

Further to my email of the 17<sup>th</sup> May I would like to make a submission to IPART concerning what should qualify under minimum operating scale and strategic capacity.

My first request is that IPART recognise that a minimum efficient Operating Scale can be obtained not just by merging councils, but by outsourcing services that exhibit economies of scale to either a Shared Services Centre or a large Private or Public Services Provider specialising in such services.

Such a model would enable many local councils not only to keep their current structures, but become smaller neighbourhood councils based on the popular Lakewood-model adopted by many cities in the USA. Attached is a paper I prepared for CEDA's book on a *Federation for the 21<sup>st</sup> Century* (Oct 2014) on how a Virtual Council would operate.

A Virtual Council is similar to a body corporate of a multi-dwelling estate, though its statutory powers and scope are wider. Its main advantage is that it can obtain cost efficiencies through outsourcing activities that exhibit economies of scale, yet be small enough to have the local knowledge and organisational flexibility to quickly respond to community needs at a micro-level.

With regards to achieving minimum Strategic Capacity it seems to me that this largely relates to the town planning design and development application processing functions of local councils. Here economies of scope are important and again these can be achieved through lifting regional planning decisions to a Regional Council of Mayors and regional development approvals to a regional planning panel served by planners located within a regional Shared Services Centre.

So my second request is that IPART recognise that minimum Strategic Capacity can also be obtained by this mechanism, not just by merging councils. Again my CEDA paper on Virtual Councils covers this aspect.

Yours sincerely,

Percy

**Professor Percy Allan AM**



## 3.2

# Virtual local government

## Professor Percy Allan AM

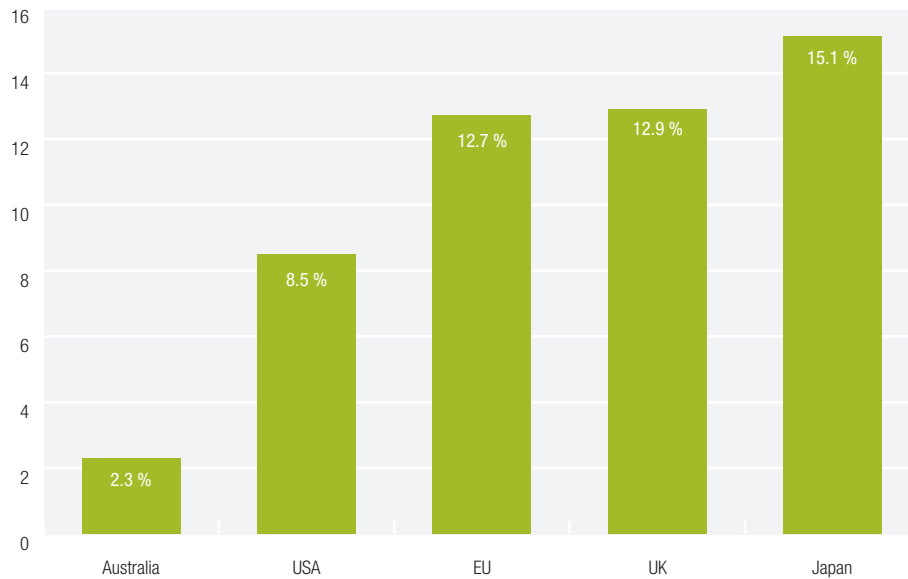


Professor Percy Allan AM advises on public policy, management and finance. He is a former Secretary of the NSW Treasury (1985–94) where he reformed the State's budgetary, accounting and financial reporting systems, corporatised its government enterprises and conceived the Independent Pricing and Regulatory Tribunal. He was then Finance Director of the Boral Group (1994–96) where he overhauled its financial management systems. He subsequently chaired the NSW Premier's Council on the Cost & Quality of Government (1999–2007), a racing regulatory body (2003–12) and an equity funds manager (1999–2012). Professor Allan was National President of the Institute of Public Administration Australia (IPAA) from 2010–12. He currently chairs a sporting complex trust and a share market advisory practice. He has been a Visiting Professor at MGSM, one of Australia's leading business schools, since 1996.

Our local government sector is small by world standards, accounting for only around six per cent of general government outlays and three to four per cent of total taxes collected in Australia.<sup>1</sup> Local government expenditure as a proportion of gross domestic product (GDP) is only 2.3 per cent in Australia compared with eight to 15 per cent in other developed countries (refer to Figure 1).<sup>2</sup>

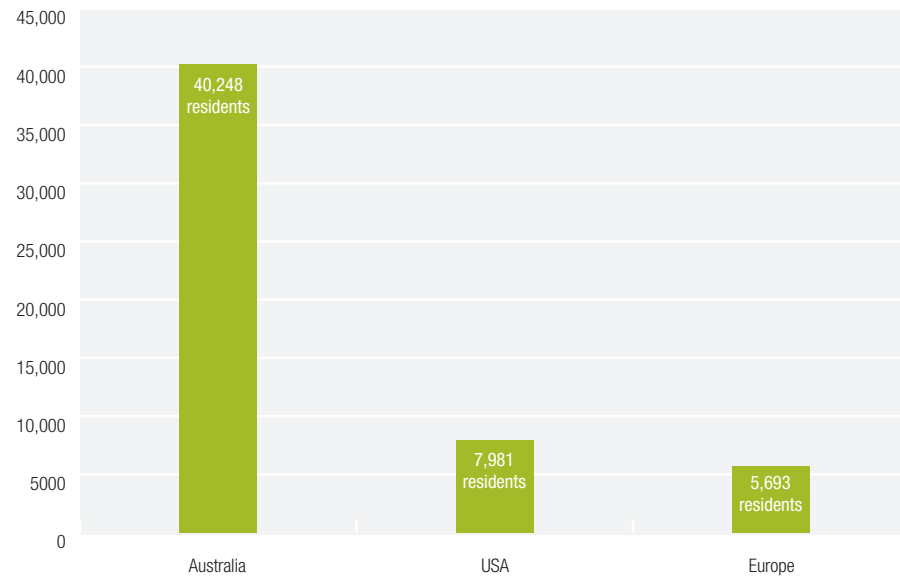
Yet paradoxically, Australia's local councils are big by world standards. In 2011, the average residency size of local government units in Australia was more than 40,000 residents; in the United States (US), 7,981; and in the European Union (EU), 5,693 (refer to Figure 2).

**FIGURE 1**  
LOCAL GOVERNMENT EXPENDITURE AS A PERCENTAGE OF GDP (2006)



Source: Dexia Bank

**FIGURE 2**  
AVERAGE SIZE OF LOCAL GOVERNMENT BODIES BY POPULATION (2011)



Source: Dexia Bank

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## The merger myth

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One of the main arguments advanced for merging councils is that increased size would increase cost efficiency. As MA Jones states, “It was once thought that small local governments allowed more community control but were more costly than larger units”.<sup>3</sup>

Yet, researchers both here and abroad have found that larger councils do not exhibit lower unit costs of servicing than smaller ones.<sup>4</sup>

It’s been found that some council functions are done best on a large scale while other tasks are performed better on a small scale. “Smaller units are the most democratic and participative, and also the most efficient”.<sup>5</sup>

In fact, the New South Wales (NSW) Local Government Inquiry<sup>6</sup> “found no conclusive evidence that mergers would reduce unit costs. For smaller rural councils a lack of population density rather than size appeared to be the main cause of higher operating costs per resident”.

“Increasing population yields a lower level of gross expenditure per capita, however, once this reaches a point between 31,500 and 100,000, increasing population size results in higher levels of gross expenditure per capita”.<sup>7</sup>

“Concentrated structures were associated with higher spending than more fragmented local government and that there may be diseconomy of scale factors operating that outweigh the technical benefits of larger units”.<sup>8</sup>

As a case in point, Sydney metropolitan councils show no significant economies of scale, that is, average council cost per resident has no bearing to council size. Furthermore, larger councils in NSW generally charge higher rates than smaller to medium-size councils charge.

The ‘big is better’ argument is not always apt for a public bureaucracy where being nimble, flexible and cost conscious can be difficult given the bigger the span of control.

The reality of councils operations is that some services enjoy economies of scale while others suffer diseconomies from aggregation. A one-size-fits-all approach is both crude and dangerous. As Brian Dollery notes, “the results of amalgamations (in Australia) has not met expectations ... structural change through compulsory council consolidation have not been effective in achieving their intended aims of meaningful cost savings and increased operational efficiency.”

Mergers are unlikely to yield efficiency gains where legislation (such as that in NSW) prohibits:

- Merged councils from having forced redundancies for three years;
- Changing employees, terms and conditions;
- Relocating staff outside the boundaries of the former council area if they claim hardship; and
- Reducing pre-existing employment levels in rural areas.

**FIGURE 3**  
**SHOULD OUR COUNCILS BE BIGGER?**

Local council processes		
Process	Example	Scale efficiency
Routine processing	Rate notices, paying invoices	✓
Case-by-case determinations	LEPs, new traffic signs	✗
Capital works and maintenance	Footpaths, lawn mowing	✓
Corporate services	Policies, codes, community consultation	✓ and ✗

Source: Review Today <reviewtoday.com.au>

Where small scale is a handicap, it can be overcome (especially in metropolitan areas) by creating ‘virtual’ councils that use a shared services centre or outsource their functions, for example, rate collections and capital works, to specialist providers.

For instance, today more than a quarter of California’s cities (about 130) are contract cities based on the ‘Lakewood model’:

“Lakewood of the early 1950s was David fighting the Goliath of Long Beach, a city intent on gobbling up its unincorporated neighbour parcel by parcel. The legal turf battles were exhausting Lakewood’s defenders, most of whom were transplants drawn to the promise of this sleepy village-turned-post-war boomtown. Then along came John Sanford Todd, a struggling attorney and proud Lakewood resident, who dreamed up a way to preserve his community’s independence without it going broke: It would become a new kind of city, one that contracted out for police protection, trash collection, firefighting – just about every service a city provides.

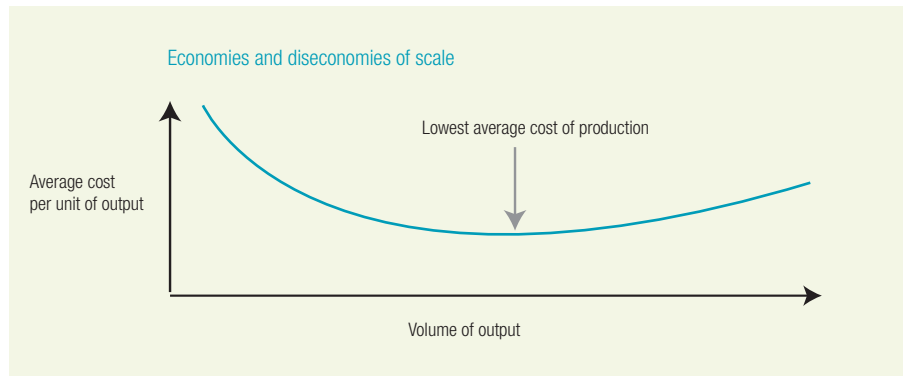
“That practice is commonplace in the USA today, but it was a revelation a half century ago. Todd’s vision, dubbed “the Lakewood Plan,” became a model of local government that informed incorporation drives throughout Southern California and beyond. Suburbia took shape in a rash of “contract cities,” including the neighbouring Dairy Valley (now Cerritos), La Puente, Bellflower, Duarte, Irwindale, Norwalk and Santa Fe Springs, which sprang up in such rapid succession that some observers began proclaiming the end of big cities”.<sup>9</sup>

## Post-industrial efficiency requires speed not scale

The argument in favour of larger councils is based on the theory of economies of scale first proposed by Ronald Coase in 1937 to explain the efficiency of large corporations using assembly lines. “Large organisations, such as companies, make sense when the ‘transaction cost’ associated with buying things on the market exceed the fixed costs of establishing and maintaining a bureaucracy”.<sup>10</sup>

However, Coase also recognised that there were limits to scale efficiencies, beyond which, unit costs rose with each extra output. Initially, cost efficiencies were obtained from division of labour and specialisation of tasks, increased scope for shared services and increased dimensional capacity. Beyond a certain point, unit costs rose from control span limits, coordination complexity, and communication and information network requirements.

**FIGURE 4**  
**EFFICIENCY AND SIZE – THEORY**



But a lot has happened to organisations since Henry Ford pioneered mechanising production on a large scale using assembly lines. A 2001 Special Supplement in *The Economist* declared, “Modern technology is shifting the balance of advantage away from firms and towards markets. The current goal is to focus on the few things at which they undoubtedly excel and to hand over everything else to equally focused specialists”.<sup>12</sup> This is something that Lakewood County and its successors found.

Aggregating activities together in a large organisation does not necessarily ensure economies of scale let alone service effectiveness. Take for instance anti-dumping laws designed to protect local producers from subsidised imports sold below cost. They are administered by a branch within the Australian Customs and Border Protection Service. In 2012, an inquiry (chaired by former Victorian Premier, the Hon. John Brumby) was established into whether the function should be performed by a separate standalone anti-dumping agency following evidence that the existing complaints process is too slow and cumbersome.<sup>12</sup>

What matters in both business and government now is not size, but speed. Speed is obtained through greater flexibility using a Shamrock-style structure as advocated by Charles Handy<sup>13</sup>, not a giant bureaucracy as preached by Coase. Shamrock organisations concentrate on their core role and outsource everything else. Their organisational structure consists of three parts:

1. Core staff, for example, senior management and others who do what can't be easily outsourced;
2. Contractors, for example, individuals who once worked for the organisation but now supply generic services to it; and
3. Consultants, who are professional and hi-tech workers who provide customised services to the organisation.

## Redesigning councils to become virtual

Virtual councils address both the popular demand for small discrete municipalities that are close enough to residents to address their special needs, and the administrative advantage of doing some things on a large scale to achieve cost efficiencies, standardised outputs and the option to switch supplier if service delivery is not satisfactory. That's the nub of the challenge facing local governance.

Lakewood-style councils use a shamrock organisation structure to achieve such an outcome. They employ a small full-time professional staff who outsource generic tasks and use part-time contractors for specialist work. Australia's local governments should be encouraged by state governments to adopt such a model. It could be trialled in one region with the state offering its local councils infrastructure rehabilitation grants in return for their active cooperation.

The first step would be to merge administrative functions of neighbouring councils that would benefit from economies of scale and scope (as established by an expert inquiry) into a linked shared services centre (SSC) that would be run as a commercial cooperative by member councils.

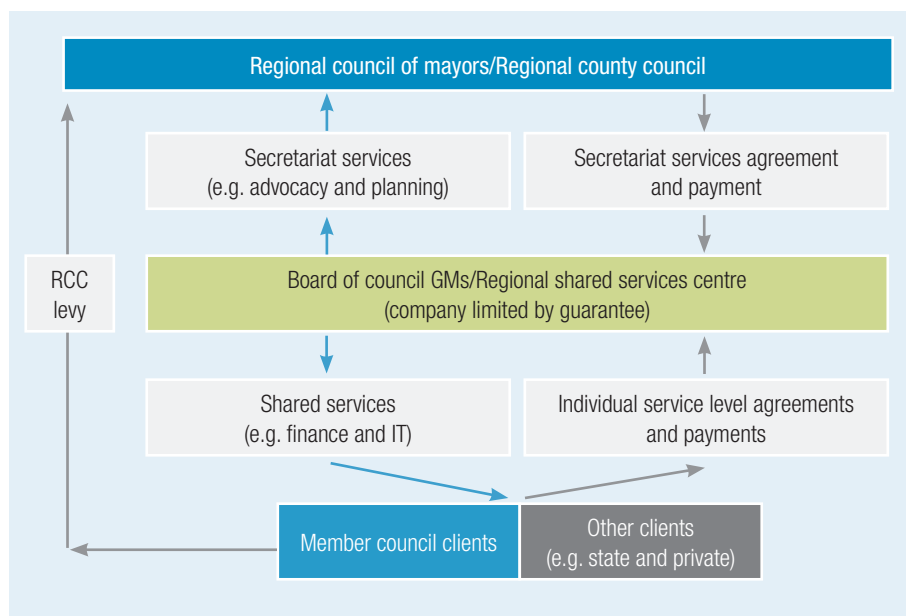
A public company or cooperative structure is best suited for operating a SSC because it is more operationally flexible and economically competitive than a county council structure.

Commercial contestability is important, not only for retaining council membership, but also for expanding sales to other clients in the public and private sectors.

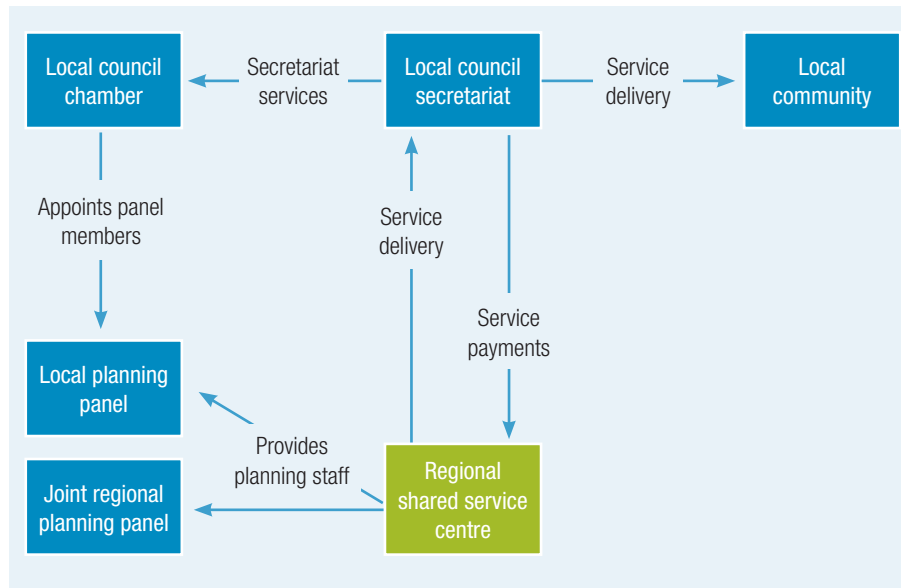
However, a county council model is better suited for regional planning functions for which regulatory powers are required. The county council model, by giving an existing regional organisation of councils (ROC) a statutory basis, would also give it greater authority when making submissions to state and federal government agencies. The regional county council would consist of mayors of member councils (refer to Figure 5).

The SSC, as a public company, would have its own CEO and be governed by a board of directors consisting of general managers of its member councils. The SSC, besides serving member councils, would also serve a regional council of mayors presiding over a regional county council (that could take on regional planning and advocacy functions). As a cooperative, the SSC would pay an annual dividend to each member council commensurate with the value of services sold to it (refer to Figure 5).

**FIGURE 5**  
**A REGIONAL LOCAL GOVERNANCE STRUCTURE**

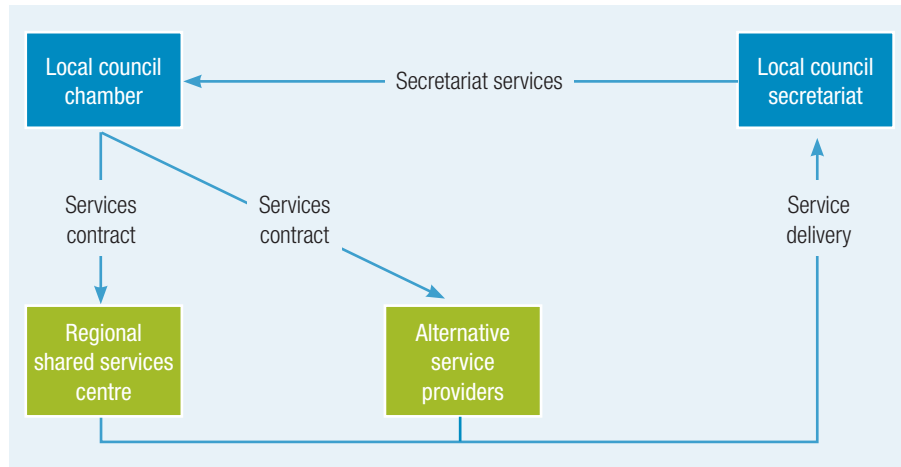


**FIGURE 6**  
**LOCAL COUNCIL SETS LOCAL PLANNING POLICIES AND APPOINTS MEMBERS TO LOCAL AND REGIONAL PLANNING PANELS**



Source: Percy Allan & Associates

**FIGURE 7**  
**AFTER FIVE YEARS, LOCAL COUNCIL IS FREE TO NEGOTIATE SERVICE CONTRACTS WITH ALTERNATIVE SERVICE PROVIDERS**



Source: Percy Allan & Associates

Each council would retain a general manager with a small support staff to provide it with secretariat services including strategic planning and policy advice, to place manage the municipality and ensure the services centre fulfilled its contractual obligations. Each council, with the assistance of its general manager, would negotiate a services contract with the CEO of the SSC.

Each council would appoint an independent local planning panel (LPP) to decide all local development applications in accordance with council planning and development policies. All councils within a region would continue to have a say in appointing a joint regional planning panel (JRPP) that decides development applications of a regional nature (refer to Figure 6). The SSC would have an ongoing mandate to provide



professional staff to assist the local and regional planning panels with fees charged for providing such planning expertise set by the states' independent pricing authority, such as the Independent Pricing and Regulatory Tribunal in NSW.

After say five years, each council would be given the discretion to buy services from any provider, public, not-for-profit or private (refer to Figure 7). Shifting business to alternative providers would mean forfeiting cooperative dividends. Nevertheless, such a sunset clause would put the SSC on notice that unless it performed efficiently and effectively it could expect to lose custom once its five-year exclusive contract expired.

If a community wanted a smaller council for better place management of its services and infrastructure, such a contract model would allow municipal councils to splinter along precinct lines without sacrificing economies of scale and scope.

Indeed, a community contract council would bear some resemblance to a strata and community title owners' corporation that used a body corporate service secretariat to plan and engage its services from external providers, such as a shared services centre (jointly owned with other body corporates) and/or a variety of other specialist services providers serving multiple clients.

The main difference with the body corporate analogy would be that:

- The council chamber would remain a political body required to service the social, environmental and economic needs of the wider community rather than just focus on property management;
- The council's secretariat would remain a public service organisation accountable to elected councillors; and
- The SSC would be a commercial cooperative using activity-based costing to price its services and (except for planning panels) subject to market contestability after five years.

Critical to establishing community contract councils is the concept of an SSC. Following are examples of such centres used in not-for-profit organisations, private enterprise and state government:

### Credit Union Movement

Independent shop fronts offer sophisticated financial services because they are linked to an SSC that acts as their bank, raise their finance, process their mortgages, service their ATMs, etc. For example, CO-OP Financial Services, the largest credit union owned interbank network in the US, provides an ATM network and shared branching services to credit unions. In Australia, Cuscal Limited does the same.

### American Union Movement

Small local unions with only a few hundred members offer full services because behind each is an SSC that provides them with membership processing, collection of dues, specialist legal advice for employee contract negotiations, newsletter production, discount deals, etc.

### Large Corporations

Conglomerates such as General Electrics often pool their support services (for example, recruitment and training, payroll and leave processing, bulk purchasing, environmental and legal advice, and financial transaction processing) to free up their autonomous business units to concentrate on their core operations.

### Business Rivals

Vipro, jointly owned by the Commonwealth Bank, National Australia Bank and Westpac, was formed in 2005 to jointly process cheques on behalf of its owners. The consortium outsourced its operations to financial information services company Fiserv Inc., in a \$600-million, 12-year deal. It claims this shared service arrangement reduced costs, improved fraud prevention and saved capital investment associated with cheque processing.

### NSW Government

Currently, there are three shared service operators in the NSW Government: Service First, BusinessLink and Health Support Services. There are moves afoot to put their functions to tender to achieve competitive pricing and greater flexibility of operations.

According to the NSW Department of Premier and Cabinet,<sup>14</sup> a 2009 review of 193 public and private SSCs in the US, EU and Asia Pacific by the Hackett Group Shared Services Performance Study found that:

- Shared service reform delivers over 20 per cent reduction in cost with improved levels of service and quality;
- 71 per cent of shared services operations plan to achieve over 20 per cent reduction in costs; and
- 61 per cent of shared services operations have achieved over 20 per cent in savings.

If diverse spheres of private and government activity can achieve greater efficiency and effectiveness through sharing services without full amalgamation, then surely the same can be done in local government.

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## Assessing alternative structures

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The Australian Centre of Excellence for Local Government (ACELG) in 2011 took a fresh and objective look at the results of consolidation in local government both in Australasia and the rest of the world.<sup>15</sup> It concluded that:

“Ongoing change in local government is unavoidable, and consolidation in its various forms will be part of that process. As a general rule benefits of some sort do accrue when councils adopt mechanisms to collaborate or consolidate with other local authorities. Potential benefits are reduced or lost when the process is flawed due to inadequate planning and consultation or a failure to consider all the options available and precisely what each could achieve”.

Its primary research finding was that “there is little evidence that amalgamation will automatically yield substantial economies of scale. What is more obvious is that various forms of consolidation have the capacity to yield economies of scope”. It also added, “In the case of more remote councils with small populations spread over large areas, consolidation (whether amalgamation or shared services) may not be feasible”. Economies of scope come from sharing services whereas economies of scale come from purely size.

The verdict is in: Sharing services makes sense, simply getting bigger does not.

In exploring future structures of local government one should not confine oneself to the binary choice of status quo versus amalgamation. Other choices in between these extremes can achieve both the efficiency of scale (through service outsourcing) and scope (via shared services), and the effectiveness of specificity (by local place management) and speed (from codified practice with time limits). This means exploring the possibility of virtual councils.

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## Conclusion

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Local governments' share of GDP is much lower in Australia than in other countries. Yet the average residency of Australian councils is much larger than that of local government authorities in most other countries. There is no empirical evidence either here or overseas that larger councils result in lower costs, rates, fees and charges. Indeed, in NSW, larger councils charge higher rates. Mergers distract from the real issues, which are massive under-spending on capital works and dysfunctional development approval processes.<sup>16</sup>

The administrative reality is that the efficiency and effectiveness of a local council is not just a function of its size, but its speed, scope and specificity in delivering services whether processing rate notices, repairing roads, answering enquiries or considering development applications. Speed and scope require:

- Front-office place management focusing on the particular problems of a local place;
- Mid-office strategic management making strategic decisions locally and regionally;
- Back-office process management achieving economies from specialist providers.

Most council frontline services require very local attention, in which small councils excel. Urban planning and large developments need a regional focus through regional institutions. Routine corporate services and public works need scale to capture economies, which either outsourcing or SSCs do best.

The political reality is that people believe small is beautiful – they want their local council centred on their neighbourhood. Residents identify with distinct neighbourhoods not amorphous regions. People expect their local councils to address micro issues within their local community, but expect the state government or joint state/local government bodies to address wider regional issues. They want impartial authorities divorced from vested interests to determine development applications based on long-term urban planning strategies agreed at a local, regional or state level depending on the significance of the project.

Citizens should be free to decide what size municipality they want. State governments could put lower and upper limits on this, for example, 20,000 to 100,000, except for remote rural councils whose populations are small and scattered. Councils would be required to transfer those services that would benefit from being done on a larger scale to an SSC, and those decisions that need to be done at a regional level to joint regional political (for example, Regional Organisations of Councils), statutory (for example, Regional County Council) or judicial bodies (for example, Joint Regional Planning Panels).

The SSC would be jointly owned and governed by its member councils. It would be run strictly as a business providing works, maintenance, IT, financial services, planning, etc. to participating councils, and their ROC, RCC or JRPP on a fee-for-service contract basis.

To ensure that an SSC gave value for money, there would be a sunset clause on its exclusive mandate. Thereafter, councils, ROCs and JRPPs would be free to choose alternative suppliers if they offered better value for money. The SSC would be required to cease those services for which it had insufficient clients. This would ensure it never took its clients for granted, thereby always giving them good service.

Finally, the choice for politicians and the community is not just one of the status quo versus amalgamation. Of the options available, the virtual council model would deliver the best of both worlds: small councils able to focus on local needs through intensive place and client management, but with the capacity to buy-in services economically from a regional shared service centre cooperative or a specialist private or not-for-profit provider.

If we want true reform of local government then we need to recast it, not just reassemble what exists on a bigger scale.

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#### Endnotes

- 1 This paper is an abridged and updated version of pages 20-32 of the Urban Taskforce's report, *Sydney's Liveability Crisis – Reforming Local Government – Keeping the local in Local Government while improving efficiency*, Sept 2012 that was prepared with the assistance of Percy Allan & Associates Pty Ltd.
- 2 Allan, P 2008, Private correspondence with Dexia Bank, July.
- 3 Jones, MA 1993, *Transforming Australian Local Government – Making it Work*, Allen and Unwin, Sydney.
- 4 For references to researchers between 1992 and 1999, see Allan, P 2003, 'Why Smaller Councils Make Sense', *Australian Journal of Public Administration*, Vol. 62, No. 3, Sept, pp. 74-81.
- 5 Jones, MA 1993, op cit.
- 6 LGSA 2006, 'Independent Inquiry into the Financial Sustainability of NSW Local Government', *Are Councils Sustainable, Final Report and Findings*, Sydney, May, pp. 21-22 and 257-262.
- 7 Soul, S 2000, *Population Size and Economic and Political Performance of Local Government Jurisdictions*, research thesis submitted to the Southern Cross University to fulfil requirements for a Degree of Doctor of Philosophy, p. 179.
- 8 Boyne, G 1998, *Public Choice Theory and Local Government*, Macmillan, Basingstoke.
- 9 Lakewood, California, *Wikimapia*, accessed at [wikimapia.org/10156810/Lakewood](http://wikimapia.org/10156810/Lakewood); Long Beach Register 2014, 'Editorial: Lakewood a model city for 60 years', Orange County Register, 20 March, accessed at [www.ocregister.com/articles/city-606374-lakewood-years.html](http://www.ocregister.com/articles/city-606374-lakewood-years.html); 'Lakewood, California', *Wikipedia*, accessed at [en.wikipedia.org/wiki/Lakewood,\\_California](http://en.wikipedia.org/wiki/Lakewood,_California).
- 10 Coase, R 1937, 'The Nature of the Firm', *Economica*, Vol. 4, Iss. 16, Nov, pp. 386–405.
- 11 2001, 'The Future of the Company: A matter of choice', *The Economist*, 22 Dec.
- 12 Kerin, J 2012, 'Brumby heads review into anti-dumping', *Australian Financial Review*, 4 July, p. 5, accessed at [afr.com/p/national/brumby\\_heads\\_anti\\_dumping\\_agency\\_n7JjBwjuU1lzhY9KUYHDP](http://afr.com/p/national/brumby_heads_anti_dumping_agency_n7JjBwjuU1lzhY9KUYHDP).
- 13 Handy, C 1989, *The Age of Unreason*, Harvard Business School Press, Boston MA.
- 14 NSW Dept. of Premier and Cabinet, 2010, *Blueprint for Corporate and Shared Services in the NSW Government*, 15 July, p. 6, accessed at [www.dpc.nsw.gov.au/\\_\\_data/assets/pdf\\_file/0003/97572/100715\\_Blue\\_Print\\_for\\_Corporate\\_and\\_Shared\\_Services\\_in\\_the\\_NSW\\_Government.pdf](http://www.dpc.nsw.gov.au/__data/assets/pdf_file/0003/97572/100715_Blue_Print_for_Corporate_and_Shared_Services_in_the_NSW_Government.pdf).
- 15 Aulich, C, et al., *Consolidation in Local Government: A Fresh Look*, ACELG, May 2011, p. 7.
- 16 See Urban Taskforce assisted by Percy Allan & Associates Pty Ltd: *Sydney's Liveability Crisis – Reforming Local Government, Keeping the local in Local Government while improving efficiency*, Sept 2012.