Submission No 2

INQUIRY INTO ABILITY OF LOCAL GOVERNMENTS TO FUND INFRASTRUCTURE AND SERVICES

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Inquiry into the Ability of Local Governments to Provide Value for Money Services and Infrastructure

Submission by Kevin Brooks (Ratepayer)

1 Introduction

Ratepayers are paying too much for poor quality Council services. It should be remembered that Councils are monopoly service providers and ratepayers cannot source alternative service providers.

This review is an opportunity to identify the root causes(s) of poor value for money, and hopefully constructive recommendations to improve management, efficiency, productivity, culture, innovation, and prioritisation across the local government sector.

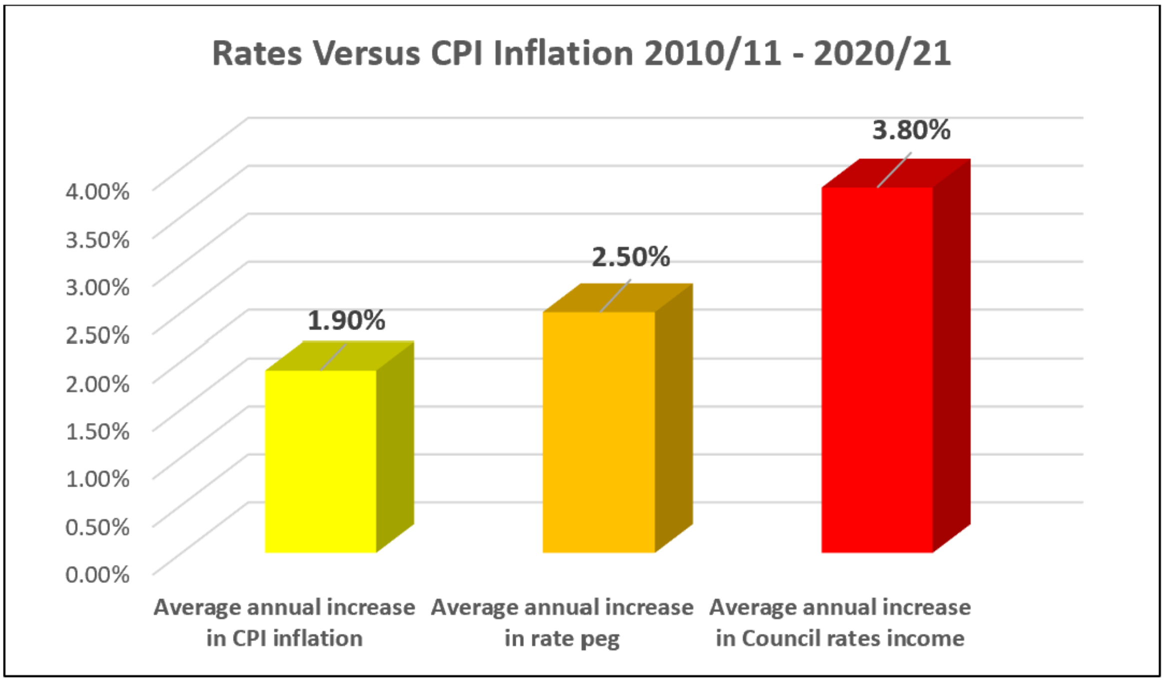
2 Is Funding from Ratepayers Adequate?

The Terms of Reference asks whether rate pegs and special variations are providing sufficient income for Councils?

There is, however, no independent evidence that insufficient rates revenue is the cause of poor quality Council services, or of threats to the long-term sustainability of the sector.

During the decade 2010/11 – 2020/21, average rates across NSW rose double the rate of CPI inflation.

Rate peg was set significantly higher than CPI over this ten-year period, and special variations increased the gap further.



Source: average annual increase in rate peg and rates income taken from IPART Issues Paper "Review of Rate Peg Methodology" September 2022; average increase in CPI taken from Reserve Bank of Australia website.

It would therefore be a missed opportunity if this review focussed solely on revenue.

The Terms of Reference asks whether rate pegs have matched increases in costs?

The Committee should also consider whether those costs are higher than necessary because of ineffective management, cost control, or inefficiency.

The review should also consider whether Councils control their costs effectively, and whether, in the absence of competition, there are sufficient incentives to improve performance, or indeed perverse incentives at work that discourage better performance and efficiency. Some of these issues are set out below.

3 Quality of Management across the Local Government Sector

Councils tend to recruit to senior positions from within the Local Government sector. There is a limited supply of high calibre candidates within the sector and mediocrity can rise to the top. This also means senior management experience is limited (by definition) to the non-commercial sector and non-commercial financial disciplines.

Encouraging applications for senior roles from outside the sector, including the private sector, would increase access to a wider range of skills and financial disciplines. It could also drive change and innovation within the sector which is much needed.

4 Excessive and growing Executive salaries in Councils

Executive salaries have been growing substantially at the same time as Council performance has been deteriorating.

In 2021, a new CEO was appointed to Central Coast Council on a salary higher than the NSW Premier – none of which was performance related. He has done little to improve performance despite increasing rates revenue (general rates and water rates) by 30% in his first three years.

To some extent this is related to section 3 above in that there are too few high calibre candidates available to meet demand – thereby bidding up salaries. Encouraging applications from outside the sector will increase the supply of candidates.

To incentivise better Council performance, Executive salaries should also be performance related to targets. This should not, however, be an excuse to hike up salaries even more. The performance related component should be a percentage of existing salaries, not an added component on top.

5 The need to improve efficiency and productivity in local government

Improvements in efficiency and productivity would lead to better financial performance and service delivery.

Yet, Councils rarely set SMART targets on efficiency and productivity.

Even State Government previously set an efficiency target of 2% per annum for State Government Agencies – but this did not extend to Local Government.

IPART has not helped by setting the productivity factor at zero in its rate peg methodology.

IPART also has no method for measuring Council productivity – relying on cherry picked anecdotes from Councils themselves when assessing the productivity criterion in special variations. If IPART were to develop a credible measure for productivity in local Councils, this could drive improvements. What gets measured, gets managed.

6 Organisational culture across the sector and how to invigorate it

A more performance related and customer orientated culture could improve value for money for ratepayers. There is also a need to encourage innovation. To some extent, this is also dependent on attracting better management to the sector. State Government could help, however, by funding "culture change" projects supported by external consultants.

7 Allocating resources in accordance with strategic and community priorities

Given the wide range of functions Councils undertake (some of them discretionary rather than mandatory), Councils would provide better value for money if they focused on doing core business well, rather than wasting resources on less important matters.

All businesses and households must make difficult choices when setting budgets. Councils often give the impression they can avoid such choices by treating the ratepayer as a magic money tree.

Councils need to improve their methodologies for identifying priorities, setting objectives and targets around those priorities, and their resource allocation in accordance with these priorities.

6 The role of IPART itself as a pricing regulator that has created a "bail out" culture leading to average rate increases in NSW double the rate of CPI inflation between 2010 and 2020.

As noted earlier, average rates across NSW rose 3.8% between the 2010/11 and 2020/21 compared with average CPI inflation of 1.9% over the same period. The annual rate peg approved by IPART was significantly higher than CPI at 2.5%, and special variations increased the rate burden further.

IPART has unwittingly created a "bail out" culture whereby Councils and interest groups find it easier to lobby IPART for higher rates than improve their own performance and productivity. They can then evade accountability to their communities by attributing the rate hikes to decisions by IPART rather than themselves.

This "bail out" culture has spawned an industry of consultants who know how to "game the system" with respect to special variation applications and produce these applications for Councils in return for high fees charged (ironically) to the ratepayer.

7 The need to remove perverse incentives in IPART processes, e.g., the special variation criteria such as "financial sustainability" that reward inefficient and poorly performing Councils with higher rates.

IPART processes, OLG regulations (and IPART's interpretation thereof) all serve to promote perverse incentives and moral hazard.

Two examples will illustrate this point.

(i) Special Variations

The Special Variation criteria are heavily weighted towards "financial sustainability" based on the Operational Performance Ratio (OPR). Poorly managed and inefficient Councils tend to have low or negative OPRs thereby getting a tick in the box against the financial sustainability criterion. The criterion therefore rewards inefficient and poorly managed Councils with rate hikes (which they then attribute to IPART rather than themselves to evade accountability).

Central Coast Council (CCC) provides a good example. In 2020, CCC, after a three-year period in which employee numbers rose 13% and employee costs 33%, found itself effectively insolvent and unable to meet payroll obligations. The Council has since been in administration for four years. The Councillors were sacked, although all members of the Executive Leadership Team and other tiers of management, paid high salaries to run the business and financial functions of the Council day to day, kept their jobs except for the CEO.

The Council freely admitted that the financial collapse was caused by mismanagement. Yet, all managers except the CEO kept their jobs. CCC applied to IPART for a 15% special rate variation as part of its financial recovery plan. IPART had no choice but to approve the application because, unsurprisingly, CCC's OPR was negative. This clearly illustrates the principle of "moral hazard" whereby the special variation criteria rewards financially reckless and poorly managed Councils with rate hikes.

Whilst IPART did limit the special variation to three years to provide sufficient funding, together with asset sales, to repay emergency loans and clear the deficit, CCC successfully applied the following year to extend this to ten years. CCC even admitted this was a "repeat application" because it was dissatisfied IPART only approved the special variation for three years. After much lobbying, IPART extended the special variation to ten years. The exact same application, assessed by the exact same people using the exact same process, was worth $70M one year and $250M the next!

The process not only rewards poor management, it also rewards persistent management. A bail out culture is one in which the management of an entity finds it easier to lobby for more public money than to do the hard work on reforms to improve performance, productivity, and efficiency. The system incentivises the wrong behaviours.

(ii) Rate Pegs

A second example of perverse incentives is IPART's new rate peg methodology which bases employee costs within its cost index on the Local Government Award rather than average pay increases across the public sector as was the case until this year. This removes the incentive for Councils to control salary increases because whatever salary increases they negotiate they can pass straight through to ratepayers.

Whilst this change to the rate peg formula has only recently been introduced and may take a while to take effect given that a three-year Award agreement is already in place, it will inevitably lead to higher local government salaries and therefore higher rates in future.

IPART's own independent economists, the Centre for International Economics, even advised IPART that this change would create perverse incentives in salary negotiations – but unfortunately IPART ignored this very good advice.