

#### FINAL REPORT

# Treatment of external costs in the local government rate peg

Options and assessment



Prepared for Independent Pricing and Regulatory Tribunal of NSW (IPART) 5 May 2023

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# Executive summary

IPART is reviewing its methodology for setting the local government rate peg.<sup>1</sup> The rate peg is the maximum amount in percentage terms by which a council may increase its general income for the year. The CIE has been asked to review the treatment of external costs in determining the rate peg. External costs are costs that are imposed on councils and outside of council control. They could include:

- costs driven by weather or natural disaster
- costs driven by NSW Government actions, such as regulatory changes or changes to required services or service standards
- costs driven by Australian Government legislative changes.

We have developed four possible options for considering external costs. An overall summary of the assessment of the options is shown in table 1. None of the options perform well against assessment criteria. Key points are that:

- Option 1 not factoring in external costs by definition does not identify external costs.
- Option 2 a process for submitting external cost claims is a feasible mechanism to identify external costs. It is likely to be biased towards external costs, with external benefit claims never being submitted. It is a fairly costly mechanism for councils and IPART.
- Option 3 examining actual cost data is not a feasible mechanism for identifying external costs. It is evident that cost data is too variable to be able to systematically identify external costs from actual data. It is also not clear if any identified changes in costs are related to external factors.
- Option 4 NSW Government estimates for regulatory changes could identify external costs directly related to activities imposed on councils by the NSW Government. It would not identify any other external costs. However, IPART and councils would have no control over whether these estimates were being developed and would likely not have access to this. It would require a central agency like NSW Treasury to collate each year.
  - We do not consider that there is currently systematic information being prepared for NSW Government decisions about the impact on councils, so this would also require much tighter oversight on regulatory and other decisions impacting on local councils.

<sup>1</sup> IPART website, https://www.ipart.nsw.gov.au/Home/Industries/Local-Government/Review-of-rate-peg-methodology, accessed 18 November 2022.

#### 1 Assessment of options

Option	(1) Do not factor in external costs	(2) Process for submitting external cost claims	(3) Examine actual cost data	(4) NSW Govt estimates
Feasible mechanism to identify external costs	No	Yes	No	Yes (in part)
Unbiased	Not clear	No	Yes	Yes
Accurate	Not clear	Medium	No	Medium
Simple	Yes	No	No	No
Low cost	Yes	No	No	No
Stable	Yes	Yes	Yes	No
Unintended consequences/perverse incentives	Not clear	Potentially	Not clear	Potentially

Source: The CIE.

The clearest option to progress is a process for submitting external cost claims by councils. This would have to detail:

- who could submit claims
- information required to provide evidence of claims
- whether claims were made prior to an external event or afterwards
- whether claims would be at an individual council level or applied to the overall percentage change in rate revenue
- how to estimate the impact of claims, including:
  - estimating the cost or benefit
  - removing other funding sources for the external cost factor
  - removing any part of the external cost factor captured in the LGCI
- whether materiality thresholds would be in place to reduce the costs of the process.

This process could be developed further if this is a direction supported by IPART.

#### 1 Introduction

## IPART's review of the local government rate peg

IPART is reviewing its methodology for setting the local government rate peg.<sup>2</sup> The rate peg is the maximum amount in percentage terms by which a council may increase its general income for the year.

The rate peg for a particular council currently involves:

- a base change the percentage change applied to general income for all councils
- a population adjustment a specific change for each council related to its population growth.<sup>3</sup>

The base change aims to capture increases in costs for councils, such as through general inflation.

Councils can receive increases above the rate peg only through special variations, which a council may seek from IPART so they can introduce new services or improve service quality, and supplementary valuations (to the extent these are not netted off the population adjustment).

The CIE has been asked to review the treatment of 'external costs' as part of IPART's broader review of the local government rate peg methodology. External costs are costs that are imposed on councils and outside of council control. They could include:

- costs driven by weather or natural disaster, or broader economic, demographic factors
- costs driven by NSW Government actions, such as regulatory changes or changes to required services or service standards
- costs driven by Australian Government legislative changes.

Examples of external costs that councils have suggested to IPART are set out in table 1.1, categorised into government imposed costs and other.

#### 1.1 Types of external costs

Government imposed	Other
Cost shifting	Aging infrastructure assets and the associated asset management plans and requirements

<sup>2</sup> IPART website, https://www.ipart.nsw.gov.au/Home/Industries/Local-Government/Review-of-rate-peg-methodology, accessed 18 November 2022.

<sup>3</sup> Note that a council can increase its rates also through supplementary valuations. These increases are netted off the population factor.

Government imposed	Other		
Emergency Service Levy	Climate and weather changes, resilience (coastal management, flooding, bushfires)		
Election costs	Cyber security		
Development Compliance	Global Economic Forecasts and delays in the Supply Chain		
E-planning portal	Public health events		
Net zero targets	Changes in private sector costs and pricing		
NSW Audit Office Fees	Changing nature of the workforce, generational change, and Pandemic impacts on operational capability		
Pension rebate entitlements	Escalating depreciation expenses associated with increasing input costs for renewal and replacement of assets		
Planning Commission Costs	Population demographics		
Rural Fire Service asset depreciation			
Planning, compliance, and regulatory costs			
Sydney Region Development Fund Levy			
Non-value add compliance activities			
State Significant Developments approved			

Source: Council submissions to IPART.

Note that there could also be external benefits. For example, if the NSW Government developed regulation that had a cost saving to councils. In the terminology below we talk about external costs for simplicity, but this really means both external costs and benefits.

# Current approach to incorporating external costs

IPART has allowed for some adjustments to the rate peg from time to time to factor in external factors.

- In 2012-13, IPART allows a 0.4 per cent facto to offset the introduction of a carbon price, which was then removed in 2013-14 and 2014-15
- In 2020-21, IPART used forecast emergency services levy contributions instead of actual figures to reduce the lag for councils
- In 2021-22, IPART allowed a 0.2 per cent increase to allow for election costs, which was then removed in 2022-23
- In 2023-24, IPART allowed a 0.2 per cent increase in relation to changes to the superannuation guarantee.

This indicates that IPART has typically allowed changes only where there are quite large changes to costs driven by external factors.

# 2 Key issues in identifying and measuring external costs

# Relevant issues in considering external costs

External costs comprise a range of changes that impact on councils but are not within their control. Any attempt to incorporate external costs would need to factor in the following issues:

- how external costs drivers are identified a process that is driven by councils, which
  is the most obvious way to identify external cost drivers, will typically be biased
  upwards because councils will identify external factors that increase costs but not that
  decrease their costs
- to what extent external costs are already incorporated in the local government cost index (LGCI) many of the factors noted by council in table 1.1 are already covered by the LGCI. For example, changes in private sector costs and pricing, increasing input costs and supply chain impacts would be part of changes to costs. As a general rule:
  - any external event that changes the price of an item used by both the private sector and local government sector would be factored into the LGCI (although with a lag). For example, if a carbon price changes the price of electricity, then this would be captured in the CPI for electricity index used in the LGCI
  - any external event that changes the quantity of an input required is probably not factored into the price index. For example, if a global pandemic means customer service facing businesses require additional people to check vaccination status, then this would not be reflected in the LGCI
  - any external event that only impacts on councils will not be covered in the LGCI
  - any external event that has a different impact on the price for councils relative to the indexation factors in the LGCI will also not be fully reflected in the LGCI.
- whether adjustments are made before the event occurring (ex ante) or afterwards (ex post) for example, for a regulatory change there may be an estimate of cost impacts for councils made at the time of deciding to implement a change, which are an ex ante measure.
- other mechanisms already in place to compensate councils some changes, such as a change in regulatory requirements imposed by the NSW Government, may have tied grant funding already associated with it. For example, we are aware of previous work related to standards of animal pounds being linked to a grant program to bring pounds up to standards. If there is other funding, then there would not need to be an adjustment in the rate peg.
- differential impacts across councils external factors may impact each council differently. Some external factors may be relevant only for some councils.

## Materiality of issues

IPART has previously allowed only a small selection of changes to the rate peg related to external costs. The impact has been at most 0.4 per cent, and this was a temporary change to ensure there was not a lag between the carbon price and local government cost implications.

LGNSW has undertaken a number of cost shifting surveys to measure the impact of changes made by the NSW Government. Its last survey in 2018 found that the largest areas of cost shifting are:

- the NSW waste levy this is not relevant for rates as it is covered in waste charges
- the emergency services levy this is incorporated directly into IPART's current LGCI
- NSW making a lower per capita contribution to libraries than in other jurisdictions
- pensioner rebates required but not funded by the NSW Government.4

These have been present in LGNSW's cost shifting survey for many years but LGNSW's estimates of their impact has been getting larger.

There are many smaller changes made over time by the NSW Government that will impact on councils. However, there is no good evidence about the overall cumulative materiality of positive and negative changes on local government costs and how much of these are already part of the LGCI.

# What might we expect to observe if there have been external costs imposed on councils?

If a significant amount of external cost was imposed on councils and this were not reflected in changes to the rate peg, then councils would have a number of choices:

- 1 raise revenue from other sources (such as user charges or developer contributions)
- 2 reduce service levels in order to ensure costs grow at a level consistent with the rate peg
- 3 become more efficient in providing services
- 4 reduce costs that can be avoided in the short term, such as maintenance or capital expenditure programs
- 5 have costs growing by more than revenues leading to financial issues.

IPART's Issues Paper indicates that income per capita for local councils and rates income per capita have grown faster than expenses per capita. Expenses per capita have,

<sup>4</sup> LGNSW 2018, Impact of cost shifting on local government in NSW, https://lgnsw.org.au/common/Uploaded%20files/PDF/Cost\_Shifting\_Summary\_2018.pdf.

however, grown at a similar rate to the rate peg.<sup>5</sup> Councils are also reporting asset maintenance at levels close to that required, and the asset maintenance ratio has increased over the past decade.

These outcomes suggest that:

- councils have achieved fairly significant increases in other non-rate income such as grants and developer contributions, which have risen by much more than rate income (item number 1 in list above)
- councils are not, as a whole, reducing short term costs to cover rising external costs (item 4 in list above), and
- councils are not, as a whole, moving into increasing financially problematic positions (item number 5 in list above), even though some individual councils are.

Whether service levels are changing or efficiency is improving or declining is difficult to tell.

The historical changes have also largely occurred under a system where the rate peg did not reflect population growth of a council, which has subsequently been adjusted. Furthermore, the observed changes have reflected many councils changing service levels to reflect the preferences of their community and funding this through mechanisms such as special variations.

Our conclusion from this is that it is very difficult to observe if there have been a lot of external costs imposed on councils and whether this has increased over time.

<sup>5</sup> Rates income has grown about 50 per cent faster than the rate peg because of supplementary valuations and special variations.

# 3 Assessment of options for treatment of external costs

## Possible options for addressing external costs

There are a range of possible options for the treatment of external costs.

- 1 Do not factor in external costs the simplest option is to ignore external costs. This would mean councils would have to reduce their services, other things equal, if external costs were imposed on them without other funding sources
- 2 Develop a process whereby councils, either individually or as a group, submit external cost claims to IPART. These claims would identify the external cost and how much the LGCI should be adjusted by to take account of it. This would then be reviewed by IPART
  - councils could submit a claim in advance of an external cost occurring or afterwards
  - councils and IPART could choose whether the same adjustment would be applied equally to all councils or not
  - IPART could identify its own external costs if it has specific information related to changes relevant to councils (e.g. a carbon tax)
- 3 Examine actual cost changes of councils to identify whether there are systematic different that are related to external costs. This could include examining:
  - overall expenses
  - specific expenses, such as depreciation as a measure of the assets required by
- 4 Seek NSW Government estimates of costs for councils in relation to all regulatory changes made.

# Criteria for assessing options

Options for incorporating external costs been assessed against the following criteria:

- whether the option provides a **feasible** mechanism to identify external costs
- whether the option provides an unbiased estimate of the external cost borne by councils — an unbiased estimate is one that is not going to systematically overestimate or underestimate the impact of external costs
- whether it provides an accurate and timely estimate of the impact of external costs —
   an accurate estimate is one that has a minimum error every year to actual impacts of
   external costs
- whether it is **simple and low cost** to implement for IPART and councils
- whether the methodology is likely to be **stable** over a long period

whether it has potential unintended consequences or perverse incentives for councils.

# Assessment of options

An overall summary of the assessment of the options is shown in table 3.1. None of the options perform well against assessment criteria. Key points are that:

- Option 1 not factoring in external costs by definition does not identify external costs.
- Option 2 a process for submitting external cost claims is a feasible mechanism to identify external costs. It is likely to be biased towards external costs, with external benefit claims never being submitted. It is a fairly costly mechanism for councils and IPART.
- Option 3 examining actual cost data is not a feasible mechanism for identifying external costs. It is evident that cost data is too variable to be able to systematically identify external costs from actual data (see section below). It is also not clear if any identified changes in costs are related to external factors.
- Option 4 NSW Government estimates for regulatory changes could identify external costs directly related to activities imposed on councils by the NSW Government. It would not identify any other external costs. However, IPART and councils would have no control over whether these estimates were being developed and would likely not have access to this. It would require a central agency like NSW Treasury to collate each year.
  - We do not consider that there is currently systematic information being prepared for NSW Government decisions about the impact on councils, so this would also require much tighter oversight on regulatory and other decisions impacting on local councils.

#### 3.1 Assessment of options

Option	(1) Do not factor in external costs	(2) Process for submitting external cost claims	(3) Examine actual cost data	(4) NSW Govt estimates
Feasible mechanism to identify external costs	No	Yes	No	Yes (in part)
Unbiased	Not clear	No	Yes	Yes
Accurate	Not clear	Medium	No	Medium
Simple	Yes	No	No	No
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Stable	Yes	Yes	Yes	No
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Source: The CIE.

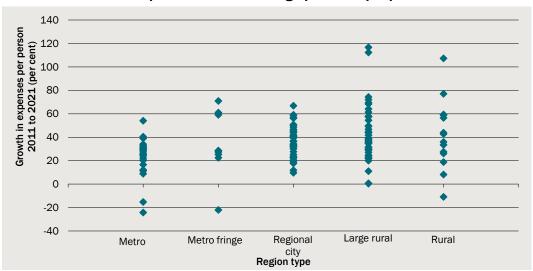
#### Actual costs and identifying external cost factors (Option 2)

We have examined historical cost data to test the degree of variation as part of understanding whether actual cost data could plausibly be used to identify external cost drivers. Our assessment is that cost data is too variable, and it would not be possible to separate out costs from external factors from:

- costs that are changing because of changes in services that councils' choose to provide
- costs that are changing because of changes in the efficiency of councils
- costs that are changing because of errors or changes in interpretation of data requirements.

To give an example of the variability, chart 3.2 shows each councils growth in per capita total expenses from continuing operations from 2011 to 2021. There is enormous variability, even within a particular region type. And note that this is adjusted to be per person, so it the metric is already normalised for changes related to population growth. Being able to determine if a change in costs was related to an external factor with this level of dispersion across councils would be extremely challenging.

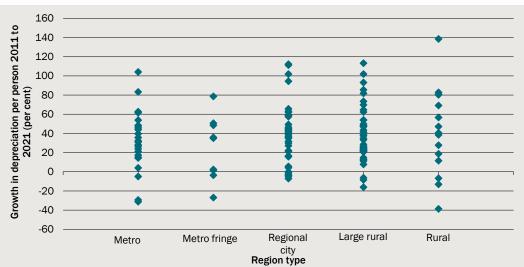
#### 3.2 Growth in total expenses from continuing operations per person 2011 to 2021



Note: Years are financial year ending. Councils that have been merged are allocated to the category of the merged council.

Data source: Population across all councils reported in Your Council Report, Office of Local Government time series data 2009-10 to 2020-21, accessed at https://www.olg.nsw.gov.au/public/about-councils/comparative-council-information/your-council-report/; total expenses from continuing operations is from data provided by NSW OLG to IPART.

We have undertaken a similar exercise for depreciation, which is a subset of total expenses and could be viewed as being an indicator of the level of assets required by councils (chart 3.3). Depreciation per person is even more variable than total expenses per person and it would be very challenging to work out what part of these changes was an external cost factor.



#### 3.3 Growth in depreciation expenses per person 2011 to 2021

Note: Years are financial year ending. Councils that have been merged are allocated to the category of the merged council.

Data source: Population across all councils reported in Your Council Report, Office of Local Government time series data 2009-10 to 2020-21, accessed at https://www.olg.nsw.gov.au/public/about-councils/comparative-council-information/your-council-report/; total expenses from continuing operations is from data provided by NSW OLG to IPART.

# How could a process of submitting claims for external costs work?

Option 2 — developing a process for councils to submit claims for external costs — is the only feasible option for incorporating external costs that is within the control of councils and IPART. Key aspects of this process to consider are that:

- councils would be highly incentivised to undertake and submit a systematic piece of work on external costs
  - this research would have to identify the external drivers, estimate the impacts of these, assess whether these are already being factored into the LGCI and estimate how much is being funded through other sources of income for councils.
  - the cost of undertaking this research would be expected to be in the \$100 000 to \$300 000 range, depending on the level of detail
  - if this identified a 0.1 per cent change relevant for the rate peg, then this would amount to more than \$5 million in extra revenue per year across all councils. Or if it identified a cost impact of \$10 000 per council, this would amount to \$1.3m per year in revenue
  - this indicates that the costs for councils to commission this work would be much less than the revenue impacts from even a small change

Note that while there are large incentives for councils, it should be recognised that the cost of doing the review is a resource cost, while the impact on the LGCI is a transfer from ratepayers to the council.

- the process of undertaking this review would favour identifying external costs rather than identifying external benefits
  - councils consulted will be much more likely to be able to identify costs imposed on them, rather than benefits they derive from external impacts

- this will particularly be the case where councils are in control of the process. If
   IPART was in control of this process then the bias could be reduced somewhat,
   but it would still likely be easier to identify costs imposed externally than benefits
- regardless of who is in control of the process, councils will inevitably be the key source of information about what they have had to do in terms of resourcing or activities in response to an external driver
- the review could either use changes that have already occurred or expectations of what will be required for councils
  - the advantage of using information from changes that have already occurred is that the data *should* be more accurate
  - the disadvantage of using information from changes that have already occurred is that councils will have incurred external costs for one or two years prior to these being reflected in the rate peg
- materiality threshold would a threshold be put in place, so that only large external
  cost factors are considered. For example, if an impact is smaller than 0.1 per cent of
  rate revenue (about \$5m per year) then it would not be considered
  - a materiality threshold would significantly reduce the cost of the process to examine external costs, and would likely lead to the sorts of changes that IPART has allowed historically
  - this would not allow for cumulative small external cost impacts to be included.

Further detail on how a process above could work could be developed if this is a direction that IPART would like to progress.



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