

Review of the Rate Peg Methodology

Comments on IPART's Draft Report

This is a thorough but in some respects troubling report. The following comments, which are intended as a constructive contribution, address three key aspects of the report:

- A failure to reflect sufficiently on the history and context of rate **pegging** in New South Wales, in particular its relationship to integrated Planning and Reporting (IP&R), and relevant practice elsewhere
- As a consequence, placing too much emphasis on the role and calculation of the rate **peg**, which is simply one element of a broader system
- The need for greater clarity around the proposed review of the 'financial model' for NSW local government.

Some further issues are canvassed briefly in a final section, which also underlines several key points. No attempt has been made to review the detailed technical analysis in Chapters 3-7 of the report.

History and Context

At the outset, it is crucial to recognise that rate pegging (or 'capping') 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'. Economically, it makes no sense for the state to place arbitrary constraints on public sector revenues from rates – which are in effect the 'broad based land tax' often seen as necessary to strengthen Australia's overall tax base. Doing so simply limits the capacity of local government to do more in sharing the burden of providing essential services and infrastructure, placing more pressure on the state to increase its own revenues and to provide grant funding to struggling councils.

In Victoria, the political nature of rate capping is made explicit: the Essential Services Commission (IPART's equivalent) makes recommendations on the annual cap to the Minister, who reserves – and has exercised – the right to vary the recommended increase.

In NSW, Ministers have sought to remove themselves from political responsibility by delegating all aspects of rate pegging to IPART. This is not acknowledged or codified in the Local Government Act, but clearly the arrangements could be changed 'at the stroke of a pen'. Also unlike Victoria, the NSW Act does not provide legislated objectives for rate pegging, which are therefore open to interpretation from time to time by Ministers, the Office of Local Government and IPART itself (including in this Draft Report), and those interpretations are difficult to test with necessary rigour.

During the period 2009 to 2013 the implementation and consequences of rate pegging were reviewed by IPART and the Independent Local Government Review Panel (ILGRP).¹ Those reviews

¹ ILGRP Final Report (October 2013): ***Revitalising Local Government***, pp.33-48

highlighted both benefits and drawbacks, including in particular the tendency for councils to accept the annual peg regardless of their particular circumstances and needs, rather than face the political risks of seeking a significantly greater Special Variation (SV). This was causing long-term financial damage. Subsequently, IPART sought to de-emphasise the significance of the peg and advised councils to focus on careful assessment of, and planning for, their particular needs. The newly introduced Integrated Planning and Reporting (IP&R) process was therefore seen as the preferred basis for formulating SVs whenever necessary to raise required revenues (see figure below).

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



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

The underlying concept here was that effective implementation of the IP&R framework would in itself both improve all aspects of financial management by local government AND provide a sound basis for formulating and processing SV proposals without the need for substantial additional documentation, and with success more or less guaranteed. In other words, IP&R and rate pegging would be intertwined.

Regrettably, while acknowledging the IP&R provisions and (rightly) identifying a need for improvements in their implementation, the Draft Report tends to de-emphasise the benefits of a close combination with the administration of rate pegging. In particular, its proposals undercut the intended importance of IP&R – specifically preparation of long-term financial and asset plans – as **the primary pathway** to addressing community needs while ensuring responsible financial management. Rather it simply portrays IP&R as a series of documents that ‘provide useful information to the community about their council and strengthen councils’ accountability’ (p.19).

In this regard it is noteworthy that having been forced to abandon attempts to introduce NSW- and Victorian-style rate pegging/capping, the South Australian government – by agreement with the Local Government Association – has instead tasked its Essential Services Commission (ESCOSA) to undertake regular reviews of councils’ 10-year financial and infrastructure and asset management plans, and to advise each council on the ‘appropriateness’ of those plans, having regard in particular to the financial contributions proposed to be made by ratepayers. This appears to offer a more constructive approach to oversight of local government financial management that recognises the fundamental importance of sound planning, inevitable differences between councils, and the potential value of utilising ESCOSA’s resources and expertise to provide expert advice.

Purpose and Scope of the Rate Peg

While the draft report explains that the rate *peg* is only one element of rate *pegging* and of the wider regulatory framework, it nonetheless portrays it as a primary, even the key, mechanism. This runs contrary to IPART's stance less than a decade ago and reflects the apparent sidelining of IP&R.

Surely the fact is that however sophisticated its calculation, a single number – or as now proposed, a series of somewhat tailored numbers – can *never* fully address the myriad points of difference between local government areas and the varied, reasonable needs of their communities. This is why the combination of a more flexible, 'lighter touch' approach to the peg coupled with a strong focus on IP&R was seen in 2013 to offer the best way forward: SVs will *always* be required.

The danger here 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 in the Draft Report (pp.3 & 19):

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.

The report does acknowledge that 'other mechanisms' have a role to play (p.19):

... the degree to which a council meets the needs of its community, and its obligations are driven by a wide range of regulatory mechanisms and various factors. Some of these other mechanisms may be more effective in achieving improvements in councils' financial sustainability and providing better outcomes for ratepayers than changes in the rate peg methodology.

However, that comment is followed by 100 pages discussing how the rate peg methodology might be improved and its scope broadened – specifically to encompass the Emergency Services Levy (ESL) and other 'external changes' in councils' operating environment. There are surely areas in which 'other mechanisms may be more effective' and those should be explored before the rate peg is further entrenched.

In the case of enabling councils to recover the cost of the ESL, there is merit in IPART's proposed intervention as an interim measure. But a preferable and less bureaucratic alternative to addressing an essentially simple problem would be an amendment to section 505(a) of the Act. This could remove from the calculation of a council's *general income* an annual charge or special rate dedicated

to funding the ESL in exactly the same way as other sources of revenue already listed in the section. A similar approach could be adopted if appropriate for other 'external costs' that apply to many or all councils. Alternatively, the Minister could be given power to add items to a list of 'exempt' sources of revenue by Regulation rather than repeated amendments to the Act. There should be no need for IPART to get involved.

In all of this, it is important to bear in mind the very limited benefits derived from rate pegging by most ratepayers, especially relative to unregulated increases in other household costs, and to balance that reality (as opposed to some political perspectives) against the costs of running the system. Assuming an average residential rate of \$1500 per annum, a 5% increase costs the average ratepayer about \$1.50 per week. To ensure that rates remain affordable and councils sustainable, it is important to enable routine imposition of such modest increases – almost regardless of 'base cost' and other calculations that will remain largely hypothetical – and thus avoid deferring 'ratepayer pain' to the point where very substantial SVs such as those approved this year become unavoidable. Remembering again that rate pegging is about politics more than economics.

Reviewing the 'Financial Model'

IPART's endorsement in Chapter 9 of the need for a broader examination of financial management and sustainability issues is welcome. However, experience suggests that unless the new State government demonstrates a likely willingness to make – not just 'consider' – significant changes to the current legislative and regulatory framework, there is no point in embarking on another costly, time-consuming review. Revisiting IPART's 2016 findings and recommendations would cover most of the key issues.

Firstly, there is very little likelihood of – and for the majority of councils, little need to make – any change to the basic revenue mix of rates, fees and charges. As a broad-based tax on land (potentially enhanced through the use of capital improved valuations for certain classes of property) rates can provide most councils with a robust and adequate revenue base. This has been confirmed by recent reviews in both Victoria² and New Zealand.³ The problem, as demonstrated in 2007 by the federal Productivity Commission⁴, is that in NSW and elsewhere in Australia their potential is not being realised due to political and legislative constraints.

Secondly, as the Draft Report again points out, a raft of proposals was formulated during the period 2013-2016 by the ILGRP and IPART that sought to remedy glaring deficiencies in the administration of rates, fees and charges in NSW, but the then State government refused to act, evidently fearing political damage and perhaps also reluctant to let local government 'off the leash'. The new government could take a similar view, although as in the case of the ESL, it may see a financial advantage in enabling councils to accept additional responsibilities and to become more self-reliant, thus relieving pressure on its own budget.

Therefore, subject to an indication of the government's thinking, an open-minded revisiting of IPART's 2016 recommendations, rather than another wholesale review, would be the best course of action, at least initially. A more extensive review could follow if the State government responds favourably. However, it would be very informative, and perhaps helpful politically, also to rerun sustainability reviews of every council along the lines of those carried by the Treasury Corporation

²https://www.localgovernment.vic.gov.au/_data/assets/pdf_file/0024/184173/FactSheet_GovernmentResponseToLocalGovernmentRatingSystemReview.pdf

³ <https://www.productivity.govt.nz/inquiries/local-government-funding-and-financing/>

⁴ <https://www.pc.gov.au/inquiries/completed/local-government/report>

(TCorp) in 2011-13.⁵ This would provide valuable data on the cumulative effects of policy and regulatory decisions, as well as changes in local government's operating environment, over the past decade.

Further Observations

This section underlines a few key points for IPART to review in finalising its report.

- **Rates are a general-purpose tax on wealth, not a service charge.** This bears repeating because the tenor of the Draft Report tends to a view of councils as the providers of a settled 'package' of municipal services that should be delivered at the lowest possible cost and closely monitored by the State, which should also determine whether or not it is reasonable to raise additional revenues for new or improved functions. If that is indeed IPART's 'world view', then it needs to be made explicit and tested with the government and stakeholders, because its application may well nullify the potential of rates as an effective broad-based tax, and to condemn local government to a condition of permanent austerity under which most councils can make only a minimal contribution to wider social, economic and environmental agendas.
- **Ratepayer views and consultation.** A surprising feature of the Draft Report are the repeated and lengthy references to the recorded concerns of ratepayers that the burden of rates is too great and/or unfairly distributed, and that councils make decisions without sufficient consultation. Evidently IPART commissioned a substantial piece of work to gather these views, none of which are new or surprising, and few of which appear relevant to the current review's methodological focus. Even more surprising is IPART's statement that it has '*considered whether additional constraints (i.e. conditions) on the rate peg would help provide individual ratepayers confidence in the rating system and reduce the likelihood of ratepayers experiencing significant changes in their rates' and that there could be merit in introducing such constraints'* (pp.121-122). In making such observations, and in its later comments on councils 'earning autonomy', IPART can be seen to exceed its brief as a pricing regulator and to position itself as an adjudicator of the quality of local democracy, standing in the shoes of government. Rate-setting is only one element of the complex mix of roles of elected local governments, and clear boundaries need to be set around IPART's role vis-vis those of the Minister, Office of Local Government, Auditor General and others exercising State oversight.
- **Legislative provisions around rate pegging.** As noted earlier, the NSW Local Government Act is silent on the objectives and protocols for rate pegging, including IPART's role. Nor does the Act draw necessary links to critical related provisions such as the Local Government Principles by which councils must abide (sections 8A-8C); the roles of a council's governing body, including the preparation of a Rating and Revenue Policy (section 223); Integrated Planning and Reporting (sections 402-406); and the need for community consultation on councils' draft annual Operational Plans or budgets (section 532). The lack of such cross-referencing, and hence a more coherent framework within which rate pegging could evolve, reflects the generally disjointed nature of the Act: a comprehensive re-write was planned in 2011 but later abandoned. As a starting point for an improved framework, IPART should consider the relevant provisions of the Victorian Act.
- **Integrated Planning and Reporting.** IPART is correct in identifying a need to strengthen some of the provisions around IP&R, but as indicated earlier that requires a sound appreciation of what IP&R can *and should* achieve. It was intended to provide a comprehensive framework for enhanced local democracy and sound financial management that would enable local choice and

⁵ NSW Treasury Corporation (March 2013) *Financial Sustainability of the New South Wales Local Government Sector*

more effective responses to community needs and aspirations. In other words, a holistic approach to local governance. This explains why it was seen by IPART in 2013 as the basis for 'lighter touch' rate pegging under which IPART would rely largely on the outcomes of IP&R processes in assessing SVs, subject only to an assurance that those processes had been thorough and fair, especially in terms of community consultation. The current Draft Report implicitly – and in some places explicitly – winds back that approach.

- **Implications for the Special Variation process.** By placing so much emphasis on an improved rate peg methodology with added 'bells and whistles', the Draft Report appears to downplay the role of the SV process. Its proposed way forward may both constrain the scope of SV applications and make their success less likely, because the rate peg could be seen as having done all the 'heavy lifting' and departures from it might be judged primarily on its perceived validity, with less weight given to the *council's* assessment of local needs. Yet, as noted previously, even a highly sophisticated rate peg can never reflect all the differences between local government areas and their communities. The SV mechanism is also crucial to the democratic exercise of local choice; to 'step-changes' that will inevitably be required from time to time to ensure long-term financial sustainability; and to enabling local governments to achieve their full potential. Therefore, the rate peg should continue to be seen as just a starting point; SVs regarded as perfectly normal and encouraged; and the SV process streamlined to the maximum possible extent with a view to minimising the resourcing required and the political obstacles to lodging them.
- **The federal dimension.** IPART's recognition of the federal government's involvement in the financial and governance framework for local government (as shown in Figure 2.2) is welcome and deserves more attention. A very large number of NSW councils would collapse 'overnight' if federal financial assistance grants (FAGs) and roads funding were withdrawn or substantially reduced. Moreover, the relative importance of those grants will increase if, as seems likely, State government funding programs for local government are cut and/or councils are expected to do more in areas such as emergency services, environmental management, rural roads, community support etc where the State wishes to relieve pressure on its own budget. These are crucial factors when considering the *overall quantum* of revenue that could and should be raised from rates, and the parameters for a future 'financial model'. Specifically, the interplay between the distribution of FAGs and the capacity of different local government areas to generate rate revenues requires closer examination, and the Local Government Grants Commission should be regarded as a key stakeholder in IPART's work. Ultimately, the federal government has the right to expect that its very considerable financial support will be used wisely, and that the intended benefits to local communities are not undermined by excessive restrictions on councils' own-source revenues.