

Dr Peter J Boxall AO
Chairman
The Independent Pricing and Regulatory Tribunal (IPART)
PO Box K35
Haymarket Post Shop
NSW 1240

25 May 2015

Dear Dr Boxall

Our Reference: CSG/14/3/7

Council Fit for the Future Assessment Methodology 2015

Please find attached a joint submission from the Councils of Hunter's Hill, Lane Cove and the City of Ryde in respect to the abovementioned methodology.

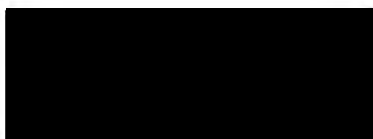
Council Officers would be pleased to assist with any queries you may have in regard to the submission or the attached accompanying Report.

Enquiries in the first instance should be directed to the undersigned.

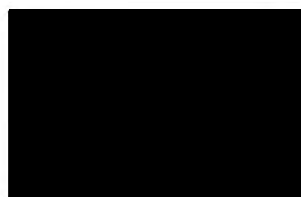
Yours sincerely



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IPART's Proposed Methodology for Assessment of Council Fit for the Future Proposals

**Local Government – Consultation Paper
April 2015**

**Joint Submission from Hunter's Hill, Lane
Cove and City of Ryde Council's**

25 MAY 2015



 **City of Ryde**



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INTRODUCTION

Following the publication of the Fit for the Future (FFTF) program by the Minister for Local Government in September 2014, NSROC Councils and a number of other Councils in northern Sydney have collaborated and held a number of discussions working towards formulating a response to the Fit for the Future program.

As a result of these discussions, a northern Sydney 'Fit for the Future' Symposium was held at Willoughby Council on 5 February 2015, to provide direction and to assist each Council in determining their Fit for the Future response.

In the City of Ryde's case, an Extraordinary Council Meeting was held on 17 February 2015 to establish the City of Ryde's response. As a result, part of Council's response was to seek interest from other participating Councils at the Symposium, to join Ryde in an investigation of a Joint Regional Organisation for northern Sydney. As a result, two Councils confirmed their interest being Hunter's Hill and Lane Cove Councils.

Since February, all three Councils have strongly collaborated and jointly committed funds in undertaking research and community engagement in formulating a single, joint response to Fit for the Future.

Therefore as part of this alliance, this is a joint submission on behalf of Hunter's Hill, Lane Cove and the City of Ryde Councils.

The Councils commissioned Professor Brian Dollery to evaluate and make recommendations in respect of IPART's proposed Methodology for Assessment of Council's Fit for the Future Proposals. His Report is attached and while the three Councils commissioned this Report, some of the non-technical views expressed in the attached Report are Professor Dollery's personal views and not the views of Hunter's Hill, Lane Cove and City of Ryde Councils.

However, in making this submission, the Councils have, in part, relied on Professor Dollery's Report in raising the key issues which we believe IPART should consider in finalising the Methodology for the Assessment of Council Fit for the Future Proposals.

Summary of Recommendations

- 1. This submission strongly recommends IPART seek the Government's agreement to extend the 30 June 2015 deadline by 90 days to 30 September 2015, to allow proper communication and consultation with local communities, after the Assessment Methodology has been finalised by IPART.**
- That IPART reject any FFTF proposal that amounts to a hostile merger or boundary adjustment bid for either part or whole of an adjoining Local Government Area, where no evidence can be provided that demonstrates the parties have an agreed position on the proposal;**
- That as a point of principle, IPART reject any FFTF proposal that includes or proposes substantially dividing or splitting a Local Government Area or a major retail/commercial centre/CBD area, for the reasons that this will adversely impact scale and strategic capacity and is contrary to the State Government's own strategic planning principles;**
- In respect of where a proposal plans to either amalgamate or transfer a significant portion of an area to another entity, IPART needs to acknowledge the public and community of interest test and consider the need for a community poll to be undertaken;**
- When assessing the scale and capacity criterion, IPART needs to consider all proposals that have identified the key functions that meet the fundamental requirements of the State Government's scale and capacity criteria;**
- When assessing the scale and capacity criterion, IPART needs to take a more sophisticated approach than just considering the preferred options as recommended by the ILGRP. Council submissions that demonstrate that they are proposing a superior option need to be objectively evaluated, especially where economies of scale for key strategic functions have been identified and meet the requirements of the State Government's scale and capacity criteria. This also may include proposals that identify economies of scale in service provision to be undertaken on a Shared Services approach;**
- When considering scale, IPART should assess scale based on the number of households and businesses, as opposed to population forecasts, as this is a more relevant and accurate basis for measurement;**
- This submission recommends a uniform approach be given to all submissions, irrespective of whether they are metropolitan, regional, rural or merged proposals for the reasons as detailed in this submission and the attached Report;**

- This submission recommends IPART consider a broader range of indicators in its determination of the sustainability of a Council's proposal;
- This submission recommends IPART include a customer/community satisfaction indicator, to ensure that there is at least one qualitative indicator to assess Councils' performance;
- That IPART consider the concept of undertaking pilots to trial a broader base of performance measures, as part of the recommendations and implementation timetable process.
- That due to the reliability of the data that underpins the Infrastructure and Service Management ratios, this submission is recommending IPART undertake further analysis or, at the very least, exercise caution in the level of reliance placed on these ratios.
- This submission recommends IPART's use of Households and Businesses and not population for use in any efficiency ratio and to introduce a different ratio for the reasons detailed in this submission and in the attached Report.
- This submission recommends IPART acknowledge that the FFTF criteria are deficient in not having any qualitative measures of Council's performance, and seeks IPART's inclusion of at least one qualitative measure, being customer/community satisfaction in IPART's methodology.
- This submission also recommends the assessment of each Council's engagement, methodology and results of each Council's community consultation process as an integral and core assessment criteria. IPART must assess the community consultation process and outcomes, in conjunction with IPART's assessment of Scale and Capacity.

1. DUE PROCESS

One of the key deficiencies in respect of responding to the Draft Assessment Methodology for Fit For the Future (FFTF) is the process and timing of both the announcement of the Expert Panel and the release of the Draft Assessment Methodology.

As IPART is aware all Councils are finalising their FFTF proposals which are due to be submitted on 30 June 2015. To be commenting on the draft Assessment Methodology by 25 May 2015, that is then due to be published in the week of 1 June 2015, sends a strong message that the Methodology will not be changing and does not show the respect, value and expertise that the Local Government industry can provide to this subject.

It is acknowledged that IPART was not in control of the timing of its appointment as the Expert Panel. However, from a Local Government perspective it is difficult not to be highly cynical of the whole process and how the assessments will be undertaken.

The other key point on the timing of the release of the Assessment Methodology is that it has been released effectively one month before submissions are due. As IPART would appreciate, Councils have undertaken extensive community consultation with our local communities and given the significance of the Assessment Methodology, this should have been a key component in all of those consultations with our respective communities.

This again is significant and clearly demonstrates how poor this process is becoming, when critical information such as the Assessment Methodology, which was not available for the community consultation process, is literally being changed at the last minute. It underpins concerns that the NSW Government has tacitly changed its position on 'No Forced Amalgamations' and to achieve this end, has announced IPART as the Expert Panel as late as possible. That appointment has resulted in publishing the Assessment Methodology late and gives no time for Councils or the community to make any meaningful response. For this reason, this submission recommends IPART extend the deadline for FFTF submissions to be lodged by 90 days to 30 September 2015. This will allow Councils to consult with their communities on the Assessment Methodology after it has been finalised by IPART.

Therefore, this submission strongly recommends IPART seek the Government's agreement to extend the 30 June 2015 FFTF deadline by 90 days, to 30 September 2015, to allow proper communication and

consultation with local communities, after the Assessment Methodology has been finalised.

Questions raised by IPART.

In your publication, IPART asked a number of questions to be addressed, in seeking responses on the Draft Assessment Methodology from Local Government. Therefore, the balance of this submission responds to the questions stated in your document.

2. How should key elements of strategic capacity influence our assessment of scale and capacity? Are there any improvements we can make on how we propose to assess the scale and capacity criterion, consistent with OLG guidance material?

The following points are made in respect of the above:

Key Principles in Assessing Scale and Capacity

This submission requests IPART consider the following key principles when assessing the scale and capacity criterion;

No Splitting of Local Government Areas and Major Town/Commercial Centres/Strategic Centres

A major inhibitor of optimising strategic capacity is where a Local Government Area is proposed to be split. Such a proposal gives no consideration to the underlying social, cultural and business infrastructure that are in place together with other support networks that make communities thrive. It also highlights a total lack of understanding of how communities work, what support structures they rely upon for shopping, education, transport, recreation, everyday life activities and where they work.

Therefore, in any consideration of splitting a local government area, it is a fundamental issue that the community in the affected area should be thoroughly consulted either through a poll or referendum of electors. IPART needs to take into consideration that an issue of splitting a Local Government Area is not just the numbers on the balance sheet. Such an issue needs extensive community consultation to allow the community to fully understand the proposal, the likely impacts and to express their view.

As detailed in the FFTF documentation, this submission also reinforces the point, that any FFTF proposal that includes a hostile takeover of an adjoining Local Government, should be rejected by IPART.

Such a proposal, as is the case with the City of Ryde, also splits a major retail and commercial centre that will adversely impact the local and State's business economy and workings of the retail and commercial centres. This splitting of major centres is contrary to the State Government's strategic planning principles for major and specialised centres.

Such a suggestion also gives no recognition to how a Council such as Ryde, has driven the development of Macquarie Park to become a magnet for industry leaders and global giants. Due to the vision of the City of Ryde, Macquarie Park is now experiencing massive growth, with the precinct projected to become Australia's fourth largest CBD behind Sydney, Melbourne and Brisbane by 2030. It is also expected to accommodate over 40,000 new jobs by the same time - a boon to both jobseekers and the local and state economy.

Therefore, in respect of Scale and Capacity, this submission requests that IPART;

- **Reject any FFTF proposal that amounts to a hostile bid for either part or whole of an adjoining Local Government Area and where no evidence can be provided that the parties have an agreed position on the proposal;**
- **That as a point of principle, IPART reject any FFTF proposal that includes or proposes substantially dividing or splitting a Local Government Area or a major retail/commercial centre/CBD area, for the reasons that this will adversely impact scale and strategic capacity and is contrary to the State Government's own strategic planning principles;**
- **In respect of where a proposal plans to either amalgamate or transfer a significant portion of an area to another entity, IPART needs to acknowledge the public and community of interest tests and consider the need for a community poll to be undertaken;**

Scale – Where Economies of Scale Exist

In respect of scale, many studies have proven that organisations can be highly efficient and effective, no matter the size of the organisation.

However, scale does matter when it can streamline the strategic planning for effective and timely decision making for a global city that Sydney both needs and deserves. Therefore, this submission stresses the importance of not taking a 'one size fits all' approach when determining scale and capacity. On this point, while proposals may not be consistent with the OLG's FFTF documentation (ie No Joint Organisations) in metropolitan Sydney, IPART needs to give proper consideration to any proposal that demonstrates it meets and exceeds, the recommended option.

As detailed in the attached Report, Professor Dollery provides details from his research, (page 41), which has also been proven in many studies, that not all functions undertaken by Councils or business, demonstrate a falling average cost as volumes increase. Therefore, a more sophisticated approach is required in the methodology that differentiates or attempts to identify those functions or services that should be consolidated, to take advantage of economies of scale.

Where strategic economies of scale exist that reinforce the FFTF scale and capacity criteria, such as the benefits of sub-regional strategic land use planning and sub-regional Section 94 plans, it justifies a regional approach being taken. For the same reasons at the services level, where services that provide economies of scale have been identified, models such as Shared Services, should be considered. Therefore, IPART needs to fully analyse all proposals objectively, even though they may be outside the preferred options of the ILGRP.

When assessing the scale and capacity criterion, IPART needs to take a more sophisticated approach than just considering the preferred options as recommended by the ILGRP. Council submissions that demonstrate that they are proposing a superior option need to be objectively evaluated, especially where economies of scale for key strategic functions have been identified and meet the requirements of the State Government's scale and capacity criteria. This also may include proposals that identify economies of scale in service provision to be undertaken on a Shared Services approach;

Scale- On Households and Business (not Population)

Detailed in the attached Report, Professor Dollery makes the point on pages 35-37, that population played a critical role in the Independent Local Government Review Panel's preferred options, which have now become the merger recommendations.

As detailed in the attached paper, it is considered appropriate that the methodology also gives consideration to scale being assessed on household and business numbers as this is a much more reliable and a more relevant basis for public policy, given that a high level of Local Government services are focused on properties, rather than individuals.

This approach is preferred, as using population ignores the business sector, which is a significant sector that Local Government services and partners with in undertaking employment, tourism and economic development initiatives.

As Professor Dollery highlights in his report, population forecasts are generally inaccurate and can lead to misleading interpretations and results.

When considering scale, IPART should assess scale based on the number of households and businesses, as opposed to population forecasts, as this is a more relevant and accurate basis for measurement;

- 3. Are there any improvements we can make to how we propose to assess the sustainability, infrastructure management and efficiency criteria, consistent with OLG guidance? Are there issues that we need to consider when assessing councils' proposals using the measures and benchmarks for these criteria?**

Assessment of Sustainability Indicators

The attached report, on pages 42-48, highlights some critical outstanding issues that the NSW Government needed to address, as a result of the ILGRP's report. It was always envisaged that issues such as changes to rate pegging and the necessary changes to the Local Government Act would be done first, thereby facilitating any structural reform that may follow.

Also, the other issue that Professor Dollery highlights are the impacts either of the removal or the continual freezing (loss in real terms) of the Financial Assistance Grant (FAG).

These issues, noting that the timing on when these matters will be addressed are still not known, have a critical impact and influence on the sustainability ratios included in each Council's submission and IPART's subsequent assessments.

As detailed in pages 7-9 of the attached report, the sustainability indicators have changed and are still changing as part of this Assessment. Professor Dollery details how the indicators that were recommended by TCorp, were modified when the FFTF program was announced and further in the proposed IPART Methodology. Clearly, the major difference in the most recent changes is in the criteria for a non-rural Council, compared to rural and merged Council proposals.

This submission seeks a uniform approach to be given to all submissions, irrespective of whether a proposal is non-rural, rural or merged, for the reasons as detailed in this submission and the attached Report.

Further, it is noted that when assessing 'sustainability', even though there are only three approved indicators, the attached paper (pages 18-21), details the additional indicators that should be considered in determining an organisation's sustainability. As stated on page 18, Dollery states although we have significant reservations regarding TCorp's (2013) approach, it did at least contain measures of liquidity and the ability to service debt; critical measures which are integral to any program purporting to measure financial sustainability.

- Therefore, when considering the sustainability criteria, this submission requests IPART consider a broader range of indicators in its determination of a submission's sustainability.**

The other main point to note is the inadequacies and contrast in approach that has been taken by the NSW Government compared to the Victorian Government, in establishing an effective Performance Monitoring System. While this is not the subject of review by IPART, the points are well made in pages 14-17 of the attachment. This also highlights that the Victorian program uses 70 quantitative and 24 qualitative measures of a council's performance, compared to NSW's 7 quantitative measures. Also, in all the FFTF Indicators, there are no qualitative indicators, such as community satisfaction.

As detailed in Victoria's example, there is a very clear role for pilot studies with the introduction of a new performance monitoring system, thereby allowing reviews and enhancements to be undertaken to the system. Therefore IPART needs to consider including both these initiatives into its assessments and recommendations for inclusion in the implementation timetable.

This submission recommends IPART;

- **This submission recommends a uniform approach be given to all submissions, irrespective of whether they are metropolitan, regional, rural or merged proposals for the reasons as detailed in this submission and the attached Report;**
- **This submission recommends IPART consider a broader range of indicators in its determination of the sustainability of a Council's proposal;**
- **This submission recommends IPART include a customer/community satisfaction indicator, to ensure that at least one qualitative indicator to assess Councils' performance;**
- **That IPART consider the concept of undertaking pilots to trial a broader base of performance measures, as part of the recommendations and implementation timetable process.**

Assessment of Infrastructure and Service Management Indicators

The Report generally, and in particular on pages 45-49, clearly demonstrates that IPART needs to be mindful of the weaknesses and the level of reliability that can be placed on the data that are the basis of the Infrastructure Ratios.

As stated, Schedule 7 details Councils' Infrastructure Backlogs, have been excluded from Auditors' opinions to date, due to the unreliability of the data. It is noted that these schedules will be audited from 1 July 2014.

Also, as IPART itself has recognised on Page 31 of its Methodology document, the Asset Maintenance Ratio is misleading;

“ Should a Council continuously exceed the Asset Maintenance target by spending more on maintenance than is required ie the ratio is >100%, this may also indicate the Council is not efficiently managing its assets.”

- **That due to the reliability of the data that underpins the Infrastructure and Service Management ratios, this submission is recommending IPART undertake further analysis or, at the very least, exercise caution in the level of reliance placed on these ratios.**

Assessment of Efficiency Indicator

The Report generally, and in particular on pages 49-54, demonstrates that this ratio is not a 'real' efficiency indicator as it does not measure outputs. This measure is a calculation of expenditure per capita.

As the Report and this submission has stated, the more effective and relevant basis of scale is the measure of households and businesses, as predominantly services delivered relate in the main to properties, not individuals. As stated earlier in this submission, basing Scale and Efficiency ratios on population, ignores the entire business sector in each community. This submission also has highlighted the inaccuracies in projections for population forecasts.

Professor Dollery also highlights on Page 52, the other critical problem with this indicator - is the empirical method chosen to establish the direction of expenditure/per capita trend. He states;

“The OLG toolkit employs linear regression to establish whether expenditure per capita is rising or falling. Unfortunately, the use of linear regression to establish the direction of the trend is completely flawed owing to the fact that it breaks the key assumption of linear regression: that the data association has a linear functional form”.

To explain this, Professor Dollery provides an example on pages 52-54 and this submission seeks IPART's consideration of the important points raised in the attached Report.

- **This submission recommends IPART's use of Households and Businesses and not population for use in any efficiency ratio and to introduce a different ratio for the reasons detailed in this submission and in the attached Report.**

4. How should councils engage with their communities when preparing FFTF proposals? Are there other factors we should consider to inform our assessment of council consultation? Please explain what these other factors are, and why they are important.

As indicated in the FFTF documentation, each Council was to fully inform and engage with its community to explain what was being proposed by the State Government and to explain the options available to Councils in formalising their responses.

As stated previously it is disappointing that in the proposed Assessment Methodology, there is no qualitative performance measure, as this is regarded by most Local Government Authorities as a critical indicator. The real risk of the Government's strategy and the Assessment Methodology proposed by IPART, is the minimal if any value it is giving to community feedback in its assessment of FFTF proposals.

To reflect this, it is not until you reach Page 36 of the 38 page written document, that Council's consultation with its community is listed under the heading;

'Other considerations in assessing FFTF Proposals'.

This submission strongly opposes the minimalist approach being given to Councils' approach on community engagement and the community survey results received.

In essence, as the Minister for Local Government, the Hon Paul Toole, has reinforced on many occasions, how important it is for Councils to fulfil their obligations in respect of the Integrated Planning and Reporting Framework. At the very core of the Framework, is the obligation on each Council to engage and listen to their communities when planning for the future.

This submission takes the opportunity to emphasise that the FFTF process is the greatest reform ever seen by Local Government in NSW and to allow such an important decision to be rushed and not to allow the voice of each community to be given appropriate weight and consideration by IPART, would leave the evaluation process exposed and open to severe public criticism.

- **This submission recommends IPART acknowledge that the FFTF criteria are deficient in not having any qualitative measures of Council's performance, and seeks IPART's inclusion of at least one qualitative measure, being customer/community satisfaction in IPART's methodology.**
- **This submission also recommends the assessment of each Council's engagement, methodology and results of each Council's community consultation process as an integral and core assessment criteria. IPART**

must assess the community consultation process and outcomes, in conjunction with IPART's assessment of Scale and Capacity.



Report to the Councils of Hunter's Hill, Lane Cove and
Ryde Councils on

IPART's Draft Methodology for Assessment of Council
Fit for the Future Proposals – April 2015

*Prepared by Professor Brian Dollery – University of New England
21 May 2015*

Contacts:

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Disclaimer

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1. Introduction

With the surprise publication of Independent Pricing and Regulatory Tribunal's (IPART) (2015) *Methodology for Assessment of Council Fit for the Future Proposals: Local Government Consultation Paper April 2015* on 27 April 2015, the NSW local government *Fit for the Future* reform program became even more convoluted with ongoing and substantial changes made to the assessment criteria with which local authorities are to be judged.

Earlier changes have already been made to the assessment criteria which were originally developed by TCorp (2013) from the work of the Queensland Treasury Corporation. Further changes were made between the publication of the Independent Panel's (2013a; 2013b) *Future Directions* interim report, its *Revitalising Local Government* final report and the NSW OLG's (2014b) *Fit for the Future* documentation. Under the *Fit for the Future* process all NSW local councils have to submit a merger proposal, 'council improvement' proposal, or a Rural Council proposal to the NSW OLG by 30 June 2015 using templates issued by the NSW OLG.

The NSW OLG's *Fit for the Future* program had set out the seven criteria and concomitant benchmarks which local authorities had to address in the submissions to the OLG. With the release of *Methodology for Assessment of Council Fit for the Future Proposal: Local Government Consultation Paper April 2015* much of the *Fit for the Future* program was rendered obsolete. In the first place, IPART (augmented by commercial consultant John Comrie) now replaces the proposed Expert Panel as the assessor of council submissions. Secondly, the criteria contained in *Fit for the Future* were modified in *Methodology for Assessment of Council Fit for the Future Proposals*.

Methodology for Assessment of Council Fit for the Future Proposals thus placed NSW local government in difficult circumstances. Local authorities across NSW, including Hunters Hill, Lane Cove and Ryde, have spent considerable effort consulting with local communities and preparing merger, 'council improvement' and Rural Council proposals on the basis of the *Fit for the Future* process and its specific criteria.

Many of these efforts were now rendered obsolete. Furthermore, too little time now remains for councils to once again go through a thorough community engagement process and carefully prepare submissions using the new *Methodology for Assessment of Council Fit for the Future Proposals*. Moreover, the new assessment criteria and benchmarks proposed in IPART's (2015) *Methodology for Assessment of Council Fit for the Future Proposals* contain serious flaws.

This Submission provides a critical assessment of *Methodology for Assessment of Council Fit for the Future Proposals*. We demonstrate that *Methodology for Assessment of Council Fit for the Future Proposals* not only fail to remedy the numerous problems in *Fit for the Future*, but also contains serious further deficiencies itself.

2. Outline of *Methodology for Assessment of Council Fit for the Future Proposals*

IPART (2015, p.43) has been instructed in its Terms of Reference (TOR) to assess each council's 'future fitness' with 'consistency, fairness and impartiality'. However, the TOR also require IPART (2015, p.43) to 'be consistent with the Government's local government reform agenda, as outlined in the *Fit for the Future* documentation'. This last requirement

places great constraints on IPART because the *Fit for the Future* (FFTF) program has numerous deficiencies. The performance criteria developed by TCorp (2013), employed by the Independent Panel and then modified in the *Fit for the Future* process, are contained in Table 1.

Table 1: Financial Sustainability Measures for NSW Local Government

Financial Ratio	TCorp Weighting	Comparative Information Report 2012/13	TCorp Threshold	Fit For The Future
Operating ratio	17.5%	Reported	>-4%	>0.0% over 3 years
Own Source	17.5%	Reported	>60%	>60% over 3 years
Cash Expense	10.0%	Reported	>3.0 months	Abandoned
Unrestricted Current	10.0%	Reported	>1.5	Abandoned
Debt Service	7.5%	Reported	>2.0	0 to 20% over 3 years
Interest Cover	2.5%	Not reported	>4.0	Abandoned
Infrastructure backlog	10.0%	Reported	<0.02	<2% (unchanged) over just one year
Asset Maintenance	7.5%	Not reported	>1	>100% (unchanged) over 3 years
Building and Infrastructure Renewal	7.5%	Reported	>1	>100% (unchanged) over 3 years
Capital Expenditure	10.0%	Not reported	>1.1	Abandoned
Real Operating Expenditure per Capita	n/a	Reported in nominal terms only according to 8 functional categories	Not considered	No time or threshold in documentation

Source: TCorp (2013); Office of Local Government (2014a), Office of Local Government (2014b).

As we can see from Table 1, the performance indicators in Table 1 changed significantly between the TCorp (2013) and the *Fit for the Future* process: some indicators were simply abandoned, and weightings, thresholds and benchmarks modified, often with little or no explanation.

Table 2 illustrates the differences between the *Fit for the Future* performance indicators and those proposed in *Methodology for Assessment of Council Fit for the Future Proposals*.

Table 2: *Fit for the Future* and IPART Performance Criteria

Criteria and measure	Benchmark	IPART Non-Rural	IPART Rural	IPART Merged
Scale and Capacity	ILGRP recommendations.	ILGRP recommendations or merger broadly consistent with ILGRP or Sound argument for no structural change.	Demonstrates it has considered merger option and has strategies to enhance capacity.	Not applicable.
Sustainability				
Operating Performance Ratio	Greater or equal to break-even over 3 years.	Must meet within 5 years.	Plan to meet within 10 years.	Must meet within 5 years (non-rural). Plan to meet within 10 years (rural).
Own Source Revenue Ratio	Greater than 60% over 3 years.	Must meet within 5 years.	Plan to improve within 5 years & consideration of FAGs	Must meet within 5 years (non-rural). Plan to improve within 5 years & consideration of FAGs (rural)
Building and Asset Renewal Ratio	Greater than 100% over 3 years.	Meet or improve within 5 years.	Met or improve within 5 years.	Meet or improve within 5 years.
Effective infrastructure and service management				
Infrastructure Backlog Ratio	Less than 2% over 3 years.	Meet or improve/inform within 5 years.	Meet or improve/inform within 5 years.	Meet or improve/inform within 5 years.
Asset Maintenance Ratio	Greater than 100% averaged over 3 years.	Meet or improve/inform within 5 years.	Meet or improve/inform within 5 years.	Meet or improve/inform within 5 years.
Debt Service Ratio	Greater than 0% but less than or equal to 20% over 3 years.	Meet within 5 years.	Meet within 5 years.	Meet within 5 years.
Efficiency				
Real Operating Expenditure	A decrease in Real Operating Expenditure per capita over time.	Must demonstrate operational savings (net of IPR supported service improvements) over 5 years.	Must demonstrate operational savings (net of IPR supported service improvements) over 5 years.	Must demonstrate operational savings (net of IPR supported service improvements) over 5 years but may not be practical in short term.

Source: IPART (2015).

In the same way that significant differences exist between TCorp (2013) and the *Fit for the Future* performance criteria, substantial differences are also evident between *Fit for the Future* and IPART (2015), as we see can see from Table 2. A major difference resides in the

differentiation between ‘non-rural’, ‘rural’ and ‘merged’ councils in IPART (2015) and the ‘one size fits all’ approach in *Fit for the Future*. In addition, the benchmarks which must be met diverge widely between IPART (2015) and *Fit for the Future*.

This presents acute problems for councils which have already undertaken *Fit for the Future* analysis of their performance on existing *Fit for the Future* criteria and associated benchmarks. Quite apart from the procedural problems derived from ‘changing the rules of the game’ towards the end of the process, it also means that local authorities have a mere two months to assess their performance under the new IPART (2015) benchmarks. It need hardly be noted that this is a chaotic way of conducting public policymaking.

The remainder of this Submission will examine the following aspects of IPART’s (2015) *Methodology for Assessment of Council Fit for the Future Proposals; Local Government Consultation Paper April 2015*:

- General principles of performance monitoring systems, such as IPART (2015);
- Recommendations, preferred options, consistency and research;
- Problems with *Fit for the Future* which affect the IPART assessment methodology;
- IPART assessment methodology for scale;
- IPART assessment methodology for sustainability;
- IPART assessment methodology for infrastructure and delivering services;
- IPART assessment methodology for efficiency; and
- Other assessment methodology considerations.

3. General Principles of Performance Monitoring Systems

IPART (2015, p.43) faces great challenges with its *Methodology for Assessment of Council Fit for the Future Proposals* because the *Fit for the Future* (FFTF) program has four important flaws:

1. ***Unfinished business relating to proposed removal of rate pegging.*** The Independent Panel (ILGRP, 2013) made a recommendation that the rate pegging scheme be overhauled in response to inter-municipal inequity and significant fiscal constraints inherent in the current regime. The Office of Local Government (OLG) seems to have accepted the argument and has promised an independent inquiry into the current rate-pegging arrangements. The obvious question is whether fitness for the *future* should be assessed according to *current* revenue constraints which are likely to be lifted in the short term?
2. ***Unfinished business relating to distribution of Financial Assistance Grants (FAGs) in accordance with the federal legislation.*** The ILGRP (2013, p.16) recommended that the NSW Government investigate opportunities ‘to redistribute federal Financial Assistance Grants (FAGs) and some State grants in order to channel additional support to councils and communities with the greatest needs’. The fact of the matter is that the NSW Local Government Grants Commission has been failing to distribute funds according to need, since the passing of the Commonwealth legislation (1995) despite the fact that the enabling legislation clearly directs it to do so (Drew and Dollery, 2014a). Now the NSW Government has finally committed to directing FAGs on the basis of need there will

likely be a significant change to future allocations.¹ Once again, the obvious question is: how can fitness for the *future* be ascertained without knowing the details of changes to this very significant source of municipal revenue?

3. ***Inconsistency in financial reporting.*** Since at least 2013 the OLG has been aware that the data it relies on for FFTF ratios was not sufficiently reliable to make informed decisions.² Specifically, the NSW Treasury Corporation (TCorp) (2013, p.66) noted that:

‘TCorp’s review process has shown an inconsistency in the approach of Councils to calculating the data included in these Schedules, particularly Schedules 7 and 8. Without a high level of confidence in the data presented, it is more difficult to make informed decisions’.

This suspicion was confirmed by Drew and Dollery (2015a) who demonstrated that inconsistent depreciation data had a very significant effect on achievement of municipal benchmarks for the operating ratio. Specifically, Drew and Dollery (2015a, p.34) used sensitivity analysis to determine that:

¹ However, the NSW Local Government may well be hampered in its attempts to follow the legislation’s intent of full horizontal fiscal equalisation by the proclamation made under subsection 6(4) relating to the minimum payment of FAGs (based on what they would have received had they remained separate entities) for amalgamating councils over a period of four years.

² In point of fact the Auditor-General advised the government of reporting irregularities back in 2012 in its report: *New South Wales Auditor-General’s Report Performance Audit Monitoring local government Department of Premier and Cabinet, Division of Local Government.*

‘When depreciation accruals were adjusted to the median depreciation to infrastructure ratio, this resulted in 38 (out of 152) councils’ benchmark status changing The results were largely consistent with expectations: ‘weak’ and ‘very weak’ councils tended to move up to benchmark levels whereas ‘sound’ councils moved down.’

A recent review of Performance Monitoring in the Public Services in the United Kingdom, published in the *Journal of the Royal Statistical Society*, notes that:

‘...[a] small amount of defective data may be quite misleading. A large amount of defective data may be extremely misleading. Thus, key preliminaries to any kind of interpretation are checks on data quality’ (Bird et al., 2005).

The problem is that the FFTF has substantial amounts of defective data. However, to the best of our knowledge, the preliminary checks and rudimentary sensitivity analysis have not been performed. This is despite the fact that the OLG (2014c) has acknowledged the problem by assigning a new role to the Auditor-General to ‘give communities the assurance they deserve on how councils are managed financially’. The key question here is whether it is reasonable to undertake the ‘most significant investment the State has ever made in the local government sector’ (Toole, 2014) on the basis of grossly distorted data?

4. ***Widespread gaming.*** Bevan and Hood (2006, p.533) have noted that ‘complete specification of targets and how performance will be measured almost invites reactive gaming by managers of service providing units’. It seems that a large proportion of

councils have accepted the OLG's tacit offer to practice gaming, specifically in relation to the infrastructure backlog ratio which is assessed on only 2014 financial year data – compiled well after TCorp (2013) and the ILGRP (2013) revealed the critical importance of this ratio for the NSW Government's reform agenda. Moreover, gaming has also occurred on other Schedule 7 and depreciation accrual items and thus affects a total of 4 of the FFTF ratios. To illustrate this point Table 3 details statistical summary data for key unexpected financial statement items from the 2014 financial statements. The estimates of unexpected financial statement items were produced according to the general approach of Marquardt and Wiedman (2004) and Pilcher and Van der Zahn (2010), developed from the earlier work of Hribar and Collins (2002) and Mulford and Comiskey (2002). In essence, we compared the quantum of the three financial statement items in the 2012/13 and 2013/14 financial statements, making adjustments for changes to the asset base or asset maintenance and renewal.

Table 3: Descriptive Statistics for Unexpected Financial Statement Items, 2013/14 Financial Year

Financial Statement Element	Smallest	Largest	Quartile 1	Median	Quartile 3
Entire State					
Depreciation	-70.5%	113.1%	-6.3%	0.2%	4.9%
Cost to Bring to Satisfactory Standard	-124.5%	462.8%	-48.6%	-13.5%	8.4%
Required Annual Maintenance	-151.6%	950%	-48.8%	-11.4%	14.1%
Greater Sydney					
Depreciation	-70.5%	27.7%	-6.5%	2.0%	7.1%
Cost to Bring to Satisfactory Standard	-124.5%	345.6%	-36.7%	-9.0%	9.7%
Required Annual Maintenance	-127.1%	723.3%	-29.4%	1.4%	32.9%
Outside Greater Sydney					
Depreciation	-65.5%	113.1%	-6.0%	-0.1%	3.8%
Cost to Bring to Satisfactory Standard	-102.6%	462.8%	-49.9%	-13.7%	8.2%
Required Annual Maintenance	-151.6%	950%	-51.3%	-13.3%	6.8%

A central question here is whether it is reasonable to undertake the 'most significant investment the State has ever made in the local government sector' (Toole, 2014) on the basis of data grossly distorted by gaming?

It should be clear from the foregoing material that the constraints placed on IPART in its TOR absolutely ensure that reasonable and reliable decisions *cannot* be made on the ‘fitness for the future’ of any council in NSW, irrespective of the methodology finally employed. It is wishful thinking to suggest otherwise. Moreover, it is a demonstrable fact that the NSW Government has known about these fatal flaws for some time. The only thing which can be done to ensure that decisions are made with ‘consistency fairness and impartiality’ (IPART, 2015, p.43) is for the entire process to be halted until it can be implemented with rigour and competency.

This begs a question regarding how a government or agency should go about constructing a performance monitoring or performance evaluation programme. The working party on Performance Monitoring in the Public Services – reported in the *Journal of the Royal Statistical Society* - made the following sound recommendations on the matter (emphases added):

1. ‘All performance monitoring (PM) procedures need a detailed protocol.
2. A PM procedure must have clearly specified objectives and achieve them with *methodological rigour*. Individuals and/or *institutions monitored should have substantial input to the development* of a PM procedure.
3. A PM procedure should be so designated that *counter-productive behaviour is discouraged*.
4. Cost effectiveness should be given wider consideration in both the design and the evaluation of PM procedures...

5. *Independent scrutiny of a PM procedure is needed as a safeguard of public accountability, methodological rigour, and of the individuals and/or institutions being monitored...*
6. Performance indicators (PI) need clear definition. Even so, they are typically subject to several sources of variation, essential or systematic – due to case mix, for example – as well as random. *This must be recognised in design, target setting (if any) and analysis.*
7. The reporting of PM data should *always include measures of uncertainty.*
8. Investigations of a range of aspects of PM should be done...
9. *Research should also be undertaken on robust methods for evaluating new Government policies, including the role of randomized trials...*
10. *Ethical considerations may be involved in all aspects of PM procedures, and must be properly addressed.*
11. *A wide-ranging educational effort is required about the role and interpretation of PM data'* (Bird et al., 2005 p.2).

A brief review of the FFTF program we will demonstrate that the NSW Government has failed to meet most of these minimum requirements for a rigorous PM program. Of particular concern is the failure to: (a) implement procedures with methodological rigour, (b) failure to allow councils to have substantial input into development of the program (Wholey and Hatry, 1992), (c) failure to respond to independent scrutiny, (d) failure to include measures of uncertainty, (e) failure to conduct appropriate research and (f) failure to take account of ethical considerations. It seems the NSW Government not only ignored leading experts on performance measurement for the public sector, but also their Victorian counterparts.

The Victorian Government (through its Department of Planning and Community Development) also decided to implement a performance framework at about the same time as NSW began developing its financial sustainability ratings with the assistance of TCorp (2013). We shall return to this question later in the Submission. It started the process with the release of a *Directions Paper* in December 2012. The process was then managed according to a number of stages:

Stage 1: Consultation with over seventy local government, academic and subject matter experts, peak associations and the Victorian Auditor-General's Office.

Stage 2: An invitation to Victorian councils to embark on a pilot program subsequent to feedback on the *Draft Local Government Performance Reporting Framework & Indicators Working Paper* dated May 2013.

Stage 3: Implementation of Enabling Legislation which included public submissions (see, for instance, Municipal Association of Victoria, 2014)

Stage 4: Data collection and refinement of the performance indicators subsequent to the pilot program (including intensive site visits of 11 councils).

Stage 5: Final reporting, due in the annual reports of the 2014/15 financial year.³

This two and a half year implementation program, including pilot programs and extensive consultation, contrasts starkly with the NSW OLG's rushed implementation which paid no heed to academic or local government concerns and involved no pilot program to evaluate relevance or reliability. It is noteworthy that the scholarly literature assumes that any competent performance monitoring system would include a pilot program. For instance, Bird

³ This should not be construed as an endorsement of the Victorian performance monitoring program. We simply seek to illustrate the different approaches taken by the governments in question.

et al. (2005) noted that ‘revisions in light of pilot studies should be anticipated in the overall timetable for PM implementation’. Moreover, the Victorian program uses 70 quantitative and 24 qualitative measures of council performance.⁴ It is thus curious that the OLG believes that it can measure municipal fitness for the future through just seven quantitative measures!

It is even more curious that the OLG has rejected the advice of the experts that it had formerly commissioned – the NSW Treasury Corporation – despite the fact that the OLG and ILGRP had formerly endorsed the TCorp (2013) financial sustainability ratings without reservation as Table 4 demonstrates:

Table 4: Changes to the TCorp Financial Sustainability Ratios

Financial Ratio	TCorp Weighting	Comparative Information Report 2012/13	TCorp Threshold	Fit For The Future
Operating ratio	17.5%	Reported	>-4%	>0.0% over 3 years
Own Source	17.5%	Reported	>60%	>60% over 3 years
Cash Expense	10.0%	Reported	>3.0 months	Abandoned
Unrestricted Current	10.0%	Reported	>1.5	Abandoned
Debt Service	7.5%	Reported	>2.0	0 to 20% over 3 years ⁵
Interest Cover	2.5%	Not reported	>4.0	Abandoned
Infrastructure backlog	10.0%	Reported	<0.02	<2% (unchanged) no time frame specified
Asset Maintenance	7.5%	Not reported	>1	>100% (unchanged) over 3 years
Building and Infrastructure Renewal	7.5%	Reported	>1	>100% (unchanged) over 3 years
Capital Expenditure	10.0%	Not reported	>1.1	Abandoned
Real Operating Expenditure per Capita	n/a	Reported in nominal terms only according to 8 functional categories	Not considered	No time or threshold in documentation

Source: TCorp (2013), Office of Local Government (2014a), Office of Local Government (2014b).

⁴ The Victorian sustainability framework itself employed 12 quantitative and 26 qualitative measures across the 3 dimensions of financial performance, capacity, governance and management. It should be noted that the OLGs FFTF doesn't include any measures related to governance which suggests that they do not believe it is an important element of sustainability!

⁵ It is important to note that the OLG has radically altered the definition of this ratio.

It is not unreasonable to suggest that the OLG might explain why it rejected the advice of TCorp (2013) which it had formerly commissioned as experts. Although we have significant reservations regarding TCorp's (2013) approach, it did at least contain measures of liquidity and the ability to service debt: critical measures which are integral to any program purporting to measure financial sustainability.

There are a number of other indicators which should also have been included in *Fitness for the Future*:

Revenue effort: This is particularly important in light of the concerns raised by the ILGRP (2013) regarding inter-municipal inequity and the deleterious effects of externally imposed revenue constraint on fiscal position.

Depreciation rate: this is needed to discourage gaming behaviour (Bevan and Hood, 2006), as well as producing measures of uncertainty and understanding external constraint (Bird et al., 2005).

Budget overrun: This is just one of the critical measures which go to the heart of corporate governance which is the foundation of sustainability. It is also important as a measure of the ability of municipalities to forecast future performance. Part of FFTF is the requirement for councils to forecast future performance four years into the future. Councils will undoubtedly have made the requisite forecasts, but the question remains whether there should be any confidence in these forecasts (which will be discussed later in this Submission) (see Levine et al., 2013).

Community need: Fit for the Future: A Blueprint for the Future of Local Government (OLG, 2014c) contains the definitional statement ‘strong councils providing the services and infrastructure communities *need*’ (emphasis added). It is thus somewhat surprising that the FFTF criteria contain no measure of community need (see Drew and Dollery, 2014b).

Distributive equity: Presumably local government should also strive to be equitable in distributing goods and services. Unfortunately, equity comes at a price. For instance, a rural council seeking to seal roads for a greater proportion of its residents has incurred, expenditure, debt (possibly), a higher required annual maintenance burden and a higher ongoing depreciation accrual estimate. Thus more equitable distribution of local government goods and services will have a negative effect on the majority of FFTF measures, yet there is no indicator to reflect this burden (see Carter, Klein and Day, 1992).

Measures of community satisfaction along various dimensions: It is impossible to compare municipalities without measures of service effectiveness and quality. For instance, councils could easily cease rubbish collection and thus improve their ‘efficiency’ but this would hardly be ‘providing services and infrastructure communities *need*’ (OLG, 2014c). Moreover, as it stands, councils are being compared against benchmarks and peers which provide vastly different services and quality of services. As Carter (1991) rightly notes, ‘quality is actually part of the concept of efficiency, rather than its antithesis’. See, for instance, Wholey and Hatry (1992) and Coulson (2009).

Estimates and timing of cyclical infrastructure expenditure: Infrastructure spending does not occur in discrete annual cycles but is instead ‘lumpy’. For instance, buildings are not repainted on an annual basis but rather when required, possibly a period of 10 years or more. Moreover, quantitative data alone cannot convey the current state and future expenditure relating to infrastructure assets (Falconer, 1991; Levine et al., 2013).

Long term debt obligations as a proportion of tax revenues: This measures the ability to service debt from predictable revenue sources and addresses the gaping hole in the current FFTF criteria which do not assess ability to cover debt but rather the proportion of revenue used to repay *and* service debt. It should be noted that TCorp (2013) sought to include a measure of ability to service debt.

Measures of liquidity (TCorp, 2013): This seeks to measure the ability of a council to meet obligations when they fall due. It is simply inconceivable for a program which purports to measure financial sustainability to neglect to include a measure of solvency: unless of course the OLG believes insolvent councils are sustainable!

Slack relative to risk: Resilience is a different concept to efficiency (Carter, 1991). Efficiency seeks to minimise slack resources, but sustainability implies the need to be able to employ slack resources to cope with financial or natural disaster shocks. Thus a measure of slack resources relative to anticipated risk is needed as a counter-balance to the focus on efficiency, if councils are to be in the position to respond to community and infrastructure need (Rose and Smith, 2011; Levine et al., 2013).

In sum, it is clear that the FFTF programme has failed to meet the majority of the minimum requirements of a competent performance monitoring programme. Given the weighty implications of the program, and the widespread prospect of distortions and gaming, the prudent option available to the NSW Government is to simply scrap the program entirely. No amount of tinkering at the edges by IPART, guided by its restrictive TOR can possibly remedy the errors in FFTF. If the intention of the OLG and NSW government to produce ‘strong councils providing the services and infrastructure communities need’ (OLG, 2014), then they will have missed the mark. Bird et al (2005, p.10) summarise the failure of FFTF best when they note:

‘...[f]ailure to design, and audit properly, a robust PM protocol is false economy because to buy cheap methodology is to buy dear in the longer term if subsequent audit or independent critique discovers problems with performance data which have been influential in public policy debate’.

4. Preferred Options, Recommendations, Consistency and Research

An interesting aspect of *Methodology for Assessment of Council Fit for the Future Proposals* is the way that it has employs subtle changes in language to create an atmosphere of uncertainty. For instance, the IPART report makes no mention of the NSW Government’s policy of ‘no forced amalgamations’ which was stressed in both the ILGRP report and Sansom’s (2015) defence of the Panel. Instead we are given an enigmatic statement that:

‘Not Fit - if the [council FFTF] proposal does not satisfy the scale and capacity criterion, or does not satisfy overall the other criteria based on our analysis; this rating which would be accompanied by our explanation and, potentially, a recommendation’ (IPART 2015, p.20).

The other interesting aspect of IPART (2015, p.15) is how it seeks to suggest that the ILGRP (2013) ‘recommended *preferred options*’ were actually based on sound evidence. For instance we are told that:

‘The ILGRP carried out research and consultation on the subject of scale and capacity and determined that there was not a “one-size fits all approach”’.

This is rather a curious statement since the OLG (2014d) benchmarks are set at the same level for every council. This indicates that the ILGRP (2013) report do in fact believe that ‘one size fits all’. Moreover, the quote above refers to a footnote which the reader might expect would contain details of the rigorous empirical evidence provided by the Panel. Instead the footnote simply informs us that:

‘The ILGRP informed its recommendations on scale and capacity (including the merger recommendations) by looking at the unique characteristics of each area – geography, economic and transport flows, communities, interest and local identity. It also considered a list of criteria for a given council area, including sustainability and strategic capacity, efficiency and effectiveness and accommodating population growth, and whether boundary changes would better achieve the criteria (OLG, *Fit for the*

Future Guidance material – Completing Template 2: Council Improvement Proposal (Existing Structure), October 2014, p 8, and ILGRP, *Revitalising Local Government – Final Report of the NSW Independent Local Government Review Panel*, October 2013, p.76.’ (IPART, 2015, p.15)

There is no reference to empirical evidence, such as regression analysis or data envelopment analysis (DEA), because these essential empirical exercises were never undertaken. Indeed, as we have shown elsewhere, they do not support the arguments of the ILGRP (2013) in any event.

A further ‘sleight of hand’ occurs when IPART (2015) states that: The ILGRP also noted that a number of recent studies in NSW, and elsewhere, clearly demonstrate the potential for amalgamations, where properly managed, to generate both efficiencies and increased strategic capacity, i.e., economies of scale and scope. Two footnotes are provided (footnote 15 and footnote 16) which could be expected to include details of the ‘number of recent studies in NSW and elsewhere’. However, the footnotes simply refer to the ILGRP report and an introductory macroeconomics textbook which is employed to define economies of scale and scope! There is absolutely no supporting evidence provided for the claim of a ‘number of recent studies’. However, we provide details of the following recent studies which have detailed evidence *contrary* to the ILGRP (2013) ‘recommended *preferred options*’:

- Abelson, P. and Joyeux, R. (2015). New Development: Smoke and Mirrors – Fallacies in the New South Wales Government’s Views on Local Government Financial Capacity. *Public Money & Management*, July: 315-320.

- Drew J, Kortt MA, Dollery B (2014). Economies of scale and local government expenditure: Evidence from Australia. *Administration & Society*, 46(6): 632-653
- Drew, J. and Dollery, B. (2015). Inconsistent Depreciation Practice and Public Policymaking: Local Government Reform in New South Wales. *Australian Accounting Review*, 25(1), 28-37.
- Drew, J., and Dollery, B. (2014). Estimating the Impact of the Proposed Greater Sydney Metropolitan Amalgamations on Municipal Financial Sustainability. *Public Money & Management*, 34(4), 281-288.
- Drew, J. and B. Dollery. (2014). Keeping It In-House – Households as an Alternative Proxy for Local Government Output. *Australian Journal of Public Administration*, 73(2): 235-246.
- Drew, J., Kortt, M.A. and Dollery, B. (2015). No Aladdin's Cave in New South Wales? Local Government Amalgamation, Scale Economies and Data Envelopment Specification. *Administration & Society*, Online First.

In general, it seems that IPART (2015) represents a 'toughening' of the rhetoric in preparation for forced amalgamations of metropolitan councils. The new 'lower expectations' for rural councils seems to suggest that the Baird Government has come to the realisation that it needs the political support of the remaining 17 Nationals in the legislative assembly and that further erosion of National seats could put the next election result at risk. Hence, it seems clear from the language of the IPART document, together with the lower expectations which have suddenly appeared for rural councils, that forced amalgamations will be contained to metropolitan councils.

The final point of interest arising from the rhetoric in IPART (2015) is its repeated reference to ‘consistent’ approaches to evaluating councils (the term ‘consistent’ is also a feature of its TOR). This is puzzling given that the methodology is clearly *inconsistently* applied to the sector. For instance, IPART (2015, p.7) declares that its method for evaluating ‘other criteria’ ‘allows flexibility for councils in meeting the forward benchmarks where there is a Merger or Rural council proposal, which may require some short term adjustment to fulfil structural objectives (e.g., a temporary increase in asset backlogs in a larger, merged council)’. Apparently IPART thus believes that it can be flexible for rural and merged councils (and not metropolitan councils) yet still be ‘consistent’!

5. Generic FFTF Failures Affecting IPART Assessment

Methodology

There are a number of generic failures built into the FFTF program which need to be understood to appreciate the futility of attempting to salvage its intent by tweaking its assessment methodology.

Principal amongst the generic failures of FFTF is the absence of any control for external constraint. Put simply, external constraint refers to the exogenous challenges which a municipality faces in providing local goods and services. Drew and Dollery (2015c) expose the inadequacy of existing municipal classification systems by noting that:

‘The impact of exogenous external constraints on municipal behaviour may thus render it unwise to compare the performance of local authorities without explicitly taking into account environmental factors.’

It is not sensible to hold two or more councils facing completely different external challenges to the same FFTF benchmarks. For instance, it is simply implausible to suggest that Manly council (with 105km of roads, an average wage of \$87,682, indigeneity at 0.3% and average density of 3,097 individuals/km²) faces the same concerns as Penrith council (with 970km of roads, an average wage of \$49,046, indigeneity at 3% and density of 462 individuals/km²). Yet this position is exactly what the OLG and now IPART are trying to argue!

A second failure relates to the enormous data inconsistencies underlying FFTF. IPART (2015, p.26) recognises the data problems when it states that ‘we consider some flexibility is required when considering some benchmarks more than others to take account of particular issues, e.g., data integrity issues’. However, more than ‘flexibility’ will be required to make any reliable assessment of ‘fitness for the future’ given the extent of the data problems outlined earlier in this Submission.

The corrosive nature of the data distortions have also been demonstrated in the scholarly literature (Drew and Dollery, 2015a). In this regard, Christopher Hood (2006, p.520) comments are pertinent to the current NSW local government reform program:

‘...[g]iven all that is known about gaming in target systems of the Soviet type, it is remarkable that so little was done from the outset, not only to verify and check reported performance data in some crucial areas but also to avoid some of the very well-known pitfalls of target systems...it seems like a case of those who refuse to learn lessons from historical experience being forced to repeat that experience.’

Unfortunately this is not the complete extent of the data problems. An additional significant source of error is introduced by the OLG's (2014d) use of population data for their so called 'efficiency' ratio (which neither measures efficiency nor uses the correct functional unit). There are two seemingly insurmountable problems with this approach. Firstly, population estimates in inter-censal years are precisely that – estimates. In this regard, a recent study by the ABS identified errors in inter-censal estimates ranging from an average of 2.4% (in statistical areas with greater than 20,000 individuals) to 15.2% (for statistical areas with less than 2,000) (Drew and Dollery 2014d). Moreover, municipal data is often constructed by combining a number of statistical areas, potentially resulting in even higher rates of error. Given the sensitivity of the ill-conceived 'efficiency' ratio to small changes in the data, this means that it is impossible to accurately undertake the task which the OLG has set for IPART.

Secondly, the OLG FFTF toolkits/proposals in fact use 2013 *projected* population data which the Australian Bureau of Statistics had clearly labelled 'preliminary figure[s] or series subject to revision' (ABS, 2015). This was unwise given that the *preliminary* population estimates used by the OLG have already been significantly *revised* in the latest release of the Regional Population Growth data (released on the 31st March, 2015)! This Submission will provide an illustration of the danger inherent in the existing methodology below.

The third generic flaw relates to errors in logic which continue to plague certain FFTF ratios. These errors have been pointed out to the ILGRP and OLG in previous documents, yet very little, if anything has been done to ameliorate same. IPART (2015, p.31) recognise the logical flaw in at least one ratio when it notes that:

‘We should note that the benchmark for the Asset Maintenance Ratio is based on the underlying assumption that previous underspending has occurred, which has resulted in the infrastructure backlog for councils being greater than 2%... Should a council continuously exceed the Asset maintenance target by spending more on maintenance than is required (i.e., the ratio is $> 100\%$), this may also indicate the council is not efficiently managing its assets’.

There are a number of difficulties raised by this acknowledged logical error. Firstly, there are a large number of councils which claim to have an infrastructure backlog ratio less than 2%. Indeed, to be ‘fit for the future’ councils must demonstrate that this is the case. According to this statement, it seems that a council demonstrating fitness on the infrastructure backlog ratio will simultaneously demonstrate inefficient asset management, if it also meets the latter benchmark!

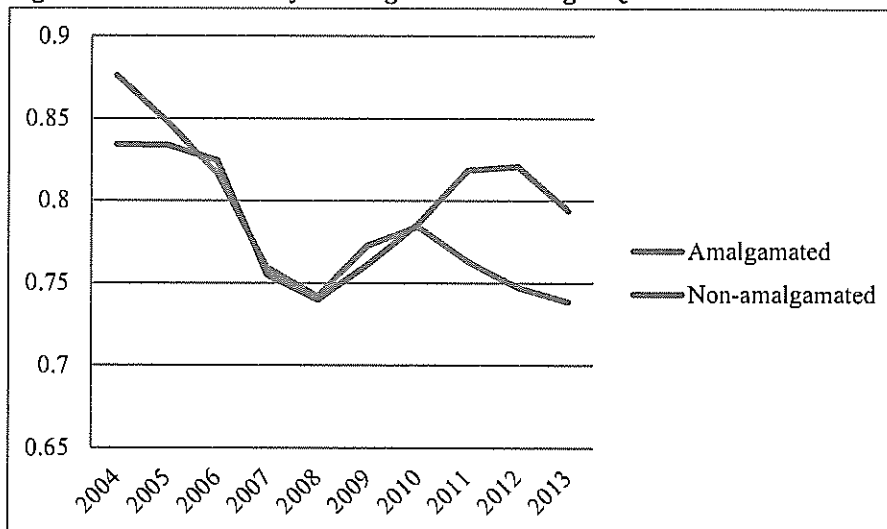
Secondly, IPART/OLG proposes to use the FFTF ratios as a long-term performance management device, even after the ratios have served their purpose of providing a purported justification for politically-motivated forced amalgamation program. Yet, by its own admission, the recurrent achievement of this ratio benchmark will indicate that councils are not ‘efficiently managing’ their assets. Put differently, the OLG and IPART are proposing to introduce a perpetual benchmark target which purports to measure fitness. But the achievement of this ‘fitness’ will in fact indicate *unfitness*!

The fourth failure is that the architects of FFTF – the OLG (2014) and ILGRP (2013) – have still have not provided empirical evidence to support the claim that suggest that municipal

mergers are the panacea to the municipal sustainability. It may come as a surprise to most NSW residents that the Baird Government has embarked on the ‘most significant investment the State has ever made in the local government sector’ (Toole, 2014) – predicated on enhancing the sustainability of the municipal sector as a result of amalgamations - without conducting an empirical investigation of whether amalgamations enhance sustainability!

However, we have employed on a stratified sample of the 2000/04 Carr Government amalgamations and found that there was no statistically significant difference in the sustainability of merged and unmerged councils. Moreover, Drew, Kortt and Dollery (2013) conducted an empirical examination of the outcomes from the Queensland 2007/08 mergers and found evidence to suggest that the forced amalgamations were generally deleterious for Queensland local government. Moreover, we have provided compelling evidence that the efficiency of merged Queensland councils was much lower than their unmerged peers over the same period. This is illustrated in Figure 1.

Figure 1: Mean Efficiency of Merged and Unmerged Queensland Councils



IPART (2015, p.32) in fact acknowledge that mergers of NSW councils will *reduce* efficiency when it states that ‘some discretion will apply to Merger Proposal councils in the short term as this measure may be affected by the transition to new arrangements that may require additional spending to achieve future efficiencies’.

The obvious question raised by this statement is how long residents should wait to see an improvement in efficiency subsequent to a merger. The rather convenient answer for the NSW Government is that local residents should wait for at least five years. This places expected improvement into the period *after* the next NSW election! However, recent scholarly evidence by Drew, Kortt and Dollery (2015b) suggests that residents may never see any improvement in efficiency arising from the proposed mergers.

The fifth generic flaw is a recent innovation which has become evident in IPART’s (2015) methodology whereby different types of councils are held to different standards of fitness. Rural councils are to be held to a lower standard of ‘fitness for the future’ than their metropolitan cousins. For instance, IPART (2015, p.8) has extended the time horizon for the Operating Performance ratio by 5 years, and even then rural councils are only required to ‘plan to meet’ the benchmark. Moreover, on the critical matter of scale rural councils will be assessed as having met the criterion where ‘the council clearly demonstrates the strategies to enhance its capacity to a more sustainable level’ (IPART 2015, p.25).

At the same time, IPART (2015) provide ‘flexibility’ for merged councils on Capital Sustainability and note that improvement in efficiency of merged councils ‘may not be practical’ in the short term. It is thus puzzling that IPART (2015) also repeatedly claim that

they are assessing council's FFTF in a 'consistent' manner! It seems that the FFTF program is being manipulated at a political level to ensure the continued political support of the Nationals.

This raises the question as to why the citizens of metropolitan councils deserve a higher standard of municipal fitness than the citizens of rural councils. Moreover, serious questions have been raised as to whether the rural/urban distinction has any meaning in terms of environmental constraint. In this regard, Drew and Dollery (2015c) note that empirically robust methods for categorising councils exist, which combine nominally urban and rural councils when forming homogenous groups, thus suggesting that the distinction between rural and urban councils has little public policy meaning.

The OLG (2014) has sought to list a number 'rural council characteristics' as if a clear and meaningful distinction can be made. The list lacks quantitative measures and many nominally urban types of council equally fit a number of the criteria. We list the rural characteristics in Table 5, along with some implications.

Table 5: Characteristics of Rural Councils

Characteristic	Implication
Small and static or declining population spread over a large area	What is a large area? Does a council cease to be rural simply because it's population has grown marginally (assuming of course that the population estimates are reliable)
Local economies that are based on agricultural or resource industries.	How exactly does one conceive 'based'. In terms of geographical area dominated by the select industries, or by the proportion of people employed directly or indirectly in the industry?
High operating costs associated with a diverse population and limited opportunities for return on investment?	Once again, the criteria lack quantitative measures. For instance Penrith is almost seven times less dense than Manly, yet few would categorise Penrith as rural (we assume 'diverse' is meant to refer to density rather than ethnic or religious diversity)! How is return on investment conceived – in terms of community satisfaction, projected savings or actual ROI? If the latter this raises the thorny question as to whether municipalities should be producing private goods (such as child care).
High importance of retaining local identity, social capital and capacity for service delivery	Firstly, many urban councils have made the argument that amalgamation will destroy local identity and social capital (see, for instance, Holroyd). Secondly, the OLG and Sansom (2015) have argued that amalgamation is necessary to <i>increase</i> capacity – so how can retaining capacity also be used as an argument by IPART and the OLG for not merging rural councils?
Low rate base and high grant reliance	As Abelson and Joyeux (2015) have argued this is an erroneous measure of financial sustainability because councils have had their rate revenue pegged for well over three decades! Moreover, the OLG has recently conceded that grant allocations have not been made according to the horizontal equalisation principals enshrined in federal legislation (see also Drew and Dollery 2014a). Therefore, how can this be regarded as a valid criteria for deciding whether a council is rural or not? Moreover, the logic flaws contained in the indicator apply equally to urban councils.
Difficulty in attracting and retaining skilled and experienced staff	Firstly, this presumes that rural councils do in fact have difficulty with staffing (despite there being no empirical data to support the claim). Secondly, if this is to be taken as an indicator that a council is rural it implicitly assumes that urban councils do not face difficulty with staffing – once again, a claim made in the absence of empirical evidence.
Challenges in financial sustainability and provision of adequate services and infrastructure.	This is a rather curious criteria for determining whether a council is rural or not given that the ILGRP (2013), OLG (2014) and Minister Toole have been loudly proclaiming that the entire NSW municipal sector is facing a financial sustainability and infrastructure crisis! If, as implied by this statement, the government believes that the challenges apply only to rural councils then there is clearly no longer a case for urban amalgamation!
Long distance to major (or sub) regional centre	Once again this criterion suffers from a lack of detail. How does IPART/OLG conceive 'long' – in terms of kilometres or travelling time? The criterion also exhibits a circuitous argument given that it is first necessary to identify non-rural councils before rural councils can be definitively recognised.
Limited opportunities for mergers	Yet another criterion which applies equally to rural and urban councils and lacks sufficient detail for judgements to be made. All councils in NSW have neighbours and therefore all councils in NSW have more or less equal opportunities for merger. Moreover, if the criterion is conceived in terms of willing partners, or merger partners which would enhance sustainability, then all urban <i>and</i> rural councils face limited opportunities.

This leads us to the point where we can answer one of the specific questions raised by IPART (2015, p.11):

Question: '[W]hich of the 'Rural Council Characteristics' are the most relevant, considering a council must satisfy a majority of the characteristics to be considered rural?

Answer: We argue that unquantified characteristics that can often be applied equally to urban and rural councils are unsuitable for meaningful classification purposes. Moreover, no process for combining the various unquantified and largely meaningless qualities has been advanced. Scholarly research suggests that the urban/rural distinction is largely illusory and of no practical value for public policy making (Drew and Dollery, 2015c). We suggest that IPART first quantifies the various characteristics, removes logical flaws from the criteria and discards the majority of the criteria which apply equally to urban and rural councils. After this has been done, informed decisions might be made regarding the relevance of any remaining characteristics. However, if IPART (2015) wishes to produce a 'consistent, fair and impartial' assessment of the fitness of councils – free from political interference – then the proposed distinction needs to be dropped entirely.

The final generic failure relates to the importance placed on forecasts of performance. Both the existing structure and rural council FFTF templates require councils to make specific forecasts of performance for each of the subsequent four years. In addition, IPART (2015, p.34) makes the following odd request of all councils:

‘We consider councils should provide as much relevant information or data as is required to support the proposals. Therefore, we consider it would be helpful if a longer time series of data to include 2014-15 and 2015-16 is provided by all councils lodging proposals (no matter the type of the proposal). We consider that the additional two years of data would provide us with a better picture of the trend in council performance relative to the benchmarks. *The additional two years of data should be available from councils’ annual reporting requirements and could be provided without imposing an unreasonable burden’* (emphasis added).

We agree that a longer time series may assist with assessment of some ratios (but not all), assuming, of course, that the seemingly unsurmountable data distortions could be corrected. However, it appears that either IPART is not aware that 2014/15 and 2015/16 reports cannot possibly exist at present, or alternatively it has an inordinate faith in the budgeting ability of councils. Moreover, as we have seen, the FFTF templates imply a similarly high level of faith in forecasting and budgeting practice. This implies an empirically testable claim that budget data in NSW municipalities contains a relatively low degree of error.

Table 6 details the accuracy of budget projections made by councils in both the 2013 and 2014 financial statements. What is immediately clear is that the average council (i.e., median result) has an absolute budget error of around 8% of actual revenue. Furthermore, there is evidence of a wide variation from the average. For instance, 25% of councils had errors in excess of 16% in 2013 and one council missed the mark by 60%! It should be noted that many of the ratios employed by IPART (2015) are extremely sensitive to variation

(particularly the ‘efficiency’ ratio). Moreover, it should be borne in mind that these errors are for forecasts which are made *only one year in advance*.

It is thus not unreasonable to suggest that the accuracy of forecasts made two years in advance (to provide IPART with its requisite longer time series), or four years in advance (for the *Fit for the Future* templates) will have errors so large as to make the forecasts effectively worthless. Moreover, according to ‘Goodhart’s Law’, ‘any observed statistical regularity will tend to collapse once pressure is placed on it for control purposes’ (Bevan and Hood, 2006, p.521). This means that forecasts made in the current atmosphere of ‘target terror’ (Coulsen 2009) will be extremely unreliable. If IPART does require a longer time series of data, then the sensible approach would be to use data from earlier periods (i.e., the 2011 and 2010 financial years) for most ratios.

Table 6: Accuracy of NSW Municipal Budget Projections (Deviance of Actual Result to Budgeted Item)

Budget Item ⁶	Smallest	Largest	Quartile 1	Median	Quartile 3
Entire State 2013					
Operating Revenue Budget Error	-29.903	68.282	3.768	9.958	18.353
Operating Expenditure Budget Error	-24.513	60.798	-1.873	2.059	7.927
Operating Result Budget Error*	0.006	60.017	3.646	7.487	16.029
Entire State 2014					
Operating Revenue Budget Error	-32.337	40.563	-0.890	4.931	11.414
Operating Expenditure Budget Error	-31.788	41.738	-3.341	0.799	6.096
Operating Result Budget Error*	0.105	76.412	4.003	8.273	13.862

* This budget error is expressed as a percentage of actual revenue and is reported in absolute terms.

6. Assessment Methodology for Scale

ILGRP ‘preferred options’ now referred by the IPART (2015) as ‘merger recommendations’ (p.15), were based in large part on the Department of Infrastructure (2013) report *NSW in the*

⁶ All items are expressed as a percentage of the deviance of actual result from budgeted result except for Operating Result Budgeted error which is expressed in terms of actual revenue to reduce the occurrence of three figure deviances.

future: Preliminary 2013 population projections (ILGRP, 2013). This raises an important question as to whether it is wise to base decision making on *preliminary* forecasts made 18 years into the future, especially given the low rate of accuracy inherent in ABS population estimates for inter-censal base years.

Unfortunately, very little work has been done in assessing the accuracy of local government area (LGA) forecasts. An exception to this is the comprehensive study by Wilson and Rowe (2011) on Queensland LGA forecasts. They found a mean absolute percentage error for three separate 15 year forecasts of Queensland's entire set of LGA's in the order of 14.6% (Wilson and Rowe, 2011), suggesting that it is not wise to put much emphasis on long-term population forecasts. Thus the basis for the ILGRP's (2013) musings on the fate of NSW metropolitan councils appears to be rather shaky. Hence our concern that the 'preferred options' are now being cast as 'merger recommendations' by IPART (2015, p.15). Moreover, it is entirely likely that the ILGRP 'preferred options' and subsequent OLG and IPART endorsements of the preferred options as 'merger recommendations' have been made on the incorrect functional unit for municipal goods and service production.

Drew and Dollery (2014d) have noted that household and business data is more reliable, less volatile and more relevant (than population data) to public policy making in Australia given the preponderance of municipal functions focussed on services to property rather than services to individuals. Moreover, use of a population measure of scale and capacity implies that business does not contribute to revenue or place demand on municipal goods and services! The neglect of business – particularly for regional centres – also means that spill-over effects are not being accounted for. In addition, population is negatively correlated to the length of council maintained roads (Pearson correlation coefficient equals -0.2659). Thus use

of population data not only ignores the single largest expenditure function of NSW municipal government (PriceWaterhouseCoopers, 2006), but actively disadvantages councils with large road infrastructure. Finally, it is the number of households and employing businesses that a council has control over (via development applications and economic development expenditure), not population growth *per se*.

Even if we were to concede that population was the appropriate functional unit for Australian public policy, there remains the inconvenient fact that neither TCorp, the ILGRP, the OLG nor IPART have provided any evidence to suggest that there is an association between population size and the various measures of municipal sustainability which have been employed to date. By contrast, Drew and Dollery (2014b, p.287) conducted a series of regression analyses for Greater Sydney councils and found ‘little evidence of any statistically significant association between the financial sustainability ratios and population size’. We now present a series of panel regression analyses which also suggest little or no association between population size and financial sustainability (according to the original TCorp (2013) financial sustainability ratios over the period 2009/11 (i.e., the three complete years of TCorp ratios published)):

Table 7: Greater Sydney Stratification of Linear Panel Regression, 2009-2011 (n = 38)

	Operating Ratio	Own Source Revenue Ratio	Unrestricted Current Ratio (ln)
Population (ln)	-4.219 (50.262)	9.876 (62.797)	1.051 (2.668)
Population Density	22.905 (35.457)	38.530 (41.750)	1.272 (1.882)
Population Growth (ln)	-4.271 (3.091)	1.820 (3.535)	-0.143 (0.164)
Exogenous Controls	Yes	Yes	Yes
Coefficient of Determination	0.18	0.07	0.12

	Interest Cover Ratio (ln)	Infrastructure Backlog Ratio (sqrt)	Debt Service Cover Ratio (ln)
Population (ln)	5.689 (9.270)	-1.732 (1.182)	3.489 (7.632)
Population Density	-1.059 (7.256)	0.408 (0.834)	3.943 (5.974)
Population Growth (ln)	-1.180* (0.524)	-0.022 (0.073)	-0.587 (0.432)
Exogenous Controls	Yes	Yes	Yes
Coefficient of Determination	0.15	0.07	0.11

	Capital Expenditure Ratio (ln)	Cash Expense Ratio (ln)	Asset Renewal Ratio (ln)	Asset Maintenance Ratio
Population (ln)	-2.442 (4.692)	6.335 (11.876)	-12.709 (8.721)	4.976 (3.019)
Population Density	-4.903 (3.310)	-5.744 (7.763)	8.827 (6.152)	-7.017** (2.130)
Population Growth (ln)	-0.113 (0.289)	0.089 (0.656)	0.205 (0.536)	-0.287 (0.186)
Exogenous Controls	Yes	Yes	Yes	Yes
Coefficient of Determination	0.38	0.12	0.18	0.20

Source: T Corp and the Australian Bureau of Statistics.

Standard errors in parentheses

* p<0.05, ** p<0.01

Table 8: Non-Sydney Stratification of Linear Panel Regression, 2009/2011 (n = 114)

	Operating Ratio	Own Source Revenue Ratio	Unrestricted Current Ratio (ln)
Population (ln)	214.249** (58.391)	-17.076 (37.244)	2.450 (2.040)
Population Density	16.343 (14.046)	4.028 (8.687)	-0.327 (0.550)
Population Growth (ln)	2.093 (2.626)	1.200 (1.627)	-0.180 (0.092)
Exogenous Controls	Yes	Yes	Yes
Coefficient of Determination	0.27	0.06	0.06

	Interest Cover Ratio (ln)	Infrastructure Backlog Ratio (sqrt)	Debt Service Cover Ratio (ln)
Population (ln)	8.025 (6.397)	0.047 (0.692)	5.312 (6.122)
Population Density	1.813 (1.703)	-0.076 (0.182)	1.044 (1.630)
Population Growth (ln)	0.028 (0.279)	0.008 (0.030)	-0.074 (0.267)
Exogenous Controls	Yes	Yes	Yes
Coefficient of Determination	0.05	0.06	0.06

	Capital Expenditure Ratio (ln)	Cash Expense Ratio (ln)	Asset Renewal Ratio (ln)	Asset Maintenance Ratio
Population (ln)	5.480 (4.025)	3.033 (4.304)	13.914** (4.646)	-3.635 (3.486)
Population Density	-0.251 (1.077)	-0.321 (1.131)	0.249 (1.252)	-0.781 (0.830)
Population Growth (ln)	0.329 (0.180)	-0.148 (0.189)	0.209 (0.209)	0.056 (0.155)
Exogenous Controls	Yes	Yes	Yes	Yes
Coefficient of Determination	0.28	0.02	0.21	0.04

Source: T Corp and the Australian Bureau of Statistics.

Standard errors in parentheses

* p<0.05, ** p<0.01

As can be seen from Table 8, panel regression of the 2009/11 TCorp financial sustainability ratios only indicates associations for population size for non-Sydney councils (and then only for two of the ten ratios examined). Table 7 shows that there is no evidence of an association between population size and financial sustainability for Greater Sydney councils when a time series analysis is conducted. Thus, this is further evidence against the ideologically imposed scale criteria.

Drew and Dollery (2015d) have also empirically demonstrated that there is no association between population size and municipal expenditure. This further demonstrates that the assumptions of economies of scale pervading the ILGRP (2013) report are illusory. Drew and Dollery (2015d) is consistent with the earlier work of Drew, Kortt and Dollery⁷ (2014c) which was available to the ILGRP (2013) at the time it prepared its final report. Moreover, Drew, Kortt and Dollery (2015b) have recently published a data envelopment analysis which demonstrates that the ILGRP (2013) proposed mergers will result in over-scaled councils which predominately exhibit diseconomies of scale. This is yet further, empirical evidence against the scale and capacity ‘preferred options’ advanced by the ILGRP (2013). In this regard, it is noteworthy that the ‘preferred options’ advanced by the ILGRP (2013) have become known as ‘merger recommendations’ (IPART, 2015, p.15), in an Orwellian sleight of hand.

A superior approach to securing economies of scale in any event is to identify those local government functions which exhibit scale economies – typically capital intensive rather than labour intensive activities – and then offer these functions at the regional level through council collaboration models, such as a Joint Organisation. This approach would not only preserve ‘local voice’ and ‘local choice’ by retaining existing local council democratic structures, but would also avoid the substantial costs attendant upon amalgamation. A wealth of empirical evidence underpins this approach which has been summarised exhaustively in Dollery, Grant and Kortt (2012) *Council in Cooperation*, chapters 5 and 6.

⁷ Available online from 2012 onwards.

We are now in a position to answer a second question posed by IPART (2015):

Question: How should the key elements of strategic capacity influence our assessment of scale and capacity? Are there any improvements we can make to how we propose to assess the scale and capacity criterion, consistent with OLG guidance material?

Answer: As we have noted above, not all municipal functions offer average cost which fall with increasing scale. It follows that the optimal approach to securing scale economies is to focus only on functions which are characterised by scale economies and then offer these at the regional level across several councils through council collaboration models, like a Joint Organisation. It is futile to simply aggregate all services by means of forced mergers, including those characterised by diseconomies of scale, and then expect net savings. As we have demonstrated, this might well yield over-scale local entities in which production costs rise.

There are many improvements that IPART can make with respect to the assessment of scale and capacity. In the first instance, IPART should use the most appropriate functional unit – the number of households and employing businesses. Secondly, IPART should disregard any scale recommendations based on preliminary population forecasts, given the evidence that long range forecasts are extremely unreliable. Thirdly, IPART should base the scale criterion on empirical evidence rather than the ‘evidence-free’ musings of the ILGRP (2013). If IPART takes cognisance of the scholarly evidence, then it would be logically obliged to drop the scale criterion entirely. However, its TOR seem to oblige IPART to abide by scale and

capacity criterion laid out by the OLG. This is rather unfortunate given that the scale and capacity criterion is devoid of empirical foundation. Thus, strict adherence to the TOR will result in decisions on the fitness of councils being made on entirely the wrong functional unit and on an underlying assumption which is false.

7. Assessment Methodology for Sustainability

According to IPART (2015), the sustainability criterion includes the operating performance, own source revenue and building and infrastructure renewal ratios. Table 9 contains the definitions employed by IPART (2015). Two of these ratios are heavily dependent on data which is still the subject of ‘unfinished business’, whilst the integrity of the data relating to the third ratio is under serious question. It is important to underline these deficiencies given IPART’s (2015, p.29) assertion that it ‘consider that ensuring councils are financially sustainable, and being able to show this will occur into the future, is fundamental to demonstrating a council is FFTF’.

However, future revenue flows from both council rates and FAGs cannot be predicted with any degree of confidence, given that the outcomes from the proposed review of rating practice and changes to ensure FAGs are distributed to councils with the greatest need are still to be completed. As Abelson and Joyeux (2015) correctly note, it is not reasonable to hold councils accountable for revenue streams over which they have little control. Local government residential taxation effort⁸ lacks inter-municipal equity and it has constrained an important stream of own-source revenue as noted by the ILGRP (2013) and illustrated in

⁸ Residential taxation effort is defined as the proportion of residential rates levied by a municipality expressed as a percentage of total annual incomes accruing to residents residing in the council boundary and is the preferred measure of municipal fiscal burden in the literature (see, for instance, Ladd and Yinger, 1989).

Table 10. Indeed, residential taxation effort ranged from 0.209% through to 2.497% with a mean of 0.998%. Thus, the long-standing rate-capping regime has constrained the local taxation revenue of some councils to just one tenth of peer councils. This suggests that if rate-capping is removed – as seems to be the likely outcome of the NSW Government’ review – then the Operating Performance and own-source ratios of some councils might be altered significantly.

It also seems unreasonable to suggest that FAG revenues ‘provide a stable income for rural councils’ (IPART, 2015, p.29), but not urban municipalities. FAGs will not be a stable source of revenue for *any* NSW council owing to (a) the ‘unfinished business’ relating to more equitable allocations and (b) the fact that the Commonwealth Government has frozen FAGs for a period of three years (which means FAGs will be reduced in real terms for each of the subsequent three years). Moreover, there is no certainty that the Commonwealth Government will not attempt to extend the freeze or make further cuts to FAGs given the pressures on its budget. In addition, the reasoning behind the Own Source ratio seems to be that ‘a council’s ability to raise its own revenue insulates it from a fall in revenue from sources that are outside its control’ (IPART, 2015, p.29). Accordingly, for IPART (2015, p.29) to argue that rural councils can rely on an external source of income seems to contradict the entire purpose of the ratio.

The final ‘Sustainability’ ratio also present significant problems for IPART if they are to assess councils with ‘consistency, fairness and impartiality’ (IPART, 2015, p.43). This is largely because the data relied on for the ratio has been the subject of ‘earnings management’ and it is thus not reliable (Pilcher and Van der Zahn, 2010; Drew and Dollery, 2015a). In addition, climatic factors and natural disasters may impact on the ratio, thus requiring very

careful analysis given limited comparability across the sector. It is also clear that municipal efforts to address this ratio will have negative implications for the Operating Performance ratio which presents a rather difficult problem for councils seeking to demonstrate ‘future fitness’.

Table 9: Fit for the Future Criteria and Measures

Criteria and measure	Definition
Sustainability	
Operating Performance Ratio	Net continuing operating result*/ Total continuing operating revenue*
Own Source Revenue Ratio	Total continuing operating revenue (excluding all grants and contributions)/ Total continuing operating revenue (including capital grants and contributions)
Building and Asset Renewal Ratio	Asset renewals (building and infrastructure)/ Depreciation, amortisation and impairment (building and infrastructure)
Effective infrastructure and service management	
Infrastructure Backlog Ratio	Estimated cost to bring assets to a satisfactory condition/ Total (WDV) of infrastructure, buildings, other structures, depreciable land and improvement assets
Asset Maintenance Ratio	Actual asset maintenance/ Required asset maintenance
Debt Service Ratio	Cost of debt service (interest expense and principal repayments)/ Total continuing operating revenue*
Efficiency	
Real Operating Expenditure	Operating expenditure/ Population

* excluding capital grants and contributions; WDV = written down value

Source: IPART (2015, p.5)

Table 10: ANOVA Results for Taxation Effort All NSW Councils, 2012

	Prob.> F	Agricultural (Ag)	Fringe (Fr)	Metropolitan (Met.)	Regional (Reg.)	Remote (Rem.)	Differences
Taxation Effort (%)	0.000	0.807 (0.302)	1.201 (0.233)	0.844 (0.213)	1.422 (0.346)	0.551 (0.000)	Fr>Ag** Fr>Met** Reg.>Ag** Reg.>Met** Reg.>Rem*

+ p<0.10, * p<0.05, ** p<0.01

We are now in a position to answer the question posed by IPART in relation to

‘Sustainability’ ratios:

Question: Are there any improvements we can make to how we propose to assess the sustainability criteria, consistent with the OLG guidance? Are there issues that we need to consider when assessing councils' proposals using the measures and benchmarks for these criteria?

Answer: It is difficult to imagine how the future sustainability of councils can be accurately assessed without the 'unfinished business' relating to rate-pegging and FAG allocations being first resolved. Moreover, cluster analysis – or another robust empirical method – should be applied so that councils can be assessed only against peers facing the same relevant external constraints (where the benchmark should ideally be altered to reflect the various levels of external constraint). Otherwise councils will be assessed against the same benchmarks as their peers even though they might face entirely different conditions. For instance, councils which are located in areas of extreme climatic conditions may have higher rates of depreciation and impairment which make achievement of the Building and Asset Renewal ratio more difficult. Finally, it would be prudent to conduct sensitivity analysis on the Building and Asset Renewal ratio given the evidence of 'earnings management' on the denominator.

8. Assessment Methodology for Infrastructure and Service Management

As we demonstrated earlier, the ratios employed to assess Infrastructure and Delivery of Services are subject to enormous levels of data distortion. It is thus hard to imagine that any methodology could be used to assess these criteria with 'consistency, impartiality and fairness' (IPART, 2015, p.3) given that local authorities which did not participate in 'reactive

gaming’ will be unjustly penalised if the unaudited data is taken at face value. Of greatest concern is the Infrastructure and Backlog ratio which was compiled according to just a single year of data well after it had become known that the data would be used as an important ratio for the assessment of future fitness. Moreover, the data is unaudited (in common with the data for the Asset Maintenance ratio) and it cannot thus be claimed that there is any basis for reasonable assurance.

It is hardly surprising that auditors have deliberately excluded Special Schedule 7 from their opinions in the past given that it relies on completely subjective assessments. For instance, the following definitions are employed to determine a ‘satisfactory standard’ and ‘required maintenance’:

‘Satisfactory refers to estimated cost to bring asses to a satisfactory condition as deemed by Council. Required Maintenance is what should be spent to maintain assets in a satisfactory standard’

This specific example of the definitions was taken from Bombala’s 2014 Financial Statements, but it is repeated in all council financial statements.

The definition falls far short of Bird et al. (2005) requirement for a competent performance management program and invites ‘reactive gaming’ owing to the fact that it (a) does not commit the council to any particular future action, (b) is defensible given that it is based on professional judgement, (c) it does not require a ‘real’ transaction with second parties (Copeland, 1968, p.102). Moreover, the breadth of municipal infrastructure along with the detailed engineering knowledge required to assess maintenance needs suggests that it would

be extremely difficult for an audit team to provide reasonable assurance on the Schedule 7 items. Without some sense of assurance of accuracy in the data the two ratios which depend upon it are of no worth whatsoever.

In addition to this formidable problem, the Asset Maintenance ratio is subject to an obvious flaw in logic. To achieve benchmark status a council must demonstrate that it is spending more on asset maintenance than what is required! We have already noted this problem earlier, along with the unconvincing attempt by IPART to try to justify the rather strange benchmark. If IPART (2015) is successful in extending the 'fit for the future' assessments to include an additional two years of data (taking this ratio up to five years of data), then the spurious nature of the benchmark will be further highlighted. Perpetual reporting of the Asset Maintenance Ratio against the existing benchmark clearly would not make any sense.

The Debt Service ratio is also an interesting choice by which to measure municipal fitness. It should be noted that the OLG chose to entirely disregard the expert advice of the NSW Treasury Corporation on the definition of this ratio, which completely eroded the ratio's utility. It no longer measures the ability to service debt, but rather measures the proportion of revenue that a council devotes to principal and interest repayments.

This has several adverse effects. Firstly, it discourages councils from reducing interest expenditure through high principal repayments, even though councils are being directed by the 'efficiency' ratio to reduce expenditure. Secondly, the ratio in its current form actively insists that councils not currently in debt take on debt! However, this lower bound benchmark for the ratio (0.0%) encourages some rather perverse behaviour for councils which currently have no debt. For instance, a council with no debt can become 'fit for the future' – according

to this benchmark – by taking out a loan large enough to be recognised in the financial statements and either (a) make interest only repayments and take no action to employ the capital for productive purposes or (b) repay the loan the next week!

The reasoning employed by the OLG for requiring councils which have no need for debt to take on some debt is that councils should ‘use debt wisely to share the life-long cost of assets and avoid excessive rate increases’ (IPART, 2015, p.31). However, as we have demonstrated above, councils can meet the benchmark without using debt in a manner able to be countenanced as wise.

Moreover, if the object is to use debt with the aim of intergenerational equity on long-lived assets, then this presents a number of problems. Firstly, requiring councils to share intergenerational costs from this time forth imposes inequities on previous generations which paid for assets which continue to have a useful life beyond this point in time. Secondly, the objective assumes that debt will be used for capital projects rather than operational expenditure, without any assurance that this will be the case. Third, the OLG/IPART objective assumes that the life of the asset will be closely correlated with the term of the debt, without any reason to suppose this will be the case! If IPART and the OLG really believe that the intergenerational burden of infrastructure should be more equitably distributed in the future, then the obvious course of action is to use bonds issued specifically for capital infrastructure projects with either (a) terms closely correlated to the expected life of the asset or (b) use consols as per the perpetual sharing scheme model (Brueckner, 1997).

We can now answer the question posed by IPART (2015, p11) in relation to assessment methodology of infrastructure and service management.

Question: Are there any improvements we can make to how we propose to assess the infrastructure management criteria, consistent with the OLG guidance? Are there issues that we need to consider when assessing councils' proposals using the measures and benchmarks for these criteria?

Answer: The first two ratios are completely unreliable as they draw on heavily gamed and unaudited data. They cannot be reliably assessed at present. Debt Service ratio is also rather strange for 0% councils and 20% councils. It does not achieve the purpose it sets out to achieve. To achieve this objective, prudent use of bond financing would be indicated such as the infinite-maturity bonds (consols) for a perpetual cost sharing scheme (Brueckner, 1997)

9. Assessment Methodology for Efficiency

The first thing to note about the FFTF 'efficiency' ratio which IPART is proposing to assess is that it does not measure efficiency! Technical efficiency measures the conversion of inputs into outputs generally through the use of non-parametric techniques such as data envelopment analysis (DEA). In the case of NSW councils, the appropriate inputs would be measures of capital and labour used, whereas outputs might be specified according to number of households, employing businesses and roads.⁹ We note that once again the OLG has ignored the expert advice of TCorp (2013) which did not include an 'efficiency ratio' in their suite of

⁹ See Drew, Kortt and Dollery (2015b) for a thorough investigation of municipal DEA specification.

financial sustainability ratios.¹⁰ We also note that IPART (2015, p.32) have sought to conflate the 'efficiency' measure with 'value for money'. However, this is a completely spurious conflation which further exacerbates the problems associated with this criterion given that 'achieving best value is not just about economy and efficiency but also about effectiveness and quality of local services' (Tichelar, 1998, p.34).

What the OLG and now IPART have chosen to calculate is expenditure per capita. It is not efficiency because it implicitly assumes that all services can be proxied by the number of people in a municipality. As noted earlier, this is problematic because (a) it uses the incorrect functional unit (Drew and Dollery, 2014d), (b) the functional unit used, entirely ignores the expenditure related to businesses in the municipality, and (c) it entirely ignores the single largest functional expenditure item for councils, which is roads (PWC, 2006). Moreover, because roads are negatively correlated with population (correlation coefficient of -0.2659) use of population effectively disadvantages councils with low populations. Victoria has also applied an incorrect measure of efficiency - 'underlying expenditure / Total number of assessments (where underlying expenditure does not include other large items and/or adjustments that are not in the ordinary course of business' (Department of Planning and Community Development, 2013). However, at least Victoria uses a functional unit which has a closer correlation to actual service provision (number of rates assessments¹¹) and excludes items, such as defined superannuation calls and one-off capital expenditure associated with specific capital grants.

¹⁰ It should be noted that recent research by Drew, Kortt and Dollery (2015e) has demonstrated that efficiency has very little association with measures of financial sustainability which probably explains why TCorp (2013) decided not to include 'efficiency' in their suite of financial sustainability ratios.

¹¹ This measure over-estimates the functional unit because it includes vacant land which is not closely associated with municipal service provision.

There are a number of other problems which plague the OLG/IPART 'efficiency' ratio (which does not measure efficiency). These problems include the population data employed in the calculations, the method used to deflate data and the method used to assess the direction of expenditure trend. With respect to the population data, the OLG have introduced significant and avoidable error by using 2013 *projected* population estimates.

This is problematic. Firstly, as we have seen earlier, population data in inter-censal periods already have significant error associated with them and this error typically increases with temporal distance from the last census (2011). Secondly, the projected population estimates were never meant to be anything other than a guide and were clearly labelled 'preliminary figure[s] or series subject to revision' (ABS, 2015). Thirdly, the figures have in fact been revised and many of the revisions are quite significant (for example, Cooma-Monaro was revised up 0.89% and Snowy River was revised down 1.17%). Given the high leverage of 'efficiency' data points, even a very small error could result in a completely different assessment on this criterion, as we show below.

The OLG/IPART 'efficiency' ratio is also deficient as a result of the method used to deflate the nominal expenditure data. Firstly, it is not acceptable to use two entirely different indexes to deflate continuous data. Secondly, use of annualise growth in calculations imputes and compounds rounding error. Given the sensitivity of the empirical method erroneously used to calculate the trend in expenditure per capita, even relatively small errors can result in the wrong conclusions being drawn from the data. Thirdly, it was entirely unnecessary to deflate the 2010 financial year data and this decision simply introduced avoidable rounding error.

The final – and fatal – problem associated with the OLG/IPART efficiency measure is the empirical method chosen to establish the direction of expenditure/capita trend. The OLG toolkit employs linear regression to establish whether expenditure per capita is rising or falling. Unfortunately, the use of linear regression to establish the direction of the trend is completely flawed owing to the fact that it breaks the key assumption of linear regression: that the data association has a linear functional form!

Figure 9.2 plots expenditure per capita against time for Willoughby council (data drawn from the OLG (2014d) FFTF Toolkit). It is immediately obvious that the data points are best represented by a quadratic equation with local *maxima* – not the linear trend used by the OLG (trend line, line formula and coefficient of determination shown on graph). The distribution of Willoughby's expenditure per capita data is quite typical and arises from the 'early payment in 2011/12 of Commonwealth Financial Assistance Grants (FAGs) that were not due to be paid until 2012/13' Comrie 2013.¹² As a result of the OLG employing a completely incorrect functional form the coefficient of determination for the regression indicates that the linear trend line explains less than 1% of the data!

However, there are further problems resulting from the supercilious method employed by the OLG. Figure 2 shows the sensitivity of the 'efficiency' result as calculated in the OLG Toolkit wherein uplift in the first leverage point of just 0.5% radically changes the assessment of Willoughby's fitness in this criterion! Given the compounded error introduced in generating nominal data, the error associated with ABS population estimates and the error introduced through using preliminary figures (which have already been revised) the

¹² However, we note that capital grants and spending associated with natural disasters have resulted in more complex polynomial distributions for some councils.

sensitivity of the 'efficiency' ratio means that it is not fit-for-purpose in a policy making sense.

Figure 3 emphasises this problem by demonstrating that the high leverage of certain data points means that others are entirely redundant. For instance, changing the 2011/12 expenditure for Willoughby to an entirely implausible figure of \$2,000,000 per person makes absolutely no difference to Willoughby's 'efficiency' status! Bird et al. (2005, p.15) have noted that 'even with longer time series, it can be very difficult to estimate trends very precisely'. However, the use of flawed methodology and a relatively short time series means that there is simply no chance of IPART (2015, p.3) assessing councils with 'consistency, fairness and impartiality'. See Figures 2, 3 and 4.

Figure 2: Willoughby 'Efficiency' Ratio

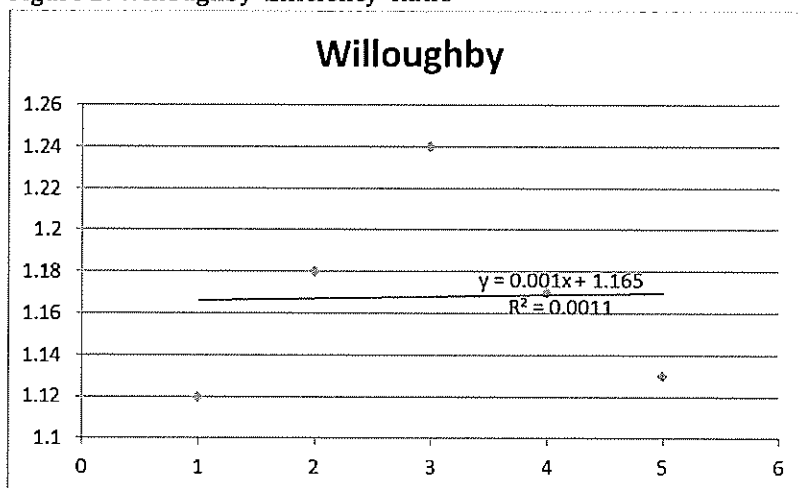


Figure 3: Willoughby 'Efficiency' Ratio with Changes Demonstrating the Sensitivity of High Leverage Points

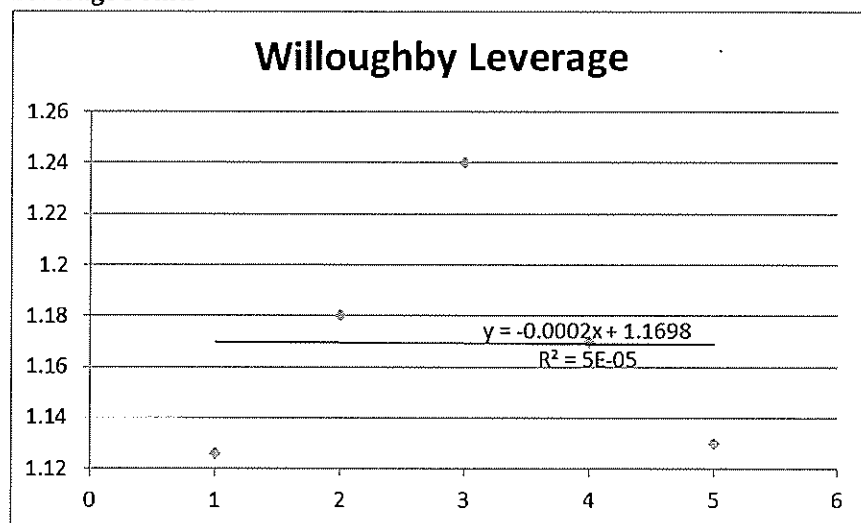
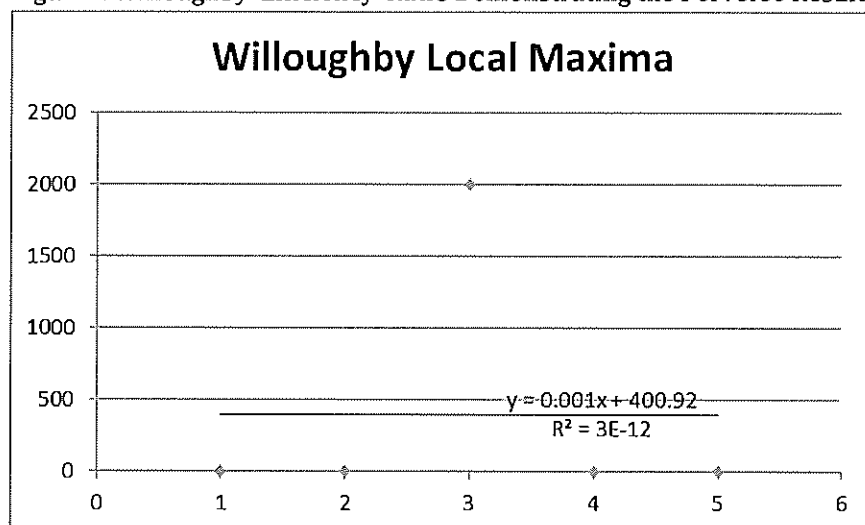


Figure 4 Willoughby 'Efficiency' Ratio Demonstrating the Perverse Results Possible



We are now in a position to answer IPART's (2015, p.11) stakeholder question:

Question: Are there any improvements we can make to how we propose to assess the efficiency criteria, consistent with the OLG guidance? Are there issues that we need to consider when assessing councils' proposals using the measures and benchmarks for these criteria?

Answer: Ideally IPART should actually calculate efficiency for the councils and use this in place of a ratio which clearly does not measure efficiency. If for some reason IPART cannot calculate efficiency, then the ratio should (a) exclude one off costs from expenditure, such as capital works (funded by specific grants or required as a result of natural disaster), and (b) use a sensible functional unit (such as number of businesses and households) which does not exclude the large business segment of rate payers. Moreover, the projected 2013 population figures need to be replaced with revised figures and a linear trend should only be calculated for data exhibiting linear functional form. Five years is probably not enough data and efforts should be made to supplement it with at least a further three years of data, which would then allow IPART to exclude the unrepresentative 2011/12 year.

10. Other Considerations for Assessment Methodology

IPART (2015) raise a number of ancillary questions in their methodology consultation:

Question: How should councils engage with their communities when preparing the FFTF proposals? Are there any factors we should consider to inform our assessments of council consultation? Please explain what these factors are, and why they are important.

Answer: Councils should at the minimum ensure all residents are aware of the flaws in the FFTF programme. No evidence of community opinion is reliable unless the opinion has been fully informed, which includes a knowledge of the completely erroneous criteria employed and the heavily distorted and gamed data which it relies on. Councils should also conduct a survey of sufficient size and randomised so that tolerable standard errors result. Survey

questions must be asked without bias, with necessary information to ensure knowledgeable answers and involve the use of a combination of open and closed questions.

Question: Should council performance against FFTF proposals be monitored? If so, are there any improvements we can make on the approach outlined for councils to monitor and report progress on their performance relative to their proposals?

Answer: Yes, future performance against proposals should be reported as a public accountability measure. However, as we demonstrated, this is unlikely to be politically palatable as it becomes obvious that forecasts will not be met. Moreover, the current assessment criteria are fatally flawed. Thus, the OLG should scrap the FFTF criteria entirely and this time build a competent performance monitoring regime which is informed by expert advice, community and municipal consultation, as well as a rigorous pilot program.

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