Submission No 104

INQUIRY INTO ABILITY OF LOCAL GOVERNMENTS TO FUND INFRASTRUCTURE AND SERVICES

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Submission to the Legislative Council Standing Committee on State Development[1]

Inquiry into the Ability of Local Governments to Fund Infrastructure and Services

1. Introduction

The issues to be covered under the Committee's Terms of Reference have been examined on numerous occasions over recent decades, but certainly warrant another look. In particular, a Parliamentary inquiry offers a valuable opportunity to take a second look at some of the problematic aspects of IPART's recent Review of the Rate Peg Methodology, and to reflect again on whether the current approach to rate pegging in New South Wales is achieving satisfactory outcomes – without suggesting that it should simply be abolished.

This submission draws on numerous sources, principally the recent IPART Review; the 2013 reports of the NSW Treasury Corporation (TCorp) on the *Financial Sustainability of the New South Wales Local Government Sector,* and the Final Report of the Independent Local Government Review Panel; the 2016 IPART Review of the Local Government Rating System; and this author's recent papers on alternative approaches to rate pegging (see Attachment).

Purpose and Sustainability of Local Government

Fundamentally, the Committee's Terms of Reference concern the future of local government as a constitutional partner to the State in advancing the good governance of New South Wales and the wellbeing of its people. Section 51(1) of the NSW constitution Act 1902 asserts that:

There shall continue to be a system of local government for the State under which duly elected or duly appointed local government bodies are constituted with ***responsibilities for acting for the better government*** *of those parts of the State that are from time to time subject to that system of local government (emphasis added).*

In turn, this raises the question of whether local government bodies can adequately discharge their responsibilities under the Local Government Act 1993. A core purpose of that Act, set out in section 7(e) is: *to provide for a system of local government that is accountable to the community and that is* ***sustainable, flexible and effective***; and the Act's object (section 8) is: *to enable councils to carry out their functions in a way that facilitates* ***local communities that are strong, healthy and prosperous*** (emphases added).

Two key points emerge from this legislation:

[1] This submission is based on the author's experience and research over five decades as a senior official in local councils and state agencies; an adviser to all levels of government across Australia; chief executive of the Australian Local Government Association (1994-98); professor and director of the University of Technology Sydney Centre for Local Government, and later the Australian Centre of Excellence for Local Government (1998-2012); and chair of the New South Wales Independent Local Government Review Panel (2011-12).

- In administering the system of local government the State has a duty to ensure its sustainability.
- Parliament has determined that local councils have a broad role to play in advancing the wellbeing of communities in ways that extend far beyond the often invoked notions of 'core business' or 'roads, rates and rubbish'.

Section 8A of the Act goes on to set out general principles that apply to the exercise of functions by councils. The following are of particular relevance to the Committee's Inquiry:

8(b) Councils should carry out functions in a way that provides the best possible value for residents and ratepayers.

8(c) Councils should plan strategically, using the integrated planning and reporting framework, for the provision of effective and efficient services and regulation to meet the diverse needs of the local community.

8(d) Councils should apply the integrated planning and reporting framework in carrying out their functions so as to achieve desired outcomes and continuous improvements.

8(e) Councils should work co-operatively with other councils and the State government to achieve desired outcomes for the local community.

8(g) Councils should work with others to secure appropriate services for local community needs.

Defining and Assessing Sustainability

TCorp's 2013 report on the *Financial Sustainability of the NSW Local Government Sector* provided a detailed analysis of the position of every council. It defined sustainability in the following terms:

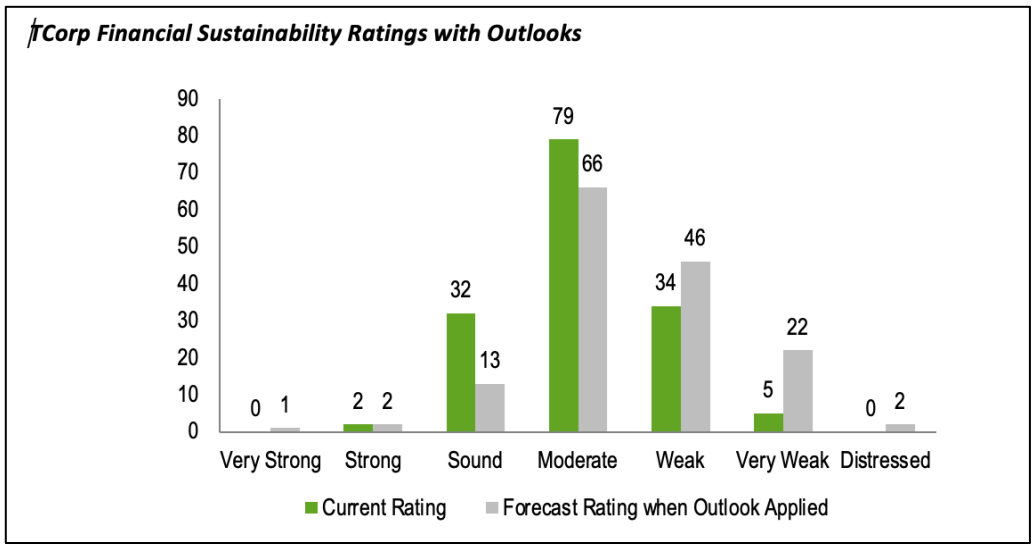
A local government will be financially sustainable over the long term when it is able to generate sufficient funds to provide the levels of service and infrastructure ***agreed with its community*** (emphasis added).

This definition took into account the potential impact that changing circumstances and emerging challenges could have on a council's operating position and service levels over the long term.

TCorp allocated each council a Financial Sustainability Rating (FSR) on a scale from Very Strong to Distressed. A council needed to be assessed at a Moderate or higher level to be acceptable in terms of its sustainability.

Councils were also assigned a short-term Outlook rating of Positive, Neutral or Negative. A Negative Outlook was a sign of a general weakening in performance and sustainability. Hence a council with a FSR of Moderate and an Outlook of Negative was at risk of being downgraded from Moderate to Weak. Councils rated Moderate-Negative or worse needed to address areas of poor performance to avoid becoming steadily more unsustainable.

As shown in the figure below, in 2012 around 75% of NSW councils achieved a rating of Moderate or better. However, only five councils had a Positive Outlook, while 73 – nearly half of the then 152 councils – rated Negative. This meant that without corrective action the overall position of the sector was likely to deteriorate.



TCorp also noted that most councils were reporting operating deficits and a continuation of that trend was unsustainable. In 2012 only one third of councils (50) reported an operating surplus. Moreover, councils' reported expenditure showed an annual shortfall in spending on asset maintenance. In 2012 alone, the reported maintenance gap was $389m across the local government sector, leading to a progressive increase in the overall local 'infrastructure backlog'. That issue was further explored by the (then) Division of Local Government, which estimated the total backlog at more than $7 bn (report no longer available online).

Regrettably, TCorp's 2013 detailed council-by-council assessments have not been repeated, so there is a lack of definitive data more recent levels of sustainability and future prospects.

Rates are a Tax

Local government rates are a general-purpose tax on the value of property – a tax on wealth, not income or consumption, and certainly not themselves a service charge even though councils do charge separately for some services. This position was underlined by the Henry Tax Review of 2010, which noted that rates and land tax are highly 'efficient' taxes in economic terms and should play a more important role in Australia's tax mix. In fact, rates are a form of the broad-based land tax now widely advocated as a desirable step in tax reform: they are the only tax on the value of the 'family home'.

Recommendation 120 of the Henry Review indicated that States should allow local governments a substantial degree of autonomy to set the tax rate applicable to property within their municipality. Its reasoning was that: *If local governments are to be accountable to ratepayers for their expenditures, it follows that they should have full or at least greater autonomy over the setting of the tax rate applied to properties in their jurisdictions.*

2. Responses to Specific Terms of Reference

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

At the outset, it needs to be understood that the NSW Local Government Act *deliberately* does not specify a definitive list of the services councils should provide, nor does it indicate priorities. Instead, as noted above, section 8 establishes the principles to be followed by each council in determining what it will do by way of services and regulation to meet the diverse needs of the local community.

Crucially, section 8(c) requires councils to make their decisions on service provision by using the Integrated Planning and Reporting (IPR) framework, introduced by amendments to the Local Government Act in 2009. IPR was conceived and imposed as the principal means of ensuring that councils are responsive to community needs and preferences, and operate efficiently, effectively and sustainably in addressing broadly agreed priorities.

Processes for sound financial management are a central element of IPR, which requires the preparation of firstly, long-term strategic, financial, asset management and workforce plans to determine community needs and required levels of income and expenditure; plus secondly, 4-year Delivery Programs and annual Operational Plans (in effect, budgets) that translate longer-term plans into short-medium term priorities. Decisions about revenue needs, including the mix of sources and setting of rates, were intended to flow from those planning processes, all of which involve extensive community engagement.

In short, IPR was intended to provide the primary pathway to determining and addressing community needs, while at the same time ensuring responsible financial management.

Following various reviews of rate-pegging, infrastructure backlogs and councils' sustainability during the period 2009-13, IPART identified the effective application of IPR as a core element of rate-pegging and the central consideration in determining applications for Special Variations (proposed rates increases above the rate peg) – which it encouraged as a principal means of matching revenues to required services. In doing so, IPART de-emphasised the significance of the annual *peg,* advising councils to focus on careful assessment of, and planning for, their particular needs (see figure below). Regrettably, IPART has since moved away from that approach: its recent Review of the Rate Peg Methodology acknowledges IPR as a useful mechanism, but describes the framework simply as a series of documents that *'provide useful information to the community about their council and strengthen councils' accountability'* (p.29).

IPART's Model for Strategic Planning, Budgeting and Rate-Pegging (circa 2015)

Source: IPART conference presentation to NSW Revenue Professionals, 19 March 2015

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

The recent IPART Review of the Rate Peg Methodology provides a range of useful information to help address this issue. However, it is impossible to offer a meaningful and definitive response because application of the rate peg has itself played a substantial role in determining increases in councils' expenditure. There is abundant evidence that many councils have preferred to limit/reduce expenditures rather than lodge an application for a Special Variation (SV) – of which there are

remarkably few. This reflects concerns about the political ramifications of exceeding the very public benchmark set by the annual rate peg announcement, as well as the perceived complexity and cost of lodging a SV application – a particular problem for smaller rural/remote councils with limited resources and expertise.

So, all too often councils have chosen to 'cut their cloth' and live within the limits of rate pegs, rather than address necessary cost increases to meet community needs identified by their strategic, financial, asset management and workforce plans. This issue is discussed further under Terms of Reference (e) and (f).

(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

Local government is an important part of Australia's system of government. It follows that its roles and responsibilities must evolve and most likely expand in response to changes in community needs and priorities, the broader operating environment, and decisions taken by state and federal governments. This is why local government Acts have moved from specifying a limited range of roles and functions to granting councils a power of general competence (or its equivalent).

Unquestionably, many councils now carry out a range of functions – notably in the broadly defined fields of social services, economic development, environmental management and new forms of regulation – that were uncommon 30-50 years ago. And some of those functions have to varying degrees been 'passed down' or imposed by central governments. Local government tends to define all such transferred or additional functions as 'cost shifting'. However, the key point is not whether increased demands have been placed on councils, but rather whether:

- The functions concerned are ones that are appropriately undertaken at a local level; and
- It is reasonable for local communities to meet all or part of the cost (having regard to their capacity to pay); and/or
- State/federal governments provide *and maintain* necessary financial support and/or enable councils to raise additional revenues locally.

For example, local government considers that the NSW government's failure to maintain past levels of financial support for library services, and its limited support for the cost of mandatory pensioner rate rebates, are both examples of cost shifting. Local libraries would be widely regarded as an appropriate function of local councils, and most communities have the capacity to fund them, but *some* will need substantial support. But in the case of pensioner rebates, it is highly questionable whether local government should be required to contribute at all to what is clearly a welfare measure that imposes an additional burden on other ratepayers, detracts from the provision of services and infrastructure, and could readily be replaced by a rates postponement scheme.

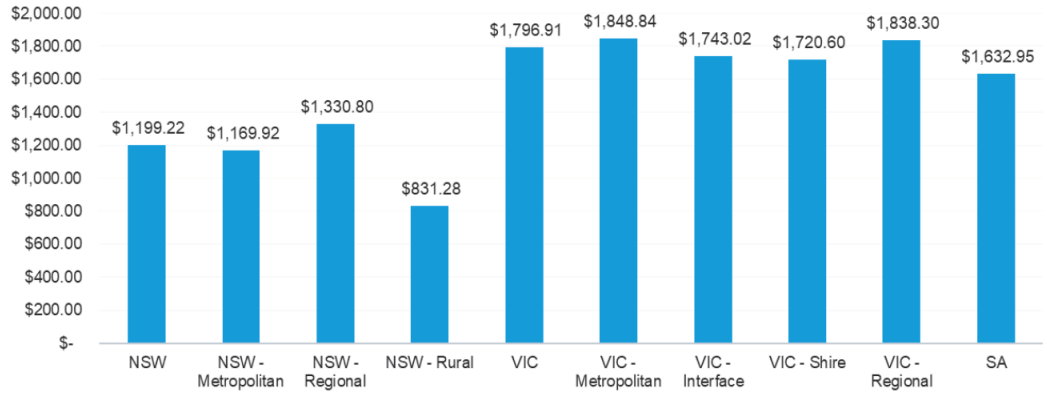
In every case, application of rate pegs and insufficient use of Special Variations could place unwarranted restrictions on councils' ability to raise required revenues and thus accentuate any adverse impacts of cost shifting.

A related issue is the distribution of federal Financial Assistance Grants, which are of particular importance to service delivery and financial sustainability in rural-remote local government areas. This is addressed under Term of Reference (g).

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

Local government in NSW has a serious revenue problem. This is documented in part in Appendix C of IPART's Review of the Rate Peg Methodology, which indicates that average residential rates are very low by comparison with other states, and that there is scope to increase rates within reasonable limits of households' capacity to pay (see figures below, drawn from IPART's Review).

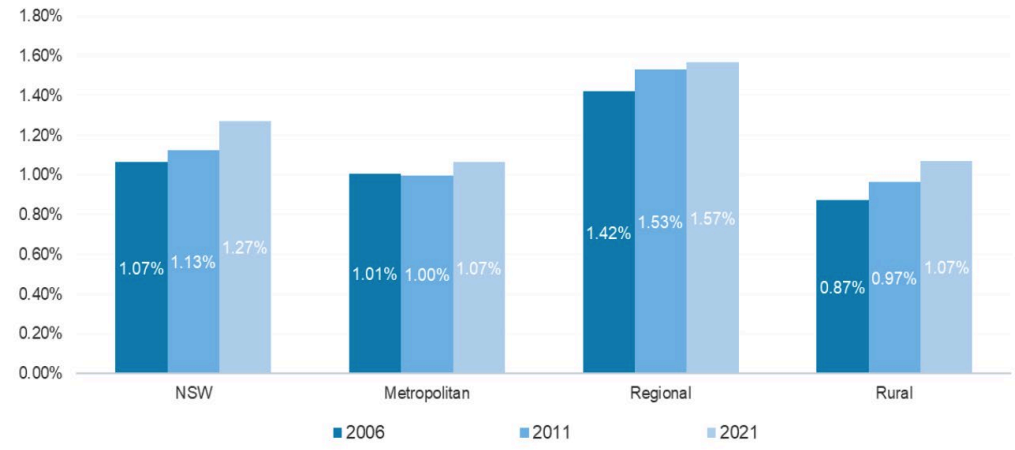
Figure C.1 Average rates in NSW, Victoria and South Australia (2020-21)



a. For NSW and South Australia this figure shows the average residential rate. For Victoria this show the average rate per property. The data for Victorian ratepayers is collected by Local Government Victoria that previously did report on average residential rates but changed their indicators in 2019 to report the average rate per property, as such this will include rates for other rating categories.

Source: Office of Local Government Time Series Data 2020-21, Local Government Victoria Performance Reporting, Local Government Grants Commission Database reports 2020-21.

Figure C.6 Average of median household income paid towards average residential rate (2001-2021)



Source: Office of Local Government Time Series Data 2020-21, ABS Median total household income ($/weekly) 2006-2011, ABS Median total household income ($/weekly) 2021.

This situation can be seen as a direct result of policies applied by successive NSW governments over several decades. Those policies include:

- Adherence to a flawed system of rate pegging (see Term of Reference [e]).

- Excessive rating exemptions and concessions.
- Failure to allow councils to rate apartments and other multi-unit dwellings on the basis of Capital Improved Value, thus limiting potential revenues and creating serious inequities between different groups of ratepayers.
- Unwarranted caps on statutory charges and development contributions that make it impossible for councils to achieve full cost recovery, thus placing upward pressure on rates.

The issues of excessive rating exemptions and concessions, and failure to use Capital Improved Value for rating apartments and multi-unit dwellings, were examined in detail by IPART in its 2016 Review of the Local Government Rating System. That report was withheld by the previous state government until June 2019, when it rejected nearly all the recommendations. IPART again drew attention to some of the measures proposed in its recent Review of Rate Peg Methodology, specifically:

- Better targeting eligibility criteria for rates exemptions. This would help to ensure ratepayers do not subsidise the costs of providing council services to properties where it is not justified on efficiency and equity grounds.
- Allowing councils to use the Capital Improved Value method to set the variable component of rates to ensure they can set equitable and efficient rates for all residential and business ratepayers, regardless of their property type.
- Ensuring that statutory charges reflect the efficient costs incurred by councils in providing statutory services, so councils do not need to use rates income to cover the costs of providing these services.

IPART indicated (p.124) that those and other measures "may improve the equity of the rating system and local government revenue framework, better support councils to serve their communities, and better support councils' financial sustainability in the longer term." **It follows that failure to address those issues is likely to have adverse social and economic impacts on ratepayers, councils and council staff. Councils will continue to be hampered in their efforts to meet the reasonable needs and aspirations of their communities, as expressed through the statutory IPR process.**

Heavy Opportunity Costs

In effect, state policies are cutting across each other. Crucially, policies that place unwarranted restrictions on local government revenue-raising are robbing the NSW public sector as a whole of resources needed to address critical economic, social, environmental and development issues. As noted in the Introduction, property rates are a tax NOT a fee for service, and the available evidence indicates that they could raise substantial additional revenues that would strengthen the sustainability of councils, facilitate expanded service and infrastructure delivery by local government, and reduce pressure on state funding. Other than a reflex to keep councils firmly under its thumb, it is almost impossible to understand why the state government would not wish to explore policy options that could realise those potential advantages. Why should ratepayers (owners of increasingly valuable properties) need 'protection from excessive rates increases' while other state taxpayers and users of state-run services have to pay more?

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

First, it is crucial to recognise that rate pegging is first and foremost a ***political*** measure that asserts a state government's right to oversee and control local government, and to take action to 'protect ratepayers'. It is entirely proper for the State to act along those lines, **provided** the outcomes truly

benefit ratepayers and are not harmful to the effective operations of councils and the welfare of council staff. As noted above, the evidence suggests that application of rate pegging in NSW has exacerbated concerns about local government's revenue base and sustainability, with adverse consequences for ratepayers, councils and staff.

The issues involved in considering alternative approaches are examined in detail in the Attachment, an edited version of two briefing papers written by this author and published in 2023 by the Local Government Information Unit (LGiU). Key points may be summarised as follows.

- Reports prepared by IPART, the NSW Treasury Corporation and the Independent Local Government Review Panel (ILGRP) over the period 2009-2013 all identified concerns with the current approach to rate pegging in NSW.
- The ILGRP highlighted the perverse potential for rate pegging to undermine rather than advance sound financial management, due to:
    - Unrealistic expectations in the community (and on the part of some councillors) that somehow rates should be contained indefinitely, even though other household expenditures are rising.
    - Excessive cuts in expenditure on infrastructure maintenance and renewal, leading to a mounting infrastructure backlog.
    - Under-utilisation of borrowing due (in part) to uncertainty that increases in rates needed to repay loans will be granted.
    - Reluctance to apply for Special Variations, even when clearly necessary, because exceeding the rate peg is considered politically risky, or because the process is seen as too complex and requires disproportionate efforts for uncertain gains.
- A key issue in NSW is that the Local Government Act does not provide any guidance on the precise purpose of rate pegging. By contrast, the Victorian Act sets two clear objectives that can be used to determine whether rate capping is working properly:
    - to promote the long term interests of ratepayers and the community in relation to sustainable outcomes in the delivery of services and critical infrastructure; and
    - to ensure that a Council has the financial capacity to perform its duties and functions and exercise its powers.
- There are at least four options for better approaches to rate pegging that can achieve its political objectives – being seen to apply downward pressure on rates increases – without undermining sound financial management in local government and damaging local democracy. Those options are:
    - *Plan plus Approval* (based on Integrated Planning and Reporting, as implemented by IPART in the period after 2013)
    - *Rates Benchmarking* (proposed in 2013 by the ILGRP)
    - *Ministerial Reserve Power* to intervene in cases of unwarranted rate increases (as included in the Victorian Local Government Act before the introduction of 'universal' rate capping in 2016)
    - *Strategic Oversight* of councils' financial planning and rating provisions (as applied/proposed in South Australia and Tasmania).
- Questions need to be asked about the suitability of utility pricing tribunals such as IPART as custodians of rate pegging/capping and overseers of local government.

The current approach to rate pegging (*Peg plus Variation*) needs to be reviewed in the context of concerns about the need to strengthen the revenue base of local government both to ensure the sustainability of local councils, and to realise opportunities to improve local services and infrastructure while relieving unnecessary pressures on the State budget.

The South Australian and Tasmanian models for *Strategic Oversight* appear to offer the best way forward – especially Tasmania's proposal to use council audit panels as an alternative to a central agency because it would embed responsibility locally and directly enhance accountability to the local community. If a state government wishes to demonstrate a 'tougher' approach, *Strategic Oversight* can be combined with formalised *Rates Benchmarking* (already implicit in the brief given to South Australia's Essential Services Commission) and/or an explicit *Reserve Power* for the minister to intervene where warranted *on a council-by-council basis.* NSW already has all the jigsaw pieces needed in the Local Government Act (perhaps with some very minor amendments), except for clear objectives to guide decision-making – Victoria's could be adopted. It could thus easily implement a lower-cost, less intrusive but equally effective form of rate pegging, essentially along the lines of the pre-2016 provisions in Victoria (as shown in Figure 2 of the Attachment).

(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

The Special Variation (SV) process is an essential element of rate pegging and its use needs to be encouraged as a means of promoting sound financial management by councils. As indicated under Terms of Reference (a) and (b), SVs can and should be facilitated by linking them to the IPR framework along the lines promoted by IPART in the years after 2013. In that way, SVs should be 'normalised', rather than seen as 'unusual' or worse, a mark of failure, and councillors may over time become less concerned about the political downside of lodging an application.

Regrettably, IPART's decisions in its recent Review of the Rate Peg Methodology may well make matters worse rather than better. The review was launched in response to IPART's faulty decision in 2022 to set a rate peg of 0.7% at a time when inflation was climbing rapidly towards 5% or more. IPART defended its action on technical grounds (a 2-year lag in receiving relevant data) and then used the Review for what could fairly be described as a 'holy grail' search for the 'perfect peg' (or perhaps just self-justification). Its report allocated some 70 pages to a detailed analysis of how the rate peg methodology could be improved and potentially expanded to include the Emergency Services Levy. Meanwhile, while noting a number of circumstances in which SVs might be used, it scarcely acknowledged the SV process as an equally important part of rate *pegging,* and as noted earlier, portrayed IPR as little more than a set of 'useful documents'. There were references to the potential for a simplified or streamlined SV process, but strangely the fact that IPART had contemplated and partially implemented such a process a decade ago was not recorded.

At this stage it seems likely that the outcomes of IPART's Review could actually increase the risk of poor financial management by councils, especially those smaller councils that lack the resources and skills to lodge SV applications. IPART's new system of tailored rate pegs for three broad classes of councils will supposedly provide a more accurate approximation of expenditure needs. This is almost certainly illusory, precisely because councils are required under the IPR framework to respond to the particular and changing needs of their communities; there is no statutory set of services councils must provide nor consistent standards of service; and there are deep differences between councils in each of the three broad groupings.

However, the danger is that, given the compliance and 'line of least resistance' culture that pervades NSW local government, sticking to a more 'scientific' (and perhaps slightly more generous?) annual peg will become to an even greater extent the preferred alternative to rigorous financial planning

and management and running the political gauntlet of SVs. This is inherent in the way the rate peg is framed (pp.11 & 29):

> The purpose of the rate peg is twofold:
>
> 1. It allows all councils to automatically increase their rates each year to keep pace with the estimated change in the costs of providing their current services and service levels to households, businesses, and the broader community - that is, their base costs. This helps ensure that they can maintain the scope, quantity and quality of these services over time without undermining their financial sustainability.
>
> 2. It also limits the impact of these automatic increases on ratepayers, by ensuring that councils cannot increase their rates by more than the estimated change in their base costs, and that they engage with their communities if they propose a step change in their rates revenue to fund improvements in the scope, quantity or quality of their services.
>
> We consider that the rate peg … can help to drive improvements in councils' performance by creating incentives for them to improve efficiency and productivity by constraining increases in councils' rates income to a measure of cost changes estimated using relevant macroeconomic indicators.

Such wording may be seen to elevate the status of the rate peg from being essentially a benchmark or starting point for analysis, to that of a definitive limit from which councils will depart at their peril. The already small number of applications for much needed SVs may well decline when all the indications are that it needs to increase.

(g) Any other related matters

A key factor for smaller (in population) rural and remote councils that intersects with rate pegging is the level of federal Financial Assistance Grants (FAGs) and Roads to Recovery payments (R2R). In 2023-24 NSW councils are receiving a total of some $953M in FAGs and $133M in R2R. Of the FAGs payments, $676M are general-purpose grants and $277M are for local roads.

General-purpose FAGs are paid on the basis of relative need. This is assessed by the NSW Local Government Grants Commission, taking into account revenue-raising capacity and expenditure 'disabilities' (eg exceptionally high costs due to remoteness). However, federal legislation provides that every council must receive a minimum per capita grant irrespective of its financial strength and the capacity of its community to pay rates, and 30% of the general-purpose funding pool is set aside for those minimum grants. In 2023-24 the minimum payment is $24.85 per capita.

The FAGs arrangements are reviewed periodically by the Commonwealth Grants Commission. Its most recent review was completed more than a decade ago, in 2013, but has never been released. It is well known, however, that one of the issues addressed was the proportion of total payments going to councils that were judged to be entitled to no more than the minimum per capita grant. The CGC evidently considered whether the allocation of 30% of the total general-purpose pool should be reduced or even abolished so that more funds could be diverted to councils with the greatest relative needs – bearing in mind that minimum grant councils would continue to receive local roads and R2R grants that are distributed by formulae. It should also be noted that the neediest local government areas include not only rural-remote communities but also fast-growing outer-suburban and regional areas that have limited resources relative to the pressures of growth.

In 2023-24 ten NSW councils received only the minimum $24.85 per capita grant, and a further eleven received less than 10% more than the minimum (less than $27), suggesting at best a marginal need for assistance. All those councils are located in the Sydney metropolitan region, and the great majority comprised mostly well-established affluent suburbs where the community might be expected to have considerable capacity to pay an extra $27 per capita in council rates. Moreover, for no apparent reason two other notoriously affluent areas received well above the minimum grant.

In total, those 23 councils received around $76M in general-purpose grants. Such an amount could make a very big difference to sustainability and service delivery amongst rural-remote councils, whilst also providing a useful ‘top-up’ for fast growing areas experiencing financial stress – again remembering that all 23 would still receive some funding from the local roads and R2R pools. As well as an amendment to federal legislation, such a change would also require a relaxation of the rate peg for those having to replace lost grants with increased rates – but neither should be seen as out of the question if governments prioritise community wellbeing and equitable distribution of public funds.

ATTACHMENT: Alternative Approaches to Rate-Pegging: The Differences Matter

Edited version of briefings published by Local Government Information Unit, February 2023

This two-part briefing discusses the significance of recent developments in the implementation of rate-pegging/capping in New South Wales and Victoria, and presents the case for alternative ways to achieve the political objectives of state governments.

- There has been renewed controversy over the systems of rate-pegging/capping currently in place in NSW and Victoria, focused on the mismatch between the peg/cap being imposed and the recent spike in inflation.
- The current approach to rate-pegging/capping in both states is costly but appears to offer only minor benefits for ratepayers while depressing rates revenues below the level required for adequate provision of services and infrastructure and long-term financial sustainability.
- Part One looks at the history of rate-pegging/capping and recent reviews. It highlights the key problems to be addressed and the need to consider alternative arrangements.
- Part Two explores four options for better approaches that can achieve the political objective of rate-pegging/capping – being seen to apply downward pressure on rates increases – without undermining sound financial management in local government and damaging local democracy.

PART ONE

After a lengthy period of low inflation and a largely predictable operating environment, local government is now faced with the challenges of post-COVID recovery (plus the lingering effects of the pandemic); serious damage to local infrastructure and increased needs for community services associated with climate change and natural disasters; attracting skilled staff in a very tight labour market; and a sharp spike in inflation. To address these challenges, robust own-source revenues are essential, and as a recent Victorian study confirmed, that still largely means the local property tax – rates.

Statutory processes of rate-pegging/capping apply only in New South Wales and Victoria respectively, but all states and the Northern Territory limit revenues to some extent. Clearly, they have a legitimate interest in ensuring that local councils are well managed, responsive to community needs and financially sustainable. But it is impossible to find any logical basis for deliberately restricting councils' ability to provide adequate – and where necessary or desirable, improved – local infrastructure and services from their own means. Doing so simply places further demands on a state government's own finances when councils' resources fall short of what's required.

Nevertheless, it seems that the NSW and Victorian governments have convinced themselves that rate-pegging/capping is politically indispensable. The question then becomes: can it be implemented in such a way that achieves a state's political objectives and promotes sound financial management by councils, but without damaging side-effects?

A Brief History

Rate-pegging was first introduced by the Wran Labor government in NSW in 1979, responding to several years of high inflation and steep increases in rates. It has remained in force ever since under both

Labor and Liberal-National governments. The local government Act details the processes involved but is silent on the purpose and principles of rate-pegging, which were perhaps considered to be obvious.

For the first 30 years rate-pegging was administered directly by the minister for local government, but in 2010 authority both to set the annual 'peg' for rate increases, and to assess applications to exceed that peg for one or several years (Special Variations – SVs) was delegated to the NSW Independent Pricing and Regulatory Tribunal (IPART), whose principal role was to oversee utility pricing. This followed an inquiry into rate-pegging undertaken by IPART in 2009, at the state government's request.

Rate-capping in Victoria was introduced by the Kennett Liberal-National government in the mid-1990s as part of its drive to dramatically reduce the number of municipalities, promote more efficient operations and cut costs. In 1999, the Bracks Labor government replaced rate-capping with a requirement to pursue a set of 'Best Value' principles and associated measures to promote sound financial management, although it also retained provisions in the *Local Government Act 1989* for the minister to limit excessive rate increases imposed by *individual* councils.

Then in 2016, giving effect to an election promise, the Andrews Labor government re-introduced a system of universal rate-capping similar to NSW, administered by the state's Essential Services Commission (ESC – a pricing regulator like IPART). There are at least three important differences, however. First, under the Victorian Act the *minister* sets the annual cap after receiving *advice* from the ESC, and may set different caps for different types of municipalities (eg urban vs rural). Second, the cap is explicitly intended to reflect CPI increases, albeit flexibly. Third, the Act sets out specific objectives for rate-capping:

(a) to promote the long term interests of ratepayers and the community in relation to sustainable outcomes in the delivery of services and critical infrastructure; and

(b) to ensure that a Council has the financial capacity to perform its duties and functions and exercise its powers.

Reviews of Rate-Pegging/Capping

Underlying issues and concerns about rate-pegging/capping and broader restrictions on local government revenues were discussed in the previous LGiU briefings mentioned earlier. In NSW, there has been no formal, wide-ranging review of rate-pegging since the 2009 inquiry by IPART. However, in 2013, as part of a broader assessment of the financial sustainability of councils, the NSW Treasury Corporation (TCorp) provided some important commentary. It had found that the financial sustainability of the great majority of councils was at best 'moderate', and that close to half had a negative outlook in the medium term. Without specifically identifying the long history of rate-pegging as a key factor, TCorp made it clear that:

- Amongst other steps, councils would need to consider options to increase own-source revenues.
- Rates increases should reflect *underlying expenditure requirements* (such as asset maintenance backlogs and requirements for new or improved infrastructure) as well as annual movements in costs.
- Councils should formulate medium-term 'pricing' paths to promote future sustainability.

These points were taken up by the parallel Independent Local Government Review Panel (ILGRP, pp. 42-45). It identified four significant unintended consequences of rate-pegging:

- Unrealistic expectations in the community (and on the part of some councillors) that somehow rates should be contained indefinitely, even though other household expenditures are rising.
- Excessive cuts in expenditure on infrastructure maintenance and renewal, leading to a mounting infrastructure backlog.
- Under-utilisation of borrowing due (in part) to uncertainty that increases in rates needed to repay loans will be granted.
- Reluctance to apply for Special Rate Variations (SRVs) even when clearly necessary, because exceeding the rate peg is considered politically risky, or because the process is seen as too complex and requires disproportionate efforts for uncertain gains.

The NSW government's response was to support the development of 'a streamlined and more proportionate process for 'fit for the future' councils [those meeting various criteria set by the government] wanting to increase rates above the rate peg…' The implications of this will be discussed under one of the alternative approaches outlined in Part Two.

Currently, the NSW IPART is undertaking a review of its 'rate peg methodology'. This was triggered by reaction to its decision to set the peg for 2022-23 at only 0.7% (plus an allowance for population growth) at a time when inflation was beginning to spike far above that level. The minister intervened and IPART responded with an 'additional special variation' process that eased the path for increases up to 2.5%. It then launched the current review to consider options to: ensure that the rate peg is reflective of inflation and costs of providing local government goods and services; stabilise volatility in the rate peg; and capture more timely changes in council costs and inflation (Issues Paper, p.2). A key concern is the 2-year time lag between when increased costs are measured, and when councils are permitted to increase rates by at least the peg and apply for a special variation.

This IPART review is limited in scope and does not address the underlying concerns about rate-pegging identified by TCorp, the ILGRP and others. On present indications, it looks very much like a search for something close to a 'perfect' cost index (peg) that is more up to date; takes into account a broader range of factors; responds more effectively to differences between councils and changes in the mix of their activities; and so on. The Issues Paper released in September 2022 did not mention what for many is the core issue – namely the *process for assessing special variation applications* to increase rates above the peg.

However, that issue did emerge during workshops held by IPART in November and December 2022. Participants argued that the special variation process was costly, time consuming and heavily politicised within communities. As a result, councils avoid lodging applications, placing their long-term financial sustainability at risk. Attention was also drawn to the opportunity for IPART to make more use of the documentation and outcomes flowing from the demanding Integrated Planning and Reporting processes that all NSW councils must undertake (discussed in Part Two).

In Victoria, section 185G of the *Local Government Act 1989* (parts of this older Act are still in force) requires a potentially wide-ranging review of rate-capping every 4 years, including 'whether the mechanism for setting a cap on rates set out in Part 8A of the Act is still appropriate.' The first Local Government Rate Capping Mechanism Review was completed by an independent consultant in December 2021, although not released until a year later. The Final Report highlighted several underlying issues:

- Continuing concerns about using the CPI as a benchmark because it may not correlate with the cost pressures facing local councils; and about the perceived failure of the ESC to give adequate attention to sector views and feedback.
- The need for the minister to publish a rationale for the annual rate cap that s/he has determined following advice from the ESC.
- The reluctance of many councils to submit applications to the ESC for rates increases above the annual cap, due to concerns about adverse media coverage and local political consequences.
- Potentially adverse long-term financial impacts on councils' financial sustainability and ability to deliver services – the Final Report recommended reviews every 10 years and highlighted the need to take into account information from other stakeholders, such as the Auditor General.

There are evident echoes of the concerns expressed by NSW councils regarding potential impacts on long-term sustainability, which ought to ring alarm bells given the legislated objectives of rate-capping.

The Need for Alternative Approaches

The objectives that underpin rate-pegging/capping appear essentially sound: responsible financial management, adequate and responsive service delivery, and avoidance of *unwarranted* rates increases. But the current method used in NSW and Victoria – what might be termed *Peg or Cap plus Variation* – is problematic.

Announcing an annual peg or cap, and being seen to bear down on proposals to exceed that figure, evidently appeals to state politicians wanting to cast themselves as 'protectors of ratepayers', but in the real world it creates political barriers to councils lodging applications for special variations/higher caps that are consistent with sound financial management. Councillors fear the glare of adverse publicity associated with potentially unpopular decisions necessary to ensure long-term financial sustainability and adequate infrastructure and service delivery. At the same time, preparing and lodging detailed applications requires time, money and skills that may be in short supply, especially in smaller non-metropolitan councils.

In NSW, from 2013-14 to 2021-22 the average number of applications for special variations was less than 15 per annum – from a total of 152 councils until 2016 and 128 since then. There was a modest bubble in applications in the three years after TCorp's warnings about financial sustainability, but from 2016-17 until the 'additional special variation' process for 2022-23 the highest number in a single year was 13.

In Victoria, the ESC's website indicates that there was *a total of only 17 applications* for higher caps across the state's 79 councils from the re-introduction of rate-capping in 2016 until 2022. It seems inconceivable that this reflects sound financial management across the board.

It is now also evident that the *Peg or Cap plus Variation* approach is unsuited to periods of higher inflation and volatility in costs, given the inevitable time lag between collection of data used to calculate the index/peg/cap and its application to the permitted level of rate increases. Moreover, a (more or less) 'generic' cost index/peg/cap can never precisely and 'fairly' reflect differences between local government areas.

On the other hand, recent history and current practice point to at least four alternatives that could achieve the objectives of rate-pegging/capping in both economic and political terms, but in a more constructive way and without adverse side-effects. Those alternatives will be presented and discussed in Part Two of this briefing.

PART TWO

The following sections identify and discuss four options for better approaches that can achieve the political objective of rate-pegging/capping – being seen to apply downward pressure on rates increases – without undermining sound financial management in local government and damaging local democracy.

Option 1: Plan plus Approval.

As mentioned in Part One, in 2009 the NSW Independent Pricing and Regulatory Tribunal (IPART) undertook a review of rate-pegging for the NSW government. Its report recommended (p.2):

*a new framework for regulating council revenue that **retains the current rate pegging approach, but builds on and improves this approach** particularly with the option of **more autonomy for councils*** [emphases added]. *This framework… links to and builds on other elements of the broader framework for regulating councils, particularly the Integrated Planning and Reporting Framework.*

Integrated Planning and Reporting (IP&R) requirements were being introduced progressively over the period 2009-12. They involve preparation of a long-term Community Strategic Plan, matched with financial and asset management plans, as well as a 4-year Delivery Program for each council term. All necessitated extensive community consultation. IPART saw an opportunity to set criteria by which councils could gain approval for medium-term rating pathways based on their IP&R documentation. It envisaged that some councils might be allowed to set rates in accordance with their IP&R plans indefinitely.

At the time, the NSW government's only tangible response was to delegate statutory authority to IPART to implement all facets of rate-pegging, except annual guidelines for special variations (applications to increase rates above the peg) that would be prepared by the Office of Local Government (OLG). As a result, IPART never fully implemented its more radical proposals. However, in 2013 it articulated a 'streamlined assessment' approach for special variations, with scope for councils to set rates within a set margin provided those increases were duly supported by their IP&R process and documentation. This approach was subsequently built into the OLG guidelines.

Thus, for several years after 2013 IPART operated what might be termed a ***Plan plus Approval*** model of rate-pegging that focused less on the primacy of the rate peg, and more on how councils determined their medium-long term revenue needs. The strong message was: *plan and consult first, establish medium-term expenditure and revenue requirements, **then apply if necessary** for a special variation* (see Figure 1).

Assessment of applications for special variations was based on the quality of both the required IP&R documentation and community engagement undertaken in preparing those plans – the requirement being that a council's constituents should be fully aware of what was proposed, NOT that there should be majority agreement. The extent to which rates should increase and how the additional funds should be

spent were seen essentially as matters for determination by councils through the IP&R process – enhancing local autonomy as proposed in IPART's 2009 report.

Using this approach IPART processed a total of 110 applications for special variations for the financial years 2013-14 to 2018-19. Ninety-one were approved in full and 12 in part. Of the remainder, 5 were refused due to inadequate IP&R documents and/or community consultation, and 2 lapsed due to council amalgamations. However, in light of some more recent determinations, the current focus on the rate-peg methodology, and views expressed in recent workshops concerning the need to give more weight to IP&R outcomes, it seems that IPART's commitment to a 'plan-based' approach may have weakened.

Figure 1: IPART's Model for Strategic Planning, Budgeting and Rate-Pegging (circa 2015)

Community Strategic Plan is a 10-year 'whole of community' strategy; Delivery Program is a 4-year plan for the council's term; Resourcing Strategy includes financial, asset management and workforce plans; Operational Plan is updated each year and includes the budget.
Source: IPART conference presentation to NSW Revenue Professionals, 19 March 2015

Option 2: Rates Benchmarking

In 2013 the NSW Independent Local Government Review Panel (ILGRP, pp.42-45) concluded that the major drawback with rate-pegging was its adverse impact on sound financial management due to councils' reluctance to lodge applications for special variations. As well, the Panel found that while millions of dollars were being spent each year by councils and state agencies on preparing, reviewing and determining those applications, the actual amount of rates increases that councils were seeking typically averaged less than $1 per household per week (about 5% of the state average residential rate).

The Panel's preferred option was to switch to *Rates Benchmarking*. IPART would calculate and publish an annual local government cost index plus comparative data on rates increases and associated expenditures, but there would be no official 'rate peg' as such. The aim would be to enable and encourage greater public scrutiny of councils' revenue and expenditure decisions, whilst also creating a heightened awareness of the need for, and key elements of, sound financial management. Benchmarking could be reinforced by a reserve power for the minister to intervene where necessary (see below).

The NSW government responded (p.5) that:

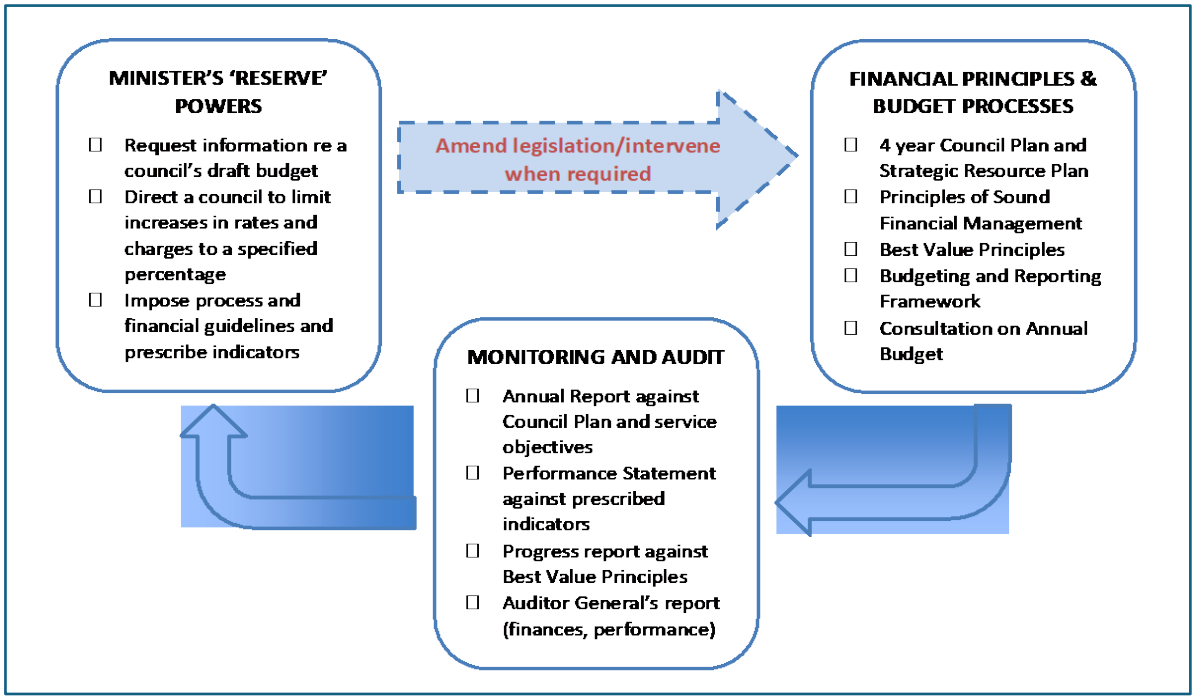
The [Office of Local Government] *will work with IPART to amend the guidelines to develop a streamlined and more proportionate process for 'fit for the future' councils* [those meeting certain financial, efficiency and scale criteria] *wanting to increase rates above the rate peg …*

This response was perhaps reflected in IPART's subsequent adoption of 'streamlined assessment', but the benchmarking concept and associated ILGRP recommendations for an overarching 'fiscal responsibility framework' (aimed at across-the-board improvements in financial management and long-term sustainability) were not followed through.

Option 3: Reserve Power

As noted in Part One, before it was amended to re-introduce universal rate-capping in 2016, Victoria's *Local Government Act 1989* already contained provisions that could have been linked to guide, monitor and benchmark rates increases. These included a strong *Reserve Power* for the minister to intervene if excessive rates increases were identified – and if necessary to impose limits on a council-by-council basis (see Figure 2). It is very difficult to see any real need for the complex additional machinery since created to prevent 'uncontrolled rate hikes'. *The deficiency was not in legislation, but in policy and administration* – a failure to set clear policy objectives and 'join the dots' in the Act.

Figure 2: Victoria's Potential Rate-Capping Framework pre-2016



Option 4: Strategic Oversight

By contrast to NSW and Victoria, both South Australia and Tasmania have recently adopted a pathway of *Strategic Oversight* of council's financial management and setting of rates.

In 2018 the then South Australian government sought to introduce rate-pegging/capping along similar lines to NSW and Victoria, but its legislation was defeated in the Upper House. Subsequently, the government negotiated with the local government association and others to empower South Australia's Essential Services Commission (ESCOSA) to undertake regular reviews of:

- material amendments made or proposed to be made to the council's 10-year financial plan and infrastructure and asset management plan, and the council's reasons for those amendments
- revenue sources outlined in the financial plan
- any other matter prescribed by the regulations.

These provisions (section 122 of the *Local Government Act 1999*) came into effect in April 2022. ESCOSA is to provide and publish advice to each local government on the appropriateness of its financial and infrastructure and asset management plans, having regard in particular to the financial contributions proposed to be made by ratepayers. The council must then publish that advice and its response in its future annual business plans. Moreover, councils must comply with new guiding principles for local government, including that:

- council resources are to be used, and services, facilities and programs provided fairly, effectively and efficiently
- councils must seek to balance the provision of services, facilities and programs with the financial impact of the provision on ratepayers.

At face value, this approach appears to strike a balance between the objectives of sound financial management and placing some downward pressure on rising rates. ESCOSA describes the arrangements as: *'an advisory scheme that aims to give ratepayers confidence that the rates they pay are set at the level necessary for their council to provide the services they value'* (p.1). The core concept is that councils should operate on a long-term financially sustainable basis, for the benefit of ratepayers. A council may be considered sustainable 'where planned long-term service and infrastructure levels and standards are met without unplanned increases in rates or disruptive cuts to services' (p.2). ESCOSA's focus is therefore on maximising stability. However, it explains that while rates should be 'stable', that does not mean 'fixed' but rather the absence of large *or unplanned* [emphasis added] year-on-year variations (p.3).

ESCOSA also notes (p.1) that: *... the scheme relates to monitoring, not economic regulation. As such, the design focuses on providing evidence-based and useful advice... [it] does not provide the Commission with powers to enforce compliance measures, set service standards or regulate any council's rates.*

In a similar vein, the Tasmanian government has flagged amendments to the local government Act that will require more rigour and community consultation when councils set rates, but under which they will largely self-regulate. It abandoned a previous proposal for oversight of rates increases by the Tasmanian Economic Regulator (the IPART/ESC equivalent). The proposed provisions now include:

- Councils are to consider the principles of taxation, such as efficiency, simplicity, equity, capacity to pay, benefit, sustainability, cross-border competitiveness, and competitive neutrality when determining how to distribute the rating burden.
- When developing rates and charges policies, councils' decision-making is to reflect the outcomes of community consultation.
- Chairs of councils' Audit Panels (who must be independent of the council) are to review any proposed rates changes that deviate from a council's Long-Term Financial Plan, and/or changes to that Plan.

As in South Australia, this package reflects the state government's evident concern to keep rates increases to a necessary minimum, but a willingness to achieve that objective at arms-length. The idea of using councils' own audit panels/committees to ensure that changes to rates are consistent with long-term financial plans, rather than giving that task to a state government entity, is particularly interesting. That function could readily extend to certifying that the financial plan itself is sound, and that the required community consultation has been carried out properly.

Commentary

If income from rates – local government's only tax – fails to keep pace with expenditure needs, then potentially less equitable and stable sources of revenue, such as fees, charges and commercial ventures, have to do more of the 'heavy lifting'; the long-term financial sustainability of councils is threatened; and state and federal governments have to increase grant support and/or undertake what are properly local responsibilities themselves. And if councils are not free to respond appropriately to the requirements and aspirations of their communities, then the purpose and value of local democracy itself is questioned.

Already, around a third or more of local governments across Australia rely heavily on grant funding for their very survival – chiefly federal Financial Assistance Grants (FAGs) and its Roads to Recovery (R2R) program. When rate-pegging was first introduced in NSW in 1979, its impact was cushioned or completely offset by the very substantial increases in FAGs funding that took place under the Fraser Coalition government. A repeat of that scenario appears most unlikely, so it is essential that rate-pegging/capping does not cut across best practice financial management.

The disadvantages of the *Peg or Cap plus Variation* form of rate-pegging/capping are plain for all to see. They may be reduced through 'streamlined assessment' as demonstrated by IPART in NSW, but the fundamental problems remain: the costs involved in running the system compared to the relatively meagre 'savings' for ratepayers; the sheer impossibility of calculating a universally applicable and up-to-date cost index; the reluctance of councillors to seek increases in rates above an 'official' peg or cap, fed in no small part by state government rhetoric about 'protecting ratepayers'; and consequently, dubious long-term financial management. In policy terms, there is an unresolved tension between legislated requirements for effective strategic, financial and asset planning on the one hand, and the imposition of rate-pegging/capping on the other.

The perverse effects of a supposedly definitive peg or cap were especially obvious in NSW in 2022. Despite the minister's intervention to 'request' IPART to revisit its proposed 0.7% peg for rates increases, and in effect a guarantee that larger increases would be approved, only 86 of the state's 128 councils applied under the 'additional special variation' process. One can only wonder how the other 42 are coping.

The approaches adopted more recently in South Australia and Tasmania point to much better ways of ensuring sound financial management geared to long-term sustainability; increased responsiveness and accountability to communities when councils set rates; and provision of services and infrastructure as efficiently and effectively as possible. There may be a case for limited supplementary oversight to reflect broader state interests – but rigorous strategic and financial planning requirements for local government now in place in all states obviate the need for heavy-handed regulation and unwarranted intrusion by state governments into local affairs.

Local communities should not need the help of state pricing tribunals or commissions to 'get local government services at a fair price.' If local democracy means anything, fairness must be a responsibility of the elected council with expert advice from its own audit committee, as proposed in Tasmania. And if strategic planning requirements are not delivering satisfactory outcomes, then they should be reinforced, not by-passed.

Looking to the future, questions should be asked about the involvement of pricing tribunals in oversighting local government, and the risks of 'regulatory creep'. While property rates are now generally regarded as a sound and efficient local tax for the purpose of meeting community needs, many people still choose to see them as a fee-for-service that should be kept as low as possible. This gives rise to the idea that councils should limit themselves to 'core services' (not defined in any local government Act) and can create an atmosphere of permanent austerity in which worthwhile initiatives to enhance community wellbeing do not proceed without state or federal grant support. Adding pricing tribunals to the oversight of local government funding – other than specific services funded as 'private goods' on a cost recovery basis, such as local water utilities – may well swing the pendulum further to a view of councils as simply another service delivery agency, rather than a crucial means of democratic community governance.

By the same token, it is debatable whether the boards and staff of pricing tribunals have the necessary background and skills to judge the need for rates (tax) increases in the broader context of councils' diverse roles and responsibilities, complex relationships with local communities, and democratic decision-making processes. This is a particular concern when tribunals invite submissions directly from ratepayers about a council's application for a special variation/higher cap, and 'second guess' council decisions about expenditure priorities.

'Regulatory creep' and its accompanying additional costs arise all too easily when an additional form of oversight like rate-pegging/capping is introduced without carefully considering ways to contain its impact from the outset. In Victoria, for example, a modest expansion of the Auditor General's long-established role in relation to local government finances and performance might have avoided the need to involve the ESC.[2] Bringing a new player into the mix inevitably creates a risk that over time the newcomer will act to entrench its role by increasing the scope or complicating the pathway of regulation. In NSW, IPART recently made an unsuccessful attempt to activate long-dormant provisions in the local government Act that would enable regulation of domestic waste charges, thus adding a further dimension to rate-pegging.

Taking all these factors into account, the *Peg or Cap plus Variation* model ought to be a relic of a bygone era. The South Australian and Tasmanian models for *Strategic Oversight* appear to offer the best way forward – especially Tasmania's use of council audit panels as an alternative to a central agency. If a state government wishes to demonstrate a 'tougher' approach, *Strategic Oversight* can be combined with formalised *Rates Benchmarking* (already implicit in ESCOSA's brief) and/or an explicit *Reserve Power* for the minister to intervene where warranted *on a council-by-council basis*, but not sector-wide. Both NSW and Victoria already have all the jigsaw pieces needed in their local government Acts (perhaps with some very minor amendments) to adopt robust, but lower-cost and less intrusive, frameworks along those lines (essentially the pre-2016 provisions in Victoria shown in Figure 2). The pieces just need to be re-arranged, and the political focus shifted from self-serving rhetoric to worthwhile outcomes.

[2] In South Australia the Auditor General does not oversight local government and the Office of Local Government is a very small agency, so there may well have been no practical alternative to involving ESCOSA.