IPART
New South Wales

Independent Pricing and Regulatory Tribunal

Measuring and Assessing Productivity Performance in Local Government

Local Government — Discussion Paper
September 2011

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Invitation for submissions

IPART invites written comment on this document and encourages all interested parties to provide submissions addressing the matters discussed.

Submissions are due by 4 November 2011.

We would prefer to receive them by email <local_government@ipart.nsw.gov.au>.

You can also send comments by fax to (02) 9290 2061, or by mail to:

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We may choose not to publish a submission—for example, if it contains confidential or commercially sensitive information. If your submission contains information that you do not wish to be publicly disclosed, please indicate this clearly at the time of making the submission. IPART will then make every effort to protect that information, but it could be subject to appeal under freedom of information legislation.

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1 Introduction and executive summary

This Discussion Paper deals with the ways the Independent Pricing and Regulatory Tribunal (IPART) assesses local council productivity and efficiency. For the purposes of this paper we use 'productivity' and 'efficiency' interchangeably.

This paper explains how we:

- determined the productivity factor that we used in setting the rate peg in 2011/12
- considered council productivity in our assessment of council applications for special variations.

We are seeking comments from interested parties on how we might improve our existing approaches, without imposing unreasonable reporting requirements on councils.

1.1 Background

In NSW, the total amount of income that a council can raise from certain council rates and charges is regulated under an arrangement known as 'rate pegging.'[1]

Under rate pegging, a rate peg percentage is set each year. This determines the maximum allowable increase in general income for most councils. However, a council can increase their income by more than the rate peg percentage by applying for a 'special variation'.

Since 2010, we have been responsible for setting the rate peg for NSW local councils and assessing councils' applications for special variations.[2]

1.2 Our current approach

In setting the rate peg for councils in 2011/12, we developed a Local Government Cost Index (LGCI) from which we deducted a productivity factor. The productivity factor was based on estimates made by the Australian Bureau of Statistics (ABS) of economy-wide labour productivity, discounted for the uncertainties in measuring local government productivity.

In assessing applications from councils for special rate variations, we considered applications against criteria set by the NSW Government. One criterion that we must consider is *'An explanation of the productivity improvements the council has realised in past years, and plans to realise over the proposed special variation'*.[3]

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1 Rate pegging is set out in the *Local Government Act 1993.*

2 These responsibilities were delegated by the Minister for Local Government.

3 Division of Local Government, *Guidelines for the preparation of an application for a special variation to general income in 2011/2012,* December 2010, p 22, p 31.

Applications from councils included cited initiatives of past and future productivity improvements. Some were quantified in dollar or other terms, many were not. We also considered a number of comparative local government productivity indicators.

1.3 List of issues on which we seek comment

We have identified a range of issues on which we seek comment from interested parties:

IPART seeks comment on:

1 Is the current method of using an economy-wide measure of productivity and then discounting it for application to the NSW local government sector the most appropriate for future years? If so, which ABS series would be most appropriate? 8

2 If not, what alternative measure would be more appropriate for determining a productivity factor? 8

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1.4 What the rest of the paper covers

The purpose of this paper is to seek the views of interested parties on possible options for improving our approach to measuring and assessing productivity in performing our local government functions. To assist interested parties in making submissions to us, this paper:

- explains how productivity is measured for the LGCI and asks for comment on options for improvement (Chapter 2)
- outlines how productivity is assessed for councils which apply for special variations and asks for comment on improvement (Chapter 3).

2 Measuring productivity for the rate peg

2.1 What is productivity (or efficiency)?

Productivity is defined as a measure of the output per unit of input achieved by an organisation.[4] Output includes both the volume, or quantity, and the quality of that output.

Productivity (or efficiency) describes how well organisations use their resources in producing products and services.

Improvements in productivity (eg, in the case of productivity per worker) can come about through improved skills on the part of employees, or by improved technology, or better management.

2.2 What is the purpose of the LGCI?

We developed the Local Government Cost Index (LGCI) for use in setting the rate peg for local government in NSW. We are required to have regard to a productivity factor in addition to the LGCI in setting the annual rate peg.

The LGCI is a measure of movements in the unit costs incurred by NSW councils for ordinary council activities funded from general rate revenue. The LGCI is designed to measure how much the price of a fixed 'basket' of inputs acquired by councils in a *given period* compares with the price of the same basket of inputs in the *base period*.

4 *The Oxford Dictionary of Economics* (online edition), http://www.enotes.com/econ-encyclopedia.

2.3 What is the role of the productivity factor?

In our Final Report on the *Review of the Revenue Framework for Local Government* in 2009, we recommended that the annual rate peg should be set so that it is equivalent to the annual change in the LGCI minus an annual productivity factor. This method is consistent with the cost index approach that we use for other industries that we regulate (such as the taxi industry).

This approach has been adopted for local government to help ensure that the allowable rate increases accurately reflect the change in councils' costs, on average, across all councils. By setting the rate peg relative to the rise in costs across all councils, individual councils are encouraged to reduce costs by improving the efficiency of service delivery. The consequent cost containment is of direct benefit to a council's total costs without affecting the rate peg.

The role of the productivity factor and the inducement to make productivity improvements were both noted in the 2009 Review:

> ... not adjusting the annual rate peg to reflect the potential for productivity gains would allow those councils that improve their efficiency to use the resulting cost savings to expand their services or help address infrastructure backlogs. But in our view, council decisions to use productivity gains for purposes other than reducing rate increases should be made in consultation with the community. ... However, a council that achieves productivity gains higher than the adjustment factor applied to the annual rate peg would be free to choose how it uses the cost savings from the additional gains.[5]

The Review also considered that it was important to ensure that productivity adjustments to the annual rate peg did not result in reductions in the standards of service that councils provided:

> In our view, the annual rate peg (including any productivity adjustment) should be set in the expectation that current service levels will be maintained and that cost reductions and efficiency savings will not be obtained at the expense of service standards, unless approved by the community.
>
> We note that our recommendation to require councils to conduct regular community satisfaction surveys is important for ensuring that this expectation is met. We also note that incentives for improved financial performance within the recommended framework for regulating council revenues, combined with our recommendations for improved setting and monitoring of key performance indicators, should drive efficiency improvements. This may mean that a productivity adjustment is not always necessary (i.e. the productivity adjustment factor may be zero).[6]

5 IPART, *Revenue Framework for Local Government – Final Report,* December 2009, pp 154-155.
6 IPART, *Revenue Framework for Local Government – Final Report,* December 2009, p 155.

2.4 Productivity factor used for the 2011/12 rate peg

In December 2010 we made a rate peg determination based on the LGCI and a productivity factor. We calculated the LGCI of 3.0% and deducted a productivity factor of 0.2 percentage points, resulting in a rate peg increase of 2.8% for 2011/12.

The 0.2% productivity factor was a conservative estimate that was set following a review of available Australian publications about local government productivity and an examination of available ABS indices on economy-wide labour productivity.

We concluded that there was no established measure of NSW local government productivity. As a result, we applied the productivity factor that was conservative and a judgment by the Tribunal:

> The latest ABS National Accounts data suggest that economy-wide labour productivity gains have averaged around 1.2% per annum over the 5 years to 2009/10. Since labour costs amount to 41.2% of total council costs, the use of the economy-wide productivity gains would lead to a productivity factor of around 0.5 percentage points. In view of the uncertainties involved, IPART has significantly discounted this figure in determining a factor of 0.2 percentage points for NSW local government in 2011/12.
>
> The Tribunal plans to consult with expert bodies, such as the Australian Bureau of Statistics and the Productivity Commission, and councils in 2011 in order to refine the productivity factor for use in the 2012/13 financial year.[7]

2.5 ABS estimates of labour productivity

The ABS produces economy-wide estimates for labour productivity by dividing Gross Domestic Product (GDP) by an index of hours worked. It also publishes sectoral estimates of labour productivity (with a lag) that divide industry Gross Value Added (GVA) by sectoral indices of hours worked.

GDP and GVA are measures of what is loosely described as 'output' but which is more accurately termed 'value added'. The concept is simply that of the value added to raw materials by transforming them with labour and capital inputs into their final form for sale to end-users.

Two economy-wide measures and a selected sectoral measure of labour productivity are shown in Table 2.1.

7 IPART, *Local Government Cost Index - Information Paper*, December 2010, p 9.

Table 2.1 ABS measures of productivity – Australia – annual percentage changes

	2005/06	2006/07	2007/08	2008/09	2009/10	5-year average
All industries	0.9	0.8	0.9	0.6	2.1	**1.0**
Market sector	1.6	0.6	1.0	0.6	2.3	**1.2**
Public administration and safety	0.8	0.0	1.5	-0.7	1.3	**0.6**

Source: ABS Australian System of National Accounts, 5204.0, 2009/10, online version Tables 1 and 15. All measures of productivity are GVA per hour worked.

We show both all industries and market sector productivity because we used the market sector measure in setting the 2011/12 rate peg and because both economy-wide measures are often cited in other contexts.

We also show productivity in the 'Public administration and safety' sector because this is the closest sector to the NSW local government sector.[8] It is not an ideal match, however, because it:

- Includes all 3 tiers of government in Australia.
- Includes law enforcement, public safety and emergency services agencies, including prisons and border control, that are not activities provided by local government.
- Excludes activities of local government that produce 'private sector like' services. These commercial and business services are classified into the same industry as private sector units that engage in similar activities.

Economy-wide measures of productivity growth include the effect of sectors that are unrelated to local government services. For example, the goods-producing sectors such as mining and manufacturing are included in both the all industries and market sector measures.

Measured productivity in the goods-producing sectors has usually been higher than in service-producing sectors, in part because measuring the output of goods is more straightforward than measuring the output of services.[9]

8 The aggregate sector is classified by the ABS as Division O - Public Administration and Safety. It includes 5 groups of which 1 is Group 753 - Local Government Administration.

9 This generalisation does not hold when a sector's services are expanding rapidly, as is currently the case in Information Media and Telecommunications (Division J in the ABS classification system) where labour productivity has risen by 6.0% per annum on average over the past 5 years. However, this observation reinforces the point that it would be better, if possible, to exclude the effect of other sectors on the local government sector when estimating the latter sector's productivity gains.

Data for 2010/11 will become available in late October 2011 once the annual Australian National Accounts are released. We will update the 5-year averages at that stage, expecting that the 5-year averages to 2010/11 will all be lower than those in Table 2.1 due to recent sluggish Australian GDP growth. However, the relativities between economy-wide and the service sectors are likely to change little, except for the mining sector which may cause a relative improvement in the economy-wide data.

An alternative approach to the productivity factor for setting the 2012/13 rate peg would be to use the 5-year average labour productivity factor of the Public Administration and Safety (PAS) sector on the grounds that its productivity growth is likely to be closest amongst published data to that experienced in the NSW local government sector. Its productivity growth would then be applied to the 41.2% of the LGCI that concerns labour costs.

If the composition of the PAS sector is deemed to be a much closer approximation to that of the NSW local government sector, there may be less need to discount its productivity growth when applying it to that sector (unlike the sizeable discount applied by us in the previous assessment when we used an economy-wide measure of productivity).

2.6 NSW Government efficiency dividend

The NSW Government's 2011-12 Budget applies an efficiency dividend to agencies of 1.5%. It applies to the portion of State Government departmental budgets funded through consolidated revenue. It is only levied on an agency's total expenditure if the Government is the only source of funding.

It would be inappropriate to apply the efficiency dividend to all local government expenditures, if only because local government contracts out many services using competitive tendering arrangements. These tenders are often not able to be revised once negotiated and often include a provision for productivity savings.

We would therefore only apply the efficiency dividend to councils' own service provision, in effect by applying an efficiency adjustment to the labour component of the cost index as was done last time.

2.7 Options for the local government productivity factor

As previously mentioned, there are no direct measures of local government productivity currently available. Measurement is complicated by the many functions of local government and the fact that many of services are difficult to quantify in output terms eg, community services.

In the absence of a direct measure of local government productivity, we used a proxy measure in 2011/12. There is a range of possible proxy measures in the available ABS productivity measures. An alternative approach would be to apply the efficiency dividend used by the NSW Government.

IPART seeks comments on the following

1 Is the current method of using an economy-wide measure of productivity and then discounting it for application to the NSW local government sector the most appropriate for future years? If so, which ABS series would be most appropriate?

2 If not, what alternative measure would be more appropriate for determining a productivity factor?

3 Assessing productivity for special variation

Special variations provide an opportunity for councils to increase their general income by a percentage amount greater than the annual rate peg.

In their 2011/12 special variation applications, many councils cited various productivity initiatives in descriptive terms but did not quantify their net cost or productivity impacts. This made it difficult for IPART to assess their materiality.

We would like to improve the way we incorporate productivity gains into our assessment of the applications for special variations. However, it is difficult to do this without greater quantification.

3.1 Productivity criterion for special variations

Applicants for special variations in 2011/12 were asked to provide an explanation of the productivity improvements the council had realised in past years, and planned to realise over the period of the special variation.

Criterion 5 of the special variation guidelines requested councils to demonstrate that they have implemented a program of productivity or productivity improvements to help fund council expenditure, before considering an increase in rates.

More specifically, applications were to provide details of:[10]

- Productivity improvements that the council has implemented over the previous 2 years (as a minimum), and the actual or estimated savings resulting from each initiative. The costing was to clearly indicate if the savings were one-off or ongoing in nature; and

10 Division of Local Government, *Guidelines for the preparation of an application for a special variation to general income in 2011/12,* December 2010, p 22 and p 31.

- Efficiencies and productivity improvements proposed for the period of the special variation. These proposed initiatives, which may have been capital or recurrent, were to have reduced costs.

For councils that have implemented the Integrated Planning and Reform (IP&R) framework, applications also needed to show how and where the proposed initiatives had been factored into the council's Long Term Financial Plan (LTFP) and Asset Management Strategy and Plans. It was suggested that councils could also include in their applications details of the current and/or projected financial position of the council if these initiatives had not been implemented.

Productivity improvements sometimes may be reflected in an improvement in the quality of a service that is provided to the community. In other words, the same service quality is improved, while inputs (such as staff numbers) are held constant. For example, an initiative that enables a wider range or more convenient options for making payments to councils would be indicative of a productivity improvement.

3.2 Productivity initiatives reported by councils

Councils cited a wide range of cost containment measures that involved productivity improvements in their 2011/12 special variation applications. These improvements included:

- labour and wage cost savings
- more efficient and flexible work practices
- energy, water, fuel savings
- technological improvements
- improvements to procurement processes, including centralised purchasing procedures, group purchasing and tender arrangements and resource sharing with other councils
- improvements in assessment of new development applications
- reductions in planning expenditure, legal expenses, library service costs
- changes to vehicle fleets (eg, lease fees, management)
- rationalisation of under-utilised or underperforming assets (eg, sale of a commercial recreational facility)
- alternative service delivery models for domestic waste operations and streetscape cleaning
- reductions in insurance costs
- innovative and efficient approaches to infrastructure maintenance and renewal.

A number of councils quantified reductions in labour costs arising from their initiatives, with some explicitly citing reductions in the volume of labour employed:

- staff reductions in information services providing ongoing savings of $210,000 (Hornsby Shire Council)
- reduced senior staff positions resulting in savings of $328,000 (Wollondilly Shire Council)
- removal of 10 positions in 2008 saving $1m per annum and introducing a new salary system saving $1m in 2009/10 (Parramatta City Council)
- reductions of overtime and casual wage costs in 2009/10 of $153,000 and $121,000 respectively (Albury City Council)
- $1.5m savings realised through using 'Work for the Dole' and 'Day Release from Silverwater Correctional Facility' programs since 2000 (Auburn City Council)
- savings of $470,000 since 2007 from changes to relief staffing structure in children's services (Penrith City Council).

Non-labour initiatives submitted by councils included:

- estimated electricity cost savings of $150,000 over 4 years by replacing desktop personal computers to reduce electricity consumption (Albury City Council)
- planned electricity savings of $15,000 per annum by developing a system to automatically shut down 300 desktop computers overnight (Auburn City Council)
- implementation of information technology in mapping areas and to improve data collection (Albury City Council)
- technology improvements such as the development and implementation of an Information Management Strategic Plan and financial system upgrades (Ku-ring-gai Council)
- proposed efficiency reviews or reviews of fees and charges (several councils).

To improve our assessment of the extent to which an applicant satisfies the productivity criterion, we propose that councils:

- Quantify the impact of initiatives in physical units where possible and certainly in dollar terms and as a percentage of total costs.
- Explain the impact of the initiative on overall costs. For example, if staff costs or overtime is reduced but more consultants or contractors are hired as a result, the overall effect on costs may be minimal. Similarly, if containment of wages or other costs is accompanied by decreases in service levels, efficiencies will not have been achieved.

IPART seeks comments on the following:

3 Can councils measure some (or all) of their productivity gains in terms of changes in physical units (that is, in volumes or quantities) of inputs and changes in prices paid for inputs? If so, in what ways would these changes be expressed?

4 Are productivity improvements able to be captured within councils' Long Term Financial Plans? If so, please illustrate.

3.3 Other productivity indicators

To supplement our assessment of productivity initiatives cited by councils, IPART also considered a number of productivity indicators (Table 3.1) published by the Division of Local Government (DLG).

We compared each council applying for a special variation with the council's DLG group average and with the NSW average. These measures were indicative of productivity *at a point in time.*

Table 3.1 Council productivity indicators, 2009/10

	Sample council	DLG Group average	NSW average
Number of council staff (FTEs)	300	313	293
Ratio of population to council FTEs	115	127	126
Average cost per FTE	$68,300	$70,875	$68,973
Employee costs as % of ordinary expenditure	34.6	36.4	38.6
Consultancy/contractor expenses	$10,400,000	$4,389,094	$5,948,248
Consultancy/contractor expenses as % ordinary expenditure	18.0	6.4	8.6

Source: DLG, unpublished comparative data, 2009/10. Ordinary expenditure excludes interest and investment losses, losses from the sale of assets and losses from joint ventures and associates.

The comparisons were useful as independent evidence of councils' expenditure patterns. However, these measures can be difficult to interpret without a deeper understanding of each council's position.

In some instances, the indicators were too simple to discriminate between different inferences that might be drawn about relative efficiency. For example, a higher staff-to-population ratio relative to peers may reflect the provision of 'non-core' services that are funded through NSW and/or Commonwealth Government grants.

The indicators are also measured at the aggregate level so that it is unreasonable to compare councils with differing service mixes. Comparisons could be made for the net cost of each individual service or function, if such disaggregated measures were available.

Of course, moving towards service-based measures would require a consistent framework across NSW councils that included definitions, measurement methods and levels of service provision for each indicator.

DLG's comparative statistics provide expenditures per capita by each council for the following:

- Environmental management and health expenses (combined).
- Recreation and leisure (also combined).
- Community services expenses.[11]

Corresponding performance figures for a more disaggregate range of services are not currently published by DLG.

IPART seeks comments on the following:

5 What indicators should IPART use in assessing the productivity of councils?

6 How can productivity indicators be improved over time?

7 Are net costs of individual services useful in measuring and comparing council performance?

3.4 Cost escalation assumptions

A council's need for a special variation will depend on its expected future costs. We will assess whether a council's cost projections are reasonable and the justification for them.

Our assessment takes into account current cost levels and assumed cost escalation rates over the 10-year life of a council's Long Term Financial Plan. In reviewing the reasonableness of the assumptions that underpin cost escalation, we will assess how these assumptions have been derived and compare them with current and expected rates of increase in the relevant costs at the time of a council's application.

IPART seeks comments on the following:

8 Can councils demonstrate how the cost escalation assumptions in their Long Term Financial Plans are derived and why they are reasonable in the light of current inflationary trends?

11 DLG, *Comparative Information on NSW Local Government Councils, 2008/09,* Tables 4.1, 5.1 and 6.1, respectively.