IPART'S Review of the Revenue Framework for Local government: Speech to the NSROC Annual Conference.

Introduction

IPART has been working on its review of the revenue framework for local government for about a year. The terms of reference for the review require IPART to review and make recommendations on:

- An appropriate inter-governmental and regulatory framework for the setting of rates and certain charges that facilitates the effective and efficient provision of local government services in NSW;
- A role for IPART in setting local government rates and certain charges in future years;
- A framework for setting charges by certain public authorities to enable these authorities to recover costs for the provision of services that are normally provided by local government.

During the year we released an issues paper and have received 65 submissions from local government, interest groups and members of the public in response to it. We have held workshops in Sydney and number of regional centres to discuss the key issues that were raised in submissions. In addition, we have undertaken 11 case studies of councils throughout NSW to understand in detail the issues that they face and how they are addressing them.

IPART recently presented its draft report to the Minister for Local Government and released it to the public. At the same time we released an Information Paper detailing our comparative analysis of revenue and expenditure with other states. We now seek comment from the councils and the community on the proposals set out in the report. As well as speaking to you today, IPART will be conducting a number of public workshops to obtain feedback. Public submissions are due by 18 September. IPART expects to provide its final report to the Minister in November.
This conference is timely as it gives me an opportunity to discuss with you some of the main issues that we faced and the key recommendations from the draft report.

IPART has made 45 recommendations in its draft report in relation to its proposed framework and its implementation. In relation to rate pegging arrangements, IPART has put forward two options for further consideration. I would like to discuss these options in greater detail. First I will outline some of the main issues that we have faced during the review to date.

**The Main Issues**

Once we started working on the revenue framework for local government it quickly became apparent that the main issue that needed to be considered was the future of rate pegging.

The majority of submissions made to IPART's review were from councils. While most, but not all, of these submissions argued that rate pegging should end, others — including some councils — suggested that rate pegging should continue. This latter group of councils argued that rate pegging protects rate payers from excessive increases in rate bills. They suggested that, if rate pegging is retained, much could be done to make the process of rate pegging more transparent and independent of political involvement and to encourage a longer term perspective.

There are two main types of argument against rate pegging that have been made in the submissions. The first type are essentially factual arguments about the consequences of rate pegging for rates revenue, the level and composition of councils' total revenue, operating positions and debt, and infrastructure provision. These arguments are capable of an empirical assessment. IPART has attempted to provide such an assessment and the results of IPART's analysis are summarised in the next section of this talk.
The second type of arguments concern the desirable ends of public policy. Many councils and commentators emphasise the accountability of councils to their communities. From this perspective, they argue that rate pegging gets in the way by diluting accountability. Local government should be responsible to the community not the NSW government.

The alternative view is that rate pegging protects rate payers and that this is a desirable objective for public policy. Ratepayers, it is argued, require protection from unreasonable rate increases for reasons similar to the ones that lead to the regulation of the prices of monopoly infrastructure, such as Sydney Water’s. In my experience, this view of the matter is frequently held by members of both the Government and Opposition parties in the NSW Parliament and staff of the NSW Department of Local Government.

It is interesting that those who emphasise one objective tend to dismiss the importance of the other. Those who wish to argue that councils should be accountable to the whole local community tend not to place much emphasis on the protection of ratepayers. They may argue, for example, that ratepayer resistance to higher rates, or competition between local authorities to provide the right combination of services and rates to attract residents and industry, will limit excessively high rate increases. By contrast, those who argue that ratepayers need protection tend to be sceptical about the effectiveness of consultation and electoral processes in local government.

However, I would prefer to argue that both the accountability of local government and the protection of ratepayers are in practice policy objectives that are important to the NSW community. There is a difficulty here because the two objectives compete with each other to some extent – more protection for rate payers can mean less accountability to the local community (as opposed to the NSW Government). In practice some compromise between the competing but desirable objectives must be
Although the need to compromise may seem unsatisfactory to those who strongly support local government autonomy or ratepayer protection, it is not unusual in public policy. Recognition of the need to compromise may encourage the development of improved, but realistic, alternatives to the present arrangements in NSW.

**The Consequences of Rate Pegging**

As we have seen, the supporters of rate pegging argue that it tends to limit rate increases. It also encourages the use of alternative revenue sources such as user charges. User charges for services may be preferable to taxation measures such as rates because purchasers have some ability to control how much of the relevant service they wish to purchase. The amount paid in charges is clearly linked to the quantity of the service that is purchased and hence to the benefit that the purchaser receives from the service.

The opponents of rate pegging argue that it limits the revenues of local councils below the desirable level, leads them to be financially unsustainable and results in backlogs of infrastructure renewals and maintenance.

It is of interest to test these claims against the available evidence. IPART has reviewed this evidence in the Information Paper that was released with the draft report. Two main types of evidence are available. The first is time series data showing developments in local government finances since the introduction of rate pegging in 1977. The second source of data is comparisons between New South Wales and other States that do not have rate pegging. Here the time series provided by ABS Government Finance Statistics have proved to be particularly useful. It has been necessary, however, to adjust the data to take account of the different functions of councils in the different States.
After examining the link between rate pegging and its impact on council finances, IPART found that:

- rate pegging has limited the growth of rate revenue of councils in NSW
- possibly in response to rate pegging, there have been significant changes in the composition of councils' total revenues with increased revenue from user pays sources
- total revenue per capita of councils in NSW has grown more than NSW Gross State Product over the period from 1976/77 to 2006/07
- except for the last 10 years total council revenue per capita in NSW has grown in line with other states since rate pegging commenced in 1977
- councils in NSW have generated larger surpluses and have tended to accumulate less debt (on a per capita basis) than councils in most other states
- capital expenditure by NSW councils on new infrastructure assets is lower and has grown more slowly than that of councils in other states
- in contrast, operating expenditure has grown more rapidly in councils in NSW relative to other states; and
- just over half the councils have increased rates by more than the rate peg amount over the last ten years, but many have increased rates by less than the rate peg amount.

I think that the following conclusions can be drawn based on this analysis.

Rate pegging acts as a constraint on taxation revenues but overall revenue growth for NSW councils has not been much below revenue growth for other Australian councils. Growth in operating expenditure has been relatively strong and there is evidence that NSW councils are spending less on new infrastructure assets than other councils. They are not using debt anywhere near as much as other states nor as much as would be optimal from the point of view of inter-generational equity.
A number of other factors contribute to a council's performance regarding infrastructure provision. These include economic growth, council policies, and the council's asset management approach, the level of grants, subsidies and developer contributions they receive and the demand on their revenue from asset maintenance.

IPART's findings suggest that there may be scope for NSW councils to increase spending on infrastructure. One option to achieve this could be through increased borrowing.

The evidence that we have reviewed suggests that rate pegging has not had a substantial adverse effect on the finances of NSW councils. Revenue from user charges has been substituted for revenue from taxation and subsidies. This may have been desirable on balance. However, it may be harder to achieve further increases in the proportion of revenue raised from user charges, for example due to the impact this has on low income sectors of the community. Developers, for example, are now arguing that the contributions they make to councils are excessive and the NSW government has acted to limit both state and local government developer charges.

It might be argued that rate pegging, by adding to uncertainty about council's future income, may have encouraged them not to take on debt. However, there are reasons other than rate pegging for councils to be reluctant to take on debt. Councils in states other than NSW have also built net creditor positions.

There probably is a backlog of council assets that require additional maintenance and renewal expenditure. However, this is also true of states other than NSW and the evidence suggests that it is no worse in NSW than elsewhere.
Perhaps because the financial arguments are ultimately not decisive, the debate about rate pegging has centred around the arguments concerning protection of ratepayers and accountability to local communities that I noted at the start of this talk. This is, as I argued, an issue of conflict of objectives. It may be that this issue will ultimately be resolved by continuing rate pegging, which has a long history in NSW, in some form. If so, there is much that could be done to improve the situation. In particular, some of the improvements in the pricing of public utilities that have occurred in recent years could usefully be applied to rate pegging.

**IPART’s proposed framework**

In developing an alternative revenue framework, we have sought to retain the desirable features of rate pegging. At the same time we have suggested ways in which the efficiency and effectiveness of rate pegging can be improved and transparency and accountability concerns can be addressed.

In doing so, we consider that much can be done to improve the current framework. In particular, some of the elements in the pricing frameworks now used for regulated utilities could usefully be applied to the local government rate revenue framework. These include:

- adopting a multi-year approach to revenue raising;
- adopting a more independent, rigorous and transparent approach to rate setting;
- linking the revenue framework to councils’ strategic planning processes to link revenue, capital and operating expenditure plans for a number of years into the future;
- the use of an explicit and independently calculated input price index to link revenue requirements with movements in costs from year to year; and
- the use of a productivity adjustment factor to encourage efficiency gains.
IPART recognises that local government is directly accountable to the community in a way that regulated utilities are not. In developing our thinking we have drawn on the NSW Government's Integrated Planning and Reporting Framework.

IPART's draft recommendations would, if implemented by the Government, make the process for setting rates more transparent and more objective, while still continuing to protect rate payers from excessive rate increases.

As I mentioned earlier, IPART has put forward two options for discussion. While the first - Option A - can operate on its own, Option B would work alongside Option A.

The proposed system, would allow regulated annual rate increases and multi-year revenue paths to operate together.

A key element of the regime is the Local Government Cost Index. IPART would calculate and publish an index for each year, commencing in 2010-11. The index would reflect annual changes in councils’ average costs and productivity levels.

**Option A**

Option A retains a system of rate capping that applies across all councils, but would provide more predictable outcomes and a better basis for assessing councils’ costs than the existing system. It would complement the Government’s recently announced Integrated Planning and Reporting Framework and thus strengthen medium term financial planning.

Option A would be the minimum or default option for all councils under the framework. It maintains the essential ratepayer protection elements of the current system while improving the rigour, transparency and independence of the rate setting process. It does this by introducing:

- a local government cost index (adjusted for productivity)
- a new, multi-year medium term rate path.
The processes for setting the rate cap and approving variations will be more understandable and predictable than at present. Those councils that do not want to move beyond the regulated annual rate increase can remain under the rate cap while other councils can apply to the Minister to have multi-year price paths approved. This would allow councils that wish to do so the opportunity to develop a medium term strategy for rate setting, rather than focusing on annual increases.

Under this approach:

- each year, IPART would calculate and advise the Minister of the percentage change in a local government cost index, after an adjustment for productivity;
- the Minister would then determine the increase in rates by setting the rate peg amount each year after having regard to changes in the Local Government Cost Index; and
- there would be a new process for the Minister to determine rates over a number of years to replace the existing special variation process.

Councils that comply with the Integrated Planning and Reporting Framework will also be able, under Option A, to apply to the Minister for a rate path over four years, which might exceed the rate peg. There would be a clear statement of the factors that the Minister would consider in deciding whether or not to approve applications for a medium term revenue path. Option A has been designed to focus on a medium term revenue path and improved links between rate setting and strategic planning.

The two elements of Option A – regulated annual rate increases and multi-year revenue paths - would operate together. Councils that wish to do so would be able to use the annual rate increases that are determined by the Minister. Councils that are not successful in their requests for a medium term revenue path would revert to the regulated annual rate increase for that year. Only in unusual circumstances would councils be able to apply for a multi-year price path more than once in a four year period. These arrangements are designed to balance both flexibility for councils and certainty of outcomes for ratepayers.
**Option B**

Under Option B councils that can demonstrate good financial performance and community endorsement of their fiscal strategy would be given the opportunity to be exempted from rate pegging for up to four years.

Option B would operate alongside Option A, but is intended to make councils more democratically accountable to their communities. Option B provides greater council flexibility, but with higher standards of accountability. Under this option some councils would be able to determine the annual rate increase over a four year period. However, councils would need to earn their autonomy by demonstrating a track record of sound financial management and a community mandate for the council’s proposed medium term revenue plan.

Councils would become eligible for Option B by demonstrating:

- a track record of sound financial management;
- that they have developed a medium term approach to revenue, expenditure and service delivery plans; and
- that they have obtained a community mandate for the council’s proposed medium term approach.

There would need to be clear guidelines on what councils need to do to demonstrate community support. For example, where councils rely upon community surveys, IPART proposes that at least 25-30 per cent of ratepayers would have to participate in the survey and 50-60 per cent would need to support the council's proposal for community support to be demonstrated. Alternatively, where a four year financial plan was adequately debated in the run-up to a council election, and supported by the incoming council, this would demonstrate a mandate from the community for that plan.
Roles

The proposed framework envisages clear roles for the Minister for Local Government, the Department of Local Government and IPART.

IPART would establish, maintain and publish a cost index, the Local Government Cost Index. Changes in the index would reflect the changes in the average costs experienced by councils and a productivity adjustment.

IPART would calculate and publish annual changes in this index. We would then make a recommendation to the Minister regarding the amount that rates should increase in the following year.

The Minister would determine the annual rate of increase in rates after taking account of IPART’s recommendations. However, the Minister would provide reasons explaining why he or she has decided on an increase which is either more or less than IPART's recommendation.

The Minister would be responsible for approving or rejecting any requests submitted by councils under Option A for medium term revenue paths. Clear criteria would be developed for the assessment of submissions.

The Minister would also be responsible for determining each council’s eligibility to move to Option B. This would involve councils:

- demonstrating to the Minister that they meet financial performance, planning and reporting requirements; and
- demonstrating to the Minister that they have a mandate from the community for proposed revenue and expenditure plans.
The Department of Local Government would monitor compliance with the regulated annual rate increase under Option A as well as compliance with the all performance and accountability criteria required under Options A and B.

**Timetable for implementing the framework**

IPART has recommended that the framework should be introduced over a number of years:

- The proposed methodology under Option A for annual rate increases to be based on the changes in the local government cost index should come into effect for the financial year 2010/11;
- The proposed medium term revenue path under Options A and B should come into effect following the conclusion of the 2011/12 financial year, prior to council elections;
- IPART should commence a survey of councils’ costs during 2009/10 to determine the weightings for the cost index model to apply from 2010/11;
- Councils with existing special variation applications or approvals may continue to implement these beyond the starting point for the new framework; and
- During 2010/11 and 2011/12 the cost index would inform the annual rate capping process and would operate in conjunction with the annual special variation system. Following the conclusion of the 2011/12 financial year, the current special variation system will be abolished and would be replaced by the medium term revenue path outlined under Options A and B of the proposed framework.