SSROC
SOUTHERN SYDNEY REGIONAL ORGANISATION OF COUNCILS

**Southern Sydney Regional Organisation of Councils**

# Submission on Review of the Revenue Framework for Local Government

Submission to:

Review of the Revenue Framework for Local Government
Independent Pricing and Regulatory Tribunal
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# EXECUTIVE SUMMARY

This submission has been prepared for the Southern Sydney Regional Organisation of Councils in response to the invitation of IPART for responses to its Issues Paper entitled Revenue Framework for Local Government. There are three matters for consideration by IPART:

- an appropriate intergovernmental and regulatory framework for setting rates and charges that facilitates 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.

This submission is focussed on the first two matters. The Issues Paper poses some 52 questions related to issues that it raises. There is no attempt to address all of these questions.

**Options presented in IPART Issues Paper**

7.4 of the Issues Paper identifies five options for alternative regulatory frameworks. Four of these are variations on different forms of the rate pegging system.

A principal thrust of this submission is that rate pegging has been a major factor in reducing the revenue base of the local government system in NSW (Section 1), and is an integral part of the problems of financial sustainability difficulties of the bulk of councils in the State. On this basis Option 5 (to institute measures to enhance accountability to the local community and remove mandatory rate pegging) is the only option that is supportable. On page 65 IPART seeks comment on the role IPART play in setting local government rates and charges in future years. If Option 5 is accepted there is no role left for IPART as mandatory rate pegging would be removed.

**Matters to be considered**

This submission considers only two of the matters listed. These two matters are very restrictive. They appear to involve a rearrangement of roles whereby IPART takes over from the Department of Local Government the responsibility of setting limits on rate increases, and provides a new regulatory process for this. There are also strong intimations that the new arrangements have a direct relationship to changes made by the Department of Planning in relation to developer charges made by councils, and on re-directing rates that now go to certain councils by some public authorities to the Department of Planning. In contrast in Appendix A (the formal terms of reference of Premier Iemma) there are 12 main terms of reference to which IPART is to have regard. These terms are really about building a robust financial system for local government. Given the terms of reference this submission addresses this critical challenge.

## Section 1: The Impact of Rate Pegging

The major conclusions in this section are:

- The failure of the rate pegging system since 1993 to provide rates cap increases that match either the CPI increases or the (much higher) increases in council cost increases.
- The failure to provide appropriate increases in rate levels has damaged the financial stability of the local government sector, and has been based largely on political considerations.
- The relativities between councils has been frozen in time as they are based on rate distributions in 1977. This has inevitably destroyed any prospect of rate revenue being shaped in accordance with the shifts in the economic and social shifts across the system.
- Comparisons with other States show that NSW local government has had the slowest revenue growth in the country.

## Section2: Cost Shifting & Local Government Revenue

The major conclusions in this section are:

- The IPART recommendations of removing local government of payroll tax exemption will increase local government costs by $180 million a year (current estimates).
- There is a potential for a perceived conflict of interest on the part of IPART. It is engaged with making improvements for the financial sustainability in this review, but adds considerably to the rate pegging problems by suggesting that the $180 million would be gained by lifting the rate limit. The communities, who would pay the increase, would be $180 million out of pocket and would receive no benefits from their increased costs. Instead they would be paying this sum to State Treasury via their council.
- There is another recommendation by IPART to lift local government's fire levies from 13% of the cost of the fire services to 86%, an increase of $427.77 million a year on current estimates. Local government is reduced to the role of a tax agent for the government. Again there are perceived conflicts of interest arising from IPART's dual roles.
- The beneficiaries of this change are insurance companies. The fire services do not benefit and local government would have to raise its rate revenue by over $400 million a year. IPART bases its recommendations on arguments on a report of the Insurance Council of Australia. Analysis of that argument shows that the assertions of the ICA cannot be supported by the relevant data.
- The sum total of just these two rate rises in a year following IPART's recommendations would be $608 million, blowing the purpose of the rate pegging system away. The recommendations would cause an immediate financial crisis in Councils.
- Beyond these two areas, councils face a further wide range of levies, imposts and charges imposed by the State Government. A request to NSW Treasury for details of these costs was unfortunately refused. Such a refusal is hard to justify in the context of open and transparent Government. SSROC has now set about gaining this information through Freedom of

Information processes. It would be appropriate for IPART to gain this data as a critical component of its deliberations.

## Section 3: Local Government Financial Challenges

- A prime obstacle to developing a new regulatory framework is the functional disparities across the local government system creating a complex and ill-defined situation which is likely to produce inefficient and inequities
- The system is not static and the roles (and therefore costs) of councils are continually changed by additional roles being added by the State. The rate of new cost demands emanating from this puts almost unsustainable strains of council's financial management and planning.
- The proposition to use the national classification of councils as a base on which to differentiate limits would give some more applicability of the rate caps but the classifications are based on only two criteria and do not reflect the interactions between the different groups which underline the dynamics of economic and social change.

## Section 4: Structural Impediments in Local Government

- The issues paper does not address the principal issues underlying the financial sustainability of councils, particularly the infrastructure challenges. Instead of simply arranging a new regulatory system for rate pegging the real need is to establish whether councils are part of the economic engine of the State (which they are) and then designing systems within which councils can operate as business entities.
- Politics have intervened with attempts to create a sounder local government system. The current emphasis of strategic collaborations cannot solve the myriad challenges that the system faces. Regional groupings of councils could become a powerful part of a reformed and renewed local government system but legal and other barriers obstruct their progress.

## Section 5: Review of the Issues Paper

There are a number of statements and conclusions within the Issues Paper, some of which are deemed incorrect and some of which are highly debateable. This section points to these situations.

# SECTION 1

# The Impact of Rate Pegging

## 1.1Measuring the impact of rate pegging: From the beginning

- In 1975 the Minister for Local Government, the Hon. H.F. Jensen, introduced the Local Government (Rating) Further Amendment Bill in the NSW Parliament. In the second reading of the Bill, Minister Jensen stated that there would be an inquiry into rate pegging to evaluate its performance after its implementation. In advance of the 1993 Local Government Act an inquiry into Local Government Rating and other revenue powers and resources (Oakes Committee 1990 was instituted), followed by a report in 1991 by the NSW Rating Task Force. In 2008 Premier Iemma called on the Independent Pricing & Regulatory Tribunal (IPART) (established in 1992) to investigate and make recommendations on three matters, two of which concern this submission. They are: an appropriate inter-governmental and regulatory framework for the setting of rates and charges that facilitates the effective and efficient provision of local government services in NSW; and, a role for IPART in setting local government services in NSW. This, therefore, is not an inquiry into rate pegging, as promised by Mr. Jensen over three decades ago. It would appear to be an internal shift by the State Government to pass the task of administering the rate pegging determination from the Department of Local Government (DLG) to IPART.

- As such, this constrained review is counter-productive to the goal of creating an effective and efficient provision of local government services in NSW. The reality is that the overall financial state of the local government system is in a parlous state. Many councils face great difficulties in matching their revenue to the demands for expenditure generated by communities and by other levels of government. On top of this year-by-year struggle there is a massive financial challenge facing the system caused by the widespread poor state that is of infrastructure either reaching the end of its economic life, or of having to create new infrastructure in growth areas. A not unrelated factor in creating the broad neglect of ensuring that robust and well-managed systems of infrastructure were maintained or created, began around the same time as rate pegging was introduced. The problems of stagflation lay behind both issues. Rate pegging was intended to protect communities (hit by sudden rises in inflation and high unemployment) from excessive increases in council rates.

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- Councils have struggled over many decades to find sufficient funds to meet their obligations to their communities. The Whitlam Federal Government recognised the problems faced by councils' essentially having only one taxation base, property rates.

- In 1975 that Government introduced the Commonwealth Grants Commission system, the financial basis of which was then called the Commonwealth Revenue Sharing Funds. The system was devised according to principles of horizontal fiscal equalisation[1], with the intention of providing enough funds to present every council with the opportunity to provide standard levels of services. The Commonwealth and State initiatives became operational at the same time (1977), but with contrasting purposes. The Commonwealth system was based on the insufficiency of funds coming out of the rating system. The State system was designed to cap the flow of funds from rates. Prior to the creation of the Federal funds pool for Local Government, the State had its own financial aid system. This was much smaller in dollar terms and was administered on competitive grounds rather than the equalisation of opportunity across the whole local government system. When the Federal system was introduced the State fund was discontinued. This arrangement was negotiated between the two spheres of government, with the NSW government agreeing to fund the operations of the Federal system.

- The system introduced in 1977 by the State Government has been variously called a rate pegging or a rate capping system. There is an important difference. A rate cap indicates that a limit will be placed on the level of rate increases that can be made by councils in any one year. A rate pegging system implies that rates are pegged to some external reference point. Often this is believed to be based on the rate increase in relation to the Consumer Price Index (CPI). In fact there is nothing in the Act that states what the peg might be, and there is no explanation, year-by-year, of what peg(s) might have been used by the Minister in setting the cap, if indeed any peg has been used. Regularly, comparisons with the CPI tend to be made when rate caps are announced.

- The CPI is a measure of changes, over time, in the prices of a basket of goods and services acquired by households in the eight capital cities in Australia. Council expenditure contains items that have little in common with the basket of goods that households might purchase. If decisions on the level of the cap were to be based on household expenditure, as opposed to council expenditure, there is a clear bias in not taking council's expenditure needs into account. This is a fundamental flaw in the rate pegging system. The fact that the rate of the rise in the costs of

[1] *The system has never strictly applied complete horizontal fiscal equalisation as is applied in Commonwealth-State situations where wealthier councils are intended to provide for less wealthy councils. The general opinion has been that the limited ability of almost all councils to match revenue with expenditure demands is such that strict application of the principles is not necessary.*

council expenditure is normally greater than that of household expenditure (the price of councils' basket of goods is heavily based on the costs of materials, petrol, and employment) means that council prices rise faster than household prices, aggravated by jumps in imposts from other levels of Government, increased demands by communities, and the serious pressures created by infrastructure requirements. For this reason rate pegging has had a pernicious impact on the capacity of councils to produce the efficient and effective provision of services that the IPART process is meant to produce.

❖ Table 1.1 shows the percentage increases in the statutory limits on rates and the CPI increases in Sydney over the period 1978 to 1991. The data show that the increases in statutory limits were 77.4% greater than the CPI increases. In some years the difference was substantial: increases in statutory limits were 494% greater in 1978; 212.5% greater in 1980; 184% greater in 1981; and 220% greater in 1985. In just two out of the 14 years rate caps were greater than CPI increases, and then by a small margin.

Table 1.1 - CPI and Statutory Limits % Increases 1978-1991

| Year | CPI | Statutory Limits |
|---|---|---|
| 1978 | 1.6 | 9.5 |
| 1979 | 3.3 | 8.0 |
| 1980 | 3.2 | 10.0 |
| 1981 | 4.4 | 12.5 |
| 1982 | 5.4 | 12.0 |
| 1983 | 6.1 | 11.0 |
| 1984 | 3.7 | 8.0 |
| 1985 | 2.5 | 8.0 |
| 1986 | 5.7 | 8.0 |
| 1987 | 6.8 | 7.0 |
| 1988 | 6.1 | 6.5 |
| 1989 | 6.9 | 6.5 |
| 1990 | 7.5 | 7.3 |
| 1991 | 5.0 | 6.7 |

*Source: DLG and ABS*

❖ The setting of statutory limit increases significantly above those of the CPI was clearly done with a realisation that councils' revenue needs were greater than household needs if basic levels of services were to be maintained. This did not satisfy Local Government of the time. In a submission to the NSW Grants Commission in 1978 made by the Presidents of the Local Government Association of NSW and the Shires Association of NSW, they noted that the then very substantial funds provided by the Commonwealth had "so far by no means solved local government's financial problems. In this State in particular, perhaps the most important factor has been the intrusion of the State Government into the autonomy of the local authority through its rate pegging legislation". The Associations complained about the expansion of local government services at the time: "*Enough has been said over the last three decades about the inadequacy and iniquity of the rate system being required to finance services in greater width and depth than it was ever originally envisaged. This philosophy has won acceptance at electoral and state level. The most important recognition has been the introduction of a formal revenue share system by the commonwealth government*". Clearly local government recognised the irony of the recognition of revenue needs by the Federal Government being countered by the introduction of State Government actions to reduce revenue income. In this context the levels of rate caps increases were made large enough to provide some modicum of compensation for councils.

❖ The situation changed significantly in the 1990s and through to the current decade. The relationship between increases in statutory limit increases and CPI was reversed. In 12 years, 1993 to 2006-2007 (Table 1.2) CPI increases were 11.7% greater than rate cap increases; in 9 years CPI exceeded rate cap increases, in one year the levels were the same, and in 2 years rate cap increases were greater than CPI increases.

Table 1.2 - CPI and Statutory Limit % Increases1993-2006/07

| Year | CPI | Statutory Limit |
|---|---|---|
| 1993 | 1.1 | 2.6 |
| 1994 | 3.8 | 3.5 |
| 1995/96 | 5.7 | 2.2 |
| 1996/97 | 1.7 | 2.7 |
| 1997/98 | 0.1 | 3.1 |
| 1998/99 | 2.0 | 1.7 |
| 1999/00 | 2.9 | 2.4 |
| 2000/01 | 7.8 | 2.7 |
| 2002/02 | 4.0 | 2.8 |
| 2002/03 | 3.9 | 3.3 |
| 2003/04 | 3.1 | 3.6 |
| 2004/05 | 3.5 | 3.5 |
| 2005/06 | 4.4 | 3.5 |
| 2006/07 | 4.1 | 3.6 |

*Source: DLG and ABS*

❖ There has been a sharp jump in the rate of increase of councils' yearly expenditure patterns in recent years. The increase for all NSW councils between 1999/00 to 2000/01 was 2.9%. In 2004/05 to 2005/06 the increase was 8.4% (calculated from data in DLG, Comparative Information on NSW

Local Government Councils for the four years). The gap between the Statutory Limit increase and the increase in NSW council total expenditure was 4.9% in the latter two years. The allowable pace of increases in rate revenue has been running at half the pace of increase in council expenditure. The NSW Local Government Rate Determination Model, created by the Local Government and Shires Association in 2003, showed that local government expenditure had grown faster than revenue since 2000. This Model used a variety of indexes relevant to local government, which could counter a fundamental flaw in the processes of rate capping, and bring revenue into line with the real costs of councils. Increases in expenditure vary between councils. The general level of rate increases (outside of rate variations) makes no distinction between councils. This means that communities with a higher capacity to pay for new facilities and services are prevented from doing so. Compounding the problem are the limitations on councils' borrowing capacities which lead to "front-end loading" the costs of infrastructure, creating generational imbalances over the life of such infrastructure.

- ❖ The Queensland Treasury Corporation (QTC) in its findings and recommendations on Financial Sustainability in Queensland Local Government (p.7-8, June 2008) makes the point that "*many local governments are basing revenue increases on or below the CPI, which fails to recognise the 'true" underlying movement in the costs of services provided"*. This observation from a State Agency from a State, which generates the highest local government, total revenue in Australia *and* has no rate pegging system (as indeed the same is true of every other State). In Queensland, as in NSW, since 2003 annual increases in costs to a number of core goods and services have been above the CPI. The QTC report notes that asset management often becomes an early casualty when budgets are tight. Queensland councils have the ability to increase their income flows through rates, user charges, business functions, and (as encouraged by QTC) more use of borrowings.

- ❖ An indicative list of current price increases that affect council's costs is detailed below:
  - Steel up 40%
  - Cement up 6%
  - Aggregates up 5%
  - Fuel up 30%
  - Contractors up 5 to 10%
  - Mill and Fill up 20%
  - Concrete up 10%
  - Trade materials up 10%

  The list is not exhaustive, but it indicates the range of impacts that affect councils, but are ignored within the rate pegging process.

- ❖ The rate pegging system is, and always has been, driven by political imperatives. The NSW Minister for Local Government in the lead up to the 2006 State Elections claimed in Parliament that "*through the past 30 years* *rate pegging has protected the people of NSW from large rate increases*". The reality is that rate pegging, particularly post 2000, has been a prime force responsible for seriously aggravating the financial sustainability problems of the local government system. The Productivity Commission's report, Assessing Local Government Revenue (April 2008), cited three reasons offered for regulations on local government revenue raising: that because councils are monopoly suppliers of some basic services (most particularly local roads); that the governance challenges of lower levels of government might lead to regulation; and that voters aware of governance limitations might prefer regulatory constraints. The first reason of these is economic theorising, and it is totally irrelevant: there is no council in NSW that does not struggle to maintain and build local roads, whilst having no prospects of receiving income from them (despite their so-called monopolistic position). Rates revenue is a necessary force in the provision of services for which user fees cannot be charged appropriately. These include local roads, bridges, street lighting, drainage systems, many parks, and human services such as health or environmental education and assistance campaigns.

- The rating system exempts almost all bodies of the State Government from paying rates, even those parts that are running commercial activities. On top of rate pegging, decreed by the State, councils (and through them their communities) effectively subsidise the activities of the State. There are no reliable data to test the effects of rate exemptions on council budgets, but they must be substantial. In business areas of cities and towns, State offices with substantial office space take up prime locations with non-rateable properties. In rural areas it is not uncommon to find that very substantial areas of land, up to and above 50% of the total area, are taken up by non-rateable government bodies. Given the degree of cost shifting from the State Government to local government, it would appear appropriate that the question be asked as to why State Government (and other exempt organisations) should not contribute to the community by way of rates. Indeed many schools (both public and private) impose considerable financial burdens on councils, particularly in relation to playing fields and other community facilities, yet do not contribute finances.

- Alternatives to rates are frequently suggested by the State Government in its defence of rate pegging in the form of user charges. This depends on the ability of the community to pay, and the social benefits that derive from different functions. The benefit principle must apply in many council situations where essential services would not exist if council did not subsidise them (eg. meals-on-wheels).

- The issue of rates incidence is also relevant to the rate pegging debate. In situations where rates are not capped, expenditure on council rates would be expected to rise with income, where property values are the basis for setting the rate level. Where there are a number of aged persons in a community who are asset rich but income poor, the reverse will be the outcome. In general, however, there is an expectation that property values will be at least partially correlated with income. With rate pegging introducing a flat rate increase across the whole system, wealthy property owners are protected from contributing a higher portion of their income to rates than the poorer members of communities. Council costs vary across the system for a range of reasons (location, topography, environmental factors, external use of council infrastructure etc) but in a period of rapid cost increases there is a general trend for the less well-off councils to struggle more to meet such costs. Another factor is the history of rate capping in NSW. The rate base of the mid 1970s has provided the floor upon which increases have grown over the past three decades. The characteristics of councils, in the number of people and their ethnic and socio-economic characteristics, the density and fabric of the built environment, have changed. The economic bases of councils have shifted, the condition of infrastructure, and the challenges of environmental management have all changed. The historic legacy of rate pegging has been that the distributional face of rate spread across Sydney, and the rest of the State, has been frozen in time.

❖ In a less regulated system, a community's ability to pay (its fiscal capacity) and its willingness to pay, constitute the mechanisms that define what payments and what outcomes will be established for an area. Income, rather than property values, is more appropriate in determining the fiscal capacity of a community, (based on disposable income after other taxes and charges are paid). The revenue-raising effort of councils varies significantly. Sydney councils in general (but with exceptions) draw lightly from their fiscal capacity, but many regional centres and rural areas draw heavily on their fiscal capacities. In an unregulated system (one without rate pegging) these factors would become germane in determining the level of rates, and other income. There are no existing data that would allow any of these 'natural' factors to inform a rate capping system. If such data were available a sensible classification of council types might be used to differentiate rate limits.

## <u>1.2 Comparisons with other States</u>

❖ The Productivity Commission's April 2008 report on Assessing Local Government Revenue (page xxxiii) comments: "*The rate of growth in rates revenue in New South Wales has been among the lowest of all jurisdictions over the past seven years for which reliable data are available. New South Wales also has rate revenue per person below that of most other jurisdictions. Rate pegging in New South Wales appears to be restricting revenue raised from rates, notwithstanding scope for councils to seek variations to mandated rate increases*".

❖ The data (2006/07) presented in the Issues Paper (p.26) points to the taxation revenue of NSW councils being the highest in NSW at $2,574 million, ahead of Victoria $2,502 million and Queensland $2,003 million. This is simply an outcome of NSW's larger population. In proportionate terms the revenue incomes of the three most populous states were 36.7% for NSW, 47.2% for Victoria, and 26.0% for Queensland. Sales of goods and services were: NSW 34.1%; Victoria 19.5%; Queensland 37.4%.

- ❖ The Issues Paper assumes from these figures that NSW is around average for Australian States in the proportion of rate revenue in relation to total revenue. From this the intimation is that despite rate pegging NSW derives a reasonable inflow of revenue from rates.

- ❖ The Productivity Commission report (April 2008) invites another view. The report's data, derived from 2005/06, is one year ahead of the Issues Paper data. The increase of NSW's total local government revenue in 2006/07 was only $154 million ahead of 2005/06 (Queensland's revenue in the same period was $1121 million). The variations in sector sources (rates, and sales of goods and services) for NSW did not change significantly. The Productivity Commission data are presented in terms of dollars per person. In this form the data show quite a different picture of NSW's rate income compared to the local government systems of the other states. (Table 1.3).

Table 1.3 - Local Government Revenue Sources ($/person)

| | Council rates | Sales of goods and services |
|---|---|---|
| NSW | 387 | 347 |
| Vic | 491 | 184 |
| Qld | 442 | 629 |
| SA | 501 | 138 |
| WA | 451 | 232 |
| Tas | 422 | 524 |
| NT | 294 | 283 |
| Australia | 439 | 339 |

*Source: Productivity Commission*

When the Northern Territory is exempted (because its local government system is primarily based on grants), it is clear that NSW councils' rate income, on a per capita basis are considerably below those of Victoria (26.7% higher) and Queensland (12.4% higher). On this basis NSW councils receive the lowest level of per capita funds of all the States.

- ❖ The NAB Government Business group released Financial Management Insights for Australian Councils in March 2008. It calculated the compound annual revenue growth rate (CAGR) by state for the period 2001/01 to 2005/06. As Table 1.4 demonstrates, NSW has fallen a long way behind in its local government revenue growth in this decade. The average of the States nationally is 7.1%. Four States are above the average. NSW languishes at 2.8% below the average. The obvious reason is its system of rate pegging which has strapped the capacity of NSW councils to boost revenue growth to match those of other States. The CARG measure shows that NSW councils are locked into a system, which progressively reduces real income year by year.

Table 1.4 - Council Revenue Growth Rate by State
% Compound rate of growth 2001/02 to 2005/06

| | |
|---|---|
| Northern Territory | 10.1 |
| Western Australia | 8.1 |
| Queensland | 7.5 |
| Victoria | 7.3 |
| South Australia | 6.6 |
| National | 6.4 |
| Tasmania | 6.4 |
| NSW | 4.3 |
| Average of all States | 7.1 |

*Source: ABS*

# SECTION 2

# Cost Shifting and Local Government Revenue

## 2.1 Cost Shifting: Payroll Tax

- The evidence from the Productivity Commission report and the NAB analysis of local government revenue (Section 1) clearly illustrates what is common knowledge: that the revenue flows for NSW councils are inadequate to provide efficient and effective service delivery across the sector. Rate pegging is a constituent part of this problem. The introduction of rate pegging in 1977 ran contrary to the quest of finding solutions for the incapacity of the local government system across the nation to garner enough funds from their singular tax base to provide adequate services. The Federal Government moved in a positive way to supplement council incomes. The NSW Government moved in the opposite direction. This has been a fundamental force in the widespread deterioration in the infrastructure base of the system, now coupled with an expansion in the array of services that councils deliver. The increase in services and the parallel increase in costs have been partly triggered by an expansion in the demands of State Agencies for councils to undertake additional functions or expand existing activities.

- IPART has now linked local government taxes to whole of state issues. The IPART Review of State Taxation June 2008 (p.3) states that NSW's own-source tax revenue represents only 39% of its total state revenue, and that more than half of this comes from just two taxes: payroll tax and purchaser transfer duty. Its own-tax revenue is the highest of all states as a proportion of Gross State Product and per capita. NSW's total revenue is lower than in most other States. IPART considers that the State tax system must be improved if NSW is to meet essential funding requirements without jeopardising its fiscal sustainability.

- IPART lauds payroll tax as one of the most efficient State taxes. It is the highest ranking State tax in terms of performance against standard taxation principles. IPART perceives that there is scope to further improve its efficiency (p.4). It believes that the current tax base is considerably narrower than the potential tax base. It also states that NSW's overall tax competitiveness ranks well compared to other States (except Queensland), and that the composition of State taxes in NSW is more efficient than in other States (p.5). In summary, IPART believes that payroll tax is the State's largest tax and one of its most efficient. It wants more from this tax.

- IPART's short-term solution to getting more payroll tax has two elements: lowering the tax free threshold (which would bring in more groups as payers of the tax; and, over a two year period, removing the payroll tax exemption for councils, and increasing the rate-pegging limits correspondingly (p.7). This is a surprising recommendation for a body charged with the responsibility of developing an appropriate inter-governmental and regulatory framework for the setting of rates and charges that facilitates the effective and efficient provision of local government services in NSW. This system, which demonstrably provides too little tax income to make the system financially sustainable, is one for which IPART may have a future role in setting local government rates and charges in future years. The two reviews into payroll tax and local government rates may reasonably raise the question as to a conflict of interest. The payroll tax proposition is very challenging. It immediately puts a substantial burden on the rate payment system but provides no income to help repair the parlous condition of the revenue base of a large part of the council system.

- IPART (p.94) argues that although employers are liable for payroll tax, in practice, they are able to pass its cost on either to consumers (through higher prices) or to employees (through lower wages). It argues that the economic effect of a broadly based payroll tax is similar to a broad consumption tax. This is a remarkably simplistic explanation of a tax that few in society believe is fair: it penalises those who supply the community with employment. In a period when both the Reserve Bank and the Federal Government have elevated inflation threats to a prime place of importance in their economic management strategy, IPART is effectively praising a tax that pushes prices up! The notion of forcing down employee wages is equally challenging, citing a regressive tax as absolving the State from responsibility. In the case of local government, if the practical effects of this tax were to push down wages in any way, it would exacerbate the problems facing councils in providing efficient and effective service delivery. In key areas (planning. engineering, finance) there are significant shortages of workers in local government. Wages are already below those of the Federal and State governments, and of the private sector. Furthermore the industrial relations and consequential political issues would be profound.

- There are 11 groups that are exempt from payroll tax. Councils are the only group in this number that has been targeted for payroll tax. For the other 10 groups IPART (p.98) considers the imposition of payroll tax "*is likely to be accompanied by demands for increased budgetary funding, resulting in a fiscal 'churning' with little net benefit*". Given IPART's role in establishing a regulatory framework to facilitate effective and efficient provision of local government services, the argument is specious. It assumes that local government (and rate-payers) would not, or could not, demand increased budgetary funding. The local government sector could not because the State determines how much revenue councils can obtain from rates. From the tone of Premier Iemma's terms of reference it would seem that IPART would be the body for setting rate levels of councils in the future. Local Government is therefore captive. There will not be any fiscal churning involved. Local Government would become a major new source of revenue for IPART's goal of increasing payroll tax income. The idea of simply adding the tax to the rate limit of councils is, essentially a double taxing of communities. The extra funds would not, and cannot, deliver any increase in council service levels since the additional money raised goes straight to Treasury. As IPART points out, the public pays for the current payroll tax system through paying extra for products and services, or accepting lower wages. Payroll tax affects the whole of society in this way. Simply, it takes money from the community and transfers it to the State.

- According to IPART figures the councils would have to collect an extra $180 million in rates (2007/08 figures), which would then boost the payroll tax take by the State to $1043 million, from $863 million, an increase of 21%.

## 2.2 Fire Service Funding Contributions

- IPART's Review of State Taxation describes insurance duty and fire services funding contributions as the least efficient State taxes. It points to "*significant free-rider problems*" associated with the fire service funding arrangements. Its short-term solution is for statutory contributions of insurance companies to fund fire levies to be replaced by a corresponding increase in the contributions by local government (p.7).

- The fire services levy is made up of three parts. Councils contribute 12.3% of total fire service funding, insurance companies provide 73.7% and the State Government provides 14%. The amounts paid by contributing companies is determined by their market shares of issuing policies for fire, industrial-specific risks, contractors, home and vehicle insurances. They generally obtain their contribution through a levy on policyholders.

- IPART believes that the industrial contribution would be phased out with this levy being shifted to councils. This would mean that councils would then be liable for 86% of the total levy. For "*administrative simplicity*" councils would introduce the increases in the rate cap to recover the cost. In practice this means that the State Government, probably through IPART, would raise the rate cap to remove the burden of levies from private companies.

- The IPART initiative is based on a report of the Insurance Council of Australia (ICA: November 2007), which was submitted to IPART's Review of State Taxation. ICA argued that fire services display several of the characteristics of public goods with the benefits of the services accruing to the wider community regardless of whether the user of the service has paid for the service through a fire levy or not. ICA reports that those States with the highest levels of insurance taxation also suffer the highest levels of non-insurance. ICA also argues that households are responsive to price signals. ICA argues that if the levy were removed from insurance companies, the fall in price would generate an additional 130,000 households with content insurance and 26,000 households more with building insurance taking out policies. Altogether providing an apparently substantial boost for the finances of the insurance companies. It will be of interest to note if the rates of individual insurance policies fall as a consequence! In 2006 NSW/ACT gross premium income of general insurance companies was $9,953 million. Including fire levies with general taxation ICA argues that since 2000 State taxes have increased at twice the rate of all other forms of State taxation. Access Economics, working for ICA, determined that overall NSW economic welfare would be improved by shifting the base of taxation away from general insurance to alternate tax bases with the biggest gains coming from a shift to residential property taxes: hence the idea of using councils as the tax collector.

- Other States have moved to charges on property values rather than relying on insurance premiums. This may or may not produce improved programs. One argument is that when insurance premiums are no longer part of the levy systems, insurance charges will drop. There is, of course, no guarantee that the levy value will be fully removed from prices. The margins are in fact fairly small. On a per capita basis NSW pays around $166 compared to the national average of $159 (ICA, p.10). Effective taxes for householders and house owners, (the main area of consideration by ICA in this context) on $100 base premium for the fire levy, is $19.

- A further problem with the bulk of the levy shifting to councils is that rates are based on unimproved property values. These have no relationship to fire risk or service provided. There is also the problem of rate exemptions (principally dominated by State ownership or occupation of land). The State buildings and structures that sit on the rate exempted sites receive the same fire services as do rated properties. Councils do not provide fire services (apart from Rural Fire services) and do not have any responsibility for management decisions associated with these services. If the levies were to be shifted councils would be responsible for organising the collection and dispatch of a significant volume of funds but would have no input into deciding any policy or administrative arrangements connected to them.

- Based on 2007/08 figures councils would have to raise $608 million extra in rates per year to meet payroll tax and fire levies. None of the increased rates would introduce new services for communities. Essentially ratepayers paying substantial extra rates will receive nothing in return.

## <u>2.3 Other State Government Imposts on Councils</u>

- There are a range of imposts whereby councils
    - have to pay State levies and charges
    - have to provide certain services to their communities at their own cost
    - have to collect funds on behalf of the State
    - have to provide services which are operated by councils but the revenue is shared by the state
    - have to pay additional amounts when State Agencies raise the cost of services

- responsibilities devolved for responsibility for new functions
- raising the bar by increasing complexity or standards
- cost shifting
- State government setting or capping fees and charges

❖ Not all of these can provide statistics that can accurately show the impact of these imposts on councils' expenditure, some imposts apply to some councils and not others, and there are variations in the level of costs over time. The Productivity Report (April 2008) argues that local governments should enter into purchaser-provider arrangements with other spheres of government and services should be delivered on commercial terms, but this does not happen in all cases. Some examples indicate the breadth of these imposts:
  - Street lighting (prospect of up to 18% increases in forthcoming years)
  - Electricity and water (expected to increase by 16% in the current financial year)
  - Tipping fees increases of 29%
  - Department of Planning levy which rises with CPI increases for the up to 30 councils levied
  - Valuer General fees (40% of the VG income comes out of local government
  - Election cost increases (of up to 120%)
  - OH&S costs
  - FOI costs
  - Library subsidy (per capita basis to be replaced by new system with the likelihood of reduced funds)
  - EPA (inspection of factories for toxic air/water/soil impacts)
  - EPA (enforcing and prosecuting dumped rubbish matters)
  - Department of Planning (likely reduction in Section 94 contributions)
  - Department of Planning (cost of establishing and maintenance of regional planning assessors)
  - RTA (reclassification of certain regional roles to local roads)
  - Climate change (State plan to be released early 2009)
  - Department of Planning (Metropolitan and Regional Strategies)

SSROC believes that this shifting in services to local government and the substantial increase in charges by State Agencies is substantial and an exploration of those transfer payments would be instructive in assessing councils' expenditures, and could form a component of IPART's review. SSROC understands that the Treasury has this data; accordingly, a request was made to the NSW Treasury to provide this data for its submission. Unfortunately this request was denied. The same request will now have to me made through the freedom of information process. SSROC would urge IPART to gain this data as part of its deliberations.

# SECTION 3

# Local Government Financial Challenges

## 3.1 Functional Bases

- Underlying the serious and ingrained financial challenges faced by NSW councils, and detailed by the Allan and PwC reports, is the simple but essential fact that the functions of councils are ill defined. In the world beyond councils this situation does not happen. Businesses and professional services in the private sector are built around identified products. Their goals centre around the creation of profits, which are essentially gained by boosting income and reducing costs. Business plans and strategies are built on this. State Governments operate around a series of portfolios whose very name suggests their function: the RTA is concerned with roads, the Department of Health is concerned with health, the Education Department with education, and so on. Budgets and resources are allocated in relation to the needs of the various Agencies. Local Government's role is much more confused because there is no clear definition of what its functions are. Chapter 6 of the Act is headed: "*What are the service functions of councils?*" It then proceeds in its introduction to say that "*this chapter confers on councils their service or non-regulatory functions*". There follows examples of the functions of which councils might provide the provision, management or operation. It then lists 16 different groups of possible functions, some of which are general (community services and facilities) and some of which are multiple and vague (cultural, educational and information services and facilities). Section 24 of the Act (Provision of goods, services and facilities and carrying out of activities) states: *A council may provide goods, services and facilities, and carry out activities, appropriate to the current and future needs within its local community and of the wider public, subject to this Act, the regulations and any other law.* How can local government be expected to operate effectively and efficiently when its role and purpose is so ill defined? The vagueness of the Act on the functional role of councils was evidently based on allowing individual councils to operate as autonomous entities in terms of their functioning. As with any entity, public or private, once a council's priorities were established they would review their income opportunities and then decide on expenditure. Councils, however, have only one area of taxation to support their operations: rates. They are unable to determine the level of their rates because of rate pegging. Since rates are the largest element of a council's income their autonomy is largely illusionary.

- The Productivity Commission (April 2008, p.143) reports that "*Nationally, each council sets its rates, and fees and charges, taking into account its budgeted expenditure and community preferences, as well as grants from other spheres of government*". NSW councils cannot operate on this standard basis.

- The functional role of councils becomes partly defined by the types of services that they provide, and which other entities are not well placed to provide. Councils provide public goods. These are non-rival, in the sense that consumption by one person will not diminish consumption by another. They are also non-excludible, in the sense that once provided no one can be excluded from consumption of them whether or not they offer to pay. With these attributes the public goods offered by a council will be designed to accommodate the wishes and expectations of its community. The revenue source for such goods is expected to be rates. This is because rates form the only non-discriminatory tax for councils producing public goods. The level of rates is based on the capacity of the community to pay, and its willingness to pay. Through this process certain equilibrium is reached. Council expenditure items will be decided in terms of community priorities, governed by the capacity and willingness of a community to pay. Rate pegging destroys this proven system.

- There are other services for which production or consumption is related to the needs or uses of certain sectors of the community but of no interest to other sectors. Examples are public health programs such as immunisation services, breast cancer checks and the like. Specialist services of libraries (like classes for people wanting to learn computer skills) are another example. Such services are provided by councils in line with community needs, and the lack of other sources (private sector or other levels of government).

- Natural monopolies represent another service area where councils can be sole providers because there are no other providers available, or where alternative providers are too expensive for the community. General examples are local roads, bridges, footpaths, water and sewerage systems, and stormwater drainage. Increasingly councils have to provide certain services by default. Examples include the financing of hospital, medical and dental facilities in small country centres. Other levels of government will not provide such services and nor will the private sector. Councils step in as service organisers where the community it believes cannot survive at the level of basic health support that would be available if councils were not to act.

- There is therefore a great deal of variety in the types of services, and the quantity/quality aspects of services, that are created by community needs and community priorities. Paralleling this is the limited variety of income streams that can be generated by councils. This is determined by a large range of factors, but ultimately by the economic base of a council. Across the 152 councils in NSW the economic structures vary greatly, and, naturally with that, the character of expenditure patterns by councils. Since rate caps are standard for councils across the State, and provide approved increases at levels below real increases in council expenses, there is a distortion in revenue opportunities across the system. Councils that have strong economic bases are capable of generating higher income streams beyond rates, and can wear the limitations caused by rate capping.

Councils with weaker economic bases are stuck with insufficient income streams. There are probably no more than 20 councils out of the152 in NSW that have economic bases that allow them to meet the forward expenditure needed to meet the needs and aspirations of their communities. There is somewhere approaching 50 councils that can be called financially unsustainable. The remaining half of NSW councils limps along trying to avoid expenditure deficits.

- ❖ Sustainable financial management must relate to the factors that determine aggregate costs. These include operating expenses, depreciation of long-lived assets, returns on the opportunity cost of holding assets, and taxes, levies and other imposts from other levels of government.

- ❖ The depreciation of assets, as discussed elsewhere in this submission, has created cost problems of huge proportions. Many councils are now adopting strategic asset management strategies to try to deal with this, but in most cases the size of the problem is far too great for councils on their own to manage.

- ❖ Imposts from other levels of government have become a very significant challenge for local government in NSW. Many examples of these are listed in Section 3. There are more subtle impacts, however, beyond such factors as levies and the like. Councils, in the usual course of their activities, are involved with a large range of Departments, Agencies, and Authorities of the State Government. Each of these relate to one or more Acts and sets of regulations. Councils have to abide by these Acts and regulations when they come into place with council activities. Without any direct charges, these circumstances can generate large increased costs to councils. In other situations Departmental or Agency policy or project shifts can impose obligations on councils that can involve very substantial and often unheralded, added costs to councils. The Metropolitan Strategy (and other regional strategies) are a very good example of this, and is treated below. Another example is the State's response to climate change challenges, which are also treated below.

## <u>3.2 Factors Affecting Financial Structures</u>

- ❖ The Metropolitan Strategy is engaged with setting the growth pattern of Sydney through to 2031. The Metropolitan area has been divided into a number of Subregions. The Subregions are amalgams of councils, and their boundaries are defined by local government boundaries. The Subregions have been set targets that must be achieved by 2031. The key targets are the number of additional dwellings that are to be built by 2031, and the number of increases of jobs by 2031.

- The target of a Subregion is made up of individual council targets of the councils that make up the Subregion. The process has involved some consultation with councils, but all the targets have been set of the Department of Planning. The responsibility for achieving the targets is left in the hands of each council.

- The Inner West Subregion is used as an example. The demands place significant challenges for councils. The Inner West Subregion, for example, in comparison with the Inner North Subregion is smaller (62 sq. kms.) than the Inner North (101 sq.kms.), but more densely populated. The Subregion dwelling targets are exactly the same: 30,000.

- Ashfield, a council area in the Inner West, has a dwelling target of 2,000 new dwellings by 2031. Sydney metropolitan area population grew by 10.9% between 1996 and 2006, and added a further 14.5% of new dwellings. Ashfield's population grew by just 0.1% in the decade, and there were 342 fewer dwellings than in 1996. If the pace of dwelling losses were to be extrapolated to 2031 at the same rate, Ashfield would lose 855 dwellings. The Subregional Strategy has ordained that it has to achieve a target of 2000 dwellings. Ashfield LGA has an area of just 8.1 sq. kms. with 5.5 sq. kms. of residential dwellings. Amongst the 43 councils in metropolitan Sydney Auburn stands out for the scope and detail of its heritage program. 1,375 properties are heritage listed, and virtually every residential street is heritage impacted, if not listed. The council, if it were to achieve Ashfield's dwelling target, has to reshape its entire planning base. With its limited area and its heritage base this will be a long and costly exercise, which will burden the Council for the next 23 years.

- Marrickville, a council area bordering Ashfield but belonging to a different Subregion, had 1614 dwellings fewer in 2006 than it had in 1996. At this rate of decline it would lose 4,035 by 2031. Instead the Subregion strategy has given Marrickville the task of adding 4150 dwellings in that period. In the decade to 2006 Marrickville's population fell by 5.3%. Both Ashfield and Marrickville populations have had a large proportion of ethnic groups, and still do, but with quite strong dynamics of change as new in-migrants take the place of other groups. It introduces the challenges to the councils in both areas to develop social and cultural resources to serve the needs of their communities. Marrickville has long been an industrial area based on traditional forms of manufacturing. Its employment target for 2031 is just 500 additional jobs based around a dedicated 144.5 hectares of industrial zoned land. The problem is that the composition of the make-up of the workforce has changed significantly in the five years from 2001 to 2006. This indicates that the nature of the employment base is shifting. Professionals make up the biggest component of those working in the Marrickville area (32.6%), up by 39.1% in five years, and both the numbers and proportions of those working in manufacturing have fallen.

- These examples touch on just three areas of councils' activities in relation to the Strategies (planning for dwelling and manufacturing changes, social and cultural planning, heritage issues, and employment growth). Expanded across a number of other council functions the time and costs that have to be borne by the councils is going to be extremely large. They will not get any targeted funds from State Agencies, and will have to bear the costs of providing infrastructure and other support systems for the growth and changes to their areas. The nature and scale of these costs are particularly difficult to estimate either in their quantity of timing. It is very difficult to build sound and sustainable financial systems when external forces (viz. the Metropolitan Strategy) impose their own scope and timing on the actions of councils and their revenue bases are limited by rate capping.

- Climate change will impact on councils' expenditure. A NSW plan by the Department of Environment and Climate Change will be released in the early part of 2009. It will require investment and resources to be made by councils. To this point councils have concentrated on mitigation strategies (if they have done anything) for greenhouse gases. This has led to some energy saving exercises within councils (lights, electric systems, vehicles) and some education programs for the community. The 2009 plan will involve councils in the much more difficult council area of creating adaptation strategies. This will mean heavy investments in building information systems concerning both the built and natural environments, and the development and implementation of adaptation systems. Both the newness of this challenge and the cost of engaging both technical and professional assistance will put substantial new costs on to council budgets, and these will be there for a long time.

- Both the metropolitan strategy and the climate change plans are being developed with the best of intentions by the State, but the bulk of the costs that arise for councils from these exercises will be met by councils; and, they will be substantial. The examples used here could be multiplied by a large number of examples where council costs are raised without any recompense from the State.

- Climate change and metropolitan strategies naturally relate to regional operations that involve councils. There are a number of other situations where regional systems, instead of individual councils, make sense. Whilst the 1993 Act encouraged councils to act as autonomous units, it did so without reference to the fact that the size and resources of councils varied enormously across the State. It is not terribly useful to have autonomy if there are outcomes where revenue bases of councils are insufficient to meet expenditure.

- The relevance of this can be illustrated by the Southern Sydney Regional Organisation of Councils. This is a group of 15 councils with a population of 1.262 million people (2006). This makes the group larger in population terms than Adelaide, Canberra, Hobart and Darwin. The revenue derived from ordinary activities for the 15 councils was over 1 billion dollars ($1.241.6 billion) in 2005-2006. This was an increase of 37.6% since 1999-

2000. The high revenue growth rate for the 15 councils as a whole was brought about by just four councils. It was the strong revenue increases of these four councils that enabled the group to have a revenue balance over costs of 15%. In fact, of the other 11 councils 6 had small surpluses, and 6 were close to suffering, or were suffering, deficits. The councils in the worst financial condition had small populations and, accordingly, weak revenue streams. They also had rate and annual charges (adapted to remove waste service charges) revenue portions of between 60 and 70% of their income. These councils did not have the capacity to even marginally increase their revenue flows through other means. Progressively, because rate limits continually fall well below the increases in real costs of councils, define a continuous path towards financial unsustainability. The issues around linking councils together into regional groupings are pursued in Section 4. It is raised here because it illustrates how with similar regional characteristics, but with large differentials in area and population, and economic bases, councils will generate quite different financial characteristics.

- In regional NSW there are similar complexities between councils in the same regions. In most parts of regional NSW small rural councils have developed new economic ties with larger regional centres. For example the City of Wagga Wagga provides the economic core of a region that holds around 120,000 people. Some of the small rural centres within the Wagga Wagga catchment zone have previously suffered quite significant downturns in their economies and, with that, relatively large population losses and a significant increase in the proportion of aged persons. The downturns were caused by drought impacts on farming industries, and factors concerning urban industries as for example the removal of the train servicing industry in the town of Junee. A decade and a half places like Junee and Coolamon have revived their economies, partly through people finding jobs in Wagga Wagga and partly through the movement of Wagga Wagga residents into the towns that offered rural lifestyles.

- All of the preceding discussion is relevant to the issues raised in the terms of reference of the review (Issues Paper p.2). The issues and examples raised indicate the breadth of complexity that lie behind the challenges that councils now have to face in terms of building financially sustainable management systems. The IPART review touches on only one aspect of a challenging problem, and that is rate pegging. At various places in this submission the limitations of rate pegging in itself are discussed. The point of the discussion in this section is to demonstrate that the solutions to boosting the financial condition of councils are much more complex than the matter of rate pegging. The real issue is not whether a more successful system for setting rates and charges can be found, but rather how can councils be enabled to build their own financial management systems. There are also many references in the issues paper to, and some questions about, the possibility of introducing a range of rate limit systems based on the National (or modified NSW) classification of councils' areas and populations. Simply put, the role of councils around the State cannot be usefully assisted by a distribution system based on these classifications.

# SECTION 4

# Structural Impediments in Local Government

## 4.1 Overcoming the Financial Challenges

- The fact that local government faces serious financial problems is well documented. It will face more desperate financial problems if the State Government continues to expand its charging of levies, transferring services to local government and the making of other imposts on councils, and at the same time, maintains rate capping at unsustainable levels. It will face catastrophes if the most compelling problem, the system's incapacity to arrest the year-by-year growth of infrastructure maintenance and renewal costs are not properly acknowledged and addressed.

- The Issues Paper pays scant attention to the financial challenge of infrastructure issues. On page 18 it gives a brief note mentioning some, but by no means all, of the different types of infrastructure[2]. On page 43 it provides a summary description of factors that affect councils' financial sustainability: "*A council's financial performance is considered to be sustainable when it can meet its long-term service and infrastructure levels and standards without unplanned increases in rates or disruptive cuts to services*". On page 42 it is noted that "*the annual capital expenditure of NSW councils on the renewal or replacement of existing assets fell short of the annual depreciation of those assets by $400 million, or 40 % of that capital expenditure in 2005/05*". On page 44 a summary of previous reviews of the financial sustainability of councils lists seven areas that may have a negative effect on a council's financial position; none of these focuses on the gigantic problems (in local government terms) of asset management and infrastructure. The Issues Paper then moves on to whether or not efficiency gains can improve council's financial sustainability (the answer, yes, is simply a truism). The Issues Paper does not deal with the infrastructure challenge in depth, and does not propose any real solutions to the challenge. In fact, the infrastructure challenge is so large in money terms and so widespread across the local government system that the solutions must rest with a targeted substantial financial package put together by Federal and State Governments, linked to broader infrastructure plans across the State.

- Solutions to the infrastructure challenge will not just be found in whether rate pegging is maintained, or whether the rate caps are set by IPART. Local government's financial base can be strengthened, but that requires including

[2] Ending on a curious, and rather irrelevant, reference to a minor comment of the Allan report concerning regional infrastructure

the whole pattern of finance and expenditure, and the underlying structure of the system. Rate pegging is but one, albeit important, aspect of all of this. There is a more fundamental issue that has to be addressed. That is defining the fundamental role that councils are to play: are they providers of community public services (a view that seems to predominate the thinking of many in the State Government)? Or, are they to operate as commercial entities, one of whose products would be the provision of certain public services (clarified by identifying just what responsibilities are involved and allowing councils to create financial bases relevant to those responsibilities).

The example of the Metropolitan Strategy expectations (Section 3.2) implies a most significant role for councils in boosting the employment base of the Sydney. This, and a large range of other examples of expected economic contributions of local government by other Departments and Agencies, demonstrates that local government has, and is expected to continue having, a fundamental role in supporting and advancing the State's economic development. Local government is part of the State's economic machine. It must then construct proper business systems at the heart of its operations, and through its financial base have the capacity to carry the costs of doing business. This implies that State Government restraints, including rate pegging, need to be removed so that councils can proceed to operate on the basis of effective business systems and approaches.

- The Issues Paper signifies that the local government revenue framework review is closely related to, and is probably partly stimulated, by the Environmental Planning and Assessment Amendment Act (2008) and the refocussing of the Section 94 and Section 94A contributions into Direct and Indirect categories. This is manifest in Part 1.1 of the Issues Paper, *Terms of reference for the review.* In fact beyond the listing of the terms of reference, the bulk of Part 1.1 concerns these changes. In the Premier's formal statement of the Terms of Reference (Appendix A) the background section makes reference to the developer contributions changes in the EP&A Act; this is the only direct reference to any other Department or Agency whose activities and structures impact on local government revenues. The fact that the Direct and Indirect contributions will have a serious impact on council revenues explains part of this. The matters listed for review, moreover, three elements: appropriate inter-governmental and regulatory framework for setting rates and charges; a role for IPART; and a framework for setting charges levied by SOPA (and other bodies) to recover costs for the provision of services that are normally provided by local government. The Department of Planning is responsible for the operations of SOPA. The entire review appears to be related to, and potentially beneficial to, the Department of Planning.

- It could be reasonably inferred that a large part of the reason why the IPART review is in place is to do with the shifting of funds from local government to the Department of Planning. There is promise in the points of reference in Appendix A (12 points in all) that could extensively provide a background leading to an in-depth analysis of local government's financial base and how to reform it. Instead, the matters to be dealt with are limited to the ways in which rate pegging can be reformed, a future role for IPART, and the shift of funds to the Department of Planning.

- These facts mean that a rare opportunity to rethink and reform the local government system, and its functions and financial bases, is lost, and part of the reason is the desire of the Department of Planning to shift funds from local government. Without assessing the rights and wrongs of the Department of Planning's goals this situation points to, a more basic barrier to developing a more efficient and more effective local government system. This is the broad relationship between State Government Departments, Agencies and Authorities and local government, and the impact that has on local government's capacity to reach a suitable level of financial sustainability, and improve the efficiency and effectiveness of service delivery systems.

- The State, over a long period of time, has adopted a dictatorial role in relation to local government that is quite contrary to the relationships developed in other States. In them[3] partnership arrangements have become important aspects of State-Local systems with clear-cut definitions of who does what in joint venture operations, and where and how the finances are garnered and used. The lack of any such arrangements in NSW has been counter-productive to the building of efficient and effective councils. There are numerous reports that show the somewhat desperate financial state of local government as a whole, a condition, which can be largely attributed to the State's unwillingness to reform the system (in contrast to other States).

  Rate capping, a system that might have had some merit in the stagflation years of the 1970s and is now well beyond its use-by date, is certainly a factor in the limited revenue streams in NSW. But it is only one element in the impact of State actions and policies that have impacted on local government's capacity to establish suitably robust to carry out its service functions. Unfortunately, the present review and its options merely cement the weaknesses of the State- Local relationships.

## 4.2 Promises and Inaction

- Local government's financial difficulties can be broadly explained by the competing demands and inconsistencies of politics. Notwithstanding often-repeated views of the need for reform, there is very little enthusiasm across all tiers of Government for fundamental change. The intersection of Commonwealth-State-Local Government roles and responsibilities, particularly as it relates to funding, is part of the blockage on the road to

[3] Tasmania has 36 signed partnership agreements. The South Australian Government and Local Government in 2004 signed an agreement to build a closer, more productive and collaborative working relationship. Western Australia in 2001 created a Partnership Agreement, which included partnership principles, a template for partnerships, and the establishment of the State Local Government Council.

reform. The substantial crisis facing local government in relation to infrastructure will require funding and a real partnership between all tiers.

- In June 2003 the then Premier of NSW announced a reform of local government. The Issues Paper refers to this (p.12). The reform was concerned primarily with amalgamations and/or boundary changes with the purpose of getting larger, better-resourced councils as a result. Structural reform was made the core issue. The prime focus was on country councils (separate to this changes were initiated earlier that affected small alterations to four councils, and then eventually, the amalgamation of City of Sydney with South Sydney). The dissolution of 42 councils and the creation of 22 new councils was effectively completed by the end of 2003. By then the reform process had failed because only a small proportion of the 172 councils were reviewed (less than a quarter of the total). There was no attempt and no design to rethink and reform the purpose and potential of local government structures and functions, and certainly no innovations to fortify the financial sustainability of councils. The reform attempt was finished almost as soon as it started, and the main reason for that was the State Government's reaction to community pressures.

- Some councils, in this brief period, took protective actions against perceived threats of amalgamation. The first (in August 2003) to do this was a trio of rural councils (Wellington, Blayney and Cabonne). They proclaimed that they had formed what they called a strategic alliance and announced no fewer than 26 operational areas in which the councils would work together, presided over by a Board comprising 2 councillor representatives from each council plus their general managers. By 2007 the alliance was claiming a saving of $1.7 million over its life to that point, but presented no specific proof of this. In 2008 a structural plan for the alliance was rejected by the Board. The threat of amalgamation by then was considered to have passed and the three councils have now retreated to their full independent status. The strategic alliance was a clever and successful move.

- The State Government by early 2004 also sought a political strategy to allay its primary fears that the reform of local government might be having political consequences. The then Minister of Local Government had been a general manager of one of the alliance councils before becoming an MP. Suddenly the focus of local government reform centred around strategic alliances. The Issues Paper (p.15) cites this as an advancement.

- DLG has produced three papers[4] in 2006 and 2007 on collaborations and partnerships between councils. The political decision of three Central West rural councils has now become the centrepiece of the State Government's plan to create a robust, financially strong local government system. In fact, it is the only plan the government has to do this.

[4] *Planning a sustainable future, A new direction for local government, and Collaborations and partnerships between councils*

- DLG claimed in 2007 that there were 22 strategic alliances of councils in NSW, exclusive of Regional Organisations of Councils. DLG claims that 494 partnerships have been formed between councils. These, however, relate to many, generally small and often temporary, arrangements between councils. They all possibly give some assistance to councils in some of their operations and a few may produce savings, although there is very little evidence of this. Despite the large numbers of alliances and partnerships suggested, there have been no evident improvements in the financial condition of the local government system as a whole (or even in its parts). Strategic alliances may bring marginal improvements to some (a very limited number) of councils, but unless the approach is welded into a genuine and fundamental restructuring of the system it will achieve very little. It is ironic that the Ministry and DLG have promoted partnerships between councils as a primary strategy, whilst the State does not promote partnerships between itself and councils.

- There are no signs of any genuine desire of the State Government to introduce such a restructuring. In this situation the one basis on which advancement can be made sits with the Regional Organisation of Councils (ROCs). ROCs have existed in NSW for over 30 years. They were formed primarily to lobby for, and advocate, issues that were important to the regions from which member councils were drawn. Over time additional functions have been added and a range of professional relationships have been created.

- Progress in some ROCs has been substantial. SSROC has some 14 current project briefs related to policy functions. Wesroc has operated for a number of years and has successfully managed major activities such as an apprentices scheme as well as a substantial policy development role relating to economic development for Western Sydney. Hunter Councils (a group of 12 councils) has developed a regional environment division, a regional procurement agency, a training body (Learning and Development) and a Records Storage company.

- The key to future expansion of the ROCs within the NSW system lies with their development of a range of regional business functions that will substantially assist councils to significantly reduce expenditure through operating combined functional systems. These could include whole of region procurement systems, waste service programs, environmental and climate change management, sports fields and recreational facilities, shared service systems, back-office collaborations, and a number of other possibilities. Two things, however, serve to restrict the advancement of local government through the adoption of regional structures.

- The first of these is the lack of recognition of ROCs in the Act. S377 permits a council to delegate functions to a ROC by resolution. S378 allows a general manager of a council to delegate functions to a ROC. A ROC might have some legal recognition under the Associations Incorporation Act (1984) but this assigns very limited roles, and has a restricted financial benchmark limit, an amount far too small for ROCs. Section 358 prohibits the formation by councils of a corporation, but a council can be a member of a co-operative society or a company limited by guarantee, S.388 allows councils to be members of a county council. These restrictions place great obstacles before councils that wish to join together and establish business-based relationships that can seize on the economies-of-scale benefits of a regional body and relate to a range of functional services that can most economically, efficiently and practically be best operated at a regional level. Allowing groups of councils to form effective structures to produce both revenue and cost-savings gains could produce some quite substantial benefits in terms of addressing financial sustainability matters.

- The other major obstacle is the voluntary arrangements that lie behind the decisions of councils to be members of a ROC. Decisions about being members are often made for political reasons, and departure from a ROC is also usually based on political factors. Within ROCs the effectiveness of its operations depend on the continuity of purpose at both the political level (particularly as a consequence of elections) and general manager level.

# SECTION 5

# Review of IPART's Issues Paper

## 5.1 Issues on which IPART seeks comments

This submission is presented in five sections. Section 1 is an introductory summary of the issues on which IPART has sought comment. It links the principal issues put forward by IPART (p. 6-7 of the Issues Paper) to where commentary and suggestions are to be found in this submission. Along with this, some comments are put forward regarding IPART's approach to the Revenue Framework for Local Government, and some specific reference is made to some ancillary questions raised at various parts of the Issues Paper (Appendix E).

*Key Questions*

1 What is the role of Local Government and how is it determined? This topic is discussed in Section 4.

2 How effective is rate pegging and what are the implications for councils and ratepayers? This topic is discussed in Section 1.

3 What are the objectives of a regulatory framework for local government revenues? This Topic is considered in Section 2.

4 How does the current regulatory framework for council revenue, or any alternative framework:
   - Promote the effective and efficient provision of services?
   - Enhance the financial sustainability of local government?
   - Meet the standard of principles for good regulation and taxation –efficiency, equity, simplicity, and transparency?
   - Enhance the accountability of local government?

   These matters are addressed in Sections 2, 3 and 4.

5 What role should IPART play in setting local government rates and charges, including charges for non-business activities? These issues are considered in Section 4.

6 Should IPART have a determinative role provided by legislation or should IPART's role be limited to making recommendations, if and when requested by the Minister? This issue is addressed in Sections 4 and 5.

## 5.2 Introductory Comment on Issues Raised

- ***Page 12***

Here, and elsewhere in the Issues Paper, IPART departs from generalised themes to defining a restrictive approach. On page 12, the EP&A Amendment Act 2008 is mentioned but then dismissed. This Act has significant impacts on the capacity of councils to raise revenue, but the Issues Paper restricts any consideration to how the changes impact on rate pegging. It is contrary to the terms of reference given to IPART. The second of these states: "the current and future financial position of local government and the scope for efficiencies".

- ***Page 15***

This reviews cooperation and partnerships between councils. It lauds the impacts that such have had on councils but there is little to no evidence supporting these assertions. The current lack of legal status to support strategic collaborations (as termed by the Department of Local Government: DLG) stymies the potential of such alliances to address the financial challenges of councils. These matters are explored in Section 5. It reflects an imbalance in the approach taken by IPART. The effective dismissal of the quite serious impacts of the EP&A Amendment Act 2008 on council's revenue, contrasts with the somewhat naïve acceptance of what amounts to a concerted spin campaign based on political pressures on DLG. This is examined in Section 5.

- ***Page 18***

Reference is made to the Local Government Act (the Act), which contains a Charter (S. 8) to guide councils in carrying out their functions. S.8 does not define in any way what the functions of Local Government actually are. In fact, nowhere in the Act are the functions of councils defined. There are a set of principles listed in S.8, some of which are admirable but not particularly directional in terms of functions[5]. The Issues Paper here admits that the Act imposes few limitations on what services local government can provide but chooses not to give this situation much attention in the bulk of the Issues Paper. Section 5 addresses this deficit. There is a reference to regional infrastructure in page 18, mentioning the Allan's Report that suggests that there should be compensation by all councils that contribute to it. Given the geographic incoherence of the NSW council structure the need to devise processes (supported by revenue systems) that will boost regional infrastructure is a vital concern.

[5] These include: encourage the promotion of multiculturalism, and the provision and planning for the needs of children (but not of aged persons!).

➢ ***Page 19***

The so-called minimalist and maximalist views are raised. Largely, this is irrelevant to what councils actually do (and the revenue needs that these activities generate). Whilst there is no movement by the Minister and DLG to clarify the functional roles of councils, there is little point in trying to relate such philosophical matters to the clear focus of IPART on rate pegging. Behind the diversity of functional roles that can be found across the sector, is the fact that the Act in 1993 encouraged councils to be autonomous in their operations. Behind this, were two considerations. First, the Act encouraged councils to take a more business-based approach to their operations, with Elected Representatives taking on a policy role similar to the Boards of companies, and the staff taking on the role of achieving the policy goals. Second, it was a recognition of the diversity of the sector challenged by the varied economic bases and social challenges of councils. In significant ways each council is different to each other.

➢ ***Page 20***

The Issues Paper addresses variations in the role of councils. The approach is to reduce the complexity of the NSW distribution of councils down to a council classification system whereby council types, based broadly on location and industry base, can be separated so that the rate pegging system (including rate variations) can be tailored to produce a more effective set of revenue outcomes. This is a reasonable approach but very difficult to implement. Rural councils in one part of the State with the same population base and the same area, may face long periods of drought, whilst others may receive good rain over a number of years. Equally, the topography and soils base of one council will help it achieve both economic sustainability that will help pay for the cost of infrastructure. Such a council will be favourably financially situated compared to many other councils of similar size (population and area). Similar disparities can be made of both regional centres and parts of the metropolis.

➢ ***Page 22***

The classification of local government functions prepared by DLG contributes very little to an understanding of what councils actually do, and whether or not the spread of functions brings any light on the relationship of this spread to the issue of rate pegging. These issues are covered in Section 4.

➢ ***Page 25***

The Issues Paper concludes that because NSW receives only 8.6% from grants and subsidies that this indicates a considerable level of self-sufficiency overall. This conclusion is fallacious. The low level of grants simply signifies the reduction of grants income for councils that have progressively occurred over a long period of time.

The Commonwealth FAG grants were based on a pool of funds equivalent to 2% of income tax. Over time the pool has been diminished whilst the role of councils has expanded (significantly prompted by cost shifting by both the Australian and NSW Governments). The calculations of the FAG grants for NSW are based on recurrent expenditure of councils. Capital expenditure is not taken into account, despite the huge infrastructure deficits faced by councils. The FAG system is based on a modified version of horizontal fiscal equalisation: that is, that each council should receive grants that enable it to provide a standard level of services. Whilst the current pool for NSW is in the vicinity of $600 million, this only provides around 45% of the amount needed, according to extensive analysis of councils' revenue/expenses situations by the NSW Grants Commission.

In 1991 the grants provided 65% of the recurrent expenditure needs. In terms of real needs of councils the Federal Government grants have reduced real income at the rate of 1% per year for over two decades. State Government grants have also progressively fallen in real terms over time. They are almost entirely competitive, time based, and their focus is largely determined by State Agencies' programs rather than defined council needs. Many such programs leave a legacy of on-going maintenance costs to council after a grant period has finished. Given the serious financial sustainability challenges that face the bulk of the NSW council system, the suggestion that it has "*a considerable level of self-sufficiency*" displays an incorrect assessment of its revenue base.

There is also an observation that "*NSW local government, which is subject to rate pegging, is close to the average (level of taxation revenue, ie. rates), of the Australian States*". Table 4.1 shows that NSW rate revenue is considerably less than that of Victoria, Western Australia and South Australia, and above those of Queensland, Tasmania and Northern Territory where special circumstances prevail. Queensland (which has higher total revenue than NSW), South Australia and the Northern Territory have much lower taxation revenue levels. Each of these does not have a rate pegging system, suggesting that having or not having a rate pegging system is irrelevant to the financial condition of a State. Table 4.3 suggests that over a decade rate levels have been stable. There might be an implication in this, suggesting that such stability might indicate that the rate pegging system has provided some stability for the revenue system as a whole. The serious and ongoing problems of increasing financial sustainability problems, particularly recognised in the past decade, runs contrary to such a sanguine view. The implication of these outcomes is covered in Section 1.

- ***Page 30***

It is stated that between 1998/99 to 2006/07 NSW rates revenue has grown faster than the CPI but less than GSP. The irrelevance of this is argued in Section 1.

- ***Page 35-37***

The shifts in spending focus in the last decade, and future possible shifts, pose problems and may have a relationship to rate pegging. Shifts in spending inevitably have implications for rate pegging, but the forces that have created such shifts (common in fact to councils across Australia) are complex and dynamic. The most important observation that can be made is that if the expenditure spread is stimulated by demands from both communities and other levels of government, the outcome will be that increasing levels of funds will be needed to address legitimate demand. These could be raised by increasing rate-pegging levels or by introducing alternative frameworks. The fact is that the Act does not adequately define what are the functions of councils. Shifting demand will continually change, the suite of functions within local government, and between councils these functions will vary.

- ***Page 38-44***

This part addresses the relationship of a council's financial position and its efficiency. It focuses on three measures: operating surplus (deficit) ratio, interest coverage ratio, and annual/renewal ratio. In different ways these measures relate to the financial performance of a council. They do give indications of performance (although the second measure and its substitute are not deemed to be particularly useful). The conclusions in the main are that there are substantial problems with councils' financial performance. None of that is surprising. Since the chapter is entitled Councils' financial position and efficiency, it might be assumed that the poor state of many councils is attributable to inefficiencies. The reality is that the situation results from three decades of deteriorating revenue streams matched by consistent rises in demand for council services. These the three decades parallel the life span of rate pegging.

- ***Page 44-46***

The Issues Paper claims that reforms have improved the efficiency of the NSW system. Although some efficiency gains have been made (largely through the efforts of local government managers rather than the State) there are no real data that can sustain the broad claim that the system (as opposed to its elements) performs with reasonable efficiency. Since the functional base of local government is so broad and ill defined it is almost impossible to introduce suitable comparative measures of efficiency. Without any evidence the Paper, after suggesting that user fees and charges *may* be a more efficient means of raising revenue than rates, and then reaches the contestable conclusion that rate pegging may in fact improve the efficiency of councils' finances.

- ***Page 49***

Special variations are twinned with the basic rate pegging system, suggesting that they are suitable and effective means of maintaining a government control over councils' taxing ability whilst allowing for special cases to be attended to. The reality is that across almost the entire local government system the lack of funds to address the infrastructure problems is such that almost every council in the state could mount a case for rate variations. All the variations granted are in one way or another related to the infrastructure problems. In many cases continuous variations for many councils would not solve the scale of the infrastructure challenge. Substantial funds will have to be sourced either through special pools created by the Federal and State Governments, and/or engaging private sector funds to assist. Making rate variations merely tinkers at the edges of the problem. They will never solve it. It is a clumsy process that consumes a great deal of time, both within DLG and the councils. Some of the most financially stressed councils lack the staff skills and the resources to obtain variations. These issues are considered in Sections 3 and 5.

- ***Page 54-59***

The Issues Paper poses a number of questions concerning the efficiency and effectiveness of the current framework, and then suggests some answers. It observes that the Act is not explicit about the goals and objectives of rate pegging. It suggests a number of pro rate pegging factors. Many of these suggestions are quite shallow and some are specious. For example: rate pegging is meant to prevent the misuse of monopoly power. The overwhelming area of local government expenditure that can be described as being based on a monopoly power is local roads. It is hard to conceive councils in any serious way abusing that power: it is an ever recurring, significant cost to councils for which there is no recompense from users. Another example of what might be called hopeful presumption is that because user charges have remained fairly constant in the past decade, it suggests that rate pegging is not causing councils overall to increase or introduce new user charges.

Socio-economic impacts of rate pegging are treated too lightly. Rate pegging does not relate to socio-economic dynamics in any way. The basis of which councils receives what and where is really based on their rate structures that were in place in 1977. Rate pegging, by its very nature, perpetuates the circumstances of that period and does not allow flexibility to address the substantial shifts in both the social and economic changes since 1977. Rates themselves are dependent on land values. There are serious issues related to the reliability of the valuation processes, especially in the cycles of boom and bust. As mooted on page 59 of the Issues Paper there are many reasons why the inability of a council to set its rates can produce adverse consequences in terms of socio-economic impacts. Since rate pegging is the standard for the entire local government system, the question posed in the Issues Paper after the discussion on consequences of rate pegging (does rate pegging increase the affordability and/or availability of local government services especially for poorer regions and sections of the community?) is especially inconsequential. It is inevitable that the majority of councils are disadvantaged financially.

- ***Page 63***

Section 7.4 of the Issues Paper gets to the nub of the matter: what alternative regulatory frameworks should be put in place. Five options are listed. Four of the five alternatives propose various different ways in which forms of rate pegging will be retained. This is not surprising. The whole tenor of the Issues Paper appears set around the retention of the system.

On page 1 of the Paper reference is made to the current Minister for Local Government stating that the Government remains committed to rate pegging. Thus, it may be argued that this review cannot be conceived as an independent inquiry that could address the multiple challenges facing the large proportion of councils with serious revenue deficiencies. In fact, there are compelling arguments that place rate pegging in the front row of the forces that have created the revenue problems.

If the continuance of rate pegging is a foregone conclusion, Options 3 and 4 hold out at least some hope of reform. The exclusion of capital expenditure in Option 3 at least allows a separate and better way to approach the demon of the infrastructure challenges. Option 4 proposes greater freedom to individual councils subject to a number of mandatory requirements. What is not canvassed by the Paper is the additional burdens that would be placed on Councils to meet what appears to be required by way of reporting. Given the pressures currently on Councils, there is serious concern as to the capacity and capability of Councils to absorb this extra workload. The fifth option removes mandatory rate pegging.

As the various Sections of this submission show, rate pegging is a practice whose usefulness has long passed. The fifth option is the only practical solution.

- ***Page 65***

7.5 raises the issue of what role IPART should play in regulating council rates and charges in future years. The answer to that must be none. For IPART to take on such a role, the position of local government as a third tier of government effectively is lost. Local Government would become simply an administrative arm of the State government (which in legal terms it already is). It would make the process of communities voting for representatives somewhat superfluous and essentially create a charade of democracy. A second reason why IPART should not play a role is that the evidence of the Issues Paper indicates that IPART, despite the quality and experience of its members, has an inadequate grasp of the complexities of local government. In dealing with its many activities related to charging and regulatory frameworks there is some sense of clarity about what the goals and functions of a government body is: buses and trains require set ticket prices, water has to be costed, etc. This is not the case with local government. If the Government is to set caps, then the Minister responsible should be held publically accountable for the setting of those caps, and the Minister should be advised by the DLG in relation to that matter.

The reality is that the NSW local government system is critically flawed and in need of reform. Tinkering with one (equally flawed) aspect of the sector will not, and cannot, address its many problems. Section 4 addressed these issues.