

## **INQUIRY INTO LOCAL GOVERNMENT IN NEW SOUTH WALES**

**Name:** Prof Brian Dollery and Dr Joseph Drew

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## **Submission to the Inquiry into Local Government in New South Wales**

We thank the Committee Chair for extending the opportunity to make a submission to the inquiry under reference. The following details our response to three of the matters detailed in the terms of reference:

### ***1. The New South Wales Government's 'Fit for the Future' reform agenda***

The New South Wales Government's Fit for the Future (FFTF) program is characterised by both a series of compounding errors and a failure to heed the advice of agencies, academics and the local government sector. The result has been an example of monumental government failure.

The FFTF program had its genesis in the Destination 2036 (D2036) forum held in August 2011. At this forum participants representing the executive and elected arms of local government overwhelmingly supported a draft 'Vision for NSW Local Government'. It is worth restating the 'refined' draft vision for Local Government in order to illustrate how far FFTF has deviated from the aspirational statement developed in D2036:

#### *Strong Communities Through Partnerships*

*By 2036, all NSW communities will be healthy and prosperous – led and served by strong, effective and democratically elected local government.*

*Through leadership local knowledge and partnerships with community, government and other sectors, we will plan our futures and deliver quality services and infrastructure. We will be recognised, respected and responsible for:*

- *Upholding the highest ethical standards*
- *Sound financial management*
- *Sensitive environmental stewardship*

- *Meaningful community engagement, advocacy and leadership*
- *Our adaptability, innovation and learning*
- *Developing the full potential of our people*
- *Responding to our diverse cultures, environments and economies*
- *Creating places that value people*

(D2036 Implementation Steering Committee, 2012)

Crucially the Vision Statement adopted in D2036 made no mention of boundary reform whether forced or voluntary. It did however stress the need for partnership between the state government and local governments and the need for ‘meaningful community engagement’.

In August 2011, the Minister for Local Government – Don Page – established the Independent Local Government Review Panel (ILGRP) on the request of the ‘Local Government and Shires Association’ to ‘draw on independent expertise’ to ‘identify how councils can best govern and be structured to support the future wellbeing and prosperity of NSW communities’ (Destination 2036 Implementation Steering Committee 2012, p.4). The terms of reference for the ILGRP clearly stated that the Panel should ‘take into account the Liberal-National’s 2011 election policy of no forced amalgamations’ (ILGRP 2012, p 7).

Despite the terms of reference the ILGRP (2012, p 5) noted that:

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The Panel will seek further evidence on the benefits and drawbacks of boundary changes in different circumstances. It will formulate proposals for amalgamations, new regional entities and shared services as appropriate throughout NSW. There is a case to consider significant consolidation of local government across the Sydney metropolitan area, and in other major urban regions, and some regional centres.

The next step in the journey to FFTF was the release of the NSW Treasury Corporation (TCorp) report – *Financial Sustainability of New South Wales Local government Sector 28 March 2013* – in which NSW councils were assigned financial sustainability ratings (FSR) based on the compilation of ten financial ratios according to various weights (see Table 1). TCorp was engaged by the OLG (then the DLG) to assign ratings on the scale of ‘distressed’ to ‘very strong’ for use by the ILGRP. Criticism of the TCorp ratios, weightings and benchmarks was expressed by academics (see Drew and Dollery, 2014a) and councils (see, for instance Pittwater council 2014). Moreover, it has been demonstrated that the method employed for compiling the ratios into a single rating is a major determinant of the rating assigned to councils and it follows that the method should have been made transparent (see Drew and Dollery 2014b unpublished).

On the basis of the TCorp report the ILGRP (2013a, p 4) made the following statement in its penultimate report *Future Directions for NSW Local Government, Twenty Essential Steps* – in April 2013:

In particular, the recently released report of the NSW Treasury Corporation (TCorp) paints a disturbing picture of a local government system facing major financial problems with apparently little awareness of just how serious the situation has become. Work needs to start immediately on assembling and implementing a package of measures.

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The ILGRP (2013a, p 5) then went on to state that it ‘seek[s] to reduce the number of councils in the Sydney basin to around 15, and create major new cities of Sydney, Parramatta, and Liverpool, each with populations of 600-800,000’. Incidentally, councils of this size would dwarf three of the eight states and territories making up COAG. Moreover, the ILGRP (2013a, p 6) justified its recommendation for amalgamations on the following basis:

It is also clear that the financial base of the sector is in urgent need of repair: many councils face very serious problems that threaten their sustainability and provision of adequate services to local communities. Put simply, there are too many councils chasing too few resources.

Thus, it is not surprising that a number of academics (see, for example Drew and Dollery 2014a; Abelson and Joyeux 2015) interpreted this document as a call for municipal amalgamations aimed at enhancing the financial sustainability of the municipal sector. On this basis Drew and Dollery 2014a published a paper in the peer review academic journal *Public Money & Management* in which they demonstrated (i) 'little evidence of any statistically association between the financial sustainability ratios and population size for Greater Sydney councils' (Drew and Dollery, 2014a, p 287) and (ii) 'an insignificant improvement in financial sustainability should the boundary changes recommended by the ILGRP proceed' (Drew and Dollery, 2014a, p 287). In response to this paper the Panel Chair – Graham Sansom (2015) – wrote a vitriolic debate piece for the same journal in which he claimed that Drew and Dollery (2014a) had misrepresented the Panel's 'preferred options' as 'recommendations'.

A curious aspect of the ILGRP (2013a, b) reports was a lack of empirical evidence for the various 'preferred options' which academics, the IPART and OLG later interpreted as 'merger recommendations' (IPART 2015a, p 15). Several well-established techniques for determining the optimal size of government – such as multiple regression analysis and data envelopment analysis – exist in the scholarly literature (see, for instance, Drew, Kortt and Dollery 2014 and Drew, Kortt and Dollery 2015) however there is no public record of the ILGRP engaging or conducting such analysis. The only substantive analysis informing the ILGRP reports was the NSW Treasury Corporation (TCorp's) FSR, which were far from comprehensive and open to attack on the basis of arbitrary weightings and benchmarks along

with the non-transparent compilation methodology employed. However, the ILGRP (2013a, p 4) appears to have unconditionally accepted TCorp's methodology and the OLG used a number of the ratios and benchmarks in its subsequent Comparative Information on NSW Local Government reports (see Table 1)

**Table 1. Changes to the TCorp Financial Sustainability Ratios.**

<b>Financial Ratio</b>	<b>TCorp Weighting</b>	<b>Comparative Information Report 2012/13</b>	<b>TCorp Threshold</b>	<b>Fit For The Future</b>
<b>Operating ratio</b>	17.5%	Reported	>-4%	>0.0% over 3 years
<b>Own Source</b>	17.5%	Reported	>60%	>60% over 3 years
<b>Cash Expense</b>	10.0%	Reported	>3.0 months	Abandoned
<b>Unrestricted</b>	10.0%	Reported	>1.5	Abandoned
<b>Current Debt Service</b>	7.5%	Reported	>2.0	0 to 20% over 3 years <sup>1</sup>
<b>Interest Cover</b>	2.5%	Not reported	>4.0	Abandoned
<b>Infrastructure backlog</b>	10.0%	Reported	<0.02	<2% (unchanged) no time frame specified
<b>Asset Maintenance</b>	7.5%	Not reported	>1	>100% (unchanged) over 3 years
<b>Building and Infrastructure Renewal</b>	7.5%	Reported	>1	>100% (unchanged) over 3 years
<b>Capital Expenditure</b>	10.0%	Not reported	>1.1	Abandoned
<b>Real Operating Expenditure per Capita</b>	n/a	Reported in nominal terms only according to 8 functional categories	Not considered	No time or threshold in documentation

Source: TCorp (2013); Office of Local Government (2014a), Office of Local Government (2014b)

The final ILGRP (201b) report – *Revitalising Local Government Final Report of the NSW*

*Independent Local Government Review Panel, October 2013* – was not released to the public

<sup>1</sup> It is important to note that the OLG has radically altered the definition of this ratio.

until early in 2014. It confirmed the ILGRP (2013b, p7) 'preferred option' for radical amalgamations of NSW councils particularly in the Sydney basin:

Sooner or later amalgamations will have to be part of the package: the number of councils in NSW has halved during the past century and that trend will surely continue.

It also made recommendations that the Government review rate-capping, rate exemptions and rate concession, increase the level of assurance provided on municipal data and review the Local Government grant allocations to ensure that more grants be provided to councils with the greatest need.

The OLG then went quiet for an extended period of time in which councils became ever more concerned regarding the spectre of forced amalgamations. For reasons best known to itself the OLG decided to set aside TCorp's work on financial sustainability ratings (used by the ILGRP in developing its 'preferred options') and develop its own set of seven FFTF ratios. In particular the OLG abandoned the Cash Expense, Unrestricted Current, Interest Cover and Capital Expenditure ratios. Moreover, it introduced the widely ridiculed 'efficiency ratio' which doesn't measure efficiency and also produces spurious results. Finally, it subordinated all ratios to the concept of 'adequate scale and capacity' – which essentially meant that councils would be deemed 'not fit' irrespective of their putative financial sustainability. Still, no evidence was provided to support the implied contentions that (i) an optimal size of local government exists and (ii) that amalgamations would enhance financial sustainability.

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It seems that the OLG consulted IPART regarding its proposed methodology which led to the IPART report *Review of Criteria for Fit for the Future Local Government – Final Report September 2014*. In this Report IPART (2014):

- Endorse the scale and capacity criteria

- Endorse the Asset Maintenance ratio with benchmark greater than 1
- State unequivocally that ‘the infrastructure backlog ratio should be adopted only if it is audited’ (IPART 2014 p 5)
- Suggest that the debt service ratio should be introduced in the form finally adopted in FFTF and with the illogical lower bound of 0%
- Endorse the real operating expenditure per capita ‘efficiency’ ratio

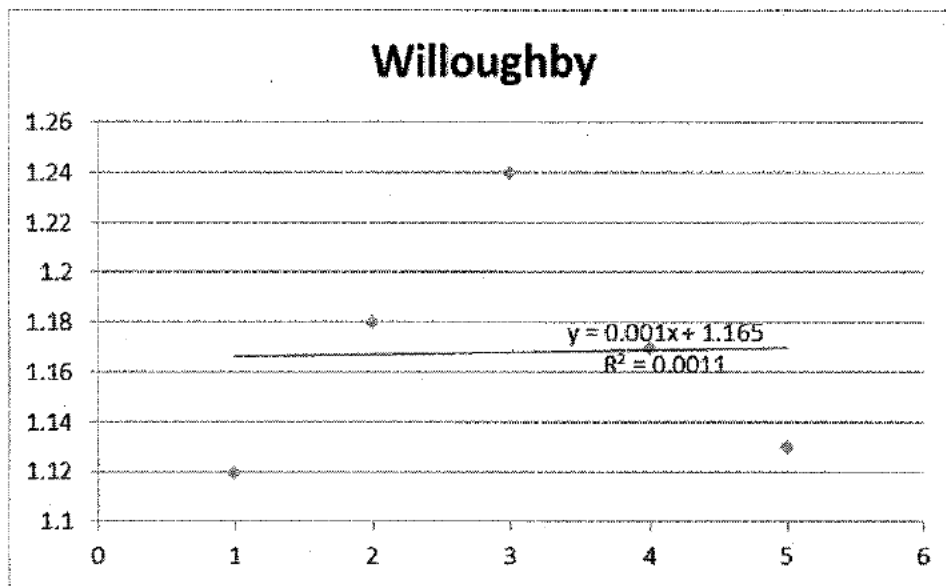
Once again, the Government ignored the advice of ‘experts’ it had itself commissioned. Specifically, the Government persisted with the Infrastructure Backlog ratio and ignored the concerns expressed by IPART (2014, p 29) that various metrics would be distorted by ‘assumptions that underpin estimates of depreciation [which] may vary significantly over time and across similar councils’. It should be noted that the changes suggested by IPART (2014) have been the focus of widespread derision and ridicule which call into question IPART’s supposed ‘expertise’ in this area. Specifically, in the face of criticism from academics, the United Services Union and councils IPART (2015b) recently ‘clarified’ that the Asset Maintenance ratio may be less than one and that the Debt Service ratio can be equal to zero. However, IPART (2015b) seems to continue to believe that a linear trend of per capita expenditure based on a flawed assumption of linear functional form and accurate population estimates can have some meaning – despite stark evidence to the contrary (see Figure 1 below and the United Services Union submission appended). Finally, the involvement of IPART in the FFTF program must also call in to question its ‘independence’

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in addition to its apparent lack of expertise.



**Figure 1 Willoughby 'Efficiency' Ratio**



Clearly the expenditure per capita of Willoughby does not follow a linear functional form. Moreover, it explains less than 1% of the data resulting in both redundant data points (2012 financial year) and high leverage data points (2014 financial year). Data compiled from the OLG Toolkit and Willoughby's audited financial statements.

About this time a number of peer-reviewed journal papers were accepted for publication and/or became publicly available. These papers have been summarised in Table 2 and appear in the appendix to this submission.

<b>Authors</b>	<b>Journal</b>	<b>Findings</b>
Drew and Dollery (2014a)	<i>Public Money &amp; Management</i>	There is no association between financial sustainability and population size in Greater Sydney. The proposed Greater Sydney amalgamations will not improve financial sustainability ratios.
Drew and Dollery (2015a)	<i>Australian Accounting Review - the Journal of CPA Australia</i>	Inconsistent depreciation accruals have significantly distorted financial sustainability assessments.
Drew, Kortt and Dollery (2015a)	<i>Administration &amp; Society</i>	The ILGRP proposed amalgamations will result in over-scaled councils and a decrease in efficiency.
Drew, Kortt and Dollery (2015b)	<i>Australian Accounting Review the Journal of CPA Australia</i>	There is little theoretical or empirical association between efficiency and sustainability.
Drew and Dollery (2015b)	<i>Australian Journal of Public Administration</i>	Financial sustainability ratios do not control for environmental constraint but should do so.
Drew and Dollery (2015c)	<i>Australian Journal of Public Administration</i>	Outlines the flaws in the FFTF program
Abelson and Joyeux (2015)	<i>Public Money &amp; Management</i>	The financial capacity of local councils is a function of the income level of the local community and not of its size.

It is clear from Table 2 that the weight of scholarly evidence speaks against the FFTF program. Moreover, it is equally clear that the Government and IPART made no effort to (i) seek expert academic advice or (ii) appraise itself of developments in the scholarly literature.

The next act in the FFTF drama was the appointment of IPART as the ‘expert’ and ‘independent’ panel for evaluating council FFTF submissions along with the South Australian commercial consultant – John Comrie – to provide ‘first hand local government sector and industry experience’ (IPART 2015a, p 5). Firstly, as we have noted earlier the extant evidence suggests that IPART is neither ‘expert’ nor ‘independent’. Secondly, it came as a surprise to many that ‘first hand local government experience’ was to be provided by what the OLG describes as ‘the South Australian local government expert’ (OLG 2015).

Another surprise was in store for NSW councils when IPART released the *Methodology for Assessment of Council Fit for the Future Proposals Local Government Consultation Paper April 2015*. This document floated an entirely new methodology for assessing FFTF and posed a number of questions relating to important assessment matters. Released in mid-April it required submissions by the 25<sup>th</sup> of May so that a final methodology could be publicly released at the end of the first week in June (IPART 2015a). The incredibly short time frame for councils to adjust their proposals and conduct thorough consultation with their communities according to the shift in rhetoric and criteria was raised in most submissions to IPART. Table 3 details the change in criteria introduced by the IPART consultation document:

Criteria and measure	Benchmark	IPART Non-Rural	IPART Rural	IPART Merged
<b>Scale and Capacity</b>	ILGRP recommendations	ILGRP recommendations or merger broadly consistent with ILGRP or Sound argument for no structural change	Demonstrates it has considered merger option and has strategies to enhance capacity.	Not applicable.
<b>Sustainability</b>				
Operating Performance Ratio	Greater or equal to break-even over 3 years	Must meet within 5 years.	Plan to meet within 10 years	Must meet within 5 years (non-rural). Plan to meet within 10 years (rural).
Own Source Revenue Ratio	Greater than 60% over 3 years	Must meet within 5 years.	Plan to improve within 5 years & consideration of FAGs	Must meet within 5 years (non-rural). Plan to improve within 5 years & consideration of FAGs (rural)
Building and Asset Renewal Ratio	Greater than 100% over 3 years	Meet or improve within 5 years.	Met or improve within 5 years.	Meet or improve within 5 years.
<b>Effective infrastructure and service management</b>				
Infrastructure Backlog Ratio	Less than 2% over 3 years	Meet or improve/inform within 5 years	Meet or improve/inform within 5 years	Meet or improve/inform within 5 years
Asset Maintenance Ratio	Greater than 100% averaged over 3 years	Meet or improve/inform within 5 years	Meet or improve/inform within 5 years	Meet or improve/inform within 5 years
Debt Service Ratio	Greater than 0% but less than or equal to 20% over 3 years	Meet within 5 years	Meet within 5 years	Meet within 5 years
<b>Efficiency</b>				
Real Operating Expenditure	A decrease in Real Operating Expenditure per capita over time	Must demonstrate operational savings (net of IPR supported service improvements) over 5 years.	Must demonstrate operational savings (net of IPR supported service improvements) over 5 years.	Must demonstrate operational savings (net of IPR supported service improvements) over 5 years but may not be practical in short term

Source: IPART (2015a)

Three submissions to IPART are of particular interest. The United Services Submission (2015) raised the following matters:

- The imparting of meaning to ‘research’ undertaken by the ILGRP which was not warranted and contrary to the meaning intended by the Panel.

- The neglect of important extant scholarly contributions.
- The abject failure of FFTF metrics to reflect any of the commonly accepted attributes of competent Performance Indicator systems.
- Failure of FFTF to deal with ‘unfinished business’ (such as rate pegging and grant allocations) before assessing council fitness.
- Failure of the methodology to respond to inconsistent reporting – specifically unreliable depreciation accruals and Schedule 7 items (Cost to bring to satisfactory standard and required annual maintenance).
- Errors in logic imputed into ratios (for instance the Asset Maintenance ratio).
- The inadvisability of using forward estimates of five years given a median operating result budget error of 8% of actual revenue for estimates just one year out.
- The failure of any agency to produce robust evidence in support of the ILGRP contentions on optimal scale.
- The dismal failure of the ‘efficiency’ ratio to measure anything of consequence owing to flawed assumptions on functional form and inaccurate and out-of-date population data.

TCorp (2015) also made a submission on the IPART methodology. The submission made by TCorp (2015) rather testily notes that TCorp had been working on municipal financial sustainability since 2011, many years before IPART had become involved in the matter. The submission by TCorp (2015) criticises the OLG and IPART focus on individual ratios and the pass/fail dichotomy proposed by IPART. TCorp (2015) also notes that ‘there are situations where a council’s performance in some areas may deteriorate in the short to medium term in order to achieve an overall improvement in the medium to long term’. Moreover, TCorp (2015) (as does the United Services Union (2015)) states that ‘IPART’s methodology paper

can be viewed as not consistent with the 'guidance material' provided'. Finally, TCorp observes that the 'Debt Service ratio' as defined by IPART (2015a) and the OLG fails to measure capacity to pay and includes a lower bound of zero which promotes perverse and unhelpful behaviour by municipal officials.

Graham Sansom, former Chair of the ILGRP also made a submission to IPART on the methodology proposed to assess council 'fitness'. He makes a number of points which broadly reflect a view that the OLG FFTF program is a misrepresentation of the ILGRP's work (Sansom 2015). Specifically, Mr Sansom (2015) notes that the Panel envisaged that the 'unfinished business' regarding rating practices, grant allocations and the like would occur 'as a precursor to, or in parallel with, structural reform'. Sansom (2015) also criticises the FFTF emphasis on financial ratios and sets this in contrast with the ILGRP's 'more rounded look at sustainability and capacity that went beyond financial ratios'. The former Panel Chair also takes pains to draw a distinction between the 'preferred options' proposed by the ILGRP and the claims of ILGRP 'merger recommendations' made by the OLG and IPART. Finally, Mr Sansom (2015) states that 'the ILGRP did not base its case for metropolitan mergers on the need to improve financial sustainability or to achieve increased efficiency and cost savings as a primary objective' noting that 'IPART may wish to give some weight to the Panel's broader objectives when making its assessments'.

In response IPART (2015b) produced the document *Methodology for Assessment of Council Fit for the Future Proposals – Local Government Assessment Methodology June 2015*

released less than four weeks prior to the FFTF submission due date. The final methodology outlines a major concession in the timeframes given to meet the Operating Performance and Own Source ratios for Office of Local Government classifications of groups 8-11 (rural councils). For Sydney metropolitan councils there is a toughening of the rhetoric relating to mergers and a statement that Joint Organisations (JOs) will not be accepted as a mechanism

to avoid merger. IPART (2015b) have also declared that the Sydney metropolitan mergers are predicated on the State's objectives of a Global Sydney City, rather than financial performance. As noted earlier, IPART (2015b) have 'clarified' the benchmarks for Asset Maintenance and Debt Service ratios. They have also claimed that decisions on whether a council is 'fit' or 'not fit' will 'be based on an overall assessment of operational and capital sustainability, rather than a benchmark pass/fail approach' (IPART 2015b, p 9). However, IPART (2015b, p 8) still make the claim that 'the ILGRP *recommended* a council to stand-alone or undertake structural change' (emphasis added) in defiance of the former Panel Chair's unequivocal statements to the contrary.

IPART (2015b) has been careful to distance itself from the ill-founded FFTF metrics and benchmarks stating that these 'were set by the Government' (and not drawing attention to the fact that they had endorsed many of the metrics in September 2014). IPART (2015b) has also sought to make a distinction between the advice it provides to the Minister and the outcome from the advice which IPART (2015b, p 14) states 'is a matter for the Government'. Moreover, it has downplayed the fiscal objectives of the FFTF program which seems to be an effort to insulate the agency from future fallout when it becomes apparent that no improvement in the fiscal sustainability of the sector has occurred. Finally, IPART (2015b, p 51) notes the tight timeframes and advises councils that while public exhibition of the proposal is desirable 'we encourage councils to submit their proposal irrespective of progress with their consultation'.

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This latest pronouncement by the IPART seems a far cry from the aspirational statements made in D2036 in which participants – including the then Minister for Local Government – declared that they would be 'recognised, respected and responsible for .... meaningful community engagement, advocacy and leadership' (Destination 2036 Implementation Steering Committee, 2012). It now appears that if there isn't time for community consultation

then this should not be let to stand in the way of the Government's amalgamation agenda. Moreover, the ideal of State Government and Councils building 'strong communities through partnership' seems to have been irrevocably destroyed (destination 2036 Implementation Steering Committee, 2012). Instead councils have had imposed on them a rushed and botched program aimed at progressing forced amalgamations based on flawed metrics and no empirical analysis. 'Ethical standards', 'meaningful engagement', 'respond[ing] to diverse cultures, environments and economies' and 'creating places that value people' have all fallen as collateral damage so that the Government can claim victory in the 'amalgamation wars'.

## ***2 The performance criteria and associated benchmark values used to assess local authorities in New South Wales***

In its report *Methodology for Assessment of Council Fit for the Future Proposals – Local Government Consultation Paper April 2015* IPART (2015a) pose a number of questions for stakeholders regarding the assessment of council submissions. We reproduce below our response to each of the relevant questions prepared on behalf of the United Services Union. Further information regarding the inherent flaws in the FFTF metrics can be found in our recent publication at the *Australian Journal of Public Administration* (2015c, appended).

***IPART Question: How should the key elements of strategic capacity influence our assessment of scale and capacity? Are there any improvements we can make to how we propose to assess the scale and capacity criterion, consistent with OLG guidance material?***

***Response: Strategic capacity is an elusive term with no firm definition. Indeed, it derives more from the skills and talents of people running a given local council than the size of the***



council. It is thus illusory to seek to improve strategic capacity by modifying the structure of local government.

These matters aside, there are many improvements that IPART can make with respect to the assessment of scale and capacity. In the first instance, IPART should use the most appropriate functional unit – the number of households and employing businesses. Secondly, IPART should disregard any scale recommendations based on preliminary population forecasts given the evidence that long range forecasts are extremely unreliable. Thirdly, IPART should base the scale criterion on empirical evidence rather than the ‘preferred options’ of the ILGRP (2013) which the Panel Chair himself has declared were never intended to be ‘recommendations’ (Sansom, 2015). If IPART thus takes cognisance of the scholarly evidence then it would be logically obliged to drop the criterion entirely. However, its terms of reference seem to force IPART to abide by scale and capacity criterion laid out by the OLG and ILGRP. This is rather unfortunate given that the scale and capacity criterion is absolutely spurious and devoid of empirical foundation. We recommend that IPART takes heed of the Panel Chair’s declaration that ‘preferred options’ should not be considered as ‘recommendations’ and instead analyse the existing scholarly evidence on the matter.

**IPART Question:** *Are there any improvements we can make to how we propose to assess the sustainability criteria, consistent with the OLG guidance? Are there issues that we need to consider when assessing councils’ proposals using the measures and benchmarks for these criteria?*

**Response:** *It is difficult to imagine how the future sustainability of councils can be accurately assessed without the unfinished business relating to rate pegging and FAG allocations being*

first resolved. Moreover, cluster analysis – or some other robust empirical method – needs to be applied so that councils can be assessed only against peers facing the same relevant external constraints. Ideally, the benchmark should be altered to reflect the various levels of external constraint. Otherwise councils will be assessed against the same benchmarks as their peers even though they might face entirely different conditions. For instance, councils which are located in areas of extreme climatic conditions may have higher rates of depreciation and impairment which make achievement of the Building and Asset Renewal ratio more difficult. Finally, it would be prudent to conduct sensitivity analysis on the Building and Asset Renewal ratio given the evidence of 'earnings management' on the denominator.

**IPART Question:** *Are there any improvements we can make to how we propose to assess the infrastructure management criteria, consistent with the OLG guidance? Are there issues that we need to consider when assessing councils' proposals using the measures and benchmarks for these criteria?*

**Response:** *The first two ratios are completely unreliable as they draw on heavily 'gamed' and unaudited data. They cannot be reliably assessed at present. IPART is thus strongly encouraged to drop the two ratios until such time that reasonable assurance of their accuracy can be had. Failure to drop the two ratios may simply promote further gaming of Schedule 7 items. With respect to the third ratio – Debt Service – the OLG and IPART are strongly encouraged to revert back to the definition previously employed by TCorp (2013). The ratio in its current form is illogical, promotes perverse behaviour and does not achieve its stated objective. The only thing that can be done to assess this criteria with 'consistency, fairness and impartiality' (IPART, 2015, p.3) is to (i) scrap the infrastructure backlog ratio*

until such time as the data can be shown to be reasonably accurate, (ii) change the Asset Maintenance Ratio so that achievement of the benchmark does not require councils to spend more than required<sup>2</sup> and (iii) revert back to the TCorp (2013) definition of Debt Service (but conduct empirical analysis to determine an appropriate benchmark).

**IPART Question:** *Are there any improvements we can make to how we propose to assess the efficiency criteria, consistent with the OLG guidance? Are there issues that we need to consider when assessing councils' proposals using the measures and benchmarks for these criteria?*

**Response:** *It appears that the previous United Services Union submission may have alerted IPART (2015) to the apparently insurmountable problems associated with the OLG's 'efficiency' ratio and that this may explain the new IPART (2015, p.32) benchmark that councils 'must demonstrate operational savings (net of IPR supported service improvements) over 5 years'. However, this new method for assessing 'efficiency' still poses problems for fair, consistent and impartial assessment. Firstly, it is clear that councils with relatively higher expenditure per capita have an advantage over leaner municipalities since there is more potential for expenditure cuts. The empirical design thus needs to be altered to take account of inequitable opportunity for expenditure reduction. Secondly, the use of population data as the denominator still presents problems related to accuracy, volatility, timeliness and functional relevance and we thus recommend a change be made on this point. The problems with deflation of data and rounding also need redress. Finally, it is critical that expenditure data exclude one-off items beyond the control of the council, such as expenditure associated with natural disaster responses.*

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<sup>2</sup> This requires more than a reduction in the benchmark. The definition needs to be changed so that it incorporates previous maintenance backlogs.

***IPART Question: How should councils engage with their communities when preparing the FFTF proposals? Are there any factors we should consider to inform our assessments of council consultation? Please explain what these factors are, and why they are important.***

***Response:*** The first point to note is that minimum standards for community consultation should have been developed by the OLG back in September 2014 before the release of the Fit for the Future Blueprint material. It really is a little late now to be thinking about minimum standards for community consultation just six weeks out from the Fit for the Future submission due date. Most local authorities have already undertaken this phase of Fit for the Future and are in the final stages of preparing submissions. However, IPART (2015) is right to raise the matter of inadequate consultation with the local community. Many municipalities have performed this function admirably. However it remains a fact that a significant proportion of the residents in NSW are entirely unaware of the Fit for the Future reforms, particularly in relation to the effect that reforms will have on personal budgets owing to the assumption of liabilities from merger partners and possible rate increases arising from harmonisation of rates and fees amongst merger partners. It goes without saying that major public policy reforms, such as Fit for the Future, which impose significant financial burdens on residents should be conducted transparently with full provision of relevant information. This is a basic principle of natural justice.

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No evidence of local community opinion is reliable unless that opinion has been fully informed. The following lists the minimum information which should be provided directly to each resident affected by municipal merger proposals:

1. *All residents should be advised of the criteria by which councils are to be assessed. For fully informed consultation, residents should be provided with the empirical evidence (not opinion) used by the ILGRP and OLG to determine minimum scale (if such evidence indeed exists). Residents should also be informed of the flaws in ratios, the effect of unreliable data, the degree of distortion imposed on FFTF ratios by gamed data, the fact that many of the ratios are not based on audited data and the assumptions violated by the 'efficiency' ratio which therefore does not measure efficiency (or anything else for that matter).*
  2. *All residents should be advised of the number of municipal jobs which must go in order for FFTF criteria to be met.*
  3. *All residents should be advised of the effects on the local economy arising from amalgamations.*
  4. *All residents should be advised of the reduction in political representation proposed by the FFTF amalgamations.*
  5. *All residents should be advised of the explicit liabilities which they will assume on a per assessment basis from the proposed merger partners. Residents should also be advised of the implicit infrastructure liabilities which they will assume as a result of the merger proposal.*
  6. *All residents should be advised of the increases to fees and rates which will arise from rates 'harmonisation' post-amalgamation.*
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*Councils should also conduct a survey of sufficient size and randomised so that tolerable standard errors result. Survey questions must be asked without bias, with necessary information to ensure knowledgeable answers and involve the use of a combination of open and closed questions. Finally, no amalgamation should proceed without a referendum. It is a*

*generally accepted principle of democracy that where radical changes to the structure and political representation of government are proposed, these changes should only occur after citizens have had a vote on the matter. This is the principle enshrined in Part 3 Division 2 of the Local Government Act 1993. It is thus not unreasonable to suggest that the principle also be adhered to in this instance.*

In summary, the FFTF metrics are ill-conceived and encourage a number of perverse behaviours from Councils. There is already extant evidence of considerable gaming on data critical for the majority of FFTF ratios. Thus, one of the unintended consequences of the program is that the government and citizens of NSW are unlikely to ever have an accurate picture of the municipal infrastructure backlog and municipal performance generally again. There is also extant evidence that councils have responded to some of the metrics with plans to enter into commercial operations (particularly aimed at improving the Operating Performance ratio). This is a troubling aspect of the program as it exposes residents to higher risks and distorts markets. The Own Source Revenue ratio may also discourage councils from pursuing grant funding and developer contributions. This would seem to be counterproductive in terms of municipal sustainability. Moreover, the ludicrous lower bound benchmark for the debt service ratio has resulted in councils planning to take on debt which was entirely unnecessary and thus unhelpful from a financial sustainability perspective. As time progresses it is entirely likely that evidence of new perverse responses will emerge in response to a program that failed to meet the minimum criteria for a competent performance indicator system (Bird et al., 2005).

### **3    *The scale of local councils in New South Wales***

The optimal scale of local government is a long debated concept in the scholarly literature. There are two prominent empirical techniques for estimating 'optimal' scale – multiple regression analysis and data envelopment analysis. Multiple regression analysis examines the

average response of expenditure to changes in the explanatory variable (generally population) whilst controlling for a range of explanatory variables (such as length of municipal roads, ethnogeneity and the proportion of children in the municipality). On the basis of this analysis an estimate of the optimal size of local government may be made. By way of contrast data envelopment analysis (DEA) creates an efficient frontier based on optimal conversion of multiple inputs into multiple outputs. The scale and efficiency of each individual council can then be estimated with respect to the efficient frontier.

Drew and Dollery (2015c) conducted a multiple regression analysis of 2012 New South Wales data and found *prima facie* evidence of a local *minima* at 163,689 persons. However, population density was also statistically significant thus suggesting conflation (Holcombe and Williams 2009). When Drew and Dollery (2015c) stratified the councils into Greater Sydney and Outside Greater Sydney municipalities, then evidence of economies of scale disappeared. This result is hardly surprising given that NSW councils produce a heterogeneous mix of goods and services. Labour intensive services are unlikely to generate economies as an increase volume of services may simply require a corresponding increase in the number of municipal employees. 'Even for capital intensive services, such as road construction, where scale economies are more likely, it is not reasonable to expect that the optimal size for the various functions will be comparable: they may simply negate one another' (Drew and Dollery 2015c, p 12).

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Drew, Kortt and Dollery (2015, p 17) conducted a data-envelopment analysis of the ILGRP 'preferred options'/'merger recommendations' and found that:

Of the 23 recommended amalgamation groups (formed from 63 existing councils) 20 will initially result in DRS [decreasing returns to scale] entities, with a mere two proposed entities exhibiting optimal scale and one recommended entity displaying IRS

[increasing returns to scale]. By way of contrast, the majority of councils not scheduled for amalgamation ('no change' councils) initially exhibit IRS.

Ideally analyses of this sort would have been completed by the ILGRP prior to it releasing its 'preferred options'. It seems quite incredible that neither the ILGRP, OLG nor IPART have performed a robust empirical analysis to support their conjecture that amalgamations are required to enhance municipal sustainability. It is even more incredible to think that the three agencies would remain steadfast in their unsupported claims of never ending economies of scale even when they have been presented with evidence to the contrary. Unfortunately, this obstinacy is symptomatic of the Government's approach to municipal reform – they have simply refused to heed the counsel of academics, stakeholders and even their own expert consultants.



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