Review of the Revenue Framework for Local Government

Roundtable Notes to Aid Discussion

Overview

On 29 July 2008, IPART released an Issues Paper for its review of the Revenue Framework for Local Government in NSW. The Issues Paper is available on IPART's website.

The terms of reference required IPART to investigate and make recommendations on the following three matters:

1. an appropriate inter-governmental and regulatory framework for setting rates and charges that facilitates the effective and efficient provision of local government services
2. a role for IPART in setting rates and charges in future years
3. a framework for setting the charges levied by certain public authorities, such as Sydney Harbour Foreshore Authority (SHFA), Redfern Waterloo Authority (RWA), Sydney Olympic Park Authority (SOPA) and the Growth Centres Commission (GCC), to enable these authorities to recover costs for the provision of services that are normally provided by local government.

In undertaking this review, IPART is also to have regard to a range of matters, including the role and the financial position of local government, the revenue sources available to local government, the scope for efficiencies, social-economic impacts of rates and charges, the differences between councils across the state. In addition IPART is to have regard to the findings of recent reviews of local government and the matters in Section 15 of the IPART Act.

Submissions to the Issues Paper were invited from interested parties by 29 August 2008. The key issues raised in submissions from local government focused on long term financial sustainability concerns and the regulatory framework options for local government revenue.

The following paper is intended to provide a basis for discussion at the roundtable discussions with local government and other interested parties. It contains the key issues raised by local government as well as those matters which IPART identified in the Issues Paper as requiring further discussion.

This paper draws on views and issues raised in the submissions to the Issues Paper and relevant findings of the recent Productivity Commission Report[1] and the Independent Inquiry into the Financial Sustainability of NSW Local Government.[2]

The discussion at the Sydney and the regional workshops will focus on the first two terms of reference. IPART will have a separate workshop to consider issues related to the third term of reference involving the public authorities, relevant councils and interested stakeholders. The key issues which IPART wishes to further explore with local government at the roundtable are:

- The role of local government and how is it determined.
- Effectiveness and efficiency of rate pegging and the implications for councils and ratepayers.
- Objectives for a regulatory framework for local government revenues.
- How the current regulatory framework, or any alternative framework:
  - Promote the effective and efficient provision of services?
  - Enhance the financial sustainability of local government?
  - Meet the standard of principles for good regulation and taxation – efficiency, equity, simplicity, transparency?
  - Enhance the accountability of local government?

Issues for Discussion

A Role of local government in providing services to the community

A.1 Changing demands on role of local government, socioeconomic and fiscal impact

The Local Government Act imposes few limitations on what services local government can provide.[3] Rather, its intention is to provide councils with the flexibility to provide services in response to the changing needs of their communities. Thus, to a large extent, an individual council's policy choices determine its role.

However, the provision of infrastructure and services is a critical part of this role. The extent to which councils fulfil this part of their role in an appropriate, equitable, effective, efficient and safe manner has significant implications for all citizens of NSW and for the broader national economy.

1 Productivity Commission Report Assessing Local Government Revenue Capacity, April 2008.

2 Independent Inquiry into the Financial Sustainability of NSW Local Government, Are Councils Sustainable? Final Report: Findings and Recommendations May 2006.

3 Chapter 6, Section 24, *Local Government Act 1993*.

Currently, the 152 councils in NSW provide a diverse range of infrastructure and services to meet the diverse needs of rural, regional and metropolitan communities.

Changing community expectations have placed significant pressures on councils to provide new services-most demand being on the areas of social, community and economic development services as well as tourism facilities and cultural development.

Local government submissions indicate that increased community expectations for services, in combination with capped rates revenue and cost shifting by other levels of government results in greater use of user charges and this may impact on the affordability of community services for some members of the community as the costs are more narrowly distributed.

A.2 Current planning practices for self determination of council roles and funding responsibilities

The current range of plans produced by councils is complex and overlapping. While they are required to prepare a Management Plan covering at least three years, the main mechanism for being accountable to the community is the annual report which is sent to the Department of Local Government. However, there is no standard format for this report. A social and community plan is required every five years and state of the environment report is required after each election.

While these are sent to the Minister for Local Government it is claimed that they are not reviewed in detail. Few linkages exist between the plans produced by councils, nor is there a requirement for councils to have a long term plan that integrates all social, economic environmental and financial strategies in a single document.

The Annual Report, which is required under the Local Government Act, provides information about councils' achievement of the Management Plan performance targets. The Local Government Act also requires the General Manager to report to council at the end of each quarter on achievement of Management Plan performance targets. Most councils supported longer term planning (10years) and linked financial plans supported by four year service delivery plans and recognition of the diversity of councils in a regulatory framework.

IPART notes there is some flexibility in determining a role for local government that is specific to the each community and its needs, and seeks comment on how the determination of this role impacts on expenditure and revenue.

IPART seeks comment on the effectiveness of the Annual Report as a mechanism of accountability to the community.

B Identification of threats to the long term financial sustainability of local government

Generally most local government submissions commented on the following financial sustainability issues:

- Adverse impact of rate pegging on ability to fund services and infrastructure backlogs and lack of certainty with rate variation approvals.
- Need for revenue approvals based on at least four year service delivery plans linked with longer term financial and management plans.
- Lack of transparency, cost reflection and financial certainty in rate pegging and rate variation approvals.
- Social impact problems with increased user fees for some community services as opposed to rates revenue funding.
- Cost shifting by other levels of government and unplanned impacts on local government revenue requirements.
- Need for a share of a growth tax such as GST.
- Increased community expectation of range of services and level of service with out an understanding of fiscal impacts.
- Need for best practice financial benchmarks and asset management planning to enable local government to monitor their financial sustainability.

Other concerns by some councils related to new Section 94 provisions (now known as direct and indirect contributions) which allow the Minister for Planning to disapprove a council's contribution requirements for new development and also to transfer some section 94 funding to Treasury thus potentially reducing local infrastructure revenue. Some councils commented on the need for more transparency in general purpose grants funding allocation and increased funding and the need for constitutional recognition of a more definitive role relating to local government funding responsibility versus other levels of government. IPART notes that some of these issues are outside the scope of its terms of reference.

B.1 Adequacy of rate pegging and variations for meeting long term obligations

In NSW rate pegging appears to dampen revenue raised by councils and there appears to have been little offset from non rates revenue sources in recent years. In NSW the rate of growth of rates revenue has been among the lowest of all jurisdictions over the past seven years. NSW also has rates revenue below that of most other jurisdictions. The Productivity Commission concluded that rate pegging in NSW appears to be restricting the revenue raised from rates, not withstanding the scope for councils to seek variations to mandated rate increases.

Council submissions claim that rate pegging does not provide adequate funding to cover the cost of some services and in particular infrastructure backlogs. For these reasons, it seems councils have reduced expenditure on assert maintenance and not matched asset depreciation with spending on asset renewals. This may result in an infrastructure backlog and an ongoing renewal gap. Councils' submissions also indicate concerns that the annual rate capping process and the special variation approval process create uncertainty in relation to revenue sources for long term commitments particularly for infrastructure renewals and new capital investments.

Data from the Department of Local Government indicate that the number of applications for special variations per year increased from 30 in 2002/03 to 34 in 2007/08, with a spike of 46 applications in 2005/06. Over the last three years, between 22 per cent and 30 per cent of the 152 councils in NSW have applied for a special variation.

IPART proposes to conduct case studies of (16) selected councils within the State to investigate common and unique drivers of financial and other areas of performance. IPART will contact councils in the near future for to progress these case studies.

IPART seeks comment on how effective is rate pegging and what are the implications for councils and ratepayers?

Given the role of special variations and the other revenue sources for local government, does rate pegging effectively constrain the level of rates and total revenues for local government?

B.2 Differences in revenue opportunities between metropolitan, fringe, rural and remote councils

Local governments in urban areas are predominantly funded from their own sources of revenue ie, rates, fees and charges. For most rural and remote councils grants are a substantial source of their revenue. Capital city, urban developed and urban fringe councils are estimated to have the highest potential to raise additional revenue and remote and rural councils are estimated to have the lowest potential.

Rates revenue: Capital city local governments are collecting the highest median rates revenue per person, due in part to the larger number of business ratepayers relative to resident ratepayers. Rural local governments are also collecting notably more than other classes which might be attributable to the higher per person expenditure required in these areas due to higher kilometres of road per person.

Goods and services revenue: Remote Local governments collect the highest amount of sales of goods and services revenue per person. This may be due to the lack of alternative private suppliers, to the relatively higher cost of services in remote locations or the ability to fully recover user fees from some local service s such as aerodromes and saleyards. Capital city councils raise the second highest amount per person of sales of goods and services revenue given the relatively large number of non residents paying for local government services such as parking and business based statutory services such as fees for inspection of restaurants and food outlets.

Other revenue: Capital cities collect the highest other revenue (i.e. developer charges, donations and fines) per person followed by remote councils. Urban developed councils raise the least. In this category there is considerable variation across councils within each class. Fines are likely to contribute a relatively larger share in capital city and urban developed. In rural and remote councils, contributions and donations are likely to account for a relatively large share of this revenue. This includes contributions for private work carried out by councils or work carried out on behalf of the roads and traffic authorities in each State.

Expenditure: Remote local governments under take the highest expenditure relative to other classes of councils. Urban developed and urban fringe councils have the lowest median expenditure per person. Rural and remote councils have more kilometres of road per person to be maintained and they also appear to provide a broader range of services than urban local governments as they fill service gaps that would be undertaken by other spheres of government or the private sector in urban areas, eg, operation of aerodromes, funding for general practitioner services.

IPART seeks comment on what demographic factors may impact on revenue opportunity for councils in different types of locations?

B.3 How rates and charges revenue align with costs of providing services including infrastructure

Local councils in NSW obtain their revenue from four main sources:

- council rates (taxes levied on property owners, on the basis of land value)
- user charges and fees (mainly for services and infrastructure provided)
- grants and subsidies from the Commonwealth Government (in the form of Financial Assistance Grants and Specific Purpose Payments and the NSW Government (in the form of financial grants for specific purposes and services)
- revenue from council business activities, interest income, dividends and fines.

Local councils are empowered through state legislation to raise revenue through rates, but are not able to impose any other form of taxation. Within the constraints of rate pegging, councils are able to adjust the level and composition of their rates revenue, by altering the percentage rate in the dollar applied to the rateable property and the structure of rates.

The legislative and regulatory framework also enables councils to raise revenue through user fees and charges, interest, fines and other penalties. In general, councils are able to levy a wide range of fees and charges, including service and utility charges, regulatory fees and other fees for service. The levels of some charges are statutorily set, however most are discretionary. Some council submissions indicate that the ability to raise further revenue through user charges as opposed to rates revenue is very limited as the services would be unaffordable to some residents.

Two principles are commonly used to guide decisions about setting the fee or charge for an individual service: the benefit principle and the ability to pay principle:

- using the benefit principle, councils would set the charge for an individual service so that the community members who benefit from and value these services contribute most to the total costs of providing the services
- using the ability to pay principle, councils would set the charge based so that individuals contribute to the cost of the services based on their ability to pay(usually measured by their incomes).

IPART notes that councils are likely to have multiple objectives in setting rates and fees and charges. In practice, they appear to apply a combination of the benefit and the ability to pay principles.

IPART seeks comment on:

Processes that are currently used to align services and charges with costs of service provision.

The implications of introducing further user charges to supplement rates revenue.

B.4 Scope for greater efficiencies in services provision including total asset management

The Department of Local Government (DLG) requires councils to submit annual reports on their performance and then uses the information to compile data on eighteen different areas. Council comparative performance then based on thirty key performance indicators. However there are views that the current performance indicators are inadequate as the performance measurement should allow for the spatial distribution of local government such as distance, climatic conditions, socioeconomic characteristics and regional price variations.

It has been suggested that indicators could be formulated following a process by which commonality of outcomes, outputs, processes and inputs is identified through a sample of metropolitan, regional and rural councils. This would not only improve the basis for benchmarking like councils with like councils but would improve the accountability of councils for service delivery against targets or benchmarks and would improve monitoring off areas such as social policy which are not effectively covered under the existing KPIs.

Borrowings are a non revenue source of finance that local governments can use to fund council operations and the provision of infrastructure. Borrowing spreads the cost of infrastructure over both current and future generations. Previous reports on local government sustainability have recommended that councils should consider making prudent use of additional borrowing to finance the acquisition of new infrastructure assets and where considered appropriate to fund the elimination of any major backlog in the renewal of existing assets (as opposed to funding routine maintenance and renewal of existing infrastructure assets which should be funded from current revenues).

IPART seeks comment on:

What types of best practices are used by local government now to achieve greater efficiencies and what else would be possible?

How is debt funding used in councils to provide services, infrastructure/facilities and what is the attitude of councils towards debt funding?

What is an appropriate level for net liability ratio and what obstacles prevent councils from making greater use of debt to finance priority infrastructure including new and replacement works?

Is rate pegging a constraint on debt funding due to lack of affordability of associated payments?

B.5 Factors other than rate pegging affecting the performance of local government

Local government submissions have noted that rate pegging has constrained revenues while at the same time other levels of government have shifted costs to them. This cost shifting has occurred, for example, where local government agrees to provide a service on behalf of another level of government but funding is subsequently reduced or stopped. Local government is then unable to withdraw because of community demand for the service. A second example is where, another level of government ceases to provide a service and local government steps in.

Other local government submissions argue that financial performance is adversely impacted by excessive charges made by State government agencies for undertaking services for local government, eg, parking fines revenue administration, local government election administration or requirements that local government section 94 funding be managed by Treasury. Reference is also made to proposed Crown land charges for lands managed and leased by councils. Some concerns have been expressed about expensive reporting requirements imposed on local government.

IPART seeks comment on:

What demographic, inter-government, economic, social, technical and environmental changes are now affecting councils and their future revenue requirements?

What statutory requirements may impact on councils and how important are these requirements?

C Options for a more sustainable financial management system to underpin local government's role

C.1 A regulated revenue framework for local government

In the Issues Paper IPART identified five options for alternative regulatory frameworks as shown in Box 1 below.

Most councils supported a self determining role in relation to revenue raising which included regulatory framework Option 5 (which removes mandatory rate pegging and retains a default rate cap), or if rate pegging power was to be maintained, Option 4 (which exempts councils from rate pegging subject to fulfilment of objective performance criteria, as referred to in IPART's Issues Paper). Preferences for Option 4 were subject to rate pegging becoming a more transparent process which properly reflected local government costs. Some councils supported IPART having a determinative role to provide certainty to councils, whilst others preferred IPART to have a recommendatory role only. Under Option 5, some councils indicated there would be little or no role for IPART.

Most submissions addressed these options without identifying new ones. Submissions have not addressed what the objectives should be for a regulatory framework and how the objectives should be achieved which is a matter which IPART would like to further discuss with local government.

Box 1 Regulatory options

1. **Retain existing rate pegging arrangements but:**

- Publish the economic indicators or indices to be used in determining the uniform rates cap to be applied across local government each year.
- Modify the special variations process to ensure that the mandatory criteria required to justify a Section 508 (2) or a Section 508A variation are published and that the process of application and approval is fully transparent and forms part of local government regulatory system.
- Leave all charges unregulated (except s 94 charges which are being dealt with separately under amendments to the NSW Planning and Assessment Act).

2. **Implement a more disaggregated form of rate pegging** which incorporates cost indices relevant to each council (or groups of councils). This option would be as for option 1 but either:

- Group councils based on specific criteria and calculate a rate peg specific to each grouping, or
- Calculate a specific cap for each council based on specific criteria (eg, cost structures, service dimensions).

3. **Reduce the scope of rate pegging to cover only local government revenue needed to fund operating expenditure** and thus exclude capital expenditure from rate pegging (noting that operating expenditure should include some expenditure approximating asset depreciation). This option includes:

- Leaving other fees and charges (except s 94 charges) largely unregulated as is.
- Providing separate guidelines on operating and capital expenditure planning and pricing. These guidelines could require approaches to operational revenue raising, related expenditure, capital expenditure plans and costings, pricing policies and charges, depreciation policy and proposed funding options including debt financing and public private partnerships. A section on relationship of Section 94 plans to these guidelines could be included.
- Modifying the special variation arrangements as described in Option 1 above.

4. **Maintain rate pegging power but promote greater freedom** by exempting individual councils from rate pegging subject to a mandatory demonstration of:

- financial accountability and governance
- financial sustainability
- comparative efficiency and effectiveness indicators (including affordability and availability of local services and facilities)
- ability to achieve the above objective criteria over a 10 year time frame through an approved and independently audited management plan. This audited plan could be tabled in Parliament.

5. **Institute measures to enhance accountability to the local community and remove mandatory rate pegging.** This option includes compulsory reporting on a comparable basis to enable comparisons between councils. Where councils fail to meet these criteria a default rate cap could apply. While IPART has included this option for discussion, it notes that the Minister for Local Government favours the continuing of rate pegging.

C.2 Objectives of a revenue regulatory framework

The Local Government Act is not explicit about the goals of rate pegging. IPART assumes that the Governments objective in using this approach was to create a financial incentive for councils to control their expenditure and seek savings though efficiency improvements. The following types of objectives have been identified in previous studies, IPART's Issues Paper and in local government submissions for a revenue framework for local government:

- sustainable financial management ie, financial performance which meets planned long term service and infrastructure levels and standards without unplanned increases in rates or disruptive cuts to services
- evaluation and priority setting based on an understanding of costs and funding identification of core service functions where the private sector are unlikely to provide an optimal level of services
- identifying costs of service as a basis for setting rates, charges and fees
- clear linkages between rate setting and pricing of services
- efficiency and effectiveness including affordability and availability of local services
- prudent use of borrowings for infrastructure
- responsibility and accountability
- openness and transparency
- clearly stipulated responsibilities for local government when providing services on behalf of other spheres of government eg, purchaser provider arrangements

IPART seeks comments on the following:

What are the objectives which should underpin a regulatory framework for local government revenues?

How does the current regulatory system and the alternative frameworks meet the objectives for a regulatory framework for local government revenue?

What role should IPART play in setting local government rates and charges in future years?

C.3 How can a regulatory framework for local government revenue recognise diversity across local government areas?

The Productivity Commission concluded that there is no simple way to classify local governments which fully accounts for the variation in the amount of revenue that they raise. It considers that one of the major drivers of differences between local governments appears to be the number of people and the density of people within a local government area.

Many local government submissions suggested that any regulatory framework for revenue and charges would need to take into account the differences across local government areas in relation to revenue opportunity and expenditure. One council suggested that this approach would be too complex to administer.

All of the regulatory options for local government revenue referred to in the IPART issues paper would involve some form of rate capping regulation. Of the two options preferred by most councils, it is noted that Option 4 would need to have a rate pegging system for those councils who did not demonstrate certain requirements to gain the necessary exemption. Such a system would also be required for Option 5 in cases where lack of adequate council performance triggered a default rate cap. Discussion on how diversity could be incorporated into rate capping regulation would assist IPART.

The Australian Classification of Local Governments classifies councils into twenty two categories according to their socioeconomic characteristics and their capacity to deliver a range of services to the community. The Department of Local Government has put NSW councils into eleven groups or categories instead of twenty two for the purposes of providing comparative information reports on local government councils. This approach may assist in grouping councils for the purposes of understanding diversity issues relevant to revenue regulation.

IPART seeks comment on:

How can we incorporate diversity into regulatory system (rate capping) options? Can we base a regulatory system on the eleven NSW Department of Local Government categories of councils or on a reduced number of these classifications?

C.4 Corporate governance options which could underpin all regulatory options

Accountability to the community

Some submissions noted that the current regulatory framework does not encourage accountability to the community.

Accountability could be facilitated by open and transparent processes for decision making eg, by making information publicly available to the community and actively consulting with the community about the choices available in providing services and how they are to be funded. Clearly defined objectives regarding activities, programs and services should be accompanied by quantifiable or measurable outcomes.

IPART seeks comment on the options for improving the accountability of councils.

Best practice financial benchmarking

The DLG creates monitoring lists of councils which appear to be experiencing financial difficulty and may have various sanctions imposed because they are deemed to be at risk. Previous studies claim that list bears little relationship to the actual financial risks of councils given the sheer diversity between councils.

Financial KPIs based generally accepted key analytical balances, may provide a stronger predictive relationship with the degree to which a council's finances are likely to be sustainable in the long term. Such benchmarks, adjusted for each council's individual circumstances, eg, developed or developing council, or growing or declining council could be developed. Comparative financial KPIs could be provided on an estimates basis for the current year, actuals for the three previous years and projections for at least the coming three years allowing users to undertake meaningful analysis of council' s finances. Indicative benchmarks could also be used to provide a basis for establishing the extent to which councils and their commercial entities could take on debt and other liabilities.

IPART seeks comment on whether financial benchmarking assist councils to evaluate and compare their performance? If so, what are appropriate measures?

How should accounting practices be more in line with asset management objectives?

Effectiveness and efficiency in service delivery

Currently, the main means of evaluating the performance of local councils in Australia is through comparative performance indicators. In NSW, the Department of Local Government requires councils to submit annual reports on their performance in 18 areas, including financial results, infrastructure status, employment information, and progress made in meeting specified external legislative requirements[4]. Previous reports consider that these indicators do not take into account the significant variations in the size and other characteristics of the areas local councils serve.

It may be of assistance to councils to improve efficiency by alternative or complementary means, such as requiring councils to monitor and report on key performance indicators (KPIs) linked to their revenue and service plans.

IPART seeks comments on what types of best practices are used by local government now to achieve greater efficiencies and what else would be possible.

Other corporate governance measures such as Local government professional development and improved information for the community

Previous reports have indicated that continued support for professional development of councils is required to improve long planning and financial performance. Some submissions have also pointed to the need for the community and elected councillors to better understand the financial implications of decision making in relation to future service and infrastructure commitments.

IPART seeks comment on opportunities to improve local government professional skills and support resources for both elected councillors and staff?

IPART seeks comment on opportunities to improve the communities understanding of the longer term financial implications of council decision making?

---

4 *Local Government Act 1993*, Chapter 13, Part 4, S428.