



SUBMISSION ON IPART'S DRAFT REPORT OF ITS REVIEW OF THE REVENUE FRAMEWORK FOR LOCAL GOVERNMENT	
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Introduction

The Local Government Association of NSW and Shires Association of NSW (the “Associations”) thank the Independent Pricing and Regulatory Tribunal of NSW (IPART) for the opportunity to make a submission on its Draft Report of its Review of the Revenue Framework for Local Government.

The Associations are the peak bodies for NSW Local Government. Together, the Associations represent all the 152 NSW general-purpose councils, the special-purpose county councils and the regions of the NSW Aboriginal Land Council. The mission of the Associations is to be credible, professional organisations representing Local Government and facilitating the development of an effective community-based system of Local Government in NSW. In pursuit of this mission, the Associations represent the views of councils to the NSW Government and the Australian Government; provide industrial relations and specialist services to councils and promote Local Government to the community and the media.

Executive Summary

The Associations remain firmly opposed to rate pegging believing it to be an unnecessary, distortionary and inefficient imposition on councils.

The Associations have welcomed the IPART Review of the Revenue Framework for Local Government and particularly its focus on the anomalous rate pegging regime that persists in NSW. This is the most significant review of rate pegging since it was introduced in 1977 and provides a real opportunity to improve the operation of the system, if not remove rate pegging, in the short term.

The Associations support the introduction of a Local Government Cost Index as the basis for determining the default rate pegging limit. This would be a significant step forward in terms of transparency and accountability. To operate effectively, it will be essential that there is a requirement for the Minister to issue a statement explaining any deviation from the index. The Associations developed a Local Government Cost Index in 2003 and advocated its adoption as the basis for rate determination.

The Associations are generally supportive of the apparent objectives of the proposed options for rate setting (options A and B). However, they fail to go far enough and both contain a number of flaws that need to be addressed before the Associations could endorse them.

Option A needs to be amended to provide greater flexibility for applying for rate variations. As it now stands it is potentially more restrictive than the current system for applying for variations. Option B as it stands, fails to deliver the purported revenue autonomy that it promises. It is highly onerous and appears to offer little meaningful advantage over the simpler Option A variation process.

It is recommended that IPART form a working group to revise and develop the options for rate setting before the report is finalised. The working group should include representatives of the Associations the Rating Professionals Group, the LGMA Finance Professionals Group and other parties with relevant expertise.

The Associations challenge IPART’s conclusions on the financial sustainability of NSW Local Government and find the time series revenue analysis to be flawed. Independent analysis by other parties indicates that NSW Local Government is not nearly as financially sound as the IPART analysis suggests.

Finally, the Associations are concerned that IPART’s recommendations were released after the integrated planning and reporting bill went before Parliament. It will be difficult now to integrate IPART’s recommendations into the IPR legislation.

Rate Setting Options A & B

The Associations generally support IPART's objectives in reviewing the current rate determination framework and the proposed options to improve the current system. However, both options ultimately fail to deliver on the objective of making councils fully and directly accountable to their communities and so improve the ability of councils to reflect community preferences.

Option A represents an improvement of the existing system, primarily through the adoption of Local Government Cost Index. Option B, while seeking to provide improved autonomy to councils, does not seem to provide a meaningful option and seems unlikely to be taken up by councils (see below). Furthermore, both options would retain or even exacerbate the complex and costly regulatory framework of setting rate pegging limits, assessing special variations and exemptions from rate pegging.

As pointed out in our previous submission, the Associations support the abolition of rate pegging in conjunction with the introduction of a framework that enables and requires councils to undertake long term, community based strategic service and resource planning. This framework should require engagement of communities on their priorities and the resources required to deliver them and be based on adequate information from comprehensive financial planning, asset management and financial sustainability considerations. Councils who have implemented such framework should not be subject to rate pegging as they will have in place adequate financial accountability and governance mechanisms as well as performance measurement and reporting frameworks ensuring financially sustainable policies and accountability to the community.

Any outcomes regulation such as setting limits for rates or approving the appropriateness of variations to the limit has the potential to weaken the desired direct accountability to the community and frustrate what really should take place in communities - an open and frank discussion between elected members and their constituents on what the communities' objectives are and how they could be pursued with (potentially) available resources. The Associations strongly believe that no revenue restriction, cost index or Minister's view should interfere with the ability of communities to make their own choices.

Instead of the complex and costly regulatory process associated with options A and B, the Associations suggest a more suitable and simpler process. Councils, who have the appropriate framework in place to ensure activities and services are planned for strategically and based on available resources and community priorities should be exempt from rate-pegging indefinitely. The Minister's and regulator's role should be limited to ensuring such framework is in place. The regulator could rely on regular independent audit of the implementation of and compliance with the framework ("fit for purpose" audit) and intervene where the framework fails. An implemented and fully audited integrated planning and reporting framework would make rate pegging effectively redundant.

Option A

Option A represents a significant improvement of the current rate pegging system insofar as it would introduce a cost index for the determination of the rate pegging limit. The index should more accurately reflect the real costs faced by councils and provide a more transparent assessment process for special rate variations. To operate effectively, it will be essential that there is a requirement for the Minister to issue a statement explaining any deviation from the index. It is recommended that IPART consult with Local Government in development and testing of the index.

While supporting the index, the Associations are concerned that the mechanics of option A in its current form are too cumbersome and inflexible.

Firstly, applications for variations would be limited to a 4-year period and, because of the link to the delivery program of the new integrated planning and reporting framework (page 170), it appears that variations can only be applied for when the delivery program is finalised by the incoming council.

After that there is no option to apply or re-apply when an application has been refused (page 166, 2nd paragraph) other than in undefined exceptional circumstances. Effectively, councils would only be able to apply for 4-year variations at the beginning of the council term leaving them unable to respond if circumstances change subsequently.

Secondly, revenue requirements which variations are sought for often have a longer time horizon than just 4 years, particularly if they are to fund infrastructure over the whole of its life or an associated borrowing program. A 4 year horizon does not capture such revenue requirements. The current framework provides for variations for up to 7 years, removing this option it would be a backward step. Also, long term revenue requirements are based on projections which are subject to change. Any rate variation process should be flexible to ensure councils can change their variations once actual requirements divert from the projection that formed the basis for the initial application.

Thirdly, it needs to be clarified whether rate variations under option A would provide for an escalated revenue base for determining future rate increases (i.e. will the income from the special rates be included in the general income that forms the basis for future calculations of what increases are allowed under the rate pegging limit).¹ The current rate pegging framework allows for both – one-year variations that are included in general revenue and up to 7-year variations that do not become part of the general income and do not escalated the basis for determining future increases.

Option B

The Associations do not regard option B as a meaningful option as it now stands.

Option B does not provide for improved autonomy for councils as the exemption from rate pegging is only granted for a specific 4-year expenditure and revenue plan that already determines the rating levels. Councils would not be able to divert from this planned rate levels. They would not be able to change the expenditure and revenue plan in response to community wishes or changing circumstances.

Furthermore, there does not seem to be a big practical difference between the special variation under option A and option B. Both options cover a 4-year period. In both cases, councils have to prepare a 4-year expenditure and revenue plan (including rate levels), demonstrate community support for the plan, and then have their ideas approved by the Minister (in option A through approval of the rate increases under the plan and in option B through an exemption from rate pegging for the period of the plan and its proposed rating levels). However, an exemption under option B requires more onerous demonstration of eligibility criteria which not only include process measures (i.e. the said framework) but also and somewhat inappropriately outcomes measures (e.g. having sufficient financial sustainability ratios) as well as community engagement that goes beyond what would be required under the special rate variation process under option A and is likely to duplicate engagement under the new integrated planning and reporting framework. The Association find it difficult to see the incentive for councils to go for option B if they could just go for a special variation under option A.²

The Associations generally accept the need for objective eligibility criteria. However, a particular flaw in the eligibility criteria is that it “requires a track record of sound financial performance”. This

¹ This is currently the case in the one-year variation under section 508(2) of the *Local Government Act (NSW) 1993* but not under the multi-year variation under section 508A *Local Government Act (NSW) 1993* (which is also why many councils choose to go with short term, one-year variations).

² The Associations understand that, in theory, the standard of assessment of a special variation under option A and a rate exemption under option B is different. Under a special variation under option A, it appears as if the Minister/regulator would be able to assess the objective necessity of certain expenditures and the appropriateness of the revenue path proposed to fund them and reject the application on this basis. Under option B, if councils are eligible by having in place adequate frameworks and being able to demonstrate adequate sustainability ratios, the Minister/regulator’s standard of assessment would be limited to whether the community supported certain expenditures and revenue paths and would not include an assessment of the objective necessity of expenditures or appropriateness of revenue paths. However, LGSA assumes that, practically, under option A, DLG would mainly look at the community support to identify a demonstrated need.

may unfairly preclude a large number of councils who are seeking to improve their financial performance by implementing sound financial policies and practices that may dictate higher rate increases. These are the councils in most need of the revenue flexibility that Option B is designed to provide.

The Associations question the need for councils to explicitly demonstrate a high level of support for their rating proposals. No other sphere of government is required to explicitly poll the community on their taxation and expenditure proposals. They are answerable at the next election and this should also be the case for Local Government.

The Associations also question the appropriateness of the survey options for demonstrating community support under option B. Simple surveys often tend to misrepresent community views as not all groups in a community respond at the same level. For example, anecdotal evidence shows that people who do not like what council does are more likely to respond than people who are satisfied with council.

The Associations suggest that councils are best placed to find and apply the most suitable community engagement strategy for their communities. Any assessment of the appropriateness of community support under option B or any other community engagement for that matter (e.g. “fit for purpose” audit of councils’ frameworks) should be outcomes based; i.e. it should look at whether council can demonstrate why its engagement strategy is appropriate for its communities.

In terms of survey mechanisms, the Associations suggest considering more comprehensive survey options such as deliberative polling (i.e. polling of a pre-determined representative sample that received background information on the subject before the actual poll). Deliberative polling can provide more accurate and reliable feedback from a smaller sample size than broad based survey proposed in the report. It is also less time consuming and costly. The response and approval rates suggested for the broad based survey also appear to be unrealistically high.

The voting option canvassed in the draft report is not considered to be a realistic option. The election environment does not always provide an environment conducive to rational consideration of complex medium term revenue and expenditure proposals. Few politicians in any sphere of government have successfully run on platforms advocating “increased taxation” , even it was good policy. (Even the GST was sold on the back of tax cuts).

IPART’s Reasoning for Rate Pegging

The Associations do not accept IPART’s reasoning on the validity of rate pegging.

Firstly, IPART’s assumption that the primary benefit of rate pegging was the protection of ratepayers from excessive rate increases is not supported by any evidence. To the contrary, practice in other Australian jurisdictions, where rate pegging does not exist, shows that ratepayers have not been subject to excessive rate increases. It appears that the democratic process and councils’ strategic service and revenue planning suffice to ensure any rate increases are appropriate and based on community priorities.

Secondly, the validity of IPART’s view that ratepayers and the general community would support rate pegging is doubtful.³ The Associations believe that a large proportion of ratepayers and the community are actually not aware of rate pegging and/or do not understand how it works. Furthermore, as pointed out in the Associations’ previous submission to this review, in a survey undertaken by the Independent Inquiry into the Financial Sustainability of Local Government in

³ This view was evident from the Chairman, Michael Keating’s remarks at IPART’s workshop on 2 September 2009 in Sydney.

NSW, about 70% of surveyed residents provided a medium to high support rating for the statement 'I would rather see council rates rise than see cuts in local services'.⁴

IPART's Conclusions on the Financial Sustainability of NSW Local Government

The Associations question a number of assumptions and findings leading to IPART's conclusion that most councils in NSW were financially sustainable. IPART's conclusion relies heavily on its relatively positive findings with respect to councils' operating balance and their infrastructure renewal backlogs.

Operating balance ratio

IPART's finding that NSW Local Government's average operating balance ratio amounts to -0.3% of own source revenue appears significantly overstated because it does not take account of the fact that NSW councils' depreciation expense might be significantly understated as a result of outdated (lower) asset valuations. NSW is the only jurisdiction where Local Government has not fully implemented, fair value asset valuations and has been relying to a large degree on old valuations often based on historical cost. This is certainly the case in years captured in the time series data. These valuations and therefore the associated depreciation expense are mostly significantly lower than what they would have been under fair value. For example, an Access Economics study commissioned by the Independent Inquiry into the Financial Sustainability of Local Government in NSW adjusted annual depreciation data onto replacement cost value for those NSW councils that recorded on "old" historical cost valuations. Access Economics found that this adjustment increased the overall annual depreciation expense of NSW Local Government by around 20%.⁵ This represents a significant increase in total operational expenditure considering that depreciation makes up about 20% of total operating expenditure. FiscalStar, in its annual financial sustainability review of NSW councils, also includes an (undisclosed) allowance for understated depreciation.⁶

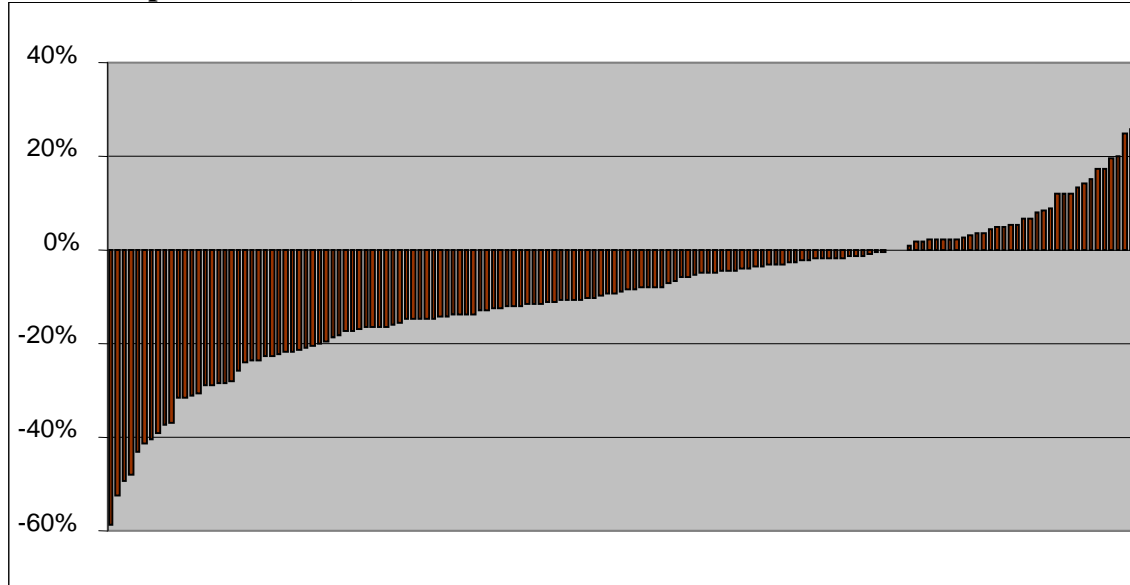
Accordingly, Access Economics found an average operating balance ratio of -4.5%. Also, Access Economics found that about 50% of NSW councils fell below the -10% benchmark for the operating result ratio whereas IPART finds that only 17.1% did not meet this benchmark (see table 11.2). To illustrate this discrepancy, the Associations include below chart 2-3 from Access Economics' report which should be compared to IPART's figure 12.4

⁴ LGSA, Submission on IPART's Issues Paper of the Review of the Revenue Framework for Local Government, (2008), pages 9-10.

⁵ Access Economics, Local Government Finances in NSW: An Assessment, (2006), page 16.

⁶ FiscalStar, 2009 NSW Local Government Financial Sustainability Review, (2009), page 5.

Access Economics, operating balance ratio by individual NSW councils, general government sector (i.e. excluding water supply and sewerage activities) 2004/05 (adjusted onto a basis involving depreciation of councils assets valued at closer to current replacement cost).



Source: Access Economics, Local Government Finances in NSW: An Assessment, (2006), chart 2-3.

For the same reason, IPART's finding that NSW Local Government had larger operating surpluses (or lower deficits) than Local Government in other jurisdictions (finding 27) is questionable.

Infrastructure renewal backlog

IPART's assessment of the infrastructure renewal backlog is also questionable.

IPART appears to assume that previous research overstates the backlog because it was based on data from special schedule 7. IPART asserts that data from special schedule 7, which is to estimate the amount required to bring assets to a satisfactory standard, would often represent what is required to achieve an ideal asset condition from an engineering/technical perspective (page 129) and therefore be overstated. However, IPART has not tested this assertion. Also, anecdotal evidence from sustainability assessment of individual councils indicates that special schedule 7 data is not based on achieving an ideal condition but on achieving reasonable levels of services.⁷

Also, IPART asserts that renewal backlog estimates might be overstated as a result of some actual (or planned) capital expenditure not being accounted for (proportionally) as renewal where old infrastructure is replaced with new, service level increasing infrastructure (i.e. all capital expenditure is wrongly accounted for as upgrade/construction of new infrastructure). However, again, IPART has not tested the validity of this assertion.

IPART's Calculation of Total Revenue

The validity of IPART's calculation of the time series for total revenue is questionable. For a number of reasons, the Associations believe that data before around 1995/96 cannot be relied on and excluding that data has a significant impact on the analysis.

Firstly, advice from the Australian Bureau of Statistics provided to the Independent Inquiry into the Financial Sustainability of Local Government in NSW indicated that the data available for the period

⁷ Percy Allan AM at IPART's workshop in Sydney on 2 September 2009 with respect to ReviewToday's sustainability assessments of individual councils.

before 1995/96 was not very reliable and should be used very carefully. However, IPART has not provided such qualification for its calculation of total revenue going back to 1976/77.

Secondly, the reliability of the time series going back to 1976/77 is discredited by unexplained spikes in revenue growth in NSW around 1980/81 (figure 7.1) and growth in sales of goods and services at around the same time (figure 7.3).

Finally, IPART did not explore the reasons for the significant slowing down in growth of total revenue of NSW Local Government over the most relevant period 10 years to 2006/07 (finding 18, figure 7.1, page 78, 79).

This detracts from the conclusion that NSW Local Government has compensated for rate pegging by increasing reliance on user fees and charges.

Cost Shifting

The Associations do not accept IPART's narrow definition of cost shifting. and note that they do not include these areas in their cost shifting survey; i.e.:

- Cost resulting from stricter regulatory requirements (page 145); and
- Increases in user charges to councils (e.g. street lighting, electricity, water).

Distinct from IPART (which only captures mandatory impositions), the Associations, in their annual cost shifting survey, also include and measure the following categories:

- (The cost related to) the situation where Local Government agrees to provide a service/function on behalf of another sphere of government but funding is subsequently reduced or stopped, and Local Government is unable to withdraw because of community demand for the service/function (e.g. reduction in funding for flood mitigation program, road safety program, community and human services); and
- (The cost related to) the situation where, for whatever reason, another sphere of government ceases to provide or provides insufficient levels of a service/function it is responsible for and Local Government steps in because of community of demand for the service/function (e.g. provision of educational services; community safety (only policing and crime prevention); medical services; certain community and human services).

Furthermore, the Associations not only include the shifting of functions themselves but also the shifting of the funding of functions which other levels of government are responsible for (e.g. Local Government contributions to emergency services funding (11.7% of total budget), the requirement for Local Government to fund 45% of the mandatory pensioner rebate, shortfall state government subsidy for the operation of local public libraries). It appears as if IPART agrees with these inclusions even though it is not covered by its definition on page 144: on page 146, second paragraph, IPART considers as "true cost shifting" unfunded pensioner concessions.

With respect to the comparison with research on cost shifting in other jurisdictions (see IPART's comments on the lower estimates in Victoria and Queensland on page 150, third paragraph), the Associations would like to note that their annual cost shifting survey currently appears to be the only comprehensive assessment of cost shifting in Australia. Furthermore, NSW Local Government is subject to a number of "big ticket items" that are not relevant in other states such as contributions to emergency services funding (e.g. Queensland, WA and South Australia operate a broad based property levy systems and does not have Local Government contributions), and the requirement to fund 45% of mandatory pensioner rebates whereas Local Government in other states is fully compensated.

If the Associations calculated cost shifting according to IPART's definition and based on their survey data, cost shifting would amount to 4.23% of total income before capital or \$300m per annum (including public library funding shortfall) or \$200m per annum (excluding public libraries funding shortfall).

The Associations would be happy to share their data and approach with IPART in order to establish a commonly accepted methodology for measuring cost shifting.

Trend to Fund Activities through Charges rather than Rates

As noted previously, the finding that NSW Local Government compensated for rate pegging by increasing user fees and charges at higher rates than other states is questionable, particularly over the last decade. Even if it were the case a likely consequence is that less funding would be available for infrastructure dependent on general tax revenue, i.e. infrastructure services you can not specifically charge for (e.g. roads). This notion is supported by IPART's findings of operating expenditure growth in NSW exceeding that of other jurisdictions (finding 26) but slower growth in capital expenditure (page 135).

A shift in revenue raising from rates (general government taxes) to user charges for specific services (where income is often bound to activity as a result of cost recovery principles) drives councils to provide more service activities they can charge for and neglect the tax supported infrastructure (mix in service activities changes in favour of operational activities).

Conclusion & Recommendations

The Associations remain firmly opposed to rate pegging believing it to be an unnecessary, distortionary and inefficient imposition on councils.

The Associations have welcomed the IPART Review of the Revenue Framework for Local Government and particularly its focus on the anomalous rate pegging regime that persists in NSW. This is the most significant review of rate pegging since it was introduced in 1977 and provides a real opportunity to improve the operation of the system in the short term and to ultimately remove rate pegging in the long run.

The Associations support the introduction of a Local Government Cost Index as the basis for determining the default rate pegging limit. This would be a significant step forward in terms of transparency and accountability. To operate effectively, it will be essential that there is a requirement for the Minister to issue a statement explaining any deviation from the index. The Associations developed a Local Government Cost Index in 2003 and advocated its adoption as the basis for rate determination.

The Associations are generally supportive of the apparent objectives of the proposed options for rate setting (options A and B). However, they fail to go far enough and both contain a number of flaws that need to be addressed before the Associations could endorse them.

Option A needs to be amended to provide greater flexibility for applying for rate variations. As it now stands it is potentially more restrictive than the current system for applying for variations. Option B as it stands, fails to deliver the purported revenue autonomy that it promises. It is highly onerous and appears to offer little meaningful advantage over the simpler Option A variation process.

It is recommended that IPART form a working group to revise and develop the options for rate setting before the report is finalised. The working group should include representatives of the Associations the Rating Professionals Group, the LGMA Finance Professionals Group and other parties with relevant expertise.

The Associations challenge IPART's conclusions on the financial sustainability of NSW Local Government and find the time series revenue analysis to be flawed. Independent analysis by other parties indicates that NSW Local Government is not nearly as financially sound as the IPART

analysis suggests. However, this difference in views on findings should not detract from the key recommendations in relation to a new rating framework (Options A and B)

Recommendations

1. It is recommended that IPART form a working group to revise and develop the options for rate setting before the report is finalised. The working group should include representatives of the Associations the Rating Professionals Group, the LGMA Finance Professionals Group and other parties with relevant expertise.

2. It is also recommended that IPART use the working group or a similarly constituted group to develop and test the proposed Local Government Cost Index.