure for a better future

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Please note: the transcript has been edited to make reading as easy as possible.

Introduction: Welcome to 'Infrastructure for a better future', a series where we have honest conversations about the infrastructure challenges we are facing and how we can build a better Aotearoa. In each episode we talk to experts from here and overseas about what works when it comes to addressing these issues.

Shelly Biswell: Kia ora koutou. Welcome to the New Zealand Infrastructure Commission's podcast series, Infrastructure for a better future. My name is Shelly Biswell and I'm a Senior Communications Advisor here at the commission. Today, we're talking with Principal Economist Graham Campbell, about research we've recently published on local government financing. I want to thank you for joining us, Graham. I'm hoping you can explain to us the research we've just undertaken, and why it's important to infrastructure, and maybe why you were the right person to do it?

Graham Campbell: Thank you, Shelly. This is a really interesting topic. We started to dive into local government infrastructure finance, because we care broadly at Te Waihanga about how infrastructure is funded and how it's financed. It's an important part of our Strategy – there's an entire chapter that's dedicated to it. This was a role that I undertook, because my background is largely in public finance, I worked in the United States, as you can tell from my accent, at a budgeting office at the state government level and I also have a background in economics. So, the economics team wanted to dive more into these funding and financing issues. We thought that looking at local government and their potential debt constraints was a good place to start.

Shelly Biswell: That makes sense. I learned a lot reading the report and I'm assuming a lot of people would. I want you to start with the basics with us. And one of the things I'd like you to explain is how we currently debt finance infrastructure in local government?

Graham Campbell: So local government's a major player in the infrastructure space. About a quarter of all dollars spent in a given year on infrastructure is done by local government. And so, we dove into how are they debt financing infrastructure. Right now, there's basically three ways. The first is they can borrow money from the Local Government Funding Agency, which I'll refer to as the LGFA. You can think of this as sort of a group of councils that are banding together to get lower borrowing costs for their debt. The next way they can borrow money, is just borrowing directly to the market themselves. So, they can go to a bank and just sort of ask for money, or it can be as complex as going out to international investors, international debt markets, central banks and the like, and issuing debt. The third is what is called these special-purpose vehicles or SPVs. This is a relatively new tool, and it's a little bit more complicated. Basically, the way it works is it allows councils to borrow money through kind of a separate financing entity and then repay that debt back to that entity. LGFA is the primary way that councils borrow money. But the catch is that members of LGFA are required to adhere to a set of financial what are called covenants, which are fiscal rules, the most important of which is having a net debt to revenue ratio of below 175% or 280% depending upon the council's credit rating. The motivation for this paper was that because we have large and growing councils with increasing infrastructure needs, councils are increasingly using debt to help pay for that infrastructure. For councils who are borrowing a lot from the LGFA, there's a concern that they're going to be reaching or coming close to those debt limits. Hence, that's kind of why the idea of the paper 'is local government debt constrained?'

Shelly Biswell: Yeah, and that's interesting, because the title of our report is, 'Is local government debt constrained?' And I guess my question is, what do you give us as an answer after doing this research?

Graham Campbell: You know, I'm going to give the classic economist response here – it depends – right? The answer is more nuanced than yes or no. Basically, what we found, and what we determined, is that the current tools provide flexibility for councils to take on more debt beyond those LGFA limits. The sort of rub is that as they approach those limits, their ability to take on debt becomes more expensive, but not completely constrained. So LGFA's debt limits are set by members of LGFA. The members of LGFA are councils themselves, and so they are the ones kind of imposing those limits on themselves. But there's nothing that says that 280% or 175% is the right number per se. Lenders would almost certainly lend to councils beyond this debt limit number because the fundamentals of council debt are very strong, it's very highly rated by the market there's a lot of demand for government debt in strong countries like New Zealand. Some of the research we did in this paper is that councils have been significantly more indebted in the past than they are now. We found that in the period between 1900 and about 1940, councils were sustaining debt burdens that were two to three times as high as they are now. We think there is capacity for the market to lend, and councils could access that debt. But for councils who are approaching that limit, it becomes more and more costly to access that debt. One approach is they could use SPV financing. That sort of provides a release valve for councils, but it comes with higher interest rates and higher administrative costs. They could exit the LGFA, there's nothing legislatively that keeps them in LGFA and borrow on their own, which has no sort of debt headroom limits other than what voters want to give them. But that comes with a certain amount of administrative set-up costs to do that. This also could affect a council's reputation – they don't want to be seen as the council that's leaving LGFA and being potentially irresponsible. In the end, I think whether councils are debt constrained is a question of whether they think the benefits of being able to debt finance more of their portfolio today are worth it, relative to higher cost of finance in the future. That's the tradeoff that councils need to make. In a sense, there's no hard constraint. It's really just a question of what types of costs councils are willing to bear to debt finance their infrastructure portfolio.

Shelly Biswell: And every council will have a slightly different view on what constraint means?

Graham Campbell: Exactly right. If you're a council within LGFA and you want to remain in LGFA, in effect, you are saying that the constraint is where LGFA has it, right? But you might say, as a council, we think we can borrow more as a tradeoff and we're willing to pay a little bit more. So, you might investigate other forms of financing, like SPV financing, or potentially looking beyond LGFA. So, one sort of complaint about the current system is, is that if you were in LGFA, you are adhering to a uniform set of rules, regardless of whether councils have the ability to take on more debt or would want to take on more debt. The current system does allow for a differentiation between councils, as well.

Shelly Biswell: You said that LGFA is the main way, but do you want to talk about the other two approaches to debt financing, and what councils are using or give us an example or two on that?

Graham Campbell: For councils that issue debt directly, since most councils are borrowing through LGFA not very many councils are issuing debt directly or going to banks and asking for money. The main exception is Auckland Council, Dunedin City Treasury and Christchurch City Holdings which are a council-controlled organisation (CCO), sort of operated or run, or somewhat controlled by council, they do borrow on their own. Auckland is the main one. Auckland utilises directly issued debt for about 75% of its overall debt portfolio and they do that for a number of reasons. One, they're just the biggest council in New Zealand and it's a well-known city and council, so they're able to go out into the market and do that. The second is the rules around LGFA. Even though Auckland is a member of LGFA, they're not allowed to make up more than a certain portion of LGFA's outstanding debt. So, Auckland has to borrow from other entities to fulfill all its funding needs, or else it would risk over representing itself within LGFA's loan portfolio. Auckland is able to get, or perceives it's able to get, similar terms to LGFA as well because it's such a well-known council. So, they have their own sort of set of incentives and reasons for borrowing directly. There's also some legislative things that allow for Auckland to access more capital, namely from international markets. It's the only council that can borrow internationally.

For SPV financing, it's a relatively new tool. It was sort of formally created in legislation in 2020. But the key benefit for using SPV financing is it allows councils to access debt financing without it necessarily affecting their financial position. One of the issues with borrowing and being in LGFA is that all that debt counts as part of the debt limit. SPV finance does not. When a council accesses SPV financing, what it is in effect doing is allowing a separate entity to borrow on its behalf, and then that entity gives those debt proceeds to council to build infrastructure, and then the council is responsible for collecting money and repaying that separate entity. The tool is relatively new, it's been used twice in New Zealand, once in Tauranga, for transport infrastructure, and then in Wellington for a wastewater treatment facility on the edge of town. There is interest in using this more. But again, it carries a different set of considerations for councils and tradeoffs. Whether we see more and more use of it will depend upon how many councils are getting close to their debt limit, and the types of projects that councils are looking to undertake.

Shelly Biswell: Yeah, okay. Well, while that tool might be new, one of the things I really enjoyed about reading was the long history that you looked at. I'm curious about what you found: what you saw as some of the trends, you've already mentioned that how we use debt has changed. If you could explain some of that, that would be great.

Graham Campbell: I think one of the things we wanted to do in this paper is, we see right now, that government, not just local government, also central government is facing significant infrastructure challenges. What we know is that this isn't the first time that both levels of government have needed to undertake significant investment. Right now, we're in a relatively mature infrastructure network. At some point in time, we needed to build this out. So how did we get here? To help inform policy solutions now, we basically asked, 'well, how did we do it before?'. Because maybe we can look to the past to help inform what we do in the future. What we found, at least for local government, and central government really, is that investment isn't the sort of long journey of sustained investment. The way it works is that governments tend to make infrastructure investments in cycles, and they tend to be in about 10- to 15-, sometimes 20-year periods.

For local government, we identified three cycles of significant infrastructure investment, the first was from 1920 to 1935. The second was from 1950 to 1970. And the third is roughly from the mid-90s, 1995 or so, to about today. So, we're currently in a period of elevated infrastructure investment. We noted the cycles, then we want to look to see how local government was using debt across the cycles. How are they financing these infrastructure investments? And what we found is that while local government in the past used debt to make infrastructure investments, what we were seeing is that their revenues were growing at roughly the same pace during those two previous cycles. What was happening was that they were taking on debt, like we do now, but they were either raising new revenues either through increasing rates or other charges. Or that because they were responding to rapidly growing urban populations where there was a lot of demand, we saw significant economic growth, that created more affordability for rates and ratepayers. So, they're able to charge a little bit more. So, the growing economy allowed revenue growth to happen.

What we see different in this cycle is that we see debt increasing quite substantially, but revenue growth is not matching that debt growth in the same way that it was for previous cycles. That in and of itself is concerning. We tried to figure out what is different about this cycle versus last cycle. We sort of posited that the main reason might be that the types of investments that we're making now are different than what they were before. So back in those first two cycles – 1920s, 1950s – we were building out new networks, we were responding to growth that was happening. There were a lot of bottlenecks in the infrastructure system that were sort of easing out or smoothing out. A lot of the investment in infrastructure nowadays, for local government and central government is in renewal investment. A lot of these assets have reached the end of their useful life and they need to be replaced. While that's really important for local and central governments to be doing, that doesn't necessarily lead to growing revenues. You can't really charge a new charge for the use of an asset that's already been there, you're not likely to generate a whole lot of new economic growth when you replace a pipe that's in the ground already. This for us led to this light bulb moment that, you know, we need to think more critically about the types of infrastructure projects that we're building, and how that might determine how we finance it and how we fund it.

Shelly Biswell: It's pretty interesting, especially when I think it's interesting to look at in cycles. And I'm really interested in that since infrastructure is quite long lived. So, what do you see for the future?

Graham Campbell: It's hard to say we don't know exactly. But I think the implications for this research going forward for us is that we need to think more critically about what we're using debt for and how we're funding it. So, this is returning to this classic link between funding and financing. That's why we often talk about these together. If you think about how going forward we face our infrastructure challenge, and how we fund and finance it than you basically have two or three ways. The first is you can pay for it, you can finance it by using current revenues, what we call pay-as-you-go. So, this is the idea that you only build when you have the money, right. What that means you'll be able to build probably a little bit less now. But you preserve the ability to build things in the future. You can debt finance, which is what we do for a lot of infrastructure. That allows you to build more infrastructure right now. But because that has to be repaid, it sort of limits the amount of infrastructure that you can build in the future. What this paper sort of highlighted for us, is that there's a need if we want to have optimal infrastructure investment over time, we need to match the debt that we're taking on for infrastructure with growing revenues. If we don't, we're going to put ourselves at greater risk for infrastructure deficit in the future. Because if we don't match with revenues, when the time comes to make future infrastructure investments, our budgets will be strained by the debt that we took on previously.

I think there's three main takeaways from some of this research. The first is, we need to think a little bit more critically about how we use debt nowadays versus in the way we did it in the past. Because a lot of our investment is in renewals, we might think of using debt, not just because it's a long-lived asset we should be using debt. Instead, we should be thinking of our infrastructure of what we call a portfolio of investments. You have a set of investments that you have to make overtime. But the issue with that portfolio is that at any given point in time there might be certain projects that are very lumpy, very large expenditures that don't make this a nice smooth profile. You might use that that lumpy expenditure as more of a smoothing approach to your budget, rather than rather than using it for any asset that has a long life. We could use debt for more lumpy assets, but for things that are steady, that we know we're going to have to do over a certain period of time, we might think about pre-funding it or using pay-as-you-go financing instead, in order to preserve that ability to make infrastructure investments in the future.

The second key takeaway that came out of the research, is that it's really important that we try to match infrastructure with revenue streams, in order to relieve that sort of pressure on future generations to the extent that we can. This is advocating for more use of things like user charges or development contributions in the local government space. When we do that, if we preserve the ability for future generations to invest, by not making them have to repay our debts now, it allows them to build the infrastructure that suits them the best. If we're uncertain about the types of challenges that we're going to face, it makes sense to preserve at least some of the ability to invest for those generations and decide what they want to build.

The third is, this is a really key point, and if we do believe we're in a sort of debt constrained world, then it's really important to have good asset management, project prioritisation and planning processes in place. So, you recall that I talked about this sort of thinking about how we use debt. This idea of a portfolio of investments over time, in order to construct that portfolio, you need to know what your assets are, you need to know what condition they're in, and when they need to be replaced. That is fundamentally what an asset management plan is. To know what you should be using debt for and when you'll need to be smoothing out those lumpy expenditures, you need to know when are the big lumpy expenditure is going to be needed – when is our wastewater treatment plant going to wear out? So that's the big expense, whereas you know, for some of the pipes will know that ‘x’ amount in a given year are going to need to be replaced. We can sort of either prefund that or use pay-as-you-go financing. For going beyond the renewal space and thinking about new infrastructure for growth, knowing or having good planning process and prioritisation are really important because it means that when you are using debt to build those things, you are maximising value for money, you're choosing the projects that are most likely to get you the biggest bang for your buck and the biggest return economically. If you do that, then you're more likely to get that economic uplift and create more affordability for your ratepayers. Otherwise, what's going to happen is you're going to be using debt for projects that don't really get you much return. So, in the future you're not going to have much of an ability to pay for that investment that you made 20 to 30 years ago. Those three pieces together, I think, sort of highlight this importance of thinking more critically about what we're actually using debt for.

Shelly Biswell: Thank you so much for this conversation. And I really want to encourage people to read your research. Thanks so much for your time, Graham.

Graham Campbell: Thank you, Shelly.

Narrator: Thanks for listening. Find out more about the work Te Waihanga is doing to transform Aotearoa at **tewaihanga.govt.nz**