A Regulatory Framework for Setting Rates and Charges for Local Government Services in New South Wales

A Submission to the NSW Independent Pricing and Regulatory Tribunal

NSW Treasury

August 2008

Contents

Executive Summary

The Premier of NSW has requested the Independent Pricing and Regulatory Tribunal (IPART) to investigate and make recommendations on:

- An appropriate intergovernmental and regulatory framework for setting rates and charges that facilitate the effective and efficient provision of local government services;
- A role for IPART in setting rates and charges in future years;
- A framework for setting the charges levied by certain public authorities such as the Sydney Harbour Foreshores Authority and others.

IPART (2008) provides a detailed discussion paper that gives substantial background information and discusses some of the major issues. Most of the discussion focuses on the regulatory framework for setting local council rates and in particular on the system of rate pegging (the annual regulation of general rate revenues). There is less discussion of regulations of charges or IPART's possible role. The discussion paper invites comments.

This submission focuses likewise on the regulatory framework for setting local council rates. Regulation of charges by local councils or by other public authorities is outside the scope of this submission. Consistent with the IPART discussion paper, the basic role and services of local government and the basic fiscal structure (the core reliance of local government on rates based on unimproved property values) are taken as a given.[1]

This submission discusses objectives of regulation, regulatory options, criteria for evaluating options and some relevant data. The submission concludes that some options have more advantages than others and warrant more investigation by IPART.

This submission starts with a brief introduction to the nature of local government services and revenues. Section 2 discusses the rationale and objectives for regulating local government general revenues. Section 3 discusses regulatory options. Section 4 discusses criteria for evaluating these options. These criteria represent practical applications of the policy objectives. Section 5 discusses the evidence that would be required for a full evaluation of the options. Section 6 provides some summary conclusions. The main points of the report are summarized below.

[1] This submission the draws extensively on the useful descriptive material provided in IPART (2008). However this submission provides a critique of some of this material and discusses more options.

Summary of main findings

Regulatory options for general rate revenues fall into three main groups. The NSW Government may:

A. Regulate general rate revenue outcomes;
B. Maintain discretionary controls over general rate revenue outcomes;
C. Regulate the process of rate revenue setting and retain reserve powers.

The submission identifies five options under strategy (A), one under strategy (B), and three under strategy (C).

A1. Retain the existing rate pegging system.
A2. Retain existing rate pegging with improved criteria.
A3. Retain rate pegging with variations by type of council and improved criteria.
A4. Retain rate pegging for operating expenditure.
A5. Retain some form of rate pegging but some council exemptions would be allowed.

B1. Councils would determine their general rate revenues with government holding discretionary reserve power to determine a council's rates (UK model).

C1. Councils determine general rate revenue subject to meeting regulated processes.
C2. Councils determine general rate revenue with only minimal regulations.

In Section 6 below these seven options are assessed in two stages. In the first stage the preferred options in groups (A) and in (B) and (C) are selected respectively. The submission finds that the preferred option in group (A) is (A2). Option (A2) is more transparent than (A1) and meets the objectives of rate outcome regulation as well as any other (A) group option and is considerably simpler to administer than these other options, each of which raises technical issues of varying complexity.

The submission also finds that option (C1) is the preferred option in groups (B) and (C). Under (C1) the state government would determine the detailed governance processes, such as development of management plans, compulsory reporting, and public consultations. However the default position would be that rates would be regulated by state government only if there were a failure of due process or local council malfeasance. The processes would be designed by drawing on best Australian and international practice. Option (C1) gives local councils more flexibility and autonomy than option (B), but in effect leaves the state government with similar reserve powers.

In the second stage of the evaluation this submission applies six criteria to an assessment of the two short-listed options. The six criteria and the summary assessment are shown in the table at the en of this summary.

The analysis suggests that any benefits from rate pegging are minor. The regulation of rate outcomes has capped rate increases below those in other states. And it may have provided some discipline to local councils and ensured that some poor projects were not undertaken.

On the other hand, councils have to some extent substituted other potentially less efficient revenue sources for the loss of rate revenue such as developer levies. Equity is poorly targeted under rate pegging. Rate outcome regulation also fails the accountability criterion.

In the view of this report, regulating the rate making process can achieve the major aims of rate regulation without the costs. Local council decision making and services should be more responsive to local household views. Taxes and charges can be selected on their merits rather than by regulation. Rates are a small part of household expenditure, but if affordability is considered significant for some low-income households, they can be protected by targeted rebates. State government would also retain the power to check abuses of process or seriously incompetent or corrupt government.

This submission recommends that IPART should devote considerably more time to developing and designing efficient and democratic rate regulating processes.

Finally there is the issue of which government agency should regulate local council rates or rate making. This submission supports the principle that separation of policy determination from implementation increases the transparency and efficiency of governance. Of course the policy guidelines will vary according to whether the state government elects to continue to regulate rate outcomes or moves to a policy of regulating the process of rate making as recommended by this submission. However this submission recommends that once these guidelines are established, an independent regulator such as IPART should be responsible for monitoring implementation of the guidelines.

Summary Table   Comparison of rate outcome and rate process regulation

Criteria	Regulation of rate outcomes (Option A2)	Regulation of rate process (Option C1)	Evidence
Allocative efficiency	May have no effect on general revenue. If it does reduce revenue, it may stop some poor projects. But it may also result in poor services and infrastructure backlogs.	Local council decision making and services should be more responsive to local household views. State government would retain power to check abuses of process.	Effects on general revenue unclear. Some evidence of infrastructure backlogs with rate pegging. Community surveys could provide more evidence on local spending and rating preferences.
Productive efficiency	Revenue controls may exert pressure on productivity and reduce unit costs of services but may also reduce services.	Public scrutiny of costs should increase productive efficiency.	Little evidence exists on effects of rate regulation on productivity and unit costs.
Revenue inefficiency	Rate regulation may lead to inefficient taxes replacing an efficient tax on land. It may also have encouraged risky investments.	Taxes and charges can be selected on their merits rather than by regulation.	Some revenue substitution appears to have occurred. May have led to increased developer charges and housing prices and risky investments.
Equity (affordability)	Rates in NSW are lower than in most other states. But other local charges are higher in NSW. The impacts are minor in dollar terms and poorly targeted.	If the issue is considered significant, low-income households can be protected by targeted rebates.	Data on rates and other revenue are available.
Administrative cost	Administrative costs are small.	Given state governance plans for local councils, incremental administrative costs would be quite small.	Costs can be estimated.
Accountability	Not accountable	Accountable	Not an empirical issue.

1 Introduction: The Nature of Local Government Services and Revenues

As IPART (2008, p.18) notes, the *NSW Local Government Act* provides a guide to councils as to how to carry out their functions but imposes few limitations on the services that they should supply. Rather, councils are intended to have the flexibility to supply the services that their communities need.

In practice, local councils provide both physical infrastructure and personal services. Infrastructure includes:

- Roads, pavements, traffic lights, bridges and car parks
- Stormwater and drainage systems
- Parks and sporting facilities
- Libraries and other community facilities
- Child care and aged care facilities

Council services generally include engineering, urban planning, public health, trade and household waste services, recreational and cultural services, social or welfare services, security and general local administration. Most of these services are provided to households within the jurisdictions of the councils. A few services are provided across local areas borders.

Councils in rural areas may be responsible for other services such as water supply, airports and caravan parks.

A key feature of the provision of these services is that local council is a sole (monopoly) supplier. For many of these services there are no effective substitutes. In the absence of price regulation, councils would have considerable freedom to charge what they wished for these services subject to local political constraints. In particular councillors are elected for a four year period and are accountable to voters each four years.

Although Australian councils are responsible for delivering several basic economic and social services, Australian local councils have a small role compared with local councils in other similar countries or economies. Total expenditure by local governments across Australia is about 5 per cent of total government expenditure and about 2.0 per cent of GDP.

In 2004 local government revenue constituted less than 3 per cent of total taxation revenue in Australia compared with almost 15 per cent in the United States and about 8 per cent in Canada and Germany. The main source of local tax revenue is general rate revenue. This includes rates on all forms of properties and special rate levies. Rate revenue is typically a combination of a fixed rate per property and an *ad valorem* rate on unimproved capital value. Within the constraints of rate pegging, councils can adjust the level and composition of their rates revenue by altering the percentage rate in the dollar applied to each rateable property and by varying the fixed charge per property and the variable amount.

The Productivity Commission (2008) estimated that general rate revenue accounts for between 1.3 and 1.9 per cent of household disposable income in most council areas across Australia. Table 1 shows local government revenue and rates in relation to gross state product (GSP) and household disposable income (HD) by state.

It is evident from Table 1 that local councils in NSW raise a lower proportion of both GSP and HDI in rates than does most of the rest of Australia.

This is almost certainly attributable to the rate pegging policy that has been in place since 1977. In March each year the Minister for Local Government in NSW determines annually the maximum percentage amount by which councils can increase their annual general rate income, i.e. their income from ordinary rates and annual charges.

The general rate increase is pegged at a weighted average of the general wage price index (ABS, Cat. No. 6345) and the CPI based on the past 12 months with approximately a 50-50 weighting.

Councils can also submit requests for variations to this percentage increase. Indeed when an increase is approved under Section 508(2) for a specified year, the council can employ an escalated base for future rate pegged increases.

Table 1 Local government revenue and rates in relation to GSP and household income

	NSW	Vic	Qld	SA	WA	Tas	NT
Own revenue / GSP							
1998-99	2.13	1.48	2.93	1.62	1.74	2.82	0.92
2005-06	1.97	1.78	3.25	1.68	1.53	2.88	1.38
Rates / GSP							
1998-99	0.95	0.85	1.13	1.11	0.91	1.19	0.63
2005-06	0.84	1.07	1.01	1.20	0.77	1.10	0.49
Own revenue / HDI							
1998-99	3.10	2.33	4.44	2.38	3.00	4.57	1.60
2005-06	3.02	2.76	5.40	2.55	3.09	4.46	2.79
Rates / HDI							
1998-99	1.39	1.33	1.71	1.63	1.57	1.93	1.09
2005-06	1.28	1.65	1.68	1.83	1.56	1.70	0.99

Source: Productivity Commission (2008).

Table 2 Rate increases between 1995/96 and 2003/04

	Per cent increase
NSW	29.2
ACT	35.2
Tasmania	36.3
South Australia	55.1
Queensland	55.6
Western Australia	64.8
Victoria	66.1
GDP	61.8

Source: Independent Inquiry (2006, Allan: Chair).

While many factors affect rate levels and changes, the rate pegging policy does appear to have resulted in lower rate increases in NSW than in other states. Table 2 shows that rate revenues increased by greater percentages in all other states than in NSW.

However rates account overall for about 40 per cent of NSW total revenues. There are many other sources of revenue. Some of these revenue sources are regulated, including major council charges for development approvals, zoning and rating certificates. Also local councils must obtain state government approval for raising any special levies and for any borrowing.

Despite the restrictions on rate revenue, Table 1 shows that councils in NSW raise broadly comparable amounts of total revenue in relation to GSP and HDI as do the other states. This implies that local councils in NSW substitute other revenue sources, notably user charges including parking charges and developer levies, for rate revenue.

Table 3 shows a breakdown of local government revenue by sources by state in 2005-06. Inferences must be drawn cautiously because local councils have different responsibilities in each state and because it is only one year which may affect one-off payments like developer levies. However this table suggests local councils in NSW offset their low rate income to some extent with revenue from sales of goods and services.

Table 3 Local government revenue sources by state ($ per person)

	Council rates	Sales of goods and services	Grants and subsidies	Interest and dividend income	Other revenue	Total revenue
NSW	387	347	173	47	130	1084
Vic	491	184	208	13	133	1029
Qld	442	629	192	38	311	1612
SA	501	138	149	10	48	846
WA	451	232	228	36	176	1121
Tas	422	524	237	51	112	1345
NT	294	283	883	32	220	1712
Australia	439	339	198	33	166	1174

Source: Productivity Commission (2008).

In summary, rate regulation has reduced general rate revenue compared with the rest of Australia. This may have protected NSW households from monopoly rate setting. However it appears that councils have generally increased applications of other tax or charging sources to make good the rate revenue deficit.

2 Rationale and Objectives for Regulating Local Government General Revenues

Monopoly and regulation: general issues

The core rationale for regulating local government general revenues is based on the notion that local government is a monopoly supplier of many basic services. Theory and evidence suggests that monopoly suppliers, be they privately or publicly owned, produce inefficient and/or inequitable outcomes (Abelson, 2008, Chapters 11 and 18).

It follows that effective regulation can improve outcomes. However poor regulation can make outcomes worse. Consequently to design effective regulation we need to understand the nature of the problem, the objectives to be achieved, and the nature of regulatory regimes.

Note first the distinction between efficiency and equity. Efficient outcomes involve efficient use of resources. In the mainstream economics literature, there are two main forms of economic efficiency: providing the goods and services that households want (given their preferences and budget constraints) and producing these goods at least cost. These efficiencies are usually described as allocative and technical (productive) efficiency respectively.

Allocative efficiency includes two sub-sets of efficiency: overall product-mix efficiency and exchange efficiency (Abelson, 2008, Chapter 3). Product-mix efficiency means supplying the total package of goods to consumers that they want (in this case this is the local community). Exchange efficiency means ensuring that the overall product-mix package is exchanged so as to ensure that consumers get the goods that they want. Households who want clean streets get street cleaning. Those who want child care services get child care services.

When markets fail to achieve efficient outcomes, there is market failure. In principle the costs of most forms of inefficiency can be estimated. When governments fail to achieve efficient outcomes there is government failure.

Equity issues arise when goods are sold at prices that are deemed to be unfairly high or when workers are paid wages that are deemed to be too low.

There is often a link between inefficiency and inequity. Monopolies may increase profits by raising prices and restricting supply. Technically price increases are an equity issue and restrictions on supply are an efficiency issue (affecting use of resources).

Consistent with the analysis above there are two main kinds of inefficiency.

1. Allocative inefficiency: failure to provide the goods and services that people want either because (a) they are not supplied at all or because (b) supply is restricted by rationing or by high prices in excess of marginal cost.

2. Productive inefficiency: failure to produce goods and services at least cost.

Although concerns about monopoly suppliers arose initially from analysis of private markets, similar thinking has carried over to the monopolistic supply of essential services by publicly-owned corporation. Although managers of public corporations are subject to different kinds of incentives and constraints to those faced by owners and managers of private corporations, similar inefficient and inequitable outcomes may occur. Concern over such outcomes has led to attempts to regulate the prices and outputs of major public corporations as well as large private monopolies.

In practice, most regulation of monopoly suppliers focuses on price levels and involves price control in some form.[2] A prime aim of such price controls is equity: to ensure that the monopoly supplier provides basic services to low income households at prices that are deemed to be socially fair.

Price controls have limited efficiency benefits. Regulating the prices at which a monopolist can sell may increase demand for a firm's goods but produce little is any increase in the quantity of goods supplied.

Price controls are also a crude but indirect lever to control costs. Regulators hope that by controlling prices, an agency will be forced to control its own costs. Price control may exert some such pressure. However if regulated prices are set on a cost-plus basis, an agency has no incentive to control costs.

Regulators may also attempt to determine provision of goods and services, usually by regulating that a monopoly provider supply certain minimum services to each household, for example telecommunication services in rural and remote areas.

However there is a critical difference between regulating the general revenue of councils with the aim of controlling expenditure and regulating prices. Expenses are the product of goods supplied and their unit costs. Regulation of revenue may reduce expenses by reducing goods supplied rather than by reducing unit costs. This is a concern of critics of rate pegging (for example Allan, 2006).

[2] An alternative and generally preferred strategy is to introduce competition in supply where this is feasible.

Local authorities have some features that are similar to those of private or public corporation monopolies, but they also have some different features. Not only are local authorities monopoly suppliers of many services. They also have tax powers to raise revenue. Whereas consumers of water or electricity can reduce their bills by consuming less water or electricity, households cannot reduce their rates by adjusting their consumption. This provides councils with greater monopoly power.

On the other hand local councilors in NSW are accountable each four years to the tax payers who can vote for alternative service and tax policies. Unlike a corporation that has a consistent profit-oriented objective, the objectives of local councils can change as a result of political competition between members.

It may also be observed that households purchase some common obligations when they purchase a unit in a multi-unit dwelling. In this case the body corporate is a monopoly supplier but all members of a body corporate vote annually on compulsory administrative and capital levies. These levies are typically of the same order of magnitudes as council levies. But Government does not regulate such levies or the amounts by which they may be increased each year. This presumably reflects the greater power of the members to determine their levies on a regular basis as well as the lower costs of changing location.

Regulating council revenues

Turning to more specific local issues, IPART (2008) cites five arguments for regulating council rates (on pages 55 and 63). These are that rate regulation:

1. Prevents use of monopoly power in supply of some basic community services.

2. Helps to control cross-subsidisation and restricts council provision of non-core services that might prove unsustainable.

3. Manages the risk of poor governance in the local government sector.

4. Limits the ability of councils to divert expenditure from essential services to marginal services that could be provided by the private sector.

5. Enhance accountability through the process of checking applications for additional increases.

As they stand, these observations are weakly defined. For example with regard to (1), it is not clear how regulating general rate revenue improves the supply of services. Presumably it refers to the possibility that rate pegging will reduce cost padding. (2) Nor is it clear why restricting general revenue helps controls cross subsidies. (3) Rate pegging may address one element of poor government (excessive rates) but it does not touch many others. (4) Rate pegging may limit the opportunity for diverting expenditure to marginal services, but it affects choice of services (resource allocation) only indirectly. (5) Rate pegging may increase accountability by checking applications for rate increases, but it is only one way to increase accountability.

On the other hand (IPART 2008, p. 55) lists four arguments against rate regulation. State government regulation:

1. Limits councils' ability to provide local services.

2. Prevents infrastructure backlogs from being addressed – infrastructure deteriorates.

3. May result in higher and less equitable user charges (distorts revenue raising; increases need for grants).

4. Is contrary to principles of democracy and accountability in local government.

All four arguments may have some strength. Constraints on general revenue distort revenue raising sources and result in higher user charges than would otherwise occur. Of course, in so far as revenue is maintained, problems of under-servicing would be reduced. But undoubtedly regulation of local council general revenue does limit local autonomy.

Two other points about rate regulation may be observed. Although regulating maximum rate increases is generally expected to control local expenditure, the reverse may occur at least in the short run. Councils generally raise rates by the maximum allowed because they are concerned about eroding the value of their rate base and being prohibited from catching up foregone increases in a later year.

Second, the process of rate regulation may itself be subject to arbitrary political decisions. Currently the basic maximum rate is pegged to a historic price index and there is a lack of transparency about the rules for approving applications for rate increases.

These issues are picked up again in the following sections. In particular the submission stresses the need for evidence to support high level arguments and the need for policy detail. Much depends on how regulations are developed and implemented in detail.

3 Regulatory Options

General practice

There are numerous regulatory options. These options contain several different components. However a key issue is whether the regulator controls rate outcomes or regulates the process of rate making. It is almost universal practice to regulate process rather than outcome. Very few governments regulate outcomes.

An exception was the United Kingdom from the early 1980s up to 1998/99. The Thatcher central government capped local council revenues in order to prevent councils increasing rates to fund various services deemed unacceptable by the central government. However since 1998/99 the government has adopted a discretionary cap policy. Local authorities now decide the total amount of tax that they wish to raise. The central government indicates the average council tax increase in England (currently 5 per cent per annum) and has the discretionary power to cap tax increases where it considers this to be appropriate. In 2008/09, the government instigated capping action against just eight councils.

A significant feature of the UK system is the attempt to protect less well off households by tax reductions for less well-off individuals rather than by controlling the total tax bill. Council bills allow for the circumstances of the taxpayer via a system of discounts and exemptions as well as of the property they live in. There are various allowances for persons living alone, students, live-in carers, and low income earners (IPART, 2008, p. 89).

The Lyons report (2007) endorsed the principle and practice of the current system which (compared with the previous system) links the tax that people pay to the benefits they receive and which provides for local councils to be accountable. Apparently central government has endorsed this report (IPART, 2008, p. 89).

One example (of many) of regulating the process of rate making rather than the rate outcome is the New Zealand approach (McKinlay, 2006). NZ local councils have a high level of autonomy over both the amount and the kind of rates that they can levy. They can establish an *ad valorem* rate or a fixed rate in respect of any property or properties defined by a wide range of characteristics. There are only a few statutory limitations, for example there is a restriction on the percentage of revenue that may be raised through a uniform annual general charge.

This freedom to determine the annual rate revenue is subject to accountability procedures. Local councils must prepare a Long Term Council Community Plan (LTCCP) every three years, which can be amended with public consultation between these times. The LTCCP must also contain a report from the local council's auditor on the extent to which the council has complied with the Act in respect of the LTCCP and various other conditions such as the information and performance measures provided.

As reported in IPART (2008) most Australian states regulate the process of rate making rather than the outcomes. For example, in Victoria councils are allowed to strike their own rates. Councils are required to prepare a rates and charges impact statement and undertake community consultation. The government has reserve powers to control rate setting.

In Tasmania, councils have full responsibility for setting rates providing processes detailed by the state government are followed. Councils must prepare a five-year strategic plan, an annual operational plan, publish budgets and hold open public meetings at which the budget is discussed and determined.

Regulatory options for NSW

Regulatory options for general rate revenues fall into three main groups.

A. State government regulation of general rate revenue outcomes;
B. Discretionary controls over general rate revenue outcomes; and
C. Regulating the process of rate revenue setting.

Shown below are five options under (A) including the existing rate pegging system, one option under (B) and three options under (C). The five options in (A) and one of the (C) options can be found in IPART (2008, pp. 63-4). However IPART devotes little discussion to (B) or (C) class options. Clearly more options could be generated and importantly more design detail could be developed. However, the options presented here provide core choices for government.

Regulation of rate revenue outcomes

A1. Retain the existing rate pegging system.

Government sets maximum increase in general rate revenues annually but allows exceptions on applications by local councils. The rate peg is apparently based on a weighted index of wage and price increases over the previous 12 months. There do not appear to be formal criteria for applications for rate increases above the peg. DLG (Circular to Councils dated 29 October 2007) outlines the process for lodging applications, the format of application and the reasons for applying, but not the criteria for the assessment.

A2. Retain existing rate pegging with improved criteria.

The existing rate pegging system would be retained but with more transparent criteria. Government would publish the economic indicators (or indices) used to determine the basic rate cap and more detailed criteria required to justify an increase above the rate cap.

A3. Retain rate pegging with variations by type of council and improved criteria.

Government would retain existing rate pegging arrangements but develop transparent indices for separate groups of councils or for separate sets of costs within councils.

A4. Retain rate pegging for operating expenditure.

Rate pegging would cover operating expenditure (including depreciation) and exclude capital expenditure.

A5. Retain some form of rate pegging but some council exemptions would be allowed.

Rate pegging would remain in place but individual councils would be allowed to determine rates if they could demonstrate financial and efficiency indicators including affordability and availability of local services and have a medium to long-term audited management plan. Examples of financial indicators would be the unrestricted current ratio (UCR) or the debt service ratio (DSR). UCR equals current assets / current liabilities. DSR equals principal and interest payments / own or total revenue.

Discretionary controls over rate revenue outcomes

B1. Councils would determine their general rate revenues with government holding discretionary reserve power to determine a council's rates.

Councils would be able to determine their rates. However, as in the UK model, government would advise local councils on appropriate rate ranges and processes. It would reserve the right to cap council rates where council decisions were deemed by various criteria to be inappropriate.

Regulating the process of rate setting

C1. Councils determine general rate revenue subject to meeting regulated processes.

Government would determine the governance processes, such as development of management plans, compulsory reporting, and public consultations. These would be based on the current Department of Local Government proposals that local councils operate formally with a ten-year Community Strategic Plan, a four-year Delivery Plan and one-year Operating Plan, with community input into the development of each plan. Additional features may be derived from the Victorian, Tasmanian, Canadian or New Zealand models.

If councils do not follow the regulated process, a rate peg may be applied. However rates would be regulated by state government only if there were a failure of due process. Government would also retain reserve powers under designated conditions to determine rates or take over local administrations in the event of gross incompetence or malfeasance.

If the state government considers that it is necessary to provide some protection for low-income households, this option could include some rate rebates for low-income households as in the UK model. However the need for this is lower than in the UK where rates are a higher percentage of HDI than they are in NSW.

C2. Councils determine general rate revenue with only minimal regulations.

Under this option, councils would be subject to minimal process regulations. In essence this is the maximum de-regulation / highest local autonomy option. The option is included for completeness in contrast to (C1) which is conceived as a regulated process.

Finally there is the issue of which government agency should determine any regulation, whether of outcomes or processes. Presently the Minister for Local Government makes the determinations. IPART has been asked to advise whether it should have a regulatory role, which could be determinative or advisory. This issue is taken up in Chapter 6.

4 Criteria for Assessment of Options

IPART (2008, p.6) proposes that the options for the regulatory framework should be assessed against four main criteria. These are that the framework:

1. Promotes (a) effective and (b) efficient provision of local government services.

2. Enhances the financial sustainability of local government.

3. Meets the standard principles for good regulation and taxation, including
    a) efficiency
    b) equity
    c) simplicity
    d) transparency.

4. Enhances the accountability of local government.

Actually this represents eight criteria because (1) contains two criteria and (3) contains four criteria.

What these criteria mean and how they might be applied in an operational context is examined below.

1a Effective provision of local government services (allocative efficiency),

1b Efficient provision of local government services (productive efficiency)

IPART (2008, page 61) defines "effective" provision as providing the mix of local goods that the community demands. As discussed in section 2 above, in the economics literature this criterion is usually described as *allocative efficiency* and includes product-mix and exchange efficiency.

IPART (*ibid.*) defines "efficient" provision as providing the mix of local goods at least cost. This is generally described in the economics literature as *technical* or *productive* efficiency.

Allocative and productive efficiency in resource use are standard criteria and terms for assessing policies. This submission generally employs these terms rather than "effective" and "efficient" provision.

2 Financial sustainability of local government,

IPART (p. 43) states that a council is financially sustainable when it can meet its long-term service and infrastructure levels and standards *without unplanned increases* in rates and disruptive cuts to services.

However expectations have little to do with the ordinary meaning of sustainability. A corporate or public agency would normally be described as financially sustainable if its revenue sources are sufficient to meet all required expenses regardless of whether the revenue charges were planned or unplanned. Sustainability requires an ability to finance future expenditures; it does not require accurate expenditure or revenue forecasts.

However, as the Productivity Commission (2008) pointed out, the financial sustainability of local councils depends fundamentally on their disposable income base. It does not depend on the method of rating or on the value of the tax base. Nor does it depend on the method of rate regulation.

Accordingly it is considered that financial sustainability properly defined is not a significant criterion in evaluating regulatory options for council rates.

3a Efficiency of regulation and taxation

In the mainstream economics literature, efficient taxation means taxes that have little effect on individual or corporate behaviour or on the allocation of resources to consumption or production. Efficient taxes therefore have little if any deadweight loss.

The regulatory regime for rating may distort the revenue raising methods of local councils (for example towards more user charges or developer levies) and create deadweight losses. While it would be expected that any such distortions to be generally minor in effect, in some cases, for example with developer levies, they could create significant distortions.

3b Equity of regulation and taxation

As has been noted above, protection of households from higher rates is a significant political objective. Rate regulation is driven partly by the desire of government that rate increases are moderated and that local services remain affordable. Thus alternative regulatory options need to be considered in terms of potential equity impacts.

3c Simplicity of regulation and taxation (administration and compliance costs)

The objective of simplicity is basically minimization of administration and compliance costs for taxes or regulations. This is a standard criterion to apply to taxes and regulations and could potentially be relevant to choice of regulatory regime.

3d Transparency of regulation and taxation

Transparency is a generally cited criterion for good governance. However this criterion applies to design and implementation of regulation rather than to choice of regulatory options.

4 Accountability of local government

The principle of accountability is often linked with the principle of autonomy. Individuals should have a right to make their own decisions (autonomy) and they should be accountable for them. These principles are linked to the concept of economic efficiency. It is often argued that individuals or groups of individuals make more efficient decisions if they make, and are accountable for making, their own decisions. However, in this case accountability is simply an instrument of, and not separate from, efficiency.

It may also be argued that people have a right to make their own decisions and that individuals should be accountable for what they choose. These are ethical or political judgments rather than economic ones. However given that they are generally held in Australian society, accountability may be held to be a separate criterion from efficiency.

Options for regulating general rate revenue should in principle be assessed in terms of the following criteria:

1. Allocative efficiency in council use of local resources,
2. Productive efficiency in use of resources,
3. Potential deadweight losses due to inefficient revenue raising,
4. Protection (equity) for low-income households in local council areas,
5. Administration and compliance costs, and
6. Accountability.

For the reasons given above, this submission considers that financial sustainability is not an useful criterion for choosing a regulatory regime.

Transparency is an important objective but it is a design issue that can be incorporated into any chosen regulatory regime.

5 Evidence for Assessment of Options

Ideally the regulatory options would be assessed in terms of the six criteria discussed above with evidence to support them. However the evidence does need to be relevant to the regulatory options. It is important to determine whether a particular regulatory option will make NSW councils more or less efficient or equitable. Broad indicators of council efficiency are not helpful in choosing between regulatory options. Financial indicators must also be used with considerable caution. If relevant evidence is not available, the assessment can to some extent draw on economic principles. Some appropriate evidence and principles in relations to the six criteria is discussed below.

Allocative efficiency in council use of local resources

There are various hypotheses about the impact of rate regulation on council expenditures. These include:

- Rate pegging stops councils spending money on discretionary low value projects;
- Rate regulation restricts councils revenues and expenditures and may result in poor services;
- Rate pegging has no effect on expenditure because councils draw on substitute revenue sources; however this may create other economic costs (see below).

The third dot point needs to be resolved first. Here it is possible to draw on comparative inter-state data on the level, growth rate and composition of Australian inter-state data. As has been noted, inferences from inter-state data must be made cautiously because of differences in institutional and economic circumstances. Also comparisons can be made between growth rates in Commonwealth and State government expenditure and local government expenditure in relation to GDP.

This data suggests that rate regulation has slightly reduced council spending in NSW relative to other states and levels of government.

If this is the case, the question arises as to whether the revenue constraint has limited poor discretionary local projects or resulted in under-provision of core services and infrastructure? Such a question is not easily answered.[3]

This question is probably best resolved by community surveys which test for local preferences on the level of services, quality of infrastructure and size of taxes. While

[3] This is usual. It is harder to test for allocative efficiency than for productive efficiency (Abelson 2008, Chapter 18).

councils do carry out community surveys, It is not known to what extent they deal with trade-offs between rates, services and infrastructure.

Applications by local council for variations to rate pegs may also indicate council needs. However councils may not apply if they expect a negative outcome.

There have also been several reports on infrastructure backlogs in NSW which may contain reliable evidence. However in the absence of information of local community preferences an adequate level of infrastructure is hard to define and measure.

Financial ratios may also provide limited information. PricewaterhouseCoopers (2006) suggests that the ratio of capital expenditure to depreciation must be greater than 1.0. Otherwise infrastructure is a declining asset. However this ratio relies on an appropriate estimate of depreciation in current dollar values. It also represents a minimum desirable achievement when there is population or income growth.

Productive efficiency in use of resources

With regard to productive efficiency, the main hypothesis is that, by restricting revenue, rate regulation will increase productivity and reduce unit costs. This again assumes that councils cannot substitute other revenue sources for constrained rate revenue.

If councils cannot fully substitute other revenue sources, then it has to be further found that the revenue constraint reduces unit costs rather than services. It is not clear why a revenue constraint would necessarily reduce costs rather than services. In addition, given that there are several regulatory options, it would need to be shown which option had the greatest effect on productivity.

In this case evidence on the unit costs of services is needed in NSW and in a suitable control group, such as Victorian councils. Such evidence may not be readily available.

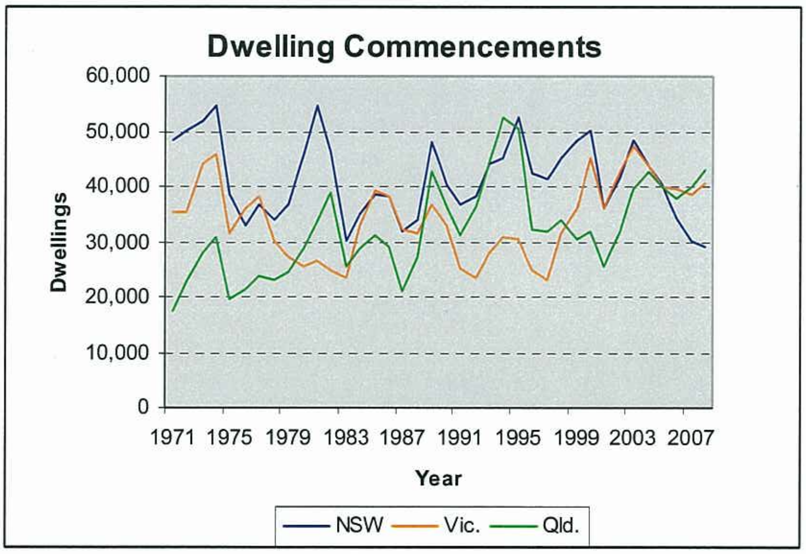
The 30 key performance indicators that the Department of Local Government compiles annually on local council services provide information on a range of efficiencies in NSW (IPART 2000, p, 45). These KPIs could be compared with interstate KPIs if comparable indicators exist. However variations in sizes of local councils and other significant factors would have to be taken into account. Again considerable care would be needed in attributing performance differences to rate regulation.

Potential deadweight losses due to inefficient revenue raising (revenue inefficiency)

The main hypothesis here is that rate regulation may cause councils to employ inefficient taxes or charges that distort consumption or production choices instead of rates which have little distorting effect on the use of land. In particular there is concern that NSW councils have raised developer levies to make good a shortfall in rate revenue. This in turn may restrict the supply of new housing in the state.

Developer levies cannot in general be passed forward directly in higher house prices because new house prices are determined by the value of their services relative to the values of existing houses. Therefore in the first instance a developer levy is a tax on the landholder. However if the levy is too high, landholders will hold on to the land in alternative uses, notably in rural residential use, rather than sell it to developers. Consequently the supply of new houses is restricted. It should be possible to test whether, and the extent to which, this has occurred by examining the market conditions for new housing.

Dwelling commencements in NSW are at record lows. For the 12 months to March 2008, the Australian Bureau of Statistics reports that there were 29,153 dwelling commencements in the State. This represents a 2.9% downturn on the previous year. This is in stark contrast to dwelling commencements in Victoria and Queensland which were up by 5.9% and 7.6% respectively for the same period. The fact that other states are experiencing increased construction activity at the same time as NSW is facing a downturn indicates that the situation in NSW is caused by local factors rather than broad economic drivers that drive the housing cycle.



Source: ABS Number of dwelling units commenced – houses and other residential (original)

Another concern is that NSW councils have engaged in risky financial transactions (borrowing or lending) in order to increase their rate base. IPART (2008) reports that there is no evidence that NSW councils have increased their borrowing due to rate pegging. On the other hand, they may have engaged in risky investments (Cole, 2008). It may be possible to examine whether NSW councils have adopted riskier investment strategies than councils have in other states.

Protection (equity) for low-income households

The main equity hypothesis is that rate pegging protects households by holding down rates. It must be further argued that households gain more from the lower rates than they do from any restrictions on services.

To assess these perspectives, it is necessary to identify how councils actually react to regulations on their rates. Do regulations on rate increases actually reduce rates compared with a regulated process for rate making? If they do, what happens to total revenue? Does rate regulation increase borrowing? Does it result in a cut in services or costs? Such information is a prerequisite for assessing equity effects.

Rate regulations may also have indirect equity affects. Of particular concern is the possibility that developer levies have restricted housing supply and hence increased house prices and reduced affordability.

Administration and compliance costs

Different regulatory options would impose different workloads on the government and different compliance costs on councils. Estimating the costs of the regulatory options may require making some assumptions if these alternatives are not currently operational anywhere. However these costs are unlikely to determine the choice of option,

Accountability (autonomy)

As has been noted, accountability may affect efficiency because councils that are accountable to voters are also likely to be more responsive to their preferences. In so far as this is the case, the effects of lack of accountability due to rate pegging would be picked up in any efficiency measures.

However accountability may also be viewed as an important democratic principle. This is a political issue separate from considerations of economic efficiency. The weight to be accorded to accountability is then a political judgment rather than an empirical question.

Summary

An assessment of regulatory options for rates depends on estimates of the impacts of the options on rate revenue, general council revenue, the provision of services and unit costs. These impacts should be estimated *relative to* other regulatory options and not to an irrelevant benchmark.

It may be possible to infer outcomes from comparisons of NSW and interstate councils. Community surveys may also be an important source of data on community preferences. Expert assessment of infrastructure and financial indicators may also provide some information but such data needs to be used carefully.

6 Conclusions

In section 3, seven regulatory options were identified. In reviewing these options below this submission concludes that there are two main options: a preferred method for regulating rate outcomes and a preferred general method for regulating rate processes. These two main options are then assessed drawing on the criteria developed in section 4 and evidence such as it currently exists discussed in section 5. This submission finds that the arguments point towards an option that regulates the process of rate making rather than rate outcomes. However more work is needed on specifying exactly how this process would work. Finally there is a short discussion of the role of IPART in the regulation process.

Selecting a short-list of regulatory options

In section 2, *five methods of regulating rate outcomes were identified.* Of these options, this submission considers that (A2), retaining existing rate pegging with improved criteria, best achieves the objectives of rate pegging with least complications. Option (A2) is preferred to (A1), the existing system, because it increases the transparency of the process and the certainty of the outcomes.

Under Option (A3) the regulator would develop different basic rate pegs for different groups of councils. However councils would presumably still have the option of applying for rate variations. This system would be considerably more complex than the present one. It is not clear how the regulator would determine the different base rate indices for which councils and administrative costs would rise. The current system allows the regulator to make exceptions in the second round. Under preferred option (A2) the regulator would clarify these conditions. Thus (A2) would achieve similar outcomes to (A3) but in a simpler way.

With option (A4), rate pegging would apply only to operating expenses and not to capital. Councils would apparently be allowed to raise rates as they considered appropriate for capital expenses. However councils could mix capital and operating expenses and it would be hard to audit the distinction. There would be over-building of facilities and under-maintenance. Option (A4) could also encourage councils to raise rates rather than borrow to fund capital expenditure, which could be quite inappropriate.

Under option (A5) rate pegging would be retained but councils that meet financial and performance standards would be exempt. It is not clear if such standards would be based on a few financial parameters or a detailed audit. These indicators are nearly always partial indicators of performance This submission does not consider it appropriate for councils to be audited in detail to establish whether or not they should be exempt from rate pegging. It is not clear how the criteria for exemptions by audit would be set. The five financial performance indicators in IPART (2008, Box 6.1) may be useful for some purposes but they are essentially arbitrary and not appropriate for determining whether a council is fit to make its own rate determinations. If the implication of option (A5) is that rate pegging should be retained as the default option, then option (A5) does not seen to have any advantages compared to option (A2) which effectively allows councils to apply for exemptions.

Of the two group (C) options *involving regulation of the process of rate making* option (C1), a strongly regulated process, is the preferred option. Given the weak governance associated with the four yearly electoral cycle for local councils, a highly deregulated process whereby councils could determine the process of annual budgeting and raising rates would pose a major governance risk.

Finally option (C1) seems preferable to option (B) under which local councils are allowed to make their rate determinations providing they are broadly in line with centrally determined advice. Under (C1) councils have a presumption of autonomy and have more flexibility within a regulated process than they would have under option (B). However the state government would have the power under (C1) to make determinations where due process was not followed or where there was evidence of misgovernment according to established criteria. Thus the state government would have effective rate capping powers when they were needed under (C1).

Regulating rate outcomes or rate processes: option A2 or Option C1

Options (A2) and (C1) are compared using the six assessment criteria in Table 4. This analysis suggests that any benefits from rate pegging are minor. The regulation of rate outcomes has capped rate increases below those in other states. And it may have provided some discipline to local councils and ensured that some poor projects were not undertaken.

On the other hand, councils have to some extent substituted other potentially less efficient revenue sources for the loss of rate revenue. And in so far as general revenue has been restricted there appears to be a significant infrastructure backlog in NSW. Rate regulation also fails the accountability criterion.

Regulating the rate making process can achieve the major aims of rate regulation without the costs. Local council decision making and services should be more responsive to local household views. Taxes and charges can be selected on their merits rather than by regulation. If the issue is considered significant, low-income households can be protected by targeted rebates. State government would also retain the power to check abuses of process or seriously incompetent or corrupt government.

Table 4 Comparison of rate outcome and rate process regulation (Options A2 and C1)

Criteria	Regulation of rate outcomes (Option A2)	Regulation of rate process (Option C1)	Evidence
Allocative efficiency	May have no effect on general revenue. If it does reduce revenue, it may stop some poor projects. But it may also result in poor services and infrastructure backlogs.	Local council decision making and services should be more responsive to local household views. State government would retain power to check abuses of process.	Effects on general revenue unclear. Some evidence of infrastructure backlogs with rate pegging. Community surveys could provide more evidence on local spending and rating preferences.
Productive efficiency	Revenue controls may exert pressure on productivity and reduce unit costs of services but may also reduce services.	Public scrutiny of costs should increase productive efficiency.	Little evidence exists on effects of rate regulation on productivity and unit costs.
Revenue inefficiency	Rate regulation may lead to inefficient taxes replacing an efficient tax on land. It may also have encouraged risky investments.	Taxes and charges can be selected on their merits rather than by regulation.	Some revenue substitution appears to have occurred. May have led to increased developer charges and housing prices.
Equity (affordability)	Rates in NSW are lower than in most other states. But other local charges are higher in NSW. The impacts are minor in dollar terms and poorly targeted.	If the issue is considered significant, low-income households can be protected by targeted rebates.	Data on rates and other revenue are available.
Administrative cost	Administrative costs are small.	Given state governance plans for local councils, incremental administrative costs would be quite small.	Costs can be estimated.
Accountability	Not accountable	Accountable	Not an empirical issue.

It follows that IPART should devote considerably more time to developing and designing efficiency and democratic rate regulating processes.

The Role of IPART

Finally there is the issue of which government agency should determine any regulation of local council rates or rate making. As IPART (2008) notes, its role could be determinative or advisory.

The NSW Government should determine the policy guidelines. These guidelines will vary of course according to whether the Government elects to continue to regulate rate outcomes or moves to a policy of regulating the process of rate making as recommended by this report. Thus, if government decides to regulate the process of rate making it would lay down the basic requirements of this process subject to standard consultation processes.

However, once these policy guidelines are determined, there is merit in having an independent regulator reviewing local council compliance with these guidelines. This should be an objective and technical process. In the event that the government is not satisfied with the way the process works, it would be free to change the guidelines.

However separating policy determination from policy implementation increases transparency and efficiency of governance.

References

Abelson, P., 2008, *Public Economics, Principles and Practice*, McGraw Hill, Sydney.

Access Economics, 2006, *Report commissioned by the Allan Inquiry.*

Allan, P., Darlison, I and Gibbs, D., 2006, *Independent Inquiry into the Financial Sustainability of Local Government.*

Cole, M., 2008, *Review of Local Government Investments.*

Fiscal Star, 2008, *The Financial Sustainability of the Existing Financial and Infrastructure Polices of NSW Councils*, 2008 Review.

Hawker (Chair), 2003, *Rates and Taxes: A Fair Share for Responsible Local Government*, Standing Committee on Economic, Finance and Public Administration, Commonwealth of Australia.

Independent Pricing and Regulatory Tribunal, 2008, *Revenue Framework for Local Government, Issues Paper*, IPART, Sydney.

PricewaterhouseCoopers, 2006, *National Financial Sustainability Study of Local Government*, commissioned by the Australian Local Government Association.

Productivity Commission, 2008, *Assessing Local Government Revenue Raising Capacity*, Melbourne.