

Local Government
Association of NSW



Shires Association
of NSW

Submission

To the Issues Paper of the

**Independent Pricing and Regulatory
Tribunal of NSW's Review of the Revenue
Framework for Local Government**

September 2008

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1. Introduction

The Local Government and Shires Associations of NSW (the “Associations”) are the peak bodies of Local Government in NSW representing the interests of all 152 general purpose councils, as well as about 13 special purpose councils. Thirteen regional Aboriginal Land Councils are also eligible to be members of the Associations.

The Associations welcome the opportunity to make a submission to the Issues Paper of the Independent Pricing and Regulatory Tribunal of NSW (IPART)’s review of the Revenue Framework Local Government.

The submission provides a summary of the Associations’ key positions and then proceeds to address questions and issues raised in IPART’s Issues Paper.

The Associations refer to the Final Report of the Independent Inquiry into the Financial Sustainability of Local Government in NSW (the “Independent Inquiry”) entitled *Are Councils Sustainable? – Final Report: Findings and Recommendations*. This is a current, comprehensive and independent report that is referenced extensively in our submission.

The Associations also refer to two of their recent submissions which are attached to this submission. They should be considered in conjunction with and are extensively referenced in this submission:

- Local Government and Shires Associations of NSW, Submission to IPART Review of State Taxation - Draft Report, (2008); and
- Local Government and Shires Associations of NSW, Submission to Productivity Commission Inquiry on Local Government Revenue Raising Capacity, (2007).

2. Executive summary and key positions

NSW Local Government is under financial duress. This has been confirmed by the Independent Inquiry which found that around:

- 25% of NSW councils are not financially sustainable under current policy settings;
- 50% are potentially vulnerable; and only
- 25% are in a relatively strong financial position.

A key finding of the Independent Inquiry was that, based predominantly on data from the financial year 2004/05, NSW Local Government had accumulated a huge infrastructure renewal¹ backlog of \$6.3 billion that continues to grow by \$500 million per annum. The Inquiry estimated that Local Government would need to increase revenues by at least \$900 million per annum to deal with the backlog and ongoing renewals. This does not include the additional revenue required for growth infrastructure or to deal with demands for improved services.

There are several, sometimes interrelated reasons for this financial situation, including:

- Rate pegging and other legislative constraints on councils fees and charges;
- The decline in Commonwealth and State financial support for Local Government relative to economic growth (GDP, GSP) and the growth in national taxation revenues;
- The expanding roles and responsibilities of Local Government, a trend explicitly recognised by the Commonwealth Grants Commission, The Hawker Report and other reviews;

¹ Infrastructure renewal refers to capital expenditure for sustaining infrastructure at the existing level of service. It does not capture infrastructure enhancement; i.e. construction of new or upgrade of existing infrastructure to provide new services or increase the level of existing services.

- Cost and responsibility shifting onto Local Government by the State and Commonwealth Government, again a trend recognised by the Hawker Inquiry and subsequently acknowledged by the national *Intergovernmental Agreement Establishing Principles Guiding Intergovernmental Relations on Local Government Matters*, (2006); and
- Deficiencies in Local Government financial and asset management practices.

The central issues that need to be addressed to improve this situation are:

- Defining Local Government's role and establishing a mechanism to allocate functions and associated revenue raising powers to Local government; and
- Improving the adequacy and flexibility of Local Government's revenue base to meet the demands being placed on it.

Any revenue framework needs to recognise Local Government's role as the third level of government responsible for all local matters and can only function effectively if a mechanism is in place to appropriately share public functions and correspondingly allocate funding or revenue raising powers between Local Government and other levels of government.

Such a mechanism is essential to ensure Local Government's revenue base is not eroded through tax creep or the imposition of functions (or funding of functions) extraneous to Local Government's role (cost shifting). The Associations have been calling on the NSW Government to enter into an intergovernmental agreement with Local Government to establish such a mechanism.

Any new revenue framework should also enhance local autonomy, accountability and transparency of local decision making, as well as financial governance.

Therefore, the Associations support the abolition of rate pegging (Option 5 in section 7.4 of IPART's Issues Paper) and the introduction of a long term strategic service and resource planning framework based on objectives agreed upon with the community. The framework should include comprehensive long term financial planning, asset management, and monitoring of financial sustainability. Councils who have implemented this system 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.

The Associations note that the Department of Local Government, through its Integrated Planning and Reporting Reform, is in the process of introducing such a framework. The Association have been working closely with the Department on the development of the Integrated Planning and Reporting framework and support its implementation.

As an interim measure, the Associations support IPART's Option 4 in conjunction with Option 2 (section 7.4 of IPART's Issues Paper). Councils who will not have implemented the new strategic planning system should be subject to a more transparent rate pegging system where the rate pegging limit is calculated using a transparent methodology that takes account of the real cost pressures relevant to groups of councils based on criteria specific to each grouping.

Furthermore, the Associations do not accept that there is a demonstrated case for imposing a regulatory framework on fees and charges that are currently unregulated. The current system is already subject to a high level of scrutiny through public consultation and the political process itself. Also, council fees and charges vary significantly to reflect local circumstances, community needs and priorities and it would be impractical and inefficient to centrally regulate the wide range and number of services and associated pricing policies.

To improve the current revenue framework, the Association also recommend that IPART consider undertaking more comprehensive reviews in the following areas:

- Rate exemptions and concessions;

- Land valuations system as the basis for determining rates; and
- Effectiveness of regulated fees and charges.

Finally, the Associations object to any proposal to extend quasi-rating powers to, share council rates with, or provide rate concessions to, property holding state owned corporations which are responsible for providing specific services in their area. Such proposals are flawed in that they fail to comprehend the nature and purpose of council rates as a form of taxation with no nexus to a defined service level.

3. Key questions and subsidiary issues

The following sections address most of the questions raised in IPART's Issues Paper. IPART has raised a number of key questions and, throughout the Issues Paper, identified a number of subsidiary issues.

3.1 The role of Local Government, drivers, and relationship with other levels of government

IPART questions and issues

- *What is the role of local government and how is it determined (question 1)?*
- *What is the current role of local government and its limits? Where does this role come from? Is it self imposed or is it legislated (subsidiary issue 12)?*
- *What should be the limits on the role of local government (subsidiary issue 13)?*
- *What infrastructure and services do councils currently provide (subsidiary issue 14)?*
- *What infrastructure and services should councils be responsible for (subsidiary issue 15)?*
- *To what extent is there overlap with other levels of government (subsidiary issue 16)?*
- *To what extent do service levels vary between councils in their scope, value and quality of infrastructure and other assets (subsidiary issue 17)?*
- *What factors cause differences between council's provision of infrastructure and services to arise (subsidiary issue 18)?*
- *What demographic, intergovernmental, economic, social, technical and environmental changes are affecting Councils now and their future revenue requirements (subsidiary issue 20)?*
- *In addition to the Pensioner Rebate Scheme, are there any other specific measures that could be introduced to address any social impact issues arising from the regulation of council revenues (subsidiary issue 38)?*

Local Government's role as the third level of government in the Australian federation

The Associations support a system of Local Government in which councils are responsible for governing all matters that affect local communities and that are most appropriately dealt with at a local level.

Facilitating local choices and making decisions on local services through a system of Local Government has a number of key advantages. Local Government has the ability to utilise local knowledge and most appropriately identify and manage local variations in needs, preferences and costs of services. Local Government, being the level of government closest to the communities, is best placed to actively engage the public in the decision making process. Furthermore, democratically elected Local Government has the political mandate to make local choices an administrative system could not be accountable to make.

The notion of making local choices at the local level is captured in the principle of subsidiarity, according to which the lowest possible level of government should deliver public functions, except where higher levels of government can undertake these functions more effectively.

For example, in federal systems, federal government should be constrained to matters that are best dealt with nationally, such as defence, foreign policy, social security, labour markets, or trade and corporate regulation. State governments, dependent on their size, tackle issues with a state-wide or major regional benefit, such as regional roads, public transport, police, prisons, courts, major hospitals and education facilities. Local Government should deal with matters that impact local communities, like local infrastructure (particularly local roads), recreational facilities, parks, local land use planning and development approvals, water supply and sewerage service provision

or waste management. Local Government should also be able to facilitate the increasing community expectations for local health and human services, culture and education.

There are a number of elements required to enable Local Government to fulfil this role, the most important of which are:

- Recognition of Local Government's role in the relevant constitutional instruments specifying it as the level of government dealing with local matters and generally assigning corresponding revenue raising powers;
- A mechanism to allocate specific functions between Local Government and other levels of government to prevent an erosion in the effectiveness of Local Government's revenue framework and to avoid wasteful duplication of service provision and confused responsibilities resulting in a lack of transparency and accountability to constituents; and
- A revenue framework that:
 - Provides the flexibility to deal with varying local needs and preferences as well as the varying cost of performing functions and delivering services and infrastructure;
 - Provides the capacity and flexibility to respond to emerging challenges;
 - Provides for transparency and accountability in local governance;
 - Balances the varying revenue raising capacity of different Local Government areas; and
 - Enhances the financial sustainability of Local Government.

An analysis of Local Government's revenue framework cannot be undertaken in isolation of the role of and allocation of public functions to Local Government. Without recognising Local Government's role and in the absence of a mechanism to allocate functions and associated funding or revenue raising powers, the effectiveness of any revenue framework for Local Government is at risk of being diminished through improper impositions of functions by other levels of government.

The recent discussion to increase Local Government's contribution to the funding of fire services clearly demonstrates the need to consider Local Government's revenue framework in the broader context of its role as the third level of government.²

Local Government does not have expenditure functions in relation to fire services and therefore, according to the correspondence principle of fiscal federalism, should not be required to fund these services through its own taxation revenue.

The requirement to fund functions extraneous to Local Government's role would erode the effectiveness of and the accountability inherent in any potential revenue framework. Other levels of government could make use of Local Government to fund their own activities and so avoid accountability to their taxpayers. Local Government's capacity to fulfil its legitimate role would be diminished and ratepayers would not have awareness of and control over activities of other levels of government funded by them.

Another example of an inappropriate imposition in the current revenue framework is the requirement for Local Government to partly fund mandatory rate rebates for pensioners. Addressing social impact issues through welfare and income support is the responsibility of higher levels of government who are able to spread the cost of such assistance more equitably and efficiently over a broader revenue base. Therefore, welfare and income support such as pensioner rate concessions should be fully funded by the higher levels of government.³

² See for further information and a solution to the funding issues: Local Government and Shires Associations of NSW, Submission to IPART Review of State Taxation - Draft Report, (2008).

³ NSW is the only jurisdiction that requires councils to fund nearly half the cost of these concessions.

There are many other examples of such cost shifting⁴ made possible under the current system that result in an erosion of Local Government's revenue base. Indicative figures from the Associations' cost shifting survey show that cost shifting amounts to around 6 per cent of councils' total income before capital amounts; i.e. about \$380 million in the financial year 2005/06 and \$412 million in 2006/07 for the whole of NSW Local Government.⁵ Other major examples of cost shifting are:

- The lack of adequate State Government funding for local public library operations to contribute to the wider educational and leisure benefits generated outside the jurisdiction of councils; or
- The lack of appropriate revenue raising powers given to councils to fully recover the cost associated with a range of regulatory functions such as companion animals control, contaminated land management, noxious weed control, food safety control, flood management, or a number of environmental regulations.

To strengthen Local Government's role and ensure revenue raising powers and financial assistance are commensurate with agreed responsibilities, the Associations have been calling on the NSW Government to enter into an intergovernmental agreement with Local Government to ultimately develop a set of principles as to how functions and funding responsibilities should be divided among levels of government.

The Associations recognise that general government involves the inherent notion of uncertainty as to individual functions and requires flexibility and the existence of default levels of government in order to address new needs and priorities. Especially given Local Government's diversity with respect to size, geography, climate, or socio-economic circumstances it is difficult to say that every council undertake a particular set and standard of functions.⁶

Therefore, an intergovernmental agreement would not itself determine responsibility for individual functions. However, it would identify a body that will determine, pursuant to a set of principles, which level of government should deliver a particular service in a given scenario and ensure that the level of government which is given the responsibility is also given corresponding adequate funding or revenue raising capacity (allocative agreement).⁷

Whatever the specific functions Local Government is to perform, its revenue raising capacity should also be sufficiently flexible to address emerging challenges in the context of local circumstances. Local Government faces a number of challenges none the least of which are:

- Increasing number and complexity of regulatory and compliance responsibilities;
- Increasing community expectations for local services in the areas of health, aged care and child care, culture, education, and economic development.
- Skills shortages;
- Demographic challenges (ageing population, sea and tree changes);
- Environmental pressures (water management, coastal protection); and
- Pressures in regional and rural areas (supplementing or back-filling state services).

However, under the existing revenue framework Local Government struggles to meet these challenges. Currently, rating is the only taxation measure available to Local Government and accounts for approximately 36% of total revenue in NSW. This narrow taxation base places a severe restriction on Local Government's capacity to raise revenue generally. Further, the rating

⁴ Cost shifting describes a situation where the responsibility for or merely the costs of providing a certain service, concession, asset or regulatory function itself are "shifted" from a higher level of government (Commonwealth or State Government) onto Local Government without the provision of corresponding funding or the conferral of corresponding and adequate revenue raising capacity. This description does not address the question of which level of government should be assigned a particular expenditure function.

⁵ For further information see Local Government and Shires Associations of NSW, The Impact of Cost Shifting on Local Government in NSW - A Survey of Councils - 2005-06 and 2006-07, (2008), available at www.StrengtheningLG.lgsa.org.au.

⁶ Independent Inquiry, Final Report: Findings and Recommendations, (2006), pages 108.

⁷ Independent Inquiry, op cit 6, pages 108f.

base varies significantly between councils, an aspect only partially addressed by the horizontal fiscal equalisation principles of the Local Government grants process. Unlike the Australian Government and state governments, Local Government does not have the flexibility to spread its taxation effort over a suite of taxation tools.

As pointed out by the Independent Inquiry, the current revenue framework, by restricting taxes to property rates and retaining rate pegging and regulated fees and charges, does not support Local Government's role as the level of government dealing with all local issues but constrains Local Government's capacity to a minimalist, i.e. merely property servicing role.⁸

To ensure Local Government can keep pace with emerging challenges and associated increasing demand for service delivery and infrastructure provision, there also needs to be a substantial increase in financial assistance from the Australian Government and the State Government to Local Government. Given the high degree of vertical fiscal imbalance in the Australian taxation system, it is the responsibility of higher levels of government to ensure that allocations to Local Government are commensurate with its roles and responsibilities.

The Independent Inquiry and other studies have demonstrated how grants have fallen well behind economic and national taxation growth. The Associations therefore advocate that the quantum of intergovernmental transfers from the Australian Government to Local Government should increase to at least 1% of total Commonwealth taxation revenue (excluding GST). This would ensure that councils gain access to a revenue stream that grows in line with the growth of the economy and therefore can keep pace with demand for service delivery and infrastructure provision.

Local Government's role and the tax system

The recognition of Local Government as a proper level of government and a clear understanding of its role are also crucial to avoiding an erosion of the effectiveness of Local Government's revenue base resulting from the imposition of taxes upon Local Government's general government activities.

A recent example of the tendency to do so is IPART's recommendation to remove the payroll tax exemption for councils.⁹ IPART also suggests that one model for a tax base for an expanded land tax could be utilising the municipal rates base by adding an additional percentage to the rates collected by local councils.¹⁰

The Associations' view is that Local Government, for its general government activities, should not be subject to taxes of other levels of government. Having said that, the Association recognise the need to apply the general taxation system to separate commercial activities of Local Government in order to achieve competitive neutrality objectives. The Associations note that significant commercial activities, such as water supply and sewerage services, are already subject to payroll tax.

As IPART correctly points out, taxation is the mechanism by which resources are reallocated from the private sector (individuals, businesses and other non-government entities) to the public sector to fund public services.¹¹ The public sector, such as Local Government's general government activities, should therefore be excluded from the general taxation system.

Taxation between levels of government has the negative consequence of resulting in a lower degree of transparency for and accountability to the taxpayer. Taxes imposed on Local Government's general government activities would need to be funded from Local Government's only form of taxation, council rates, without being identifiable to the ratepayer as a contribution to another level of government's general revenue.

⁸ Independent Inquiry, op cit 6, page 12.

⁹ IPART, Review of State Taxation, Other Industries - Draft Report, (2008), recommendation 2.

¹⁰ Ibid, pages 112-113.

¹¹ Ibid, page 48, box 4.2.

Finally, imposing taxes upon Local Government would also challenge the justification of rate exemptions for the State Government and require the establishment of complex and costly reciprocal taxation arrangements. Such transaction cost would present an unnecessary burden on taxpayers.

Revenue framework and local accountability

Any revenue framework for Local Government should also be embedded in a community strategic planning framework that ensures understanding of and support by the community, councillors and council staff of the community's long term goals, the resources required and trade offs involved in achieving them, and the necessity of setting priorities.

The Associations note that the Department of Local Government, through its Integrated Planning and Reporting Reform, is in the process of introducing a framework that will enhance accountability and transparency of local decision making as well as financial governance. The Association have been working closely with the Department on the development of the Integrated Planning and Reporting framework and support its implementation.

According to the Department's reform proposal, councils will be required to undertake long term strategic service and resource planning (10 years minimum) and prepare a community strategic plan based on community goals arrived at through extensive consultation and community engagement. Importantly, the community strategic plan is also to consider the level of resources that will realistically be available to achieve its goals and councils will have to prepare a resourcing strategy outlining how to utilise external and internal resources to achieve them. Internal resources will be identified and managed through long term financial planning and asset management.

The introduction of this new framework will enhance councils' accountability to their community, introduce forward-looking strategic service and resource planning, greatly improve financial governance and reporting, and so ensure financially sustainable policies. It will therefore eliminate any justification for the existence of rate pegging and any other interventionist elements of the revenue framework.

IPART questions and issues

- *To what extent are ratepayers satisfied that councils provide services that are appropriate and delivered effectively and to acceptable standards (subsidiary issue 19)?*

Community views on Local Government

There is generally a high satisfaction of ratepayers with the services provided by councils.

The Independent Inquiry commissioned IRIS Research to undertake a comprehensive survey of more than 900 NSW households to canvass community expectations on the role and responsibilities of Local Government (IRIS Survey).¹² The IRIS Survey specifically asked participants to rank council services and facilities by both their degree of importance and their satisfaction with them. The survey deliberately faced participants with the trade-offs involved in delivering services under a constrained revenue base and explored the community's willingness to pay higher rates and charges for increased service levels.

The IRIS Survey found that even though higher priority was given to highly visible services used by a large population (e.g. local roads, waste management, water supply and sewerage, public areas and environmental management) other services, including human, cultural and educational services, were rated as being of high importance by a majority of respondents. Importantly, the survey found that the community does not want councils to withdraw or curtail any other services (human services, recreation, culture and education).

¹² IRIS Research, Opinion Poll on the Role of Local Government in NSW, (2005); available at www.StrengtheningLG.lgsa.org.au. For a summary see Independent Inquiry, op cit 6, pages 72ff.

In terms of satisfaction, 50% of respondents rated their level of satisfaction as high; 35% as medium; and only 15% as low. The majority of respondents (80%) considered that council services provided good value for money.

Finally, the IRIS Survey found that at large the community does not oppose rate increases when necessary. 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'. Support for a rate rise rather than service cuts was stronger in wealthier households with incomes \$100,000 and above.¹³

¹³ Independent Inquiry, op cit 6, section 9.3, page 203.

3.2 Assessment of the current regulatory framework

IPART questions and issues

- *How effective is rate pegging and what are the implications for councils and ratepayers (question 2)?*
- *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, transparency?*
 - *Enhance the accountability of local government (question 4)?*
- *How does the current regulatory framework impact on the efficiency of rate setting by councils (subsidiary issue 11)?*
- *What are the implications of the different revenue sources and revenue raising capacities for rate pegging or alternative regulatory frameworks which may be proposed? (subsidiary issue 21)?*
- *What scope is there for councils to make greater use of user charges (subsidiary issue 22)?*
- *To what extent has the control of rates revenue under the rate pegging regime limited overall revenue growth or encouraged greater use of non-rate revenue (subsidiary issue 23)?*
- *Are there any other significant factors affecting financial performance of local government (subsidiary issue 27)?*
- *To what extent does rate pegging affect financial sustainability (subsidiary issue 28)?*
- *How do rate pegging and other constraints on councils' revenues affect the efficiency of councils' operations (subsidiary issue 31)?*
- *If there are negative unintended effects on financial viability [of rate pegging], what modifications or alternative mechanisms would reduce these (subsidiary issue 40)?*
- *To what extent does rate pegging enhance or diminish the revenue raising by local government when assessed against the above criteria for taxation options by altering the revenue mix or enhancing/diminishing criteria such as efficiency, equity, simplicity, and accountability (subsidiary issue 41)?*
- *If variations under Section 508(2) provide for an escalated base for future rate increases under rate pegging, what benefits do councils gain from making application under the alternative Section 508A? (subsidiary issue 32)?*
- *What is the frequency and pattern of individual council requests for special variations to the rate cap (subsidiary issue 33)?*
- *Are rate pegging special variations becoming the norm rather than the exception with local councils and should alternatives to existing rate pegging practices be considered to provide greater certainty for councils and reduce the need for Government approvals (subsidiary issue 34)?*
- *Given the role of special variations and the other revenue sources for local government, does rate pegging effectively constrain the level of rates and total revenues for local government (subsidiary issue 35)?*
- *Should councils be able to achieve a permanent increase in revenue by applying for a special variation (subsidiary issue 36)?*
- *Does rate pegging increase the affordability and/or availability of local government services especially for poorer regions and sections of the community (subsidiary issue 37)?*

Revenue trends

The current regulatory framework needs to be considered in light of the current revenue trends in Local Government.

The Productivity Commission's *Issues Paper – Assessing Local Government Revenue Raising Capacity* demonstrates an upward trend in all categories of Local Government revenue.¹⁴ This is consistent with the findings of the Independent Inquiry which found modest real growth in all categories of NSW Local Government revenue over the period 1995/96 to 2003/04. While maintaining real growth over this period of 21.6%, the Independent Inquiry found that Local Government lagged NSW State Government revenue growth of 30.3%, Commonwealth revenue growth of 30.7% and NSW Gross State Product (GSP) growth of 31.3% over the same period.¹⁵

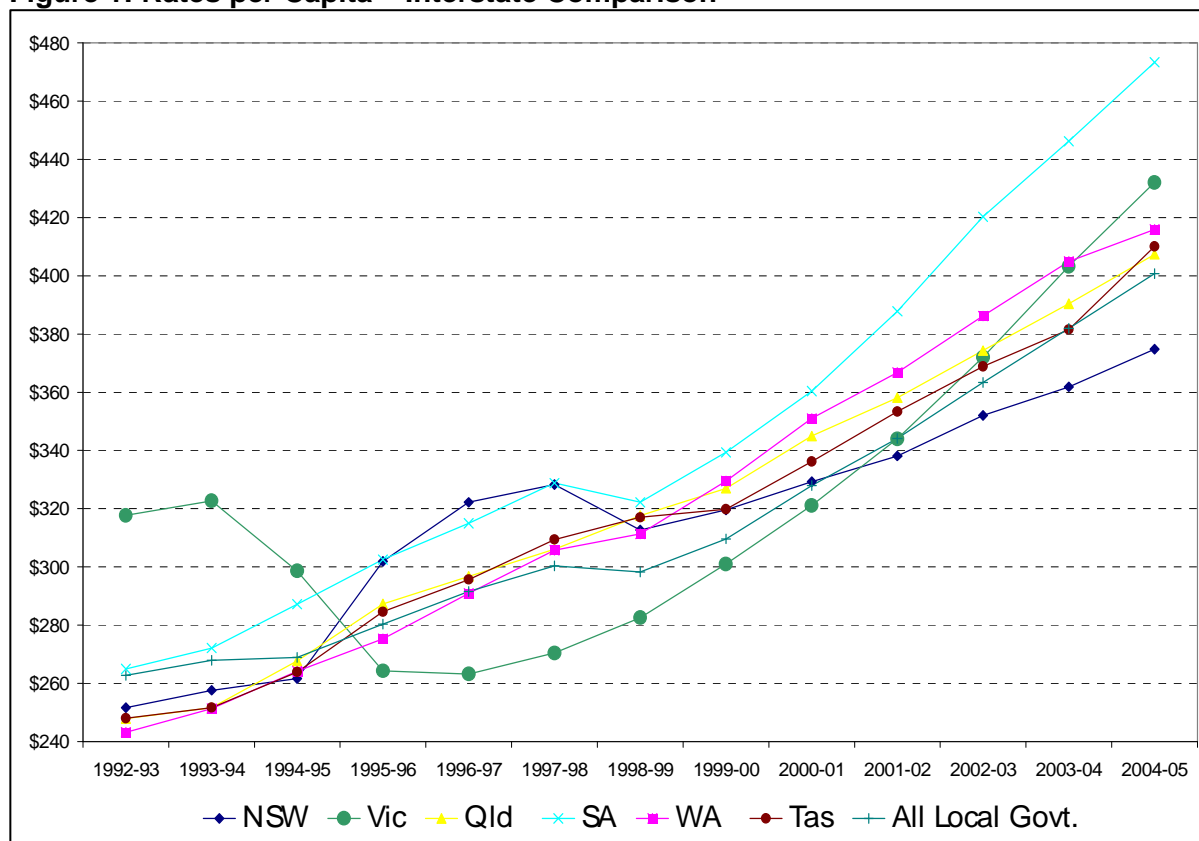
Like the Productivity Commission's *Issues Paper*, the Independent Inquiry also demonstrated varying growth rates for different revenue categories over the period 1995/96 to 2003/04:

- The slowest growth was rate income with real growth of only 0.8% p.a.;
- Grant income grew by only 1.0% p.a.;
- User fees and charges grew by 2.4% p.a.;
- Contributions and donations growth most strongly at 5.4% p.a.

There are several reasons for the differing growth rates.

As illustrated in Figure 1, rates revenue growth in NSW has lagged that of all other states and the Northern Territory during the period and as a result NSW has the lowest rates per capita of any jurisdiction in Australia. This strongly suggests that rate pegging is a major revenue constraint on NSW councils.

Figure 1: Rates per Capita – Interstate Comparison



Source: MAV Viability Index, 2007.

The major component of grant income, the Australian Government's financial assistance grants (FAGs), have grown at a similar rate to NSW rates, marginally exceeding the consumer price index (CPI). This is because FAGs are only escalated in real terms per capita (CPI plus population

¹⁴ Productivity Commission, *Assessing Local Government Revenue Raising Capacity*, (2007), pages 12-15.

¹⁵ Independent Inquiry, *op cit* 6, section 9.2, pages 196-197.

growth) and are not linked to Commonwealth taxation growth or the growth of the gross domestic product.

User fees and charges, including annual charges, have been growing quite steadily in real terms. This suggests a growing reliance on user fees and charges for the provision of goods and services. It would also reflect the growing application of user pays and full cost recovery principles in pricing policies. This is particularly evident in the provision of water supply and sewerage services by councils, where full cost recovery is effectively mandated.¹⁶

Contributions and donations largely consist of developer contributions and, paradoxically, block grants from the NSW Roads and Traffic Authority for regional and local road maintenance.¹⁷ Developer contributions for local infrastructure are collected under section 94 of the *Environmental Planning and Assessment Act (NSW) 1979* (EPA Act) or under section 64 of the *Local Government Act (NSW) 1993* (LG Act) where they relate to water and sewerage infrastructure. The relatively strong growth in contributions revenue is probably explained by two factors:

- The increasing application of user pays and full cost recovery principles; and
- The strong growth in the Australian economy over the last decade reflected in development.

Further information on this issue is available in chapter 9 of the Independent Inquiry's Final Report.

While the longer term data supports the trends discussed above, it should be noted that the Department of Local Government's publication *Comparative Information on NSW Local Government Councils 2004/05* indicates the proportion of revenue derived from contributions and donations had declined from 12.7% to 10.8% between 2002/03 and 2004/05.¹⁸

'Other income' has grown faster than rate revenue or sales of goods and services. 'Other income' includes developer contributions. Developer contributions have been a strong area of growth over the past decade and are likely to be the main driver of growth in 'other income'.

As noted above, rate revenues in NSW have been constrained by rate pegging.

Growth in revenue from sales of goods and services has growing steadily in real terms despite the fact that many fees and charges are regulated under NSW Government legislation. Regulations cover a range of fees including planning and building related fees, health inspections, dog registrations, rating certificates and so on. Regulated fees are only adjusted periodically (3-5 years) and adjustments are usually related to CPI only.

IPART questions and issues

- *To what extent are local governments' expenditure requirements likely to grow in the future (subsidiary issue 24)?*
- *What are the implications of this expenditure growth for rate pegging or alternative regulatory frameworks proposed by submitters (subsidiary issue 25)?*

The Independent Inquiry estimated that, on a no policy change basis, i.e. councils continue to deliver the services they currently deliver and do not respond to additional challenges and functions, revenues would grow in real terms by 8%; expenditures by 9% over the next decade. Taking into account additional functions and pressures, the Independent Inquiry estimated

¹⁶ See below, section 3.5, page 30.

¹⁷ Block grants from the NSW Roads and Traffic Authority, a NSW state agency, are classified as contributions and not as grants from the NSW State Government.

¹⁸ Department of Local Government, *Comparative Information on NSW Local Government Councils 2004/05*, (2006), page 66.

operating expenditure growth to be at least double than the figure estimated for growth on a “no policy change” basis.¹⁹

The Association’s policy position on rate pegging

The Associations maintain that rate pegging is an unnecessary intervention that distorts the operation of the rating system and produces negative consequences. Not the least of which is the direct and indirect suppression of the rating effort.

The experience of other states and territories supports the Associations’ position. While rates have grown more slowly in NSW than in other states in recent years, rates in other states have not increased excessively. This supports the Associations’ view that the political process holds councils accountable.

The effectiveness of rate pegging

If the objective of rate pegging was simply to constrain council rate revenues, rate pegging has been a success. This is clearly demonstrated in the preceding discussion. NSW rate revenue growth is lagging other jurisdictions and other relevant comparative measures. The Independent Inquiry has demonstrated that real rate growth in NSW was negligible over the period 1995/96 to 2003/04.

It could also be claimed that rate pegging has been effective in terms of extracting cost efficiency gains from NSW Local Government. Objective research indicates that NSW Local Government is highly cost efficient and the need to operate within tight revenue constraints may have contributed to this. As noted elsewhere, the Independent Inquiry found strong managerial and administrative capacity and performance in nine benchmarked NSW councils and highly efficient, almost too lean councils in a corporate overheads study with 58 NSW councils.²⁰

While rate pegging may have contributed to this performance, it would be overly simplistic to conclude that it was the sole or even major driver Local Government efficiency. Other factors are also likely to have contributed, not the least of which being the close public scrutiny that councils are subject to. Local Government is highly visible and accountable.

If the objectives of rate pegging include enabling councils to satisfy the growing infrastructure and service demands of the community and enhancing the financial sustainability of Local Government it has been ineffective. This is evidenced by the infrastructure backlogs, funding deficits and prevalence of operating deficits identified by the Independent Inquiry.

Rate pegging provides an incentive not to invest in less visible, less politically sensitive responsibilities (e.g. infrastructure maintenance and renewal) when council is faced with ever increasing community expectations and does not have the option to increase revenue to match them.

Even though NSW councils may apply for special variations to general income which allow for rate increases over and above the rate pegging limit, the Independent Inquiry found that actual increases in average rate revenue only marginally exceeded the rate pegging limit for the period 1995/96 to 2003/04.²¹ This indicates that the rate pegging system has a broader dampening effect than the actual limit.

One likely explanation for the dampening effect is that rate pegging provides a public benchmark and creates public expectations about maximum rate increases, placing political pressure on councils to stay within the limit and not seek special variations.

¹⁹ Independent Inquiry, op cit 6, pages 284f.

²⁰ See below, section 3.3, page 25.

²¹ Independent Inquiry, op cit 6, section 9.3, pages 207-208.

Another related reason is that the rate pegging limit provides an easy default option from both a political and managerial perspective. Possible reasons for this include:

- The increase may be attributed to the State Government;
- Rate pegging alleviates the need for councils to undertake community consultation to justify rate increases within the rate pegging limit;
- Increasing rates within the rate pegging limit avoids the need to enter into the complex process of applying for special rate variations;
- Councils can blame the State Government for their financial deficiencies; and
- Rate pegging reduces the need for long term strategic and financial planning.

In the long run, rate pegging results in the:

- Under-provision of community of infrastructure and services;
- The deferral of infrastructure maintenance and renewal expenditure; and
- Undermining the financial sustainability of councils.

A further criticism of the rate pegging system is that it lacks transparency. There is no official or publicised methodology on which it is based and ultimately it is a political decision. While the rate pegging limit has tended to track CPI over the past 10 years, there have been exceptions and the system is vulnerable to political manipulation.

Another major flaw of the rate pegging system is that it effectively breaks the traditional nexus with land valuation. Land valuations do not drive revenue under rate pegging; they only serve to redistribute the rate burden within council areas.

It could also be considered hypocritical for rate pegging to be maintained on Local Government while NSW State Government land taxes remain uncapped.

The Associations have opposed rate pegging since it was introduced. However, while advocating removal of the system, the Associations have in past promoted the adoption of a Local Government cost index as an interim measure. The Associations developed an alternative model, the *NSW Local Government Rate Determination Model*,²² and presented this to the NSW Government in 2003. The model provided a specific Local Government cost index as the basis for determining the rate pegging limit. This would help ensure that the rate pegging limit would more accurately reflect the actual cost pressures facing councils. As a public index, it would also overcome the lack of transparency associated with the current system.

With the implementation of the Department of Local Government's new Integrated Planning and Reporting framework, the Associations would now see the index based model as a default measure applicable only to councils who have not achieved the new strategic planning and reporting requirements. This is discussed in more detail below.²³

Further information on the issue of rate pegging is available in chapter 9, pages 207 to 211 of the Independent Inquiry's Final Report.

Box section – history of rate pegging

NSW is the only state that currently applies rate pegging. Rate pegging was introduced in response to the prevailing economic and political environment of the mid 1970s and it is doubtful that the concerns of the time are still relevant.

²² Local Government and Shires Associations of NSW, *NSW Local Government Rate Determination Model*, Prepared by the National Institute of Economics and Industry Research, (2003); available from the Local Government and Shires Associations of NSW.

²³ See below, section 3.4, pages 27-28.

An interim form of rate pegging was reintroduced to NSW by the Wran Government in 1977. A revised system, much the same as is currently operating, was implemented in 1978. A form of rate pegging had previously operated in NSW between 1901 and 1952, after which it was discontinued because of its impracticality. The situation had been reached where the majority of councils were successfully applying for an exemption or variation in the limit. This situation was administratively cumbersome and ultimately self defeating.

The incoming Wran government had committed itself to the introduction of rate controls during the 1976 state election campaign. The justification and appeal of rate pegging needs to be considered against the backdrop of the time. The 1970s were a period of rapid social, political and economic change. The pertinent aspect in relation to rate pegging was that the roles of, and relationships between, spheres of government had changed substantially.

The Whitlam Government had established a more direct relationship between the Commonwealth and Local Government. While this involved substantial increases in direct financial assistance to Local Government it was also accompanied by an expanded range of roles and responsibilities. This expansion of the roles and responsibilities of Local Government were also driven by increased community demands and expectations.

To quote Independent State MP John Hatton during the debate on the rate pegging bill:

“The responsibilities of Local Government have grown so rapidly that they have completely outgrown the revenue base and, despite the impetus of money in the form of direct federal grants from the Whitlam Government, which have been carried forward by the Fraser Government, this is still the case.”

At the same time, public perceptions about government were changing, particularly in relation to perceived excesses. While this applied to all spheres, Local Government as the most accessible and familiar sphere of government was particularly vulnerable to criticism.

Most importantly, it was a period of high inflation that impacted on rates through both escalating property values and increasing council operating costs. It was also a period when many believed that wage and price freezes were an appropriate response to inflationary pressures. This view was promptly discredited, however, rate pegging, an analogous concept, is still maintained.

The impetus for the introduction of rate pegging was provided by the rapid escalation of rates in the early 1970s. In the four years, 1973 to 1976, rates increased by an average of 118% while average weekly earnings increased by only 75% and the consumer price index by 56%. Annual increases of between 30 to 40% had been applied in many areas. While this was largely the result of the factors such as expanded roles and responsibilities, it was easy for the public to perceive the increases as excessive.

Interestingly, the argument that rate increases were excessive is not supported by comparison with the revenue growth of other spheres of government. While Local Government general rate revenue increased by 148% between 1970 and 1976, NSW Government revenue increased by 212% and Commonwealth Government revenues increased by 167%. Clearly, Local Government rate increases were quite modest compared to the revenue increases of other spheres of government - a situation that persists today.

Rates are a highly visible form of taxation and because they are presented in the form of bill to be paid annually or quarterly, ratepayers are very conscious of the amount paid and changes from year to year. This is not true of many other major forms of taxation. Bracket creep allows income tax revenues to quietly escalate with little protest by taxpayers and GST revenues escalate in a like manner.

The introduction of rate pegging was also made easier by increases in the level of Financial Assistance Grants by the Commonwealth Government, which many perceived to be a substitute for rate revenue.

In brief, the rationale for the introduction of rate pegging is summarised in the following points:

- It was a period of high inflation and the public were demanding stringency measures;
- Grant funding was (wrongly) perceived as a substitute for rate revenue; and
- Rates increases, unlike many other tax increases, are highly visible.

More recent arguments for maintaining rate pegging include the view that Local Government should reduce its reliance on rate (tax) revenue in favour of user fees and charges for services. Further, the major political parties in NSW appear to believe it is popular and the relevant NSW bureaucracies appear to like to maintain the control mechanism. The experience of other states and territories supports the Associations position that rate pegging is an unnecessary intervention. While rates have grown more slowly in NSW than in other states in recent years, rates in other states have not increased excessively. This supports the Associations view that the political process holds councils accountable.

Principles for a Local Government revenue framework

As indicated above, a revenue raising framework for Local Government should:

- Provide the flexibility to deal with varying local needs and preferences as well as the varying cost of performing functions and delivering services and infrastructure;
- Provide the capacity and flexibility to respond to emerging challenges;
- Provide for transparency and accountability in local governance;
- Balance the varying revenue raising capacity of different Local Government areas; and
- Enhance the financial sustainability of Local Government.

The Associations refute the need for a highly interventionist regulatory framework for Local Government revenues. The Associations do agree that the revenue framework for Local Government should reflect the criteria proposed by IPART; i.e. a framework that:

- Promotes the effective and efficient provision of Local Government services;
- Enhances the financial sustainability of Local Government;
- Meets the standard principles for good regulation and taxation, including:
 - Efficiency;
 - Equity;
 - Simplicity; and
 - Transparency; and
- Enhances the accountability of Local Government.

The legislation that enables Local Government to raise revenue should instil these principles. This should not ordinarily require the State Government to determine increases in rate income, fees or charges. Likewise, the same principles should also be reflected in council rating, fees and charges policies.

Ideally, Local Government revenue policies should be determined by the community. This process should be facilitated through strategic community engagement mechanisms that councils are required to undertake when setting policies and determining corresponding rates, fees and charges and, ultimately, through the electoral process itself.

To ensure an adequate process for the setting of policies and revenue items, the Associations support the Department of Local Government's Integrated Planning and Reporting Project which is to introduce a mandated, integrated community strategic service and resource planning framework supported by long term financial planning and asset management. This framework will enhance

councils' accountability to their community, introduce forward-looking strategic service and resource planning, greatly improve financial governance and reporting, and so ensure financially sustainable policies. This new framework is based on the notion of local autonomy accompanied by strong local accountability. It will eliminate any justification for an interventionist regulatory framework and the existence of rate pegging. The new framework is further discussed below.²⁴

Charges and fees

The current revenue framework for fees and charges has both regulated and non-regulated components.

The Associations do not accept that there is a demonstrated case for imposing a regulatory framework on fees and charges that are currently unregulated. There are several reasons for this including:

- High level of scrutiny: council fees and charges are already subject to a very high degree of public and State Government scrutiny. Councils proposed fees and charges schedules are advertised for public comment as part of the annual management planning process. Any additional changes proposed during the year are also subject to an advertising requirement.
- Reflect local needs and priorities: council fees and charges are typically based on comprehensive policies that reflect local circumstances, community needs and priorities. Different policy criteria may apply to the pricing of particular types of services. Subsidies will often apply where there are equity or public benefit objectives; commercial or market based pricing may apply where the services are subject to competitive neutrality principles.
- Impracticalities of regulation: as a result of the wide range of services that councils provide, a schedule of council's fees and charges will often include hundreds of individual items. Further, the range of services and pricing policies vary significantly between councils. It is clearly an impractical and unrealistic proposition to suggest some form of centralised or prescriptive price regulation under these circumstances.
- Non-essential or non-monopolistic: price regulation is justified where there are monopoly characteristics. The majority of unregulated fees and charges do not reflect these characteristics. In many cases, there will be a private alternative to the council service or facility, for example, a club or hotel may provide an alternate venue to a council hall for a private function. Where monopoly characteristics may exist, it will be commonly found that the services in question are often subsidised for equity and public benefit reasons.

As this submission will discuss below,²⁵ there are probably two major areas where it could be argued that the accepted grounds for regulation may be warranted, namely domestic waste management and water supply and sewerage services. However, both areas are already effectively regulated. The LG Act ensures that domestic waste charges represent only the cost of providing the service and the water supply and sewerage activities of Local Government are regulated by guidelines provided by the Department of Water and Energy. In the latter case the challenge has been to move councils towards full cost recovery, not curtailing monopolistic profiteering, as the political process itself not only provides a disincentive to overcharge but often also an incentive to undercharge where possible.

In relation to other legislatively regulated fees and charges (e.g. planning certificates) it is more a question of whether the regulated fees fall short of cost recovery and thus represent cost shifting onto Local Government (see above for the results of the Associations' cost shifting survey).²⁶ A regulatory measure to ensure that such fees and charges enable Local Government to fully recover the cost involved in performing the related function would be a welcome improvement.

²⁴ See below, section 3.4, pages 27-28.

²⁵ See below, section 3.5, pages 29-30.

²⁶ See above, section 3.1, page 7.

The Associations recommend conducting a review of regulated Local Government fees and charges to determine whether regulation is effective; warranted in all instances; and providing for cost reflective pricing.

A summary of the current policy framework for fees and charges is provided in the text box below.

Box section - Local Government pricing policies

Overall there are 5 general cost treatments for fees and charges available to councils:

- **Legislative cost** – whereby prices are determined by legislation;
- **Zero cost** – whereby Council fully absorbs the cost of the service;
- **Partial cost recovery**- tied to a fee or charge to offset the cost of the service but which has some form of subsidy reflecting equity or public benefit objectives;
- **Full cost recovery** – tied to efficiency and revenue neutral objectives; and
- **Market or competitive pricing** – tied to council business operations and bound by competitive neutrality principles. Council business operations must have cost structures and pricing that does not use its public ownership status to generate a competitive advantage over private providers. For example competitive neutrality prohibits councils from cross subsidising their business services from non-business operations in order to offer discounted business services and undercut private sector competitors.

Fees and service revenues are the main areas where councils can apply varying cost treatments. Section 608 of the LG Act allows councils to charge or recover a fee for any service it provides such as:

- Supplying a service, product, or commodity;
- Giving information;
- Providing a service in relation to council's regulatory functions; or
- Allowing admission to a building or other council owned venue.

In determining which cost treatment is appropriate for each type of service, Councils are guided by principles of “fair imposition” and “user pays”. *Fair imposition* principle is contained in Section 8 of LG Act which sets out the council's charter and states that *councils may raise funds for local purposes by fair imposition of rates, charges and fees, by income earned from investments, and when appropriate by borrowings and grants*. The principle of *user pays* is attached to those council services that are made available to the public but not necessarily provided collectively and generically to all ratepayers. Hence payment is sought from the user or direct beneficiary of the service rather than imposing that cost on all ratepayers.

Mindful of these pricing principles, councils commonly split their services and fee treatments into the following categories:

- **Simple revenue services** – such as parking fees and specific “user pays” services
- **Non-business or “traditional” council services** – free or partial cost services associated with community service obligations such as public library services or community venue hire
- **Competitive or business services** – whereby Council services compete with the private sector providers such as building approval services or nursing homes or child care facilities
- **Legislated or exclusive services** – such as charges for council infrastructure access or planning approval lodgement fees tied to exclusive or monopoly service provision by councils

For some time councils have been exploring new revenue opportunities by breaking down their broad service categories into sub-categories with different cost treatments.

For example, a council may provide a free (zero cost) resident membership for local libraries but

charge a partial cost for use of internet facilities and photocopying services, and apply full cost charges for lost or damaged books. Similarly a council may apply the prescribed legislative fee for the issue of a building certificate, a partial cost charge for variations or reissue of certificates, and full cost for the restoration work (i.e. guttering and paving) relating to the approved building work.

A council may also apply differential fees on the basis of the type of service user. For example councils may allow discount venue hire fees for not-for-profit organisations compared with hire rates for private or commercial operators.

While Councils have the discretion across these areas to set fees and charges, under section 610F of the LG Act, a council must not determine the amount of a fee until it has given public notice of the fee and considered any submissions. In addition there are transitional, disclosure and review requirements imposed on ongoing fees and charge arrangements. Through these mechanisms councils are implicitly required to assess their particular community's capacity to pay and set appropriate price policies.

Rate concessions and exemptions

There are number of rate exemptions and concessions present in the current revenue framework that result in inequities and diminished accountability to ratepayers and so reduce the effectiveness of the revenue framework. Such exemptions and concessions have the potential to violate the principle that all stakeholders should equally contribute to the public services provided by Local Government. Also, ratepayers should not have to subsidise public services to outside groups that are exempt from rating.

The Associations recommend that IPART conduct a major independent review of rate exemptions and concessions in NSW.

The LG Act provides for a wide range of rate exemptions, many of which were carried over from the *Local Government Act (NSW) 1919* and which, in the Associations' view, are outdated and no longer appropriate. The need for a review of these exemptions was recognised by the Independent Inquiry which states in its recommendation 23:

"The State Government should review and remove rate exemptions for all land use for commercial or residential purposes regardless of ownership."

A review should include State Government trading enterprises (e.g. NSW Forests' landholdings used for commercial forestry) and benevolent organisations' commercial activities (e.g. retirement homes and business premises). Councils should also be allowed to apply charges pursuant to section 611 LG Act for all commercial use of public spaces (e.g. underground pipes and cables, street poles, overhead wires).²⁷

The Associations are not opposed to rate exemptions where they are justified; for example, genuine benevolent institutions and charities, public lands, schools and hospitals. The Associations concerns are that in modern times the distinction between public and private or commercial use is becoming blurred in many instances. This arises in areas such as seniors residential and aged care facilities. Many facilities operated under the banner of churches, charities and benevolent institutions bare little distinction from privately owned complexes and facilities. Similarly, many councils cannot see why rate exemptions apply to the large land holdings of many private schools, a large proportion of which is utilised for sporting, recreational, staff accommodation and other non-core educational uses.

Further, the Associations are concerned that some commercial uses of state owned lands remain exempt from rates. This includes commercial activities within national parks, unleased properties held by land holding agencies and the commercial forestry plantations of Forests NSW. As the

²⁷ Independent Inquiry, op cit 6, section 12.6, page 307.

latter compete with private plantations, which do pay rates, there are also concerns with respect to competitive neutrality.

The Associations have also called for new a new provision to be inserted in the LG Act to allow councils wider powers to charge for the commercial use of public spaces. This relates to cables, pipes and wires under or over public corridors. Limited provision is provided under section 611 of the LG Act to charge for such usage. However, this is not enforceable in most instances.

Pensioner rebates are the major concession available in NSW. The expense of the rebate is jointly funded by councils and the NSW Government on a 45:55 basis. The level of the compulsory rebate has been static since 1993. Similar pensioner rebates are provided in other states and territories but are fully funded by the respective state and territory governments.

The cost of compulsory pensioner rate rebates is a rapidly growing burden for many councils and is affecting the level and range of services that councils are able to deliver. The scheme already costs some individual councils well in excess of \$1 million annually. The total cost to councils is now around \$76 million annually. The impact on councils is uneven with higher concentration of pensioners in many coastal councils, regional centres and some older established suburbs.

The issue of pensioner rebates is exacerbated by Australia's ageing population. Australia's population aged 65 and older is projected to increase from 2.5 million (12%) in 2002 to 4.2 million in 2021 (18%). Based on this figure, over a quarter of the population in most Local Government areas will be aged over 65. Despite growing superannuation coverage, many of the retirees will still be pensioners or partially funded retirees who will become pensioners at some stage after retirement.

There are also mounting pressures to increase the levels of the rebates and extend them to self funded retirees. Of immediate concern are recent amendments to Commonwealth legislation whereby asset limits for Centrelink purposes are to increase from 20 September 2007. These trends will potentially swell the number people receiving concessions and dramatically increase the cost of concessions.

It should also be recognised that the costs of pensioner rebates are inequitably distributed among councils. Those who qualify for rebates are disproportionately represented in low income areas; areas that already have a high demand for council services but a limited revenue raising capacity. Given the limited revenue base of Local Government it is unfair that it should be required to fund this form of welfare assistance. This form of benefits should be funded by from the broader revenue base of the state or federal governments. As previously noted, the NSW Government is the only state government that does not fully fund pensioner rate concessions.

Land valuation

As part of a review of Local Government' revenue framework, particularly the rating framework, it is also important to consider land valuation methodologies that form the basis for rate determination.

Currently, in NSW, valuations for rating and land tax purposes are provided exclusively by the Valuer General. Valuations are provided on an unimproved capital value (UCV) basis.

A change in the valuation methodology would have little direct effect on a council's revenue raising capacity in a rate pegging environment. However, it will potentially affect the distribution of the rate burden within a council area.

While it may be argued that UCV methodology theoretically promotes the highest and best use of land, many would argue that an improved capital value (ICV) basis allows for more equitable outcomes. ICV provides a more accurate reflection of the market value of a property and the owner's capacity to pay.

ICV would help alleviate the apparent distortion where, for example, very high value home units pay significantly less rates than free standing homes (of comparable or lesser value) in the same council area. For example, many high value units in many areas pay minimum rates while other properties pay significantly more.

Outside a rate pegging environment, capital values could increase a council's rate revenue raising capacity by increasing the valuation base. Within a rate pegging environment, there may be indirect advantages via greater flexibility to maximise rate revenue through special rate variations; for example, better targeting of capacity to pay.

The Associations recommend that the relative equity and efficiency of the current and alternative land valuation methodologies be specifically addressed in a separate review.

Developer contributions

Developments contributions make a significant contribution to Local Government revenue, particularly in growth areas, and should form an important element of any new revenue framework.

This is why the Associations have strongly campaigned against NSW land use planning reform proposals designed to limit the level and scope of contributions. Restrictions on developer contributions will inevitably lead to increases in rates, fees and charges.

The Independent Inquiry in its Interim Report found that:²⁸

“The principle of developer contributions is a sound one. Developer contributions are efficient and equitable. They are efficient because they set charges that should reflect the real costs of local public infrastructure needed to support a private development and so ensure that such a development does not occur when its total costs exceed its total benefits in both a private and public sense. Also, they provide a mechanism for financing development.

They are equitable because the charges are borne by the beneficiary of the works. The major beneficiary is the owner of the land on which the development is made. As shown in Abelson²⁹, when the supply of land for urban housing is fixed and the price of housing land exceeds its value in alternative uses, as is usually the case in NSW, developer charges reduce the price of land. When the supply of housing land is fixed, the number of new houses supplied is independent of developer charge. The price of new houses is determined by the relative attractiveness of the new housing compared with the existing stock of housing. This relative attractiveness is not affected by charges that the developer has paid.

However, developer charges have to be paid from somewhere and, in general, development is a competitive business so the charges cannot come out of developer profits. Faced with developer charges, developers bid less for land. Of course, if developers already hold land, they pay the extra charge as the landowner. In the absence of developer charges, the land price would be substantially higher. This would be inequitable because the landowner has contributed nothing to this higher price.

In practice, there can be problems in the application of developer charges. There needs to be a nexus between the charges and the development and it can be hard to determine in advance exactly what costs will be involved. Special problems arise when development incurs ‘lumpy’ infrastructure. It can also be difficult to identify marginal incremental costs when development occurs in established areas. Many councils simplify administration of developer contributions by estimating an average rather than marginal or project specific cost for a new development.

²⁸ Independent Inquiry, Interim Report – Findings and Options, (2006), section 9.4, page 177.

²⁹ Abelson P, The Real Incidence of Imposts on Residential Land Development and Building, Economic Papers, (1999), vol.18, pages 85-90 and Abelson P, Taxation and Subsidies for Housing and Land: Market Impacts and Economic Efficiency Implications, Paper presented to 34th Annual Conference of Economists, (2005).

Dollery³⁰ argues that this is inappropriate because it sends the wrong price signals to developers and may encourage the wrong form of development.

In a working paper on developer charges for the Inquiry, Dollery³¹ concludes that developer charges have worked well and that there is a strong case for expanding them.”

The proceeding discussion refutes the most common criticism that developer charges add to the cost of housing, particularly impacting on first home buyers. These arguments are supported by the Productivity Commission’s Inquiry Report into First Home Ownership (2004) which found:

“While infrastructure charges, like other costs of bringing housing to the market, have increased over time, they cannot explain the surge in house prices since the mid-1990s. The claimed cost savings and improvements in affordability from reducing reliance on developer charges for infrastructure appear overstated:

- *Most categories of charges are both justified and desirable on efficiency/equity grounds;*
- *Housing affordability should not be significantly affected by greater reliance on upfront charging as opposed to charging over time;*
- *Developer charges for those items of social or economic infrastructure that provide benefits in common across the wider community have generally been relatively small; though such infrastructure should desirably be funded out of general revenue sources; and*
- *Even if the cost of providing infrastructure to new developments were shifted onto the wider community, housing affordability might not be greatly enhanced.³²*

Developer charges and contributions for infrastructure should be:

- *Necessary, with the need for the infrastructure concerned clearly demonstrated;*
- *Efficient, justified on a whole-of-life cost basis; consistent with maintaining financial disciplines on service providers by precluding over-recovery of costs; and*
- *Equitable, with a clear nexus between benefits and costs.”³³*

It has been argued that development contributions represent only a small proportion of Local Government revenue and therefore the proposed changes to the land use planning framework will have only a minor impact. It is estimated that development contributions represent only around 5% of council revenue.

The problem with this argument is that it overgeneralises. The importance of contributions pursuant to section 94 of the EPA Act varies significantly between councils. It represents between 5-10% of revenue in some cases. And more relevantly, it represents a much higher proportion of capital expenditure; over 30% in some instances.

³⁰ Dollery B, Developer Contributions and Local Government Infrastructure, (2005), for the Independent Inquiry; available at www.StrengtheningLG.lggsa.org.au.

³¹ Ibid.

³² Productivity Commission, First Home Ownership – Inquiry Report, (2004), page 155.

³³ Ibid, recommendation 7.1, page 177.

3.3 Sustainability, efficiency, financial indicators and performance measurement

IPART questions and issues

- *Which performance measures should be developed for councils (or groups of councils) to provide information on outcomes, outputs, processes, inputs and cost effectiveness in their service delivery (subsidiary issue 39)?*
- *What are the appropriate measures for efficiency of local government (subsidiary issue 29)?*
- *To what extent have councils undertaken efficiency reforms and has this been effective (subsidiary issue 30)?*

Financial indicators

The Associations support the introduction of a meaningful and consistent framework of indicators to measure the financial position, performance, and sustainability of Local Government.

The Associations in principle support the indicators for councils' financial position and performance as suggested in IPART's Issues Paper (section 6.1). Financial sustainability indicators should be integrated in and inform councils' long term financial planning and reporting and asset management frameworks as proposed as part of the Department of Local Government's Integrated Planning and Reporting Reform.

Financial sustainability indicators should include/consider the following:

- An appropriate operating result measure to ensure current ratepayers pay for the services they consume. The operating result should generally exclude capital amounts (e.g. grants and contributions provided for capital purposes, profit from disposal of assets). However, the portion of capital grants from other governments available for the maintenance and renewal of assets should be treated as "operating grants" for the purposes of calculating the operating result. Such capital activities are normally funded from rates and charges (directly in the case of maintenance expenses and indirectly through the funding of annual depreciation expenses in the case of capital expenditure for renewals); they are intended to relieve current ratepayers and should therefore be regarded as operating revenue.
- A measure of actual renewal of assets in comparison to their consumption (depreciation) to ensure assets are renewed at the same rate as they are consumed (depreciated).
- To ensure an appropriate perspective on intergenerational equity, any sustainability ratio looking at councils' infrastructure should distinguish between capital expenditure for the renewal of infrastructure and capital expenditure for the enhancement of infrastructure. Capital expenditure on enhancements needs to be spread appropriately between current and future generations. Infrastructure renewal expenditure, on the other hand, should be funded by the current generation as it restores a certain level of service reduced through the current generation's consumption.

The Independent Inquiry has produced a comprehensive framework of financial indicators which is set out in the table below. The Associations are fully supportive of these indicators:

Financial Key Performance Indicators	Average Council Actual	Proposed Council Target	Proposed Upper limit	Proposed Lower limit
Net debt as % of total revenue	10.5%	100%	150%	50%
Net financial liabilities as % of total capital employed	2.2%	10%	15%	5%

Net interest expense as % of total revenue	0.6%	15%	20%	7%
For general govt activities: Operating surplus as % of own-source revenue	-4.5%	5%	10%	0%
For commercial activities only: EBIT as % of non-financial assets	0.9%	5%	7%	3%
Net borrowing as % of capex on new or enhanced assets	1.3%	50%	60%	30%
Annual renewals deficiency as % of renewals capex	40.2%	0%	10%	-10%
Infrastructure renewal backlog (\$M) as % of total infrastructure assets (estimated at fair value)	8.1%	0	1%	0%

Source: Independent Inquiry, op cit 6, table 11.3

Efficiency indicators

There have been attempts to measure managerial and administrative performance and capacity of Local Government. However, such measurement is often based on qualitative research and individual judgements. It is therefore doubtful whether such measurement is suitable for comparison and benchmarking. Furthermore, undertaking regular qualitative benchmarking would be a very costly exercise for councils.

A comprehensive benchmarking exercise was undertaken by the Independent Inquiry with nine NSW councils.³⁴ The exercise showed that Local Government in NSW is well placed within the world best practice model. Service performance and maturity of management practices were found to be above those of both the Local Government sector and service organisations generally in other parts of the world.³⁵

Another exercise undertaken by the Independent Inquiry assessed the managerial efficiency of 58 NSW councils by looking at the back office cost (corporate overheads) in relation to total expenditure. According to this exercise, NSW councils outperform NSW Government benchmarks and the results of most state government agencies.³⁶

The Associations question the value of other generic efficiency indicator, particularly where such measures would make judgements about the appropriateness of council policies. Output measures like the ones used in the Department of Local Government's annual publication *Comparative Information on NSW Local Government Councils* are misleading as they do not take account of different local circumstances and community preferences. They are also meaningless in the sense that they are not linked to community objectives agreed upon through proper community strategic service planning.

It is not desirable to compare measures of efficiency of service provision among councils where the range and level of service differs dependent on local preferences and priorities and the cost of service provision varies dependent on local circumstances.

Therefore, the Associations support the establishment of a performance measurement framework that is focused on outcomes agreed upon by individual communities and their council. It should be up to the community to determine and judge the policies of their council.

³⁴ QMI Solutions and Service Probe, *Service Practice and Performance in NSW Local Government*, (2005); for the Independent Inquiry; available at www.StrengtheningLG.lgsa.org.au; for a summary: Independent Inquiry, op cit 6, pages 245-249.

³⁵ Independent Inquiry, op cit 6, section 10.4, pages 245-249.

³⁶ DG&AB Maxwell, *Corporate Overheads of Local Governments*, (2006); for the Independent Inquiry; available at www.StrengtheningLG.lgsa.org.au; for a summary: Independent Inquiry, op cit 6, pages 250-252.

The Associations are thus fully supportive of the Department of Local Government's Integrated Planning and Reporting Reform. An essential part of this reform is for councils to be required to monitor and report on the achievement of long term community goals through performance indicators agreed upon by the community.³⁷

Efficiency improvements

The Independent Inquiry found that resource sharing and regionalised provision of services can enhance the efficiency of municipal service delivery if it is applied through specific and flexible structures which are able to determine delivery of which service would benefit from resource sharing in their particular circumstances and to implement such arrangements.³⁸ Ad-hoc resource sharing models and regional organisations of councils and other strategic alliances provide such structures.

In recent years, many councils have entered into shared service arrangement and strategic partnership either through their regional organisation of councils or other strategic alliances to capture economies of scale and enhance the efficiency and effectiveness of service provision.

A number of examples such arrangement are described in detail in the Independent Inquiry's Final Report (pages 262 to 264).

³⁷ See below, section 3.4, pages 27-28.

³⁸ Independent Inquiry, op cit 6, pages 262-266 and option 10.5.9.

3.4 Comments on alternative revenue frameworks

IPART questions and issues

- *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, transparency?*
 - *Enhance the accountability of local government (question 4)?*
- *What alternative regulatory models could be used to regulate rates and charges in NSW (subsidiary issue 42)?*
- *How do the various alternatives rate against the criteria listed above i.e., financial accountability and governance, financial sustainability, comparative efficiency and effectiveness indicators including affordability and availability of local services and facilities (subsidiary issue 43)?*

The Associations have outlined the general principles for an improved Local Government revenue framework in their comments on the role of Local Government (see above).³⁹ In this section, the Associations will briefly comment on the options with respect to rate pegging proposed by IPART in section 7.4 of the Issues Paper.

The Associations support the complete removal of rate pegging (see above for a detailed discussion of the negative consequences of rate pegging)⁴⁰ and the introduction of a framework of enhanced accountability (Option 5 of Issues Paper).

The Associations note that the Department of Local Government, through its Integrated Planning and Reporting Reform, is in the process of introducing a framework that will enhance accountability and transparency of local decision making as well as financial governance.

According to the Department's reform proposal, councils will be required to undertake a long term strategic service and resource planning (10 years minimum) and prepare a community strategic plan based on community goals arrived at through extensive consultation and community engagement. The purpose of the plan is to identify the community's main priorities and expectations for the future and to plan strategies for achieving these goals.

Importantly, the community strategic plan is also to consider the level of resources that will realistically be available to achieve its goals and councils will have to prepare a resourcing strategy outlining how to utilise external and internal resources to achieve them. Internal resources will be identified and managed through long term financial planning and asset management. Long term financial planning should include a framework of financial sustainability indicators (see above)⁴¹ to ensure council and the community can keep track of council's financial situation and regularly assess the sustainability of its resourcing strategy.

Finally, to ensure a high degree of accountability and transparency, the achievement of community goals is to be measured through an outcomes focussed performance measurement framework agreed upon with the community during the consultation process and reported on in council's annual report.

³⁹ See above, section 3.1.

⁴⁰ See above, section 3.2, pages 14-17.

⁴¹ See above, section 3.3, pages 24-26.

The introduction of this new framework will enhance councils' accountability to their community, introduce forward-looking strategic service and resource planning, greatly improve financial governance and reporting, and so ensure financially sustainable policies. It will therefore eliminate any justification for the existence of rate pegging.

As an interim measure, the Associations support IPART's Option 4. Councils who will have fully implemented the integrated strategic planning and reporting framework should be exempted from rate pegging as they will have in place adequate financial accountability and governance mechanisms and performance measurement and reporting frameworks ensuring financially sustainable policies.

Councils who will not have implemented the new system should be subject to a more transparent rate pegging system where the rate pegging limit is calculated using a transparent methodology that takes account of the real cost pressures for groups of councils⁴² based on criteria specific to each grouping (Option 2 of Issues Paper).

IPART questions and issues

- *Is the Department of Local Government modification of the Australian Classification of Local Governments (ACLG) a suitable framework within which to consider the differences between councils (subsidiary issue 42)?*

Council groupings

The Associations support in principle the ACLG and the Department of Local Government's modification of it as an appropriate way of grouping councils.

However, it would be desirable to also include the following criteria:

- Population growth to capture the different challenges faced by growing and councils with declining populations (e.g. infrastructure enhancement, human services);
- Location in terms of coastal or inland to capture the different environmental challenges faced by councils in coastal areas to councils in inland areas (e.g. water availability, drought, impacts of climate change);
- Economic circumstances to generally capture different economic status and development opportunities; and
- Revenue raising capacity and grant dependency to capture any fiscal disabilities faced by different types of councils.

⁴² For a discussion of such a methodology see above, section 3.2, page 15.

3.5 Role of IPART in setting rate, charges and fees

IPART questions and issues

- *What role should IPART play in setting local government rates and charges, including charges for non-business activities (question 5)?*
- *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 (question 6)?*
- *What role should IPART play in setting local government rates and charges in future years (subsidiary issue 44)?*
- *How should IPART's role be implemented (for example, by a legislative amendment giving IPART a determinative role or by a terms of reference from the Minister requiring recommendations from IPART) (subsidiary issue 45)?*

The Associations have outlined their position on rate pegging and the issue of setting or regulating rates by another body. The Associations preferred rate pegging model (Option 5) does not require the involvement of IPART.

However, the Associations' submission points to a potential determinative role for IPART to undertake the annual determination of a default rate pegging limit (Option 4 in conjunction with Option 2) to apply to councils that have not implemented long term community strategic service and resource planning pursuant to the Department of Local Government's Integrated Planning and Reporting proposal. Apart from providing a default rate pegging limit, this would provide a benchmark for reviewing the community strategic plans of comparable councils.

Further, as set out above,⁴³ the Associations do not accept that there is a case for the imposition of a prescriptive regulatory framework for fees and charges that are currently unregulated.

In terms of large scale commercial service, the Associations recognise the benefit of a regulatory framework to ensure councils fully recover their economic costs, including cost of capital, but not exploit any monopoly powers. However, the Associations do not support a determinative role for IPART in the pricing determination for commercial activities for the following reasons and see IPART's role rather as one that provides consistent guidelines on the charging for commercial services:

- Pricing of commercial activities is an important consideration in the determination of whole-of-community outcomes and should be the responsibility of democratically elected councillors to ensure that pricing decisions are responsive to community needs, based on local circumstances, and integrate commercial service provision into broader whole-of-community outcomes;
- It would be highly impractical and costly from a regulatory perspective as well as for councils to enable IPART to collect information about and consider the diverse supply and demand profiles and community preferences in Local Government areas across NSW. Councillors, because of their local knowledge and supported by best practice pricing policies and other regulatory instruments, are better placed to make strategic decisions about pricing;
- The current system of price setting is transparent and cost-efficient; and
- Determination by a central agency such as IPART could result in significant inefficiencies caused by operational inflexibility (e.g. long periods between pricing determinations during which councils are unable to timely respond to changes in circumstances such as potential

⁴³ See above, section 3.2, page 18.

additional cost associated with required infrastructure spending due to drought or increased demand).

It also needs to be noted that significant commercial activities are already subject to (quasi-) price regulations.

Council owned and operated local water utilities are already subject to (quasi-) price regulations as part of the *Best-Practice Management of Water Supply and Sewerage Guidelines* produced by the NSW Department of Water and Energy. The guidelines set requirement for water charges and developer charges for water supply and sewerage infrastructure and require local water utilities to achieve full cost recovery. Local water utilities have continuously improved best practice management and made significant progress in their adoption of the criteria of best-practice management identified in the guidelines.

Councils' domestic waste management are regulated by the LG Act requiring charges not to exceed the "reasonable cost" to the council providing those services; section 504(3) LG Act.

Furthermore, water and sewerage services (38 per cent of total turnover of Local Government businesses) and waste collection and related services (8.8 per cent, *ibid*) are commercial businesses and as such expected to meet the requirements of National Competition Policy (NCP).

3.6 Framework for setting charges levied by other public authorities

IPART questions and issues

- *To what extent do government authorities - such as SHFA, SOPA, RWA and the GCCs - provide services that duplicate or overlap with those of local government? (question 7)?*
- *What are the implications for local government rates where these authorities provide services normally provided by local government (question 8)?*
- *Should a common regulatory framework be introduced for these authorities? (question 9)?*

- *Whether a common legislative or regulatory framework be introduced to improve consistency in the levying of charges by authorities (such as SHFA, SOPA, RWA and GCC) that provide services akin to those provided by local government (subsidiary issue 46)?*
- *The best form for this legislative or regulatory framework to take (subsidiary issue 47)?*
- *To the extent that these authorities provide services that overlap with or duplicate those of local government, what benefits and disadvantages arise from the duplication of service provision (subsidiary issue 48)?*
- *To the extent that these authorities provide local government services how should the costs of these services be recovered? To what extent would these arrangements promote: efficiency; equity; simplicity; and transparency (subsidiary issue 49)?*
- *Similarities and significant differences (in quantum, scope or standard of service) between SHFA, SOPA, RWA and neighbouring councils in regards to:*
 - *current regulatory frameworks including governance arrangements, accountability to the local community and the role of the State Government in setting fees and charges and determining revenue levels and/or mix*
 - *property related services including land use planning, the processing of development applications, development activities, the levying of developer contributions, conservation of natural and cultural heritage, management of public domain areas and provision of infrastructure 75*
 - *management of major events and regional promotions, and*
 - *responsibilities under the Roads Act 1993 (subsidiary issue 50)?*
- *The potential overlap between the Growth Centres Commission's development approval and infrastructure planning processes and those used by Growth Centres Councils (subsidiary issue 51)?*
- *The extent to which SHFA, SOPA, RWA and the GCC, respectively, impact upon the costs incurred and revenues generated by the corresponding councils (subsidiary issue 52)?*

The Associations would object to any proposal to share council rates with, or provide rate concessions to, property holding state owned corporations. The Associations would consider such proposals to be flawed in that they fail to comprehend the nature and purpose of council rates. Rates are a form of taxation, the only taxation instrument available to Local Government. There is no nexus between rates and a defined service level. Local Government rates are similar to land taxes and, like other State and Commonwealth taxes, they do not entitle the individual taxpayer to a specific range of goods and services.

“Municipal service” provision by state owned corporations is analogous to the type of “municipal services” provision by, for example, Westfield shopping centres in and around the shopping mall. This would not warrant any concessions or re-allocation of rates.

The Association note in this regards the following incorrect statements in the IPART Issues Paper:

- Domestic and trade waste/garbage services are not covered by council rates but are financed by separate and specific waste charges. Trade waste services as used by businesses are

generally competitive and businesses may opt to engage services directly from private providers rather than use and pay for the trade waste service provided by councils.

- Non-commercial properties on lands held by the Sydney Harbour Foreshores Authority and the Sydney Olympic Park Authority are not subject to rates.

The question of the payment of rates by state owned businesses has previously been reviewed at length by the former Reciprocal Charging Committee convened by NSW Treasury to develop policies and principles relating for achieving competitive neutrality under National Competition Policy. The Reciprocal Charging Committee provided its final report to Cabinet in December 2001. The report concluded that all land held by State Government businesses for commercial purposes should be fully rateable. This included bodies such as the Sydney Harbour Foreshores Authority. A relevant extract from the report can be found in the text box below.

Apart from the issues involving taxation principles, it is also questionable whether these authorities should continue to administer and service these land holdings in the long run. Once the areas have been fully developed for commercial and particularly residential purposes, it may be more appropriate that they either be absorbed into adjoining Local Government areas or be separately established as Local Government areas with their own democratically elected councils.

Box section - extract from the Reciprocal Charging Committee's Final Report to Cabinet in 2001

5.2 PAYMENT OF COUNCIL RATES

There is an argument for State Government businesses to pay Council rates simply from the perspective that the private sector businesses with which they compete are required to pay rates on all land. Government businesses should also be required to earn a commercial return on their assets to recover the opportunity cost of capital investments. The Commercial Policy Framework was developed in recognition that NSW Government businesses, like their private sector counterparts, should be exposed to the disciplines of the market.

As indicated in section 3.3, Government businesses lose their exemption from Council rates when they become corporatised. The complete implementation of competitive neutrality policy would require that Council rates be imposed on all Government businesses to remove any competitive advantage attributable to these exemptions.

In principle, there is no reason for a State Government business to be exempted from Council rates when they operate in potentially competitive markets and are subject to the financial requirements of the Commercial Policy Framework. To ensure consistent application of the policy framework, Government businesses should pay full Council rates on all landholdings currently (or potentially) used for commercial business purposes.

Policy Principle 1b:

State Government businesses to commence payment of full Council rates and charges on all commercial (or potentially commercial) landholdings from the scheduled commencement of the reciprocal charging policy (page 31).

The Working Group therefore considered that protection or exemption from Council rates should only be retained by 'non-commercial' or 'non-business' activities. For the purposes of this Review, the coverage of charging policy will include all land held for commercial, or potentially commercial, purposes by Government businesses.

To give effect to this policy, the principle has been established that all land owned by a Government business is deemed to be held for commercial purposes and therefore fully rateable under the charging policy, including all public recreation areas (see Box 1). This principle excludes land that is held for 'non-commercial' or 'non-business' purposes by virtue of the Government's social policy objectives.

The Working Group recognises that there is a much broader issue at stake, whether ownership of 'non-commercial' land should be retained by Government businesses.

Policy Principle 2a:

All land owned by a State Government business is deemed to be held for a commercial purpose and therefore fully rateable under the reciprocal charging policy. This principle excludes land that is held for 'non-commercial' purposes by virtue of the Government's social policy objectives (page 32).