Submission
No 85

INQUIRY INTO ABILITY OF LOCAL GOVERNMENTS TO FUND INFRASTRUCTURE AND SERVICES

Organisation: Common Thread Consulting

Date Received: 26 April 2024

26 April 2024

Standing Committee on State Development

Inquiry into the ability of local governments to fund infrastructure and services

Please find following my submission on the above, responding to the Terms of Reference. My comments in what follows are relatively brief given the complexity of the issues, but I'd welcome the opportunity to expand on these at a hearing if there's an opportunity to do so.

I'm in the process of creating a video – *How to fix local government* – that will explain the solution I've developed to address the problems the Committee is inquiring into. I've referred to this video at several points in this submission. A YouTube link will be posted on my website once the video is complete.

Ben Lawson
Director
Common Thread Consulting

(a) the level of income councils require to adequately meet the needs of their communities

There are two questions here: the income of councils and the needs of the community.

We tend to focus on the first and assume the answer to the second… we assume councils are clear what their communities need, want *and* are willing to pay for… which leaves us with a relatively straightforward question of securing additional income to meet this need.

In the video (referenced above) I'll provide evidence at the level of individual councils, across NSW and across Australia, that councils have generally *not* established what their communities need and are willing to pay for. If you don't measure it, you can't manage it.

This is <u>not</u> a criticism of councils. Think of the saying 'a poor workman blames his tools'… well, this *is* a case of poor tools, not poor workmen. The *system* is the problem.

In the video I'll outline the tool I've developed to help councils overcome these problems by developing a shared story with service as the common thread. The fundamental problem is *governance* – how councils make and implement decisions – not *finances*.

The income councils need can only be quantified in the context of what they use it for. We should not assume this is clear, it's simply a question of finding the money. We won't fix the problem by throwing money at it… and besides: whose money are we going to throw?

The lack of the proper tools for councils to quantify community needs and wants – the cost of delivery and the community's willingness and ability to pay – is impacting the income of councils, particularly that of regional, rural and remote councils, in two directions:

- income from *rates*, increases obtained via the Special Rate Variation (SRV) application process administered by IPART and
- income from *grants*, most importantly, the Financial Assistance Grant (FAGs) from the Commonwealth Government.

The tool I've developed will address the fundamental problems with SRVs and FAGs. The problems and the general principles of the solution are outlined below.

<u>Special Rate Variations (SRVs)</u>

IPART evaluates SRV applications from councils against 5 criteria established in OLG's *SRV Guidelines*. The criteria of most interest in this context are #1 and #3.

Criteria #1 requires councils to **articulate the need** for the SRV (the increase in rates). There are two options by which the need can be **communicated**. Either:

- the *community's* need for services and council's resource limitations <u>OR</u>
- the *council's* need for additional income to balance its budget.

Criteria #3 requires councils to demonstrate that the proposed SRV (increase in rates) is **reasonable**. There are two options by which this can be justified:

- what the community is *willing* to pay OR
- what the community can *afford* to pay.

As I'll demonstrate via a case study in the video, in practice the SRV process has been simplified to the point where it is *only* focused on the second option in each case:

- what *council needs* to be financially sustainable and
- what the community is *capable of paying*, what's affordable.

This approach simplifies the evaluation process from IPART's perspective considerably… which is perhaps part of the reason IPART advises councils to adopt this approach (and if councils want an SRV they should be following IPART's advice, right?). To put it bluntly, the way the system is operating now is about *bureaucracy* not *democracy*.

But if it is true that councils have not established what their communities need, what it costs and what they're willing to pay then this approach is the *only* practical option. It is important to recognise the assumptions that sit behind it:

- council's current expenditure reflects what the community needs and wants and
- the community will *never* be willing to pay, so the only option is to impose an increase "for their own good" (provided the capacity to pay analysis demonstrates they can afford to pay it) because we need our councils to be sustainable.

In the video, I'll offer a case study of a council that *did* have a meaningful conversation with its community about what they need, want and were willing to pay for… and *did* gain agreement to increase rates to achieve this. The community recognised this represented the best *value for money* option to them. It is possible… but it isn't happening in practice.

The system as it is operating in practice has a deleterious impact in four related areas. It is:

(1) undermining the community's trust in their local council and in the democratic process more generally
(2) discouraging councillors from making responsible decisions about council's financial sustainability
(3) resulting in far larger, less affordable, albeit less frequent, SRVs and
(4) taking the pressure off cost containment and efficiencies.

In relation to (1), it seems IPART doesn't see how it is contributing to the problem. In its recent *Review of the Rate Peg Methodology*, IPART references (page 131) a ratepayer survey it commissioned to inform its review, which found 61% of the community doesn't trust councils to keep rate increases **reasonable**. IPART said this suggested "that there is an insufficient level of **communication** from councils and that trust from ratepayers is lacking".

IPART points a finger at councils but 3 more fingers point back at it, and ultimately at NSW Government who established the system. IPART *must* reject an SRV application:

- if the council hasn't articulated the need for the increase sufficiently (criteria #1), in other words, if there was "an insufficient level of **communication**") OR
- if the increase on ratepayers isn't **reasonable** (criteria #3).

IPART needs to recognise that the **communication** breakdown that is undermining trust is largely attributable to the fact that councils are articulating the need for the rate increase based on what *council* needs to be financially sustainable rather than the *community's* need for services. The solution isn't just up to IPART, much of the problem – as I'll explain in the video – relates to the way OLG has mandated that councils are to communicate what they do and what it costs in the delivery program. It's about the tools, not the workmen.

IPART also needs to recognise that the community will only see SRVs as **reasonable** if the council makes a genuine attempt to secure their agreement, their *willingness* to pay. Instead, councils commission consultants to undertake 'capacity to pay' analysis to justify increases. If councils want to build trust, they need to focus on the *value for money* on offer from the extra rates compared to maintaining the current rate path.

Both these issues are about *democracy* over *bureaucracy*.

In relation to (2) it is no wonder **councillors are reluctant to pursue SRVs** given how unpopular they are. But delaying the inevitable is having a negative impact on financial sustainability, not least in terms of under-investment in infrastructure.

The big picture is cash and reserves make up less than 10% of most council's assets. The other 90% is infrastructure and other physical assets where a stitch in time saves nine… but the big question for councillors then, is what we need to stitch. This is where our continued inability to report meaningfully against key infrastructure asset performance measures – the infrastructure backlog renewal and asset maintenance ratios – undermines efforts to improve financial sustainability. These two measures are supposed to quantify the cost to bring to, and maintain, assets at a level that is "satisfactory" to the community… but the reality is – as I will discuss in my video – the numbers reported are "accounting fiction", to quote a cynical 2015 Headline from the *Sydney Morning Herald*. The sad thing is that a decade on, we're no closer to being able to report the 'facts'.

The problem with point (3) above is closely related to (1) and (2). Because the SRV process is bureaucracy, not democracy, and because councillors are so reluctant to pursue them, the **size of most SRVs is very large** by the time the governing body resolves to do something about it. Of the 17 SRV applications approved by IPART (all 17 applications were approved, although one was only partially approved due to a process issue) the average was 46%.

As discussed at point (b) below, rates in NSW across all councils went up at just over double the rate peg, which was slightly higher than CPI, over the past decade. If councils were to seek increases approximating their increase in expenses (which, it appears, has been about double CPI) and to apply for SRVs on a more regular basis to match their revenues to these and so maintain a balanced budget (as discussed below, I suggest SRV applications be aligned to the electoral cycle) then the community will still see rate increases higher than the rate peg or CPI but <u>not</u> of something like the 46% increases of the 17 SRVs IPART approved last year. The aim is to address the affordability issue: **smaller SRVs, more often**.

Encouraging councils to apply for SRVs more regularly may be perceived to lead to higher rates overall, but I'd argue the opposite is possible *if* there is adequate transparency and accountability. The problem now – as noted at point 4 above – is that there is less pressure on **cost containment and efficiencies** as a result of the irregular SRV application process.

If there is a heighted awareness amongst councillors, community and staff that ALL decisions resulting in an increase in expenses will have an impact on rates in the short term (rather than the current situation, which in some ways tends to kick the can down the road because the next SRV application is 10 years away) then there is the *potential* to add pressure to consider these decisions more carefully. I'm not saying councils don't do so now, but if the nexus between spending and rate increases is strengthened, then so is accountability and pressure to contain costs.

<u>Financial Assistance Grants (FAGs)</u>

The same issues that impact council income in relation to SRVs are impacting their income in relation to FAGs from the Commonwealth Government.

The intent of the Local Government (Financial Assistance) Act is, among other things, to provide assistance to the states for the purpose of improving:
- the financial capacity of local councils, and
- their ability to provide residents with an equitable level of services.

It has been recognised for many years that the current model fails to achieve the intent of the legislation. Grants are distributed to states on a population basis and then to councils such that no council receives less than 30% of what it would if FAGs were distributed simply on the basis of population.

This results in large, relatively self-sufficient councils (in metro areas) getting *more* than their 'fair share' (i.e., enough to provide their residents with an equitable level of service) while relatively grant-dependant councils (mostly in regional, rural and remote areas) get *less* than their 'fair share'.

The problem of the inequities in the distribution of FAGs has been recognised for at least a decade. The Productivity Commission undertook a review back in 2013… but the report was never released. Why? Because it is one thing to highlight the problem, to cite practical examples, point to the inequity… it is another thing altogether to come up with a solution.

In the video, I'll discuss the Grattan Institute's report *Potholes and Pitfalls: how to fix local roads* from last year. They've done a great job making the case for change based on the inequities in the system (e.g. the City of Greater Geelong receives more in general FAGs than the entire NT)… but it hasn't even attempted to solve the problem. It has simply recommended (page 40) the Commonwealth Grants Commission be asked to determine a revised basis for the inter-state distribution of FAGs.

That needs to be put in perspective: the Grants Commission has been battling to come up with an equitable way to distribute the GST amongst the *8* states and territories… how are they supposed to come up with an equitable way to distribute FAGs across the *543* Australian local government authorities? The answer is, they can't.

The fact is that the Commonwealth doesn't have the information required to make such decisions… councils don't have it either… the two key variables – whether distributing GST between the states or FAGs between councils – are *expenditure need* and *revenue capacity*. These are the *same variables* that apply to SRV applications: what the *community* needs and their *capacity* to pay (*willingness* to pay is not relevant in this context as this varies between communities: it is their own decision and it is related to, but distinct from, capacity).

As I'll explain in the video, using roads as a case study, it is possible – in fact, it is relatively simple – to quantify what the community needs and is willing to pay for *if* councils 'tell a story with service as the common thread'. There are considerable benefits to be gained by councils in doing so *individually*, however the real opportunities – not least a more equitable distribution of FAGs – can only be realised if councils tell their stories *consistently* and *collectively*. Again, the fundamental problem is *governance* rather than *finances.*

A final point here: there will obviously be winners (small rural councils) and losers (big metro councils) in any redistribution of FAGs. I'll explain in the video how I suggest impacts on metro councils can be offset by increasing the size of the pie at the same time it is carved up more equitably. ALGA has advocated for an increase in FAGs for years. The Grattan Institute recommended funding be increased by $1.2B p.a.

But in the end, the pitch to the Feds about increasing FAGs needs to be the same as to ratepayers about increasing rates (an SRV): the *value for money* for local communities.

(b) examine if past rate pegs have matched increases in costs borne by local governments

In Figure C4 of its 2023 *Review of the Rate Peg Methodology*, IPART found that between 2012 and 2022, the increase attributable to the rate peg was 31% (higher than CPI at 26%), the actual increase in rates over this same period was double this amount, $2.1B (64%) and that this was primarily due to increases associated with Special Rate Variations (SRVs).

In Table D1 of IPART's *Review* only covers 2017-2022, but it found 107 councils reported a surplus in 2017, while only 67 did in 2022. While performance clearly varies from year to year, it seems there was a visible decline down to only 49 councils being in surplus in 2021 before improving (due to SRVs, other income, lower expenses, FAGs timing?) in 2022.

This suggests that not only have past rate pegs not matched increases in council costs, even the increase in rates with SRVs on top (which has seen rates go up twice as fast as the rate peg) haven't been sufficient to keep up with cost increases. I'm not sure it is helpful to refer to costs "borne" by local governments, though… at least some of these increases in costs is the direct result of council decisions to increase service levels and so costs.

Looking further back, TCorp's 2013 *Review of the Financial Sustainability of the NSW Local Government Sector* found only one third (50) of the 152 councils then reported a surplus in 2012 *however* TCorp was analysing *consolidated* results (general fund + water fund + sewer fund) <u>not</u> general fund alone, as IPART has done.

The fact that OLG only reports consolidated figures (in *Time Series Data* and its *Your Council* website) is very unhelpful. The results are meaningless… but these are the *only* publicly available figures (the note below Table D1 shows OLG supplied data direct to IPART).

The only data I've seen of the real financial situation of councils *by fund* (IPART was only interested in general fund) was published by LG Solutions in their *Debits and Credits* newsletter in April 2023. LG Solutions identified the number of councils reporting a deficit or a surplus *by fund* and *by size of council*. This offered a couple of important insights.

Firstly, this is clear evidence that the rate peg <u>not</u> the root cause of the financial sustainability issues in many, if not most, councils. Councils have the power to increase water and sewer rates and charges as need be to eliminate the deficit… but they are *choosing not to do so*. The reason – as I discussed at (2) under point (a) above – is that councillors are reluctant to seek increases… and the reason for this – as discussed at (1) under point (a) – is about the tools available to communicate the need and secure the community's willingness to pay on the basis of this being the best *value for money* option.

Secondly, it highlights the financial sustainability concerns of council water and sewer funds. IPART was focused only on general fund (it is only ordinary rates that are pegged) but two thirds of smaller councils are reporting a deficit in water and sewer (larger councils were somewhat better). This is of serious concern given the *Safe and Secure Water* grants program is oversubscribed, small councils are not always eligible (e.g. funding to renew sewage treatment plants under 2,000 population) or they are of lower priority <u>and</u> that investment in new or upgraded infrastructure (often essential for water and sewer, particularly treatment plants) will push these councils far further into deficit as a result of the higher operating costs and depreciation expenses.

(c) current levels of service delivery and financial sustainability in local government, including the impact of cost shifting on service delivery and financial sustainability, and whether this has changed over time

I don't have much to add about the impact of cost shifting other than to say that if councils get their stories straight about current levels of service delivery and financial sustainability – not just individually but *collectively* – they will be in a far better position to quantify the real impacts of cost shifting on local communities and so support advocacy against it.

(d) assess the social and economic impacts of the rate peg in NSW for ratepayers, councils, and council staff over the last 20 years and compare with other jurisdictions

I'd argue that the social and economic impact of the rate peg in NSW has been <u>both</u> and negative. It has been *positive* in that it has served to limit unjustified rate increases by councils that might otherwise have chosen to do so… but it has been *negative* in that many councils that needed to increase rates haven't done so (because SRVs are so unpopular) and so those councils haven't invested responsibly and sustainably in their infrastructure which is creating significant social and economic impacts, even if these aren't always visible.

I suggest it is unhelpful to attempt to evaluate the social and economic impacts of the rate peg in isolation anyway. The rate peg is one piece in a larger system encompassing SRVs and governance processes whereby councillors decide how funds raised via rates.

The social and economic impacts of this broader system of local governance are *negative* because in practice, the system is broken. I've highlighted some issues briefly above. I'll expand on this in case studies in my video. I'll also be discussing the negative impacts of the current system on staff. Given the challenges of attracting and retaining skilled and qualified staff, human resources are of as much of a concern (if not more) than finances.

(e) compare the rate peg as it currently exists to alternative approaches with regards to the outcomes for ratepayers, councils, and council staff

I suggest there are three basic alternatives to the current approach of rate pegging:
(1) abolish the rate peg and associated arrangements (SRVs)
(2) more bureaucracy or
(3) more democracy and *less* bureaucracy.

The terms of reference for IPART's *Review of the Rate Peg Methodology* (Appendix F) required IPART to have regard for the (then) Governments commitments:
- to protect ratepayers from excessive rate increases and
- to independently set a rate peg that is reflective of inflation and cost and enabling financial sustainability for councils.

I'd imagine the current Government would endorse these… but IPART's *Review* is evidence the current system is broken by its own measures. The emperor has no clothes:
- *ratepayers don't feel protected from excessive increases* (IPART's survey found 61% of ratepayers don't trust councils to keep rate increases reasonable, although it needs to be said that IPART itself approved all 17 increases last year including their justification against criteria #3 that the SRVs, averaging 46%, were 'reasonable') and
- *the financial sustainability of councils is in decline* (IPART, section D1: "our analysis suggests that council's financial positions deteriorated from 2016-17 to 2020-21").

I can't see there's any votes, or benefits, in abolishing the current system. It seems clear from IPART's *Review* that the community sees the rate peg to be protecting them… even if it's not. As I've argued at point (a) it is leading to larger, less frequent increases and perhaps a reduced focus on keeping downward pressure on expenses and pursuing efficiencies.

The deficits in water and sewer funds discussed at point (b) above are evidence (contrary to what some people might say) that the financial sustainability issues in council are a result of rate pegging. Clearly, even if the rate peg were to be abolished, many councillors would still be reluctant to increase rates sufficient to balance the budget. Meanwhile the 'protection' would be lost in communities where councillors were unconcerned about increasing rates.

The second option is *more bureaucracy*. I've outlined my concerns with the way IPART is approaching its role in administering the SRV process above. I'm not saying it intends to do so – I don't think it even *realises* it *is* doing so – but the fact remains that while IPART may be adding to the bureaucratic justification of SRVs (producing a 50 page report on each one) it is perhaps not adding much value to the process, particularly given it is approving virtually all of the SRV applications it receives. As noted above, IPART approved all 17 last year. The case study of one of the SRVs IPART approved last year will reinforce this view.

In the video, I'll discuss how similarly well-intentioned bureaucratic processes mandated by OLG, DPE Water and DPE Planning are falling short of their desired outcomes. The evidence is clear that smaller councils can't keep up with all the red tape… and meanwhile the big councils who can are making things so complicated they can't get their story straight: the story they're telling is *incoherent* (they can't get all the parts of their bureaucracy to *cohere*, to fit into the big picture… the bigger story).

That's the principle behind the third, and I'd argue only viable, option: *more democracy and less bureaucracy.* I'll leave the details to the video but in summary this is about giving the governing body the tools they need to govern… to make and implement decisions about the most complex organisation in our local area by developing a shared story with service as the common thread in consultation with the local community, in collaboration with staff.

This story is 'told' via the *Common Thread Framework,* a simpler approach to the integrated planning and reporting (IP&R) framework – the community strategic plan, delivery program, operational plan, resourcing strategy – that *is* truly integrated. It incorporates council's risk management framework, local strategic planning statement and integrated water cycle management strategy within IP&R. **Less bureaucracy.**

Central to the move to this new way of working – the *Service Delivery Reboot*™ – is, in part, a program designed to embed the planning process *including decisions about council's revenue path* (i.e. decisions about SRVs) within the electoral cycle. The current approach sees the governing body engage the community and prepare their IP&R documents after an election and then – as a separate process, in a different year – submit an SRV application. As I'll explain in my video, I propose a means of embedding the SRV process into the electoral cycle. **More democracy.**

Feedback from the community in IPART's *Review* (page 157) seems to support this:

- 4 in 5 ratepayer respondents believe that they should have some or a lot of influence in how rates are decided
- 4 in 5 ratepayer respondents said their preference was for IPART to approve a small change in rates each year, with councils being required to actively consult about larger changes (*I'm proposing councils consult about smaller changes too*).

A key outcome of councils adopting this approach is for councils to apply for *small SRVs more often* (as part of the electoral cycle). Clearly, councils must build trust with their communities before councillors will be willing to adopt this approach (as I've said, councillors are understandably reluctant to increase rates now)… but a *significant* benefit of this approach is that it will maintain pressure on expenditure decisions and the pursuit of efficiencies because the impact of decisions on rate increases will be more transparent… thus making councillors more accountable to their local communities.

We need to get away from focusing primarily on the revenue side of the ledger (thinking the solution is throwing more money at the problem… how do we get more income?) and pay attention to the expenditure side too… but to do so, we need to get a grip on what we spend the money on… which is why services need to be the common thread in the story.

(f) review the operation of the special rate variation process and its effectiveness in providing the level of income Councils require to adequately meet the needs of their communities

As discussed at point (b), the actual increase in rates over the last decade (twice the rate peg as a result of additional increases from SRVs) and number of councils now reporting deficits (half of all councils) shows the current system is <u>not</u> effective **in providing the level of income councils require** to *cover their costs*, even with SRVs.

As I've argued, the SRV process is basically only focused on what *council* needs to balance its budget and what the community can *afford* to pay <u>not</u> what is needed **to meet the needs of local communities**. Councils aren't clear what local communities need or what that costs. Our inability to measure and report on the backlog and asset maintenance ratios (the "cost to bring to satisfactory condition" and "maintain assets at satisfactory condition") is arguably the clearest evidence of a broader problem. This is reflected at state and national levels, it is not just individual councils (as I'll explain in my video in relation to roads). This is about the TOOLS councils have available to use, it does <u>not</u> reflect poor performance.

Thus the current system fails by its own measures. The fundamental problem is *governance* not *finance*. Finances can only be understood in the context of what they pay for… services. This is where I suggest the review of the financial model for councils that IPART is currently undertaking is destined to fail because it is not grappling with the broader governance issue.

In the video I'll offer a case study to demonstrate that it is possible for a council to have a meaningful conversation with their local community about *what they need, want and are willing to pay for* and to gain their endorsement of council pursuing an SRV based on this representing the best *value for money* to them… but even so this is best understood as the start, not the end, of the roadmap to financial sustainability and a stronger local democracy.