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INDEPENDENT PRICING & REGULATORY TRIBUNAL

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Review of the Revenue Framework for Local Government
Independent Pricing and Regulatory Tribunal
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Review of Revenue Framework for Local Government.

We offer some supplementary comments that were compiled for – or reflect on - the roundtable discussion held in Sydney on 29 September 2008. They refer to some of the issues in the sequence in which they were raised in the *Roundtable Notes* compiled by IPART for those discussions.

The comments refer principally to matters of interest to residential ratepayers. This continues the emphasis in our original submission of 10 August 2008, and reflects the virtually complete absence of direct consideration of ratepayer interests in the submissions made to IPART by councils and their regional and industry organisations.

TERMINOLOGY

As a general comment, we emphasise the desirability of distinguishing between the concepts of the *local community* – which may variously include any or all adults and children, in groups of various sizes, who live in or visit a council area or use its services – and *ratepayers*, which refers only to landowners liable to pay rates to the council.

It is also desirable to ensure a clear distinction between ordinary rates – those subject to ratepegging - and the other forms of council income that are raised from ratepayers such as the domestic waste management charge.

ROLE OF LOCAL GOVERNMENT

Potential roles for a council that are specific to an individual community – that is, roles that are beyond the traditional roads, recreation and rubbish scope – are diverse. However, the mere *diversity* of activity among councils is not important for ratepayers. The specific funding implications of specific services are what affect rates, and they are certainly important.

It is not clear that funding implications are always addressed in detail when new roles are adopted. One reason might be that council roles often change marginally and/or by default, as councils direct their priorities incrementally away from activities such as infrastructure provision and maintenance, and incrementally towards other activities such as 'community development'. While councillors make the priority decisions nominally, the choices and the implications of changed emphasis may not always be explicit or clear to the decision-makers. Tactics can intrude: councillors are often advised that "x" – being (co-incidentally?) a very popular and fundamental service – will suffer if more funds are not found, but they are not always made aware that alternative economies and adjustments of services are possible.

Expenditure patterns necessarily change as council roles change over time, and revenue potential does too. But, when the change is incremental and not explicitly addressed and adopted, the changes are masked within the greater ambit of the council budget.

Before new roles are adopted, it would be desirable for councils to undertake serious analyses, including an explicit analysis of the capital- or labour-intensity and the investment and capital-sourcing requirements over time of the proposed activity; specification of the community segment to whom the service is directed, relevant agency agreements and cost recoupment arrangements where services are provided for third parties, the capacity of user charges to cover supply costs, and implications for the ordinary ratepayer.

The notion enshrined in the legislation that councils may do as they (legally) please is understandably appealing to them, but for ratepayers it is also important to know just what councils may not ***not do***..., that is, what would be sins of omission, and to know what may and may not reasonably be charged against the rate income.

It would be good to have a statement of the *basic role/obligations* of councils, to make clear to ratepayers what services they can expect as a bare minimum, and to make clear to councillors what they are supposed to do as a general rule. The traditional local council activities would serve that common purpose: for example, local road provision and maintenance, refuse removal, building and development supervision, all to safe standards, and recreational open space provision and maintenance to appropriate local standards.

In a context of rate-pegging, it is important to note that the DWMC is an un-restricted charge, and waste management is fully covered by it. Ratepayers seem to accept that the DWMC reflects service costs and what they are charged, presumably because they accept the auditor's assurance to that effect. That may be a useful precedent for other basic services.

Provided the rates revenues were directed solely to basic activities and not diverted to other activities, and subject to similar assurances, a must-do list of activities that councils must undertake could perhaps be exempt from rate-pegging.

For non-basic activities, councils would have to discern the funding sources actively, and could not bury the expenditure in the rate revenue pool. That seems fair enough.

COUNCIL REPORTING

The current form of Annual Report is unhelpful as a way of accounting to *ratepayers* in their role as captive compulsory financiers of councils. The Quarterly Reports of councils on their management plan activities and budget estimates are similarly unhelpful in providing assurance to ratepayers that their compulsory contributions are being used with due prudence. Neither type of report is user-friendly for non-financial types, or forward-looking in terms of role changes and explanations of adaptations of services to changing economics of supply and user demands. Neither explains in plain words the role choices being taken by the council and the reasons which underlie them.

Good reporting should include, among other things, readable accounts of the explorations undertaken to arrange funding of new services, the reasons which underlie gradual or complete abandonment of existing services, the rationale for council decisions to require ratepayers to subsidise specific community segments, details of council decisions to accept *voluntary revenue constraints* such as adoption (complete with its no-charge-for-basic-services requirement) of the Library Act subsidy arrangement, and explanations of council action in relation to external revenue and expenditure constraints and obligations, such as statutory charge limitations and fire service and planning levies on councils set by the NSW Government.

EFFECTIVENESS OF RATEPEGGING

All the councils' submissions seek removal of ratepegging. It is not always clear whether they object to the principle or to the detail, but their submissions lack any indication of concern about the impact of rate bills on ratepayers as such, and seem to adopt the view that reporting to them is enough for the purpose. It might be too much to expect councils to agree that their captive financiers need protection from them, but ratepayers themselves certainly think they do!

Ratepegging is often very useful for councils. They see the maximum allowable rate increase as being officially and objectively sanctioned, electorally readily saleable, and as a working minimum increase that requires no further justification. Ratepegging is a highly convenient whipping post for councils who have not planned ahead in their budgets, or who do not wish to choose between alternative electorally popular activities or reduce them to a level compatible with their financial resources.

In practice, ratepegging is only a partial tool when the range of traditional council activities is considered. For example, the DWMC looks after waste management for residential ratepayers, and is completely outside the ambit of ratepegging. Although a significant charge, it seems to escape criticism when rates and ratepegging are discussed by councils, but payment is compulsory. Perhaps the auditor's certification of the costings is reassuring for everyone.

Some service users, such as developers, are protected by the maximum charges that are statutorily imposed on much of their council business. It is fair to ask why this happens.

Councils say ratepegging constrains the level of rate revenues. Even if that is so, it may not matter much. Ratepegging does not constrain all revenues, and only constrains rate revenues at the margin, if at all: the great bulk of rate revenue is contained in the established body of the rate roll. Importantly, the DWMC is not pegged. Besides, councils automatically adopt the maximum allowable increase before they even think about program and priority discipline. Justified or not, the maximum becomes the (officially sanctioned) minimum increase.

Councils also constrain their revenues themselves. For example, they sterilise part of their future revenues by borrowing for non-critical purposes; they choose to take on populist programs from community wish lists without assured funding; they choose to adopt programs that specifically prohibit revenue-raising (such as acceding to the conditions attached to subsidies under the Library Act); they choose to subsidise service users without assessment of their capacity to pay; they choose to continue providing services without charge and therefore without real understanding of underlying user preferences and efficient supply costs.

Ratepayers *hope* ratepegging as presently operated has a restraining influence on ordinary rates. They note that the special levies that may be allowed on top of the pegged increase are not built permanently into the rating base, and that is seen as a good thing. They think - perhaps naively - that universal council condemnation of ratepegging suggests it might actually work!

Ratepayers have no choice about paying their rates; they do have a choice about using optional community services that attract a user charge (or not). Leaving aside the detailed and clearly imperfect method by which it is presently conducted, a credible form of ratepegging is politically necessary and effective for ratepayers: nothing else signals to them that there is a potential external restraint on dramatic rises in rates.

The *evidence* as to whether ratepegging really restrains rates is ambiguous, because of the concurrent impacts of the DWMC, State/Commonwealth financial assistance, council choices and policies relating to fees and charges, and the conversion by councils of the maximum permitted increase into the minimum.

DEMOGRAPHIC FACTORS

An important aspect is signalled in the remarks of the LGMANSW submission relating to the inherent inequity for ratepayers and the adverse social implications of the present property tax base of rates. Urban consolidation is an urgent equity issue and by derivation, an equally urgent revenue issue. We hope IPART will address this issue directly.

PROCESSES TO ALIGN SERVICES AND CHARGES WITH COSTS OF PROVISION

Council cost allocation is often a bit rough, if indeed it exists at individual service level. The DWMC seems successful, to the extent that ratepayers believe it to be based on audited costs of service provision – it may well constitute a useful precedent for an improved system of ratepegging. Similarly, special levies accompanied by specific works programs seem to have a fair degree of acceptance among ratepayers that contrasts sharply with their attitude to the bulk collection and amorphous expenditure of the ordinary rate revenue.

IMPLICATIONS OF USER CHARGES TO SUPPLEMENT RATES REVENUE.

The primary question is *why* rate revenue might need supplementation.

It needs to be said that it is NOT rate-pegging as such that constrains the funds available for *infrastructure*; councils do. Rate dollars are no different from other dollars – money is fungible – and councils determine their expenditure programs in terms of total available resources. No-one has all the funds they want (or could use). The diversion of rate income away from traditional activities is the councils' choice. When they say they reflect community wishes, we should note that the community's wish list is infinite. Infrastructure spending has to compete with spending on nicer things like art prizes, shopping centre banners, and subsidised services of all kinds.

Council submissions to IPART profess concerns about affordability of *user charges*, but formal assessments of user capacity to pay for individual services are rare in practice. The efficient supply implications of under-charged or free services are an important issue, as is the need to adapt services over time to effective demand by users.

Services supplied under (or at no) cost are supplied in a market vacuum, divorced from the expressions of demand that can tailor services to the needs of users. They have no basis in service economics, and their assumed demand structure is not based in economic reality. Commonly, simple un-costed wish lists derived often from community surveys prevail – they create unrealistic expectations among users. Uncharged services confer undue authority on suppliers/council administrators to determine the nature, scale, cost and content of services to be supplied to meet the stated 'need'.

Where a service has a sufficiently defined character that could lend itself to charging, and unless subsidies are transparently justified, user charges should fund the net cost of the service supplied. Even if subsidies are found to be justified, it does not automatically follow that ratepayers should necessarily fund them, since their own capacity to pay is not assessed.

An affordability concern might fairly apply specifically to ratepayers. Property values do NOT reflect the current (or even past) capacity of owners to pay, because they do not reflect owner equity now or at or since the time of purchase. The current world financial crisis illustrates at the extreme the importance of consideration of the debt level involved in asset ownership.

User charges empower service users to demand effectively the services they want, even when they are only a small minority of the community. Forcing ratepayers to cater for special interest groups has important equity implications.

User resistance to new charges for established free services is common, and readily audible. There is a natural reluctance by councils to excite this resistance. Rating/ratepayer implications of failure to charge, and ratepayer concerns about the outcome of that failure, are not generally recognisable in the wider ambit of a council budget, nor are they typically canvassed in a new charging proposal advertised for public comment. And the economic implications of the charge/non-charge choice for efficient supply of the service/s are usually also undocumented.

BEST PRACTICE > GREATER EFFICIENCIES > POSSIBILITIES

Discovery of market demand for council services should be encouraged, together with clean-sheet budgets that do not assume that all existing services are to remain unchanged, and formal justification of subsidies for service user categories. Formal purchaser/provider arrangements with performance criteria specified would be effective in service delivery by councils on behalf of other tiers of government.

DEBT FUNDING

Debt is a commercial concept and a commercial tool; the best use of debt funding is in commercial activity. When councils undertake commercial activity, their users should be paying the full cost of the debt in user charges. If not, the use of debt as a tool is being perverted.

Natural disasters aside, debt funding is an inferior substitute for forward financial planning. It assists councils to meet voter expectations that could not otherwise be met this year – and thereby limits what can be met next year. It postpones the need to adjust activity to budget reality. It masks the need to adjust priorities in council programs. It sterilises future revenue streams, encourages current budget profligacy, assigns apparent criticality to issues/activities that are merely currently popular.

Despite the enthusiasm of the Allen Report and the apparent enthusiasm of IPART too, ratepayers probably don't care much about inter-generational equity, *nor should they* when they observe defective maintenance of past infrastructure investment. They want this year's rates to be spent this year on what is needed this year, not to pay for something done five, ten, twenty ...years ago, when they maybe didn't even live in the area anyway, and it is falling to bits in front of them.....

OBSTACLES TO GREATER USE OF DEBT FOR INFRASTRUCTURE

It is ***not*** rate-pegging - or other exogenous controls - that constrains the funds available for *infrastructure*; councils do, by determining their own priorities in funding allocation. Rate revenues and Government grants and user charges dollars are just the same as other dollars – money is fungible – and Councils determine their expenditure programs in terms of total available resources. No-one has all the funds they want (or could use). The diversion of rate and other income away from infrastructure provision and maintenance activities is the councils' choice. When they say they reflect community wishes, we should note that the community's wish list is infinite. Infrastructure spending relevant to an amorphous body of users competes with spending on 'nicer' things like art prizes, shopping centre banners, and subsidised services of all kinds that have clear appeal to identifiable community segments.

Use of debt for infrastructure will *not ensure* provision or maintenance of infrastructure. Given the choice of a wide menu of potential activities, councils have clearly and collectively decided to turn a relatively cold shoulder to infrastructure investment in favour of 'human services'. Using debt for infrastructure will, in the short term, release other funds for more of whatever it is that councils presently favour more; in the longer term, debt servicing obligations will merely handicap infrastructure maintenance – and all other – on-going programs.

RATEPEGGING AS A CONSTRAINT ON DEBT FUNDING

Debt servicing obligations can be met by any of a council's revenue sources. It is not clear that there is any constraint on debt funding as such, especially in circumstances when it is essentially appropriate, that is, in cases of natural disaster. If there is a constraint in less appropriate circumstances, that is fortunate. Affordability of debt servicing is a function of priority accorded to other expenditures, and the approach of the council to revenue policies.

OBJECTIVES OF A REGULATORY FRAMEWORK

For ratepayers, a suitable statement might include these aspirations:
- equitable contribution of rate revenues to activities that have a *general* benefit
- reasonable stability of rate imposts year-to-year
- recognition of social inequities inherent in the present property value-based rate system
- equitable contribution by users of council services to the costs of providing those services
- accessible reporting to ratepayers in their role as captive financiers of councils

Ratepegging as presently practiced is imperfect, and under constant threat because of councils' sustained complaints. Whatever its imperfections, it remains the only reassurance presently available to ratepayers as a distinct category of captive financiers that the imposts they face are somehow reasonable in extent and responsible in use. An improved system of regulation could reduce the imperfections and improve the economic and efficient use of ratepayer-derived funding for local councils.

The claim that an electoral sanction protects ratepayers is theoretical, not real. Voters are not necessarily ratepayers; elected councillors may or may not be ratepayers themselves; they may or may not stand for re-election; on-going accounting by councils to ratepayers is at best obscure; councillors have no required or obvious expertise in public finance; the inherent inequity in the present Land Value base of rating is inappropriate, and fast becoming unacceptable in the face of the realities of urban consolidation.

What is needed is a mechanism that can reassure ratepayers that they matter; that they are recognised as being a category that pays, directly and totally, and involuntarily; that they are not dismissed by misidentification with the community as a whole, or seen as an unimportant minority, or as tenants who may or may not have rate bills passed on to them depending on the state of the market, or as people whose capacity to pay rates can fairly be taken for granted.

IPART ROLE

Acknowledging the imperfections of the present system of ratepegging, and supporting the intent of the Minister relating to ratepegging as expressed in the IPART Review terms of reference, we think a productive and useful role for IPART would lie in:-

Advocacy for a defined minimum (and obligatory) role for councils;
Advocacy for revision of the terms of the Library Act;
Advocacy for user charges to be applied to commercial activities of councils
Support for a version of the auditor's role in relation to the DWMC, extended to the expenditure of rates for traditional services;
Definition of an appeal role which would enable assurance for users that user charge levels for specific council services are appropriate
A mechanism of supervision of council rate increases for basic services based on relevant costs, not CPI

RECOGNITION OF COUNCIL DIVERSITY IN RATECAPPING

The identification of basic – compulsory – council functions and assignment of rate revenues to them would help. Advocacy of user charging and/or purchaser/provider funding for non-basic functions is needed. The *process* by which councils determine changes to their roles needs more sophisticated financial analyses than presently occur. Ratepegging needs only to deal with the rate; charges are another matter, and should be generally required to reflect service supply costs except where the need for explicit subsidy is demonstrated, when it should be funded by non-rate revenue.

Hylda Rolfe, Principal 6 October 2008