

Are Councils Sustainable?

Final Report: Findings and Recommendations

Independent Inquiry into the Financial
Sustainability of NSW Local Government

May 2006

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VOLUME 2

1. Research Reports
2. Research Papers

ACRONYMS

AAS27:	Australian Accounting Standard (applying to Local Government)
AASB:	Australian Accounting Standards Board
ABC:	Activity Based Costing
ABS:	Australian Bureau of Statistics
ADR:	Alternative Dispute Resolution
BPM:	Best Practice Management
CCQG:	Council on the Cost and Quality of Government (NSW)
CGC:	Commonwealth Grants Commission
CoA:	Commonwealth of Australia
COAG:	Council of Australian Governments
CPI:	Consumer Price Index (Sydney)
CSOs:	Community Service Obligations
DA:	Development Application (NSW)
DCP:	Development Control Plan
DEA:	Data Envelopment Analysis
DEC:	Department of the Environment and Conservation (NSW)
DEUS:	Department of Energy, Utilities and Sustainability (NSW)
DIPNR:	Department of Infrastructure, Planning and Natural Resources (NSW)
DLG:	Department of Local Government (NSW)
DLO:	Direct Labour Oncost
DOTARS:	Department of Transport and Regional Services (Commonwealth)
EIS:	Environmental Impact Statement
EPA:	Environment Protection Authority (NSW)
EPA Act:	Environmental Planning and Assessment Act 1979 (NSW)
EPI:	Environmental Planning Instrument
FAGs:	Financial Assistance Grants
FTE:	Full-Time Equivalent
GFS:	Government Finance Statistics
GSP:	Gross State Product
HFE:	Horizontal Fiscal Equalisation
HFI:	Horizontal Fiscal Imbalance
IGA:	Intergovernmental Agreement
IPART:	Independent Pricing and Regulatory Tribunal (NSW)
IPWEA:	Institute of Public Works Engineering Australia
KPI:	Key Performance Indicator
LEP:	Local Environmental Plan (NSW)
LGAs	Local Government Associations
LGAA:	Local Government Auditors Association (NSW)
LG Act:	Local Government Act 1993 (NSW)
LGGC:	Local Government Grants Commission (NSW)
LGI:	Local Government Inquiry (Independent Inquiry into the Financial Sustainability of NSW Local Government)
LGFP:	Local Government Financial Professionals (NSW)
LGMA:	Local Government Managers Australia
LGSA:	Local Government and Shires Associations (NSW)
LWU:	Local Water Utility
MAV:	Municipal Association of Victoria

NCC:	National Competition Council
NCP:	National Competition Policy
NGO:	Non-Government Organisation
NSWCO:	NSW Cabinet Office
NSWT:	NSW Treasury
PA:	Partnership Agreement (Tas)
REP:	Regional Environmental Plan (NSW)
RIS:	Regulatory Impact Statement
ROC:	Regional Organisation of Councils
RTA:	Roads and Traffic Authority (NSW)
SEPP:	State Environmental Planning Policy (NSW)
SPP:	Specific Purpose Payments
SSC:	Shared Service Centre
TAM:	Total Asset Management
VFI:	Vertical Fiscal Imbalance
VFU:	Vertical Fiscal Under-equalisation

FOREWORD

When we ask friends what proportion of the public sector is represented by Local Government, they invariably guess somewhere between 10 and 30 per cent.

The truth is that Local Government accounts for only five per cent of the total size of government in Australia and its own source revenue is an even smaller share.

Our *Final Report* examines whether NSW local councils are sustainable as presently constituted and funded.

It uncovers a number of pressing problems that need urgent attention. The biggest of these is a huge backlog in infrastructure renewals (over \$6 billion), which is expected to grow to almost \$21 billion within 15 years if the annual renewals gap (the difference between the rate at which councils' physical assets are depreciating and the rate at which they are being replaced) stays at around \$500 million per annum.

This report concludes that NSW Local Government needs to find an extra \$900 million a year to overcome its infrastructure crisis. \$400 million of this would go in debt charges to service a \$5.3 billion debt raising to overcome the infrastructure renewals backlog problem (excluding water and sewer assets). The remaining \$500 million would be used to close the annual gap between what is spent on renewing assets and what is actually consumed in assets as measured by their depreciation.

The Inquiry recommends that the Commonwealth and State Governments come to the rescue of councils to the extent of an extra \$200 million a year in general purpose grants, which in future would be fixed as a proportion of these governments' respective total revenues. The balance of \$700 million would need to be found by Local Government itself, with say \$200 million from cost savings and \$500 million from extra revenue.

The extra \$900 million a year does not take account of the additional infrastructure needed in future to accommodate a larger population that is shifting to new growth centres. Nor does it take account of the higher standards of service, and therefore public assets, that people increasingly demand of their councils.

Also, it may not suffice to address the special problems of rural councils, which, because of their vast road networks and narrow rate bases, will only survive with increased grant funding. Their lean back and middle offices would suggest they have little fat to shed. Indeed, to upgrade their management practices they will need to bolster their professional staff.

Other challenges for councils are their role and relationship with higher tiers of government, including the problem of cost shifting; managing rising community expectations; maintaining existing service commitments in the face of a huge infrastructure bill and constraints on rate income; strengthening governance arrangements including restoring public faith in the development control process; overcoming skills shortages, perhaps through greater resource sharing and using tools such as performance benchmarking to upgrade management practices.

What is clear is that with only five per cent of public resources at their disposal, councils cannot be all things to all citizens. They will need to prioritise and plan their future role and

agenda in close consultation with their local communities. Much of the real growth in council revenues from hereon will need to be devoted to infrastructure renewal rather than expanding recurrent services.

The *Final Report* is based on the *Interim Report*, but takes account of corrections and comments from interested parties and includes additional research information.

It makes 49 final recommendations and spotlights a smaller number as key reforms. Most of the proposed changes need to be introduced in concert because they are either interdependent or insufficient on their own to underpin council sustainability.

We are especially grateful to those readers who provided feedback on the *Background and Issues Paper* and the *Interim Report*. That input helped us shape this *Final Report*.

The Inquiry urges Local, State and Commonwealth Governments to take its findings seriously and urgently act upon its recommendations so that the chronic infrastructure and other problems uncovered in this review do not escalate further.

Percy Allan AM (Chair and Research Director)

Libby Darlison (Panel Member)

Diana Gibbs (Panel Member)

1. EXECUTIVE SUMMARY

1.1 INTRODUCTION

This summary presents the major findings of the Inquiry, under each of the chapter headings used in this *Final Report*. These summaries use the ‘gap analysis’ format adopted as the Inquiry’s methodology - the ‘requirements’ (i.e. what should be) are compared to the ‘reality’ (i.e. what is). The options representing possible ‘remedies’, designed to bring reality and requirements closer together, are canvassed in each chapter itself. They have not been changed since the *Interim Report*. Indeed, further options have been added where gaps were drawn to the Inquiry’s attention.

The Inquiry’s Panel, after carefully reading all the responses to the *Interim Report*, has selected as its final recommendations those options which it believes offer a net benefit (i.e. their advantages outweigh their disadvantages) in the context of the serious infrastructure and financial problems besetting most councils. However, it has refined many of these options to take on board comments by respondents to the Interim Report. The Panel’s final recommendations are all listed in Chapter 12.

1.2 PROFILE

More than 100 state acts impinge on council activities, but the main ones are the *Local Government Act (NSW) 1993* (LG Act) and the *Environmental Planning and Assessment Act (NSW) 1979* (EPA Act) and subsequent amendments thereto. The Department of Local Government (DLG) oversees the first act while the Department of Planning administers the second.

The first local council in NSW (City of Sydney) was founded in 1842. The number of councils peaked at 324 in 1910, but subsequent mergers reduced it to 152. About half of all councils are in cities or large country towns. Councils vary in size from under 1,400 (rural – Urana Shire Council) to almost 280,000 (metropolitan – Blacktown City Council).

Compared with other federal systems, Australian Local Government is very small; it commands only five per cent of the nation’s general government resources. Yet the Inquiry’s informal enquiries would suggest that the overwhelming majority of citizens think that the third tier of government controls between 10 and 30 per cent of the public purse. This misconception may explain why Local Government is under pressure to replicate the wide range of policy areas already served by the state - people believe that local councils’ capacity is much greater than it actually is.

Unlike other federations, Australian Local Government is not involved in providing major community services such as schools, hospitals, police or social security. Its traditional functions were typecast as ‘the three R’s’ - roads, rubbish and rates. However, since the replacement of the *Local Government Act (NSW) 1919* with a new one in 1993 (LG Act), the trend towards serving people, not just property, has intensified. Currently councils’ functions cover at least eight R’s:

- **Roads** (including bridges, footpaths, kerbing, drains and street lighting)
- **Refuse** (including recyclable waste collection and disposal tips)
- **Regulation** (e.g. town planning, land use zoning, development approvals, safety inspections and environmental controls)
- **Recreation** (e.g. parks, sport grounds, swimming pools and libraries)
- **Relief** (e.g. community welfare, childcare, health, education and security)
- **Regionalism** (e.g. tourist and other forms of economic development)
- **Retail** services, which are provided by regional and rural councils (e.g. water and sewerage, transport, gas supply, salesyards, aerodromes and caravan parks)
- **Rate** collections also absorb a council's resources, but of course this activity is only a means to an end.

Under the *Local Government Act (NSW) 1919* the mayor was chief executive officer (CEO), and the town clerk was notionally head of the staff, but the chief engineer and the health and building inspector also exercised real statutory power. The LG Act of 1993 gave general managers the powers of management and councillors the role of strategy and policy makers. Yet many councillors still see their role as making decisions on individual matters (e.g. development applications), not just strategic policies (e.g. floor space ratios). This distinguishes councils from other tiers of government where the executive and legislative functions are completely separate.

Moreover, councils can also take on the role of the judiciary in certain matters, further confusing and combining roles that in other tiers of government are distinctly separate. This combination of powers, and the lack of a clear understanding of governance issues, is fundamental to understanding council behaviour.

1.3 DRIVERS

Polling conducted for the Inquiry reveals that public confidence in Local Government is high and indeed better than for State or Commonwealth Government. Yet Local Government is under many electoral pressures, such as:

- The public expects it to supplement state services (e.g. health and human services);
- The public wants councils to give highest priority to waste management, roads, pavements, kerbing, parks and gardens, litter and graffiti control, water & sewerage, maintenance of bushlands, waterways and the natural environment; and
- The public is least satisfied with local roads, pavements, kerbing, traffic management, parking facilities, town planning and timely processing of development applications.

Anecdotal evidence presented to the Inquiry suggest that most citizens think Local Government earns two to six times the revenue that it actually receives, which may fuel false expectations of what it is capable of doing. Other pressures on councils' limited resources include:

- New standards are forcing councils to recruit and develop more professionals yet there is a growing shortage of planners, engineers and accountants, which will intensify since many of them are nearing retirement age;
- Regional and rural councils have to subsidise doctors and their premises in order to attract them to their towns;

- State and local demands for better environmental management are putting cost pressures on councils;
- As the population ages more retirees will move to coastal and inland regional centres where they expect councils to provide aged care services (e.g. nursing homes and Meals on Wheels);
- Sea- and tree-changers used to city standards demand higher grades of service than non-metropolitan councils can afford;
- The depopulation of farming areas and small towns is undermining the revenue-raising capacity of rural councils; and
- To counteract the decline in their populations some councils in rural areas or non-regional centres are under local pressure to pursue costly and sometimes risky economic development initiatives.

It is widely held that both State and Commonwealth Governments are offloading their responsibilities onto Local Government without adequate compensation. For example, local councils have to collect state fees or levies under the NSW Plan First and the Builders Long Service Leave schemes, but get no recompense for this. Also, councils complain that the State Government is imposing more statutory obligations on Local Government without recognising, let alone funding, the extra cost involved. One example of this is the state-imposed requirement for councils to prepare Energy Savings Action Plans.

At a national level, National Competition Policy has forced local water utilities (LWUs) and other council businesses to become more commercial and competitive, yet the NSW Government, unlike most other states, has not shared with Local Government the Commonwealth incentive payments for complying with NCP obligations.

The findings of a survey commissioned by the Inquiry (Moegen 2006) indicate that the total burden of 'cost shifting' may be costing NSW Local Government about \$430 million per annum. The survey of 19 councils found a cost shifting ratio of almost 7 per cent of total ordinary revenue excluding capital revenue.

1.4 ROLE

Requirements

In a democratic federal system the roles and associated regulatory and revenue raising powers of each tier of government should be clearly stated in the national constitution, legislation or formal compacts agreed between each tier. Under the principle of 'subsidiarity', the lowest tier of government should deliver public functions except where higher tiers are better placed to undertake them.

Under the principle of 'correspondence', each tier of government should have revenue raising and regulatory powers commensurate with its responsibilities. The revenue level and hence expenditure capacity of each individual unit of Local Government should be decided by its elected representatives unless restrictions have been put on their authority by resolutions approved by local referendum. The right of citizens to be represented if they pay taxes is now a tenet of democracy not only in America.

Reality

In accordance with the principle of ‘subsidiarity’, the lowest level of government should undertake public services. However, unless councils were organised on a much larger scale (e.g. Brisbane City Council), it is doubtful that they could take over most of the state’s functions (e.g. hospitals, schools, police, courts).

Replacing state and Local Government with regional regimes could disadvantage non-metropolitan areas since a Sydney-based province, unlike a Sydney-ruled state, would not be legally obliged to cross-subsidise the rest of New South Wales. Nevertheless, there is evidence to suggest that the notion of replacing state and Local Government with regional government has a strong following, at least in Queensland (Brown 2002a).

Local Government is not recognised in the Australian constitution as a third tier of government. Two attempts to amend the constitution failed when they became associated with other issues.

The official view in State Government is that local councils are legally no more than state statutory corporations and as such they are not an autonomous tier of government even though elected by citizens. State legislation such as the council’s charter in the LG Act does not define Local Government’s role vis-à-vis other governments. Nor is there an intergovernmental agreement to clarify this.

The new Local Government legislation in 1993 freed up councils to embrace a ‘maximalist’ (people servicing) role, yet by restricting taxes to property rates and retaining rate pegging and regulated fees and charges, in reality, Local Government’s capacity has remained constrained to a minimalist (property servicing) role. In the absence of a wider tax base and constraints on other sources of revenue, councils will need to curb their recurrent spending ambitions until they have overcome the shortfall in their capital spending on infrastructure renewals (especially roads, pavements, kerbing, public places, etc).

In deciding the most appropriate future role for Local Government, there are three distinct possibilities. The definition and case for each are set out below:

- **Minimalist:** Councils are the body corporate for the local community and as such should look after the common property and regulate the usage of private properties. This role would ensure that councils live within their meagre resources largely dictated by a single tax base (land rates) subject to a state imposed ceiling (rate pegging).
- **Maximalist:** Councils are the governments of their areas and as such should foster the welfare of the whole community even if this means duplicating the work of other tiers of government. They should undertake such services that local communities want and are prepared to pay for.
- **Optimalist:** Councils are champions of their areas and as such should take a leadership role in harnessing public, NGO and private resources to promote particular outcomes rather than attempt to fund and operate local initiatives on their own. Because of funding constraints an ‘optimalist’ approach may allow a ‘minimalist’ resourced council to exercise maximum leverage.

1.5 INFRASTRUCTURE

Requirements

Local Government infrastructure should serve the needs and priorities of the community within the agreed role of Local Government. Such infrastructure should be of a satisfactory standard in terms of providing services in a relevant, functional, safe, reliable and cost efficient manner.

Each local council should have a total asset management system for the whole of life planning, acquisition, registration, operation, maintenance, disposal and renewal of each component of its infrastructure. Sufficient funds should be set aside each year for routine maintenance, renewal of depreciating assets and the expansion of the asset stock to meet the short to medium term future needs of the local community.

Reality

Most Local Government infrastructure is in the form of local and regional roads, most of which are outside the metropolitan area. The NSW Roads and Traffic Authority (RTA) funds about three quarters of regional roads. Councils also get funding through the Commonwealth's 'Roads to Recovery' program and are contracted by the RTA to look after about a quarter of state roads.

A decade ago many regional roads that no longer served this purpose were reclassified as local roads, thereby increasing the responsibility of and cost to councils for road works. The RTA insists that councils were adequately compensated for this transfer, but councils dispute this. Many roads that are now deemed to be regional and local were funded by state and Commonwealth Governments in the mid-twentieth century, and are now coming to the end of their useful economic life and need to be renewed.

Studies commissioned by the Inquiry estimate that overall under-spending on infrastructure renewal has been of the order of \$400-600 million per annum. It would cost over \$6.3 billion to restore these assets to a satisfactory condition. A further \$14.6 billion is needed to replace existing assets over the next 15 years. This does not take account of new infrastructure needs for a growing and shifting population.

Seven per cent of rural councils and 25 per cent of urban councils are renewing less than 30 per cent of the infrastructure that should be replaced each year. Furthermore, only one in five councils are managing infrastructure risk via asset or risk management plans. Only between five and 37 per cent of any asset class within councils is subject to asset management planning. As assets deteriorate, councils' risk exposure is increasing – it is not clear that councils fully appreciate the extent of this.

Unlike state agencies, local councils are not required to regularly estimate the 'fair value' of their physical assets (e.g. replacement cost of roads). Nor do councils use consistent depreciation rates for estimating the annual consumption of their assets. As a result, their accounts significantly understate the true magnitude of their infrastructure problem. The Inquiry has adjusted existing data to obtain a more accurate picture of the condition of councils' assets in NSW.

The existing infrastructure survey requiring councils to report on their infrastructure in their annual reports (special schedule 7), while an important initiative by the DLG, is deficient.

For instance, it does not split up future infrastructure renewals by time frame, nor does it define what is a ‘satisfactory’ condition for an asset. Also, it does not distinguish between capital expenditure on infrastructure renewal and capital expenditure on the expansion of existing assets or the acquisition of new assets. Most councils do not have the asset management systems and skills to ensure that assets are properly registered, valued, planned, acquired, operated, maintained, disposed of and renewed, let alone costed on a whole of life basis.

1.6 SERVICES

Requirements

Local Government services should meet the needs and priorities of the community within the agreed role of Local Government. Such services should be delivered in a relevant, effective, prudent and cost efficient manner. Each local council should identify the needs and priorities of its residents by conducting not only public meetings, but also objective and representative opinion polls that ascertain the views of citizens not active in local affairs.

A council should also have a medium to long-term strategic and financial plan that identifies the major objectives, strategies and funding sources of its services and regulations as well as an annual operational plan (known in NSW as a management plan), incorporating three-year budget forward estimates, for implementing those strategies. Key performance indicators that are SMART¹ and have quantifiable targets should apply to all major services and the results be annually disclosed, audited and benchmarked against other councils.

Reality

Councils have expanded from property services to a wide range of people services. They have done this by using capital funds that were meant for renewing infrastructure assets to bankroll deficits in their operating accounts (excluding capital revenues). The general public has wanted councils involved in environmental, health, human services, culture and education facilities – these are functions traditionally associated with State Government.

Such services have come about not just through popular pressure, but because of government seed funding to encourage such tasks (e.g. Connecting Rural Families program), councils backfilling services withdrawn by government (e.g. medical centres and aged care facilities) and state requirements for councils to plan for and report on social and environmental improvements (e.g. mandatory social and community plans). This increased level of services has forced most councils into an operating deficit.² The Inquiry has noted that some councils spend much more per capita on services than other comparable councils.

Reasons for this disparity include councils being:

¹ SMART is an acronym that means each indicator satisfies five tests: is specific, measurable, achievable, relevant and time based.

² As we shall see later, many councils treat capital revenues as operating income, thereby producing an operating surplus instead of a deficit. While this is allowed under AAS27, the Inquiry believes the result is misleading.

- Locked into this pattern historically by rate pegging;
- Subject to different electoral pressures (e.g. some areas have strong green movements);
- Exposed to groups with abnormal needs (e.g. a higher share of aged people); and
- The ‘last one standing’, especially in rural areas where if a council does not fund a badly needed service (e.g. a school bus) the community may be denied it.

In other cases it may be due to a more liberal fiscal stance and poor management accounting that conceals the true financial position of councils. While councils adhere to statutory accounting requirements, these permit under-valuation of assets and depreciation and the inclusion of some capital revenues as operating income, practices that can make a council with a deep deficit look like it’s running a healthy surplus.

With council views (Inquiry workshops), public opinion (IRIS 2005) and expert advice (Access 2006 and Roorda 2006) all suggesting a need to increase spending on infrastructure, councils might have to curtail operating expenditure growth to make ends meet unless they substantially increase their revenue and debt. Polling suggests that savings may be possible in waste management, culture, education, recreation, town planning and economic development without impacting significantly on overall satisfaction with Local Government.

Significantly, councils’ business activities, especially water and sewerage services, have become more commercialised (i.e. recovering more of their costs through user charges) yet public satisfaction with these services remains high (IRIS 2005).

Unfortunately, only a small proportion of councils have undertaken long-term assessments and planning of their community’s service needs and potential future service requirements for services other than water and sewerage. Whilst 77 per cent of councils have a long term (i.e. 30 year) strategic business plan and financial plan for water and sewerage services, most councils do not prioritise beyond three years (the horizon of their mandatory management plans) or budget beyond one year for the remainder of their services. Only a tiny fraction has long term strategies for services related to most asset classes (Roorda 2006).

1.7 PLANNING

Requirements

A land use planning system should be a mechanism for agreeing on a vision for an area, identifying the objectives and strategies to realise that vision and the resultant actions required of both government and private interests.

It should consist of a long-term strategic plan (e.g. the newly announced Sydney Metropolitan Strategy) of sufficient detail to give developers and residents a blueprint of how an area will develop. It should also have legislated prohibitions on certain defined activities or uses on defined parcels or zones of land where the market can not be trusted to give an optimal outcome (e.g. ensuring that a residential parcel of land is used for only residential purposes) and a process for enacting development controls (preferably expressed in an easily accessible single document) that set the criteria for permitting uses that would otherwise remain prohibited (e.g. permitting a convenience store within a residential block that is a long distance from a corner shop).

It should provide for an independent, professional, objective and open process for considering a development application that does not strictly comply with regulations and a right by either a direct or third party to appeal any decision on that application. For developments that comply with the core legislative and regulatory requirements the consent process should be simple and fast. All planning rules and criteria should be easily accessible and explicit and their application should be transparent, consistent and impartial.

Reality

The Inquiry found that there are too many pieces of legislation (e.g. *Local Government Act (NSW) 1993*, *Environmental Planning and Assessment Act (NSW) 1979*, *Protection of the Environment Operations Act (NSW) 1997*, *Coastal Protection Act (NSW) 1979*, *Heritage Act (NSW) 1977*, etc) and regulation (e.g. multiple SEPPs, REPs, LEPs and DCPs most of which require Ministerial consent)³ to guide a council in dealing with a development application (DA) for a specific parcel of land.

In other states (e.g. South Australia) there is a single document for each zone or parcel of land that sets out all the development controls that apply to it. This makes it easier for both owners and councils to review the controls in force, but it is inconvenient for the state if it wants to apply blanket controls because each document then has to be varied. In NSW there are too many matters (e.g. ‘the environment’) mentioned in each of the many control documents that need to be considered with each DA. For example, the Coastal SEPP has 28 complex matters that need to be considered and assessed by council staff. The EPA Act (S79C) contains criteria (e.g. ‘the public interest’ and ‘the circumstances of the case’) for councils to consider when assessing a DA, which expands the obligations of a council beyond that intended elsewhere in the Act.

The Minister may not only ignore statutory controls when dealing with called-in DAs or projects of state significance, but is under no obligation to explain his reasons for doing so. Compared with other jurisdictions, the Department of Planning gets heavily involved in individual development applications rather than confining itself to making, monitoring and enforcing state and regional planning policy.

Generally, there is no third-party right to have a court reassess, on its merits, a DA decision by a council. The only legal recourse is an administrative challenge, generally based on a failure to comply with the process. This increases the insurance risk to councils of getting the process wrong by overlooking any required ‘matter’ or ‘criteria’ for consideration.

The multiplicity of planning control documents, the complexity of their processes and the considerable risks of error increase the cost and delays to applicants, objectors and councils. There is a lack of transparency and due process in dealing with DAs and spot rezonings (permissions to undertake a prohibited development on a single site), which exposes the system to undue influence by interested parties.

There is no separation of powers within most councils between the legislative (setting land use controls), executive (administering controls) and arbitral (deciding specific control

³ State Environmental Planning Policy (SEPP), Regional Environmental Plan (REP), Local Environmental Plan (LEP) and Development Control Plan (DCP). Contrary to label, a SEPP and a REP may be used by the state not only for setting development controls for the whole state or a region, but also for controlling the development of a specific parcel of land that would otherwise be decided by the local council.

exemptions) functions of dealing with DAs. Persons seeking a development approval may briefly state their case to a council meeting, but they are not always given the opportunity to face all councillors when speaking, nor are they necessarily accorded the attention and respect associated with an arbitral process. Councils have a conflict of interest when acting as both a developer and consent authority (e.g. the Oasis project undertaken by Liverpool Council). Councils are prohibited from charging special fees for fast tracking DAs that would help them employ additional resources for such purposes and thereby dedicate existing staff to routine applications.

Many councillors are not familiar with environmental planning controls, or with their role in the application of such controls. Public opinion wants to minimise councils' political involvement in the processing of DAs (IRIS 2005). The public wants councils to give less priority to town planning and DAs and more to basic infrastructure and services, a view shared by many in the State Government (Inquiry interviews). Community activists want councils to exclusively control the development of each land parcel to ensure that it is compatible with its neighbourhood. The State wants a bigger hand in planning and approvals so that councils don't nit-pick every development to death.

In summary, to quote one Ministerial taskforce (DIPNR 2003, p5):

...the development approval process was characterised by a focus on process (rather than outcome), inconsistent policies, varying procedures, timeliness, as well as a pervading sense of frustration and conflict. The process was not generally regarded as strategic, did not appear to focus on the quality of development as an outcome and did not encourage investment in NSW.

1.8 REVENUE

Requirements

Local Government's revenue raising capacity should be commensurate with its agreed roles and responsibilities. External grants should either be to help local councils meet minimum responsibilities that cannot be fully funded by normal rates and charges or to fully fund activities on behalf of another tier of government. Their criteria should be explicit and stable.

Specific taxes, regulatory fees and fines should be economically efficient, socially equitable and relatively simple and inexpensive to administer. Commercial services should fully recover their economic costs, including cost of capital, but not exploit any monopoly powers. For other services, full or partial cost recovery should be tied to specific outputs and be consistent in rationale and application.

Reality

NSW councils are confined to one tax based on unimproved property value, namely rates. Rates income averages 37 per cent of a council's total revenue, although this proportion varies significantly between different categories of councils. There is also a large variation in rates revenue per residential, business and farmland assessment between councils of the same category (e.g. metropolitan, regional or rural). Ironically, larger councils generally charge higher rates per capita than smaller councils. Larger councils have often pursued a more 'maximalist' agenda than smaller ones, which has occasioned higher taxes. Variations in

average rates may also reflect historical relativities before rate pegging was introduced in 1976.

The rate's bill paid bears little relationship to the level of council services used by a household. In terms of equity considerations, rates may not equate to a wealth tax. For instance, a freestanding house (with high land content and hence higher rates) may not be worth more than a luxury unit in a multiple dwelling, but will pay very much higher rates. Also, some residents may be asset rich, but income poor, limiting their ability to pay and therefore raising equity concerns.

Nevertheless, rates are efficient and administratively simple because they are impossible to escape unless subject to statutory exemptions (e.g. for state agencies, charities and benevolent institutions) or concessions (e.g. for aged pensioners). Also, since they average just over \$600 per household, residential rates are a small proportion of the cost of a home and as such not very distortionary. Exemptions are important, for when the State Government expands its land holdings (e.g. the creation of national parks or state forests) councils may suffer a loss of rateable property.

Council charges for services such as domestic waste management, water supply and sewerage, use of public spaces and parking meters, are not subject to state controls; nor are parking fines. Also, developer charges for water supply and sewerage are not capped. However, other statutory fees (such as for processing DAs) are capped. Rate pegging and fee caps have constrained NSW Local Government revenue growth, notwithstanding, special rate variations. Council rates have certainly grown at a much slower pace than state land tax. There does not appear to be a consistent set of criteria for determining rate pegging and variations thereto.

Commonwealth financial assistance grants (FAGs) to Local Government have grown faster than the consumer price index (CPI), but much slower than the state economy (gross state product or GSP) and have shrunk as a proportion of federal tax revenue. The formula for distributing FAGs between councils is only partially based on their revenue and expenditure disabilities. Furthermore capital (i.e. infrastructure) disabilities are not considered. Unlike the Commonwealth Grants Commission, the NSW Local Government Grants Commission does not publicly disclose its calculations of disability for each council. Instead, it only discloses its measure of disability of a council to that council itself. This prevents third parties (like this Inquiry) comparing LGGC disability measures for all councils.

State grants to Local Government are not published by either the NSW Government or the Australian Bureau of Statistics (ABS) so their total size, composition and past trends are not publicly known. However, data specially provided to the Inquiry by the NSW Treasury shows that total grants (excluding pensioner rate rebates, physical asset transfers, rate payments by state entities, interest subsidies, assumption of HIH insurance liabilities, and capital and welfare disaster relief) increased from \$544 million in 1996/97 to \$740 million in 2003/04, an average annual rate of growth of 4.6 per cent.

In addition to grants, councils also receive payments from state agencies for performing services on their behalf. For instance, the Roads and Traffic Authority pays councils for maintaining state roads under performance specific contracts.

Councils have been recovering a larger share of the cost of providing commercial services. For instance, following the introduction of NSW Department of Energy, Utilities and Sustainability (DEUS) guidelines and reporting requirements in 2000, country water and sewerage utilities significantly increased their revenues, mainly by the introduction of appropriate water and sewer usage charges, liquid trade waste fees and charges and developer charges in addition to their annual water and sewerage access charges. Nevertheless, cost recovery still varies from about 50 to 140 per cent between different utilities (Access 2006, p38) and the economic return on assets is only 2.7 per cent (Byrnes 2005a, p4). The extent of cost recovery in other commercial activities (e.g. salesyards, aerodromes, caravan parks) is not known.

1.9 GOVERNANCE

Requirements

Local Government should be democratically elected. Its primary accountability should be to its electors.

The respective roles and responsibilities of councillors, mayors and general managers should be clearly defined. There should be a clear separation of legislative, executive and judicial or arbitral positions. Councillors should act honestly, avoid conflicts of interest, respect confidentiality and use due care and diligence in performing their duties. Councils are obliged by law to have a code of conduct to which all councillors, members of staff and delegates (and in some cases all suppliers) must adhere.

Councillors have a conformance role (e.g. fiduciary obligations, monitoring results/risks, appointing and evaluating the general manager, checking management delegations and ensuring compliance with statutes). Councillors also have performance role (e.g. setting objectives, strategies and targets, making policy and rules, rewarding and sanctioning management performance), and representational and accountability roles (e.g. bringing the problems of their constituents to council's attention and ensuring council decisions are widely communicated).

They should also demonstrate the vision and leadership expected of someone who is entrusted by the community to exercise power on its behalf. Councillors should undergo a thorough induction program before taking up their position. They should be well-briefed by management, particularly on formal council meetings, to handle their conformance, performance, accountability and leadership obligations.

Reality

Council elections follow similar procedures to state elections except in two regards:

- Property owners can vote only once in each council constituency, but they may also vote in all Local Government areas where they own property. For example, if someone lived in Leichhardt and also owned properties in Byron, Orange and Wingecarribee, they could vote four times, but only once in each council area, regardless of the number of properties they owned in that area. However, it is not compulsory for non-residents to vote, it is only compulsory for them to vote in the area in which they reside.

Even if they vote as a non-resident elsewhere, it is still necessary for them to vote in the area in which they reside. They need to register as a non-resident if they wish to vote.

- Council elections provide for postal and pre-poll voting, but do not provide for absentee voting.

Unlike with other tiers of government, it is not clear whether councils are governed by a legislature representing diverse interests or a board that executes policy on behalf of the municipality or shire as a whole. The absence of a separation of legislative, executive and judiciary/arbitral roles at a political level may create conflicts of interest - for instance, making uniform development controls on the one hand while giving exemptions to such controls for specific parcels of land on the other.

Unlike other tiers of government, which exercise considerable autonomy, a council can have its orders revoked or modified by the Minister for Local Government acting on his own.

Empirical research shows that the current methodology used by the Department of Local Government to identify 'at risk' councils is not a good predictor of those that get listed for closer 'monitoring' purposes. Instead, revenue and cost disabilities seem to be the main causes of financial risk. Furthermore, poor governance (e.g. failed Public Private Partnerships (PPPs), factional infighting, staffing problems, skill shortages, poor internal controls) seems to have been the critical factor in most recent council failures. (Murray and Dollery 2005).

Relations between councillors and general managers vary greatly between councils. Most councillors accept that the general manager is the chief executive and confine their tasks to that of legislators (i.e. policy makers). In other cases a strong council faction and/or a dominant mayor act as a de facto executive even though statutory power legally resides in the general manager. In such cases good relations depend on the willingness of the general manager to accept a subservient role.

The inability to appoint a political executive (cabinet) as in state or national government means that general managers are forced to make decisions of a political nature between council meetings. This can not only create tensions, but as the Inquiry was told, is also a reason why otherwise well qualified people are not willing to take on the position of general manager.

1.10 MANAGEMENT

Requirements

The general manager of a local council should ensure that it operates appropriately (in terms of pursuing agreed outcomes that meet community needs and priorities), effectively (through meeting its goals and satisfying its residents), efficiently (by keeping unit costs low), prudently (via careful financial management, risk management and statutory compliance) and accountably (by publicly reporting results against agreed targets).

Each council should have the structure, personnel, processes and systems to understand its client and stakeholder needs, meet its statutory obligations, undertake longer-term strategic and shorter-term operational planning, foster an ethical and motivated work culture, communicate internally and externally, specify job tasks and accountabilities, develop and

appraise staff, manage assets, risks and finances, and monitor and report operational performance and regulatory compliance.

Reality

The Inquiry benchmarked the administrative capacity and performance of nine ‘volunteer’ councils (three metropolitan, three regional and three rural) against other councils, public institutions and private enterprises world-wide (QMI survey). The results show that these councils while not in the elite ‘best practice’ league were very close to it except in one area (client focus, where the result was still reasonable). It is likely that the sample was skewed because only ‘volunteer’ councils were rated. Nevertheless, the results show that Local Government in this state is capable of performing as well as or better than other public and private organisations here and overseas.

The Inquiry commissioned a study to measure the back-office overheads of a representative sample of 58 councils (Maxwell 2006a). It found that these on average represented only 10 per cent of a council’s total operating expenses. By contrast, best practice is of the order of 10 to 16 per cent for organisations of the size of the vast majority of councils (25-1000 FTE⁴ staff, with an average of 238).

This would suggest that councils have a lean corporate support structure, a good pointer to the general state of cost efficiency of an organisation. An alternative explanation is that councils are understaffed on vital middle to back office functions, which may explain why many are struggling to implement non-mandatory Australian Standards, especially in management practices, and state reporting obligations.

The only negative quantitative data obtained by the Inquiry on councils’ administrative performance was the low use of asset management plans (five-37 per cent) and risk management plans (six-23 per cent) across all asset classes (Roorda 2006). Nevertheless, other evidence (Inquiry workshops and public submissions) suggests that while mandatory management plans are taken seriously by councils, their three-year planning and one-year budgeting horizons are too short for meaningful medium to long-term decision-making.

The Inquiry also commissioned a review of council performance indicators using three councils, each with a different profile. The work shows that the existing key performance indicators prescribed by the DLG appear reasonable as ‘dashboard indicators’, but for Local Government to have a robust set of indicators it should emulate what has been done for each policy area of the State Government by developing an ‘outcomes hierarchy’ for each major category of councils (i.e. CBD, metropolitan, regional and rural) that ascribes key performance indicators to all critical outcomes, desired end and intermediate results and specific services.

The LGI examined the considerable research into whether council mergers would result in greater cost efficiencies. It found that the evidence was inconclusive, except perhaps for the smallest councils (i.e. under 8,000 in rural areas). Yet in these cases other factors better explained higher costs per resident, especially low population density in remote areas. For those activities that might be more economical to operate on a larger scale, service sharing

⁴ FTE means full time equivalent. Full-time staff are equivalent to 1.0 FTE, while staff who work fractionally equate to an FTE of less than 1.0.

(e.g. mobile libraries), joint processing (e.g. rates notices) and external outsourcing (e.g. garbage collection) might be a more targeted way to realise savings than amalgamating the entire operations of councils within a region.

The Inquiry undertook a survey of 28 council general managers who have been involved in planning joint ventures on a voluntary basis through regional organisations of councils (ROCs) and strategic alliances. The 19 who responded identified possible areas where neighbouring councils could band together to share resources (e.g. community services, fire protection, emergency services, health inspections, noxious weeds, museums, water and wastewater, tourism and promotion, saleyards and markets).

The evidence in Local Government as in other tiers of government and private enterprise is that some functions (e.g. financial transaction processing, call centres, IT, procurement) can benefit from aggregation while other activities (e.g. delivery of on-ground services to widely dispersed localities) are too expensive to run from a hub that is a long distance from where people live. Also, larger organisations require more internal coordination, which can result in high overheads. This would suggest that Local Government should both centralise some functions and devolve others to maximise its efficiency and effectiveness.

The importance of Local Government as an employer in smaller rural centres, and the strong role of a council in the 'identity' of rural areas, cannot be ignored when examining alternative resource sharing models. For example, the relative merits of selectively outsourcing certain activities (e.g. processing of receivables, payrolls and other payables) to a third party (e.g. a local accounting firm that already performs such tasks for multiple clients) or pooling them with other councils through a shared service centre may generate more savings without the political backlash of completely merging the operations of many councils into one mega one that residents feel no rapport towards.

In any event, state requirements that merged councils must have no forced redundancies for three years, employees terms and conditions must be preserved, staff may not be relocated outside the boundaries of the former council area if they claim hardship, and that pre-existing employment levels must be retained in rural areas, effectively inhibits a merger from being used to drive efficiency gains. (Greater Hume Shire Council 2005, pp 5-6).

The Inquiry explored whether economies could be achieved by merging water and sewerage utilities. Expert opinion advised against this for councils not in close proximity to each other because water pumps and sewerage treatment works are locally based with short networks (unlike electricity transmission and distribution). However, for such operations, using a shared service centre or private outsourcing might cut back-office costs.

A significant problem in all councils is a shortage of professional skills, especially in planning, engineering and accounting. This will get worse since most of their experienced employees are middle aged and many are set to retire in the next decade. The situation is most acute in rural councils without normal urban amenities expected by professionals.

Finally, the role of the DLG is more akin to a 'nanny' than a 'mentor' and 'monitor'. Though the department is gradually shifting from crisis intervention and rescue to monitoring and publicising a council's performance, this process has a lot further to go, including reviewing the appropriateness of the measures used to evaluate the performance of councils. New Zealand and South Australia have shown that when councils are treated as self-governing

entities that are expected to fix their own problems, they rise to the occasion or are punished by their electors. Such an approach has less political and financial fallout for the state.

1.11 FINANCES

Requirements

All councils should have a common high-level chart of accounts to enable meaningful consolidation of data for Local Government as a whole. Where an asset's expected life is not known, a standard schedule should be used for depreciating it. Assets should be re-valued at least every three years. Councils should not only comply with statutory accounting standards, but also produce meaningful management accounts, budgets and key performance indicators to help councillors make and monitor fiscal policy and priorities.

Local councils should separate their general activities (funded largely from taxes, statutory fees and fines) from their commercial activities (funded largely from user charges). Councils should balance their general annual operating statements and fully fund their routine maintenance and at least 90 per cent of the annual depreciation of their physical assets. Councils should not include capital revenues in their operating statements. Where they have a backlog in infrastructure renewal they should introduce a funding strategy to overcome it within a reasonable timeframe.

Broad financial risk parameters used by credit rating experts for general government authorities and government-trading enterprises indicate the extent to which councils and their commercial entities could take on debt and other liabilities without being fiscally imprudent. Each of these ratios should be adhered to, not just some of them.

Councils, depending on their rate of population expansion, should borrow between 30 and 60 per cent of the cost of expanding their asset base to ensure intergenerational equity. For general activities, councils experiencing static to strong population growth should keep the ratio of net debt to total annual revenue between 50 and 150 per cent, net financial liabilities to total assets (excluding unrestricted financial assets) between five and 20 per cent and net interest payments to total revenue between seven and 20 per cent. Council commercial activities, depending on their risk profile, should have a debt ratio between 30 and 60 per cent and a return on assets ranging from three to seven per cent.

Councils should ensure that they develop and implement long term (10 years) policy and funding strategies to prepare for their emerging demographic, economic, social and environmental challenges.

Reality

Local Government is required to produce conventional accrual accounting consolidated financial statements in accordance with Australian Accounting Standard 27 (AAS27), Local Government Code of Accounting Practice & Financial Reporting, and Local Government Asset Accounting Manual. Councils are also required to prepare separate accounts for their commercial activities (e.g. water and sewerage utilities). Though councils are required to have three year management plans, their budgets don't have to be longer than one year.

Councils, unlike state agencies, are not required to regularly update the value of their physical assets. Nor do they use consistent depreciation rates for identical assets. This results in not

only a miscalculation, but also an under-estimation of their infrastructure renewals gap (i.e. the gap between the annual rate at which infrastructure depreciates and the amount spent annually on restoring its service capacity).

Councils do not have a standard high-level chart of accounts. As a result it is difficult to obtain the composition and trends of income, operating expenditure and capital outlays for Local Government as a whole (e.g. state grants, corporate overheads, infrastructure spending) or to make accurate comparisons between councils. Financial briefing papers for councillors vary in quality with no agreed intelligible format or training program for helping councillors without accounting skills to understand accounts, let alone frame fiscal strategies, set budget priorities and monitor results.

The DLG prescribes a standard set of financial indicators. However, as already mentioned they do not appear to be a good predictor of council financial failure. Also, the DLG does not disclose the tolerance ranges it uses for monitoring performance against those indicators, which makes it hard for councils to know where the goal posts are. The Inquiry has attempted to fill this void.

The balance sheets of most councils are exceptionally strong, displaying very low levels of indebtedness to other sectors of the economy. On average, the net financial liability of councils is little more than two per cent of their total assets. Only a handful of councils exceed 10 per cent. This compares with 25 per cent for the State Government and over 50 per cent for PPP infrastructure operators (Access 2006).

By contrast, the operating statements of most councils (when stripped of capital revenue) are in deficit. Excluding commercial utilities (e.g. water and sewerage where 76 per cent of councils achieved full cost recovery), councils on average run an operating deficit of almost five per cent of their total own-source revenues.

Running a surplus on capital account rather than resorting to borrowings largely funds councils' operating deficits. This means capital contributions, capital grants and proceeds of asset sales are mainly used to prop up operating costs rather than undertake capital renewals and enhancements, which is the intent of these moneys.

The annual deficiency in capital spending (infrastructure renewal gap) for all council purposes is of the order of \$400 million (Access 2006) to \$600 million (Roorda 2006) a year. This has resulted in a current infrastructure renewal backlog of over \$6.3 billion (Roorda 2006). This backlog will grow by a further \$14.6 billion over the next 15 years if the ongoing annual renewal gap is not closed (Roorda 2006). This figure does not take account of any future infrastructure enhancements as a result of population growth, increasing social mobility and rising building standards.

On a no-policy changes basis, council per capita revenues and expenses are expected to grow in real terms by only eight and nine per cent respectively over the next decade (Access 2006). This would aggravate their existing operating deficits and make it difficult to address the infrastructure renewal gap.

Additional functions and pressures could result in council real per capita expenditure growth being double what it would be without any policy changes. Under these circumstances councils' expenditure growth could be matched by their revenues on average if all water

utilities achieved full cost recovery (so they could pay commercial rates of dividend) and all councils lifted their rates, charges and fees to those of the top 25 per cent of councils.

However, even these radical revenue measures would not be sufficient to eliminate most council operating deficits. Indeed, for two thirds of councils, deficits would still be eight per cent of their own source revenues. For one in four councils the long-term outlook is particularly bleak. Without substantial rate, grant and debt increases and/or disruptive expenditure cuts, they are financially unsustainable (Access 2006).

Overall, Local Government needs to find an extra \$1,000 million a year in revenue or cost savings to overcome its infrastructure crisis. This would comprise about \$500 million to close the annual infrastructure renewal gap and \$500 million in annual debt charges to borrow \$6,300 million to overcome the infrastructure renewals backlog.

1.12 REFORM OPTIONS

The Inquiry has identified specific gaps between ‘requirements’ and ‘reality’ for Local Government’s role, intergovernmental relations, infrastructure management, service provision, development controls, revenue capacity, governance practice, administrative capacity and financial sustainability. For each gap the Inquiry has asked:

- What options exist for bridging that gap?
- What does each option actually involve?
- What are the pros and cons of each option?
- What are the political or technical obstacles to implementing it?

The answers to these questions are provided in the Remedy sections of each chapter.

There is no magic bullet that will solve the financial problems of each and every council. Depending on the gravity of the situation, a combination of measures will be necessary. These might include:

- **Boosting supply**
Removing rate pegging in whole or in part, broadening or increasing the tax base, removing tax exemptions, accruing all unpaid rates to estates with an interest charge, increasing statutory fees and fines, securing increased grants, selling surplus assets, getting better returns on investments, and/or increasing borrowings and debt.
- **Reducing demand**
Charging for services, and/or imposing or tightening eligibility rules.
- **Shedding responsibilities**
Abandoning certain functions, and/or transferring these to other organisations.
- **Revising obligations**
Resetting one’s own standards, and/or renegotiating with other tiers of government the nature or application of their statutory obligations.

- **Reordering priorities**
Saying no to future cost and responsibility shifting where legally possible; embracing a ‘back to basics’ agenda until the infrastructure crisis is fixed; adopting ‘zero-base’ budgeting, whereby all existing activities are re-examined as to their necessity; and developing and implementing credible long-term strategic and financial plans to assist in identifying priorities and responding to emerging challenges.
- **Pursuing efficiencies**
Benchmarking operational practices and results against other organisations, adopting flexible work practices, reengineering work processes and systems to streamline and standardise them, setting productivity savings targets, sharing limited staffing resources (e.g. planners), changing procurement practices (e.g. resorting to ADR rather than litigation, accessing bulk discounts under state supply contracts), joining a shared services centre (e.g. general accounting and financial transaction processing), outsourcing services (e.g. internal audit), and/or merging smaller councils where other alternatives for achieving economies are not viable; and
- **Improving capacity**
Raising the management and governance capacity of both elected councillors and professional staff, which will include clarifying roles and responsibilities of each party, and setting milestones for monitoring performance.

1.13 RECOMMENDATIONS

Certain reforms are suggested by the findings in this report. They go beyond strictly financial matters because financial sustainability rests on councils winning the trust and confidence of their clients, their communities and their government overseers and sponsors.

The Inquiry canvassed many options before settling on 49 final recommendations, which are listed in Chapter 12. The most important of these are repeated below under the main challenges facing NSW Local Government, namely to:

- Define its role relative to other tiers of government;
- Renew infrastructure to overcome a growing backlog;
- Prioritise services to better reflect public preferences;
- Reform development controls at both state and council levels;
- Improve strategic planning and operational efficiency;
- Boost revenues from rates, fees and grants;
- Strengthen governance structures and procedures; and
- Achieve long-term financial sustainability.

Making NSW Local Government financially sustainable will require a combination of fiscal measures including rate deregulation, increased State and Commonwealth grants, greater application of user pays, increased operating efficiencies and increased borrowings. The most vulnerable councils are rural ones whose small population densities mean that they do not have the financial capacity to maintain let alone renew their road infrastructure. Increased government grants and/or a transfer of their regional roads to state responsibility may be their

only chance of survival. Simply amalgamating them will not generate the savings needed for meeting their infrastructure obligations.

Define councils' role

Recommendation 2: Intergovernmental Agreement

The State Government and the NSW Local Government and Shires Associations enter into an intergovernmental agreement (IGA) that draws on both the Memorandum of Understanding in South Australia and the Local Government Policy of the New Zealand Government. See 5.6.11

The IGA should establish a mechanism for determining the respective roles, service responsibilities and financial obligations of each level of government, the limits of state intervention in Local Government and future consultative processes. It would also give greater operational autonomy to councils in return for councils introducing more effective community consultation, longer-term strategic and financial planning and more meaningful performance accountability.

Recommendation 3: Cost Shifting

The LGSA build on the work of the Inquiry and undertake an annual survey of all councils to establish the total cost to Local Government of the main regulatory, policy and reporting responsibilities imposed by other tiers of government and any changes thereto over the previous year. See 4.2.1

The LGSA will need to get further data on the magnitude of and trends in cost shifting in order to seek any changes or compensation under an IGA.

Recommendation 5: Revised Role

All councils with an infrastructure renewal gap and backlog voluntarily agree to restrain operating expenditure by adopting an 'optimalist' approach to new recurrent services until their physical assets are restored to a satisfactory condition. See 5.4.7 and 11.5.10

This would involve devoting the bulk of future real growth in council total revenues to renewing and enhancing local infrastructure, especially roads, kerbing and pavements, until the renewal gap and backlog was overcome.

At the same time each council would continue to strive for better social, environmental and economic outcomes for its community provided any additional resources required for expanding recurrent operating services were largely provided by external public, private or not-for-profit sources as envisaged in an 'Optimalist' approach to Local Government.

Renew infrastructure

Recommendation 6: Infrastructure Management

The State Government provide financial incentives and technical assistance to enable all councils within three years to adopt a total asset management (TAM) system with consistent asset accounting practices. See 6.3.2

TAM covers the registration, valuation, depreciation, condition assessment, planning, design, acquisition, funding, maintenance, operation, replacement and disposal of all council physical assets. It includes a long-term plan of infrastructure spending and funding, which gets incorporated within a council's long-term strategic and financial plan (see recommendation 34).

Recommendation 7: Infrastructure Funding

To overcome the infrastructure crisis, increase council funding by the order of \$900 million per annum through a combination of increased Commonwealth and state grants (\$200 million), council expenditure savings (\$200 million) and higher income from rates, fees and charges (\$500 million). See 6.4.4

To minimise the impact on council rates, fees and charges of overcoming the \$6.3 billion infrastructure backlog and closing the \$0.5 billion annual infrastructure renewals gap, the Inquiry would suggest the following course of action:

- Borrow \$5,300 million to overcome the infrastructure backlog (other than that in water and sewerage which DEUS insists can be funded with existing charges). This would generate about \$400 million in debt charges (interest and principal repayments) annually;
- Raise an extra \$900 million per annum in revenue to both close the renewals gap (\$500 million) and meet the new debt charges (\$400 million); and
- Derive the extra \$900 million in revenue by seeking \$200 million in extra grants (say \$100 million from the Commonwealth and \$100 million from the state), \$200 million in council expenditure savings and \$500 million in extra income from rates, fees and charges.

Recommendation 9: Regional Roads

The NSW Government assume responsibility for all regional roads in rural shires since such councils do not have the financial capacity and asset management systems to maintain and renew them. See 6.4.6

Most council infrastructure is comprised of roads and a high proportion of roads are in under-populated rural shires which do not have the rate base to support the upkeep let alone renewal of such roads, especially regional roads. Neither improved FAGs nor rate deregulation will be sufficient to solve the rural regional road problem

Prioritise services

Recommendation 10: Opinion Survey

Each council periodically (at least at the start of its four year term) conduct an opinion survey of its residents to find out how they rate the importance of each of its major services and how they rate their satisfaction with each service. See 7.3.2

The survey results should be used to shape the priorities of the council's annual management planning and long-term strategic and financial planning from the outset of its term.

Reform development controls

Recommendations 15 - 20: State and Council Controls

Reform land use planning and development control, approval and appeal processes in conjunction with the State Government so as to improve the probity, timeliness and quality of outcomes and thereby restore public trust in the handling of these matters at both state and council levels.

The Inquiry's public opinion survey found that town planning and development controls attract the least public satisfaction with council performance. To win the trust of residents both Local and State Governments need to improve the policies, processes and structures that apply to this activity.

Boost revenues

Recommendation 21: Rate Pegging

The State Government free councils to determine their own income by removing statutory limitations on their rates (i.e. rate pegging) and certain fees (e.g. development application processing fees) in return for councils adopting longer-term strategic and financial planning with outcome targets. See section 5.2.1, 9.3.1 and 11.5.8.

Rate deregulation would bring NSW into line with all other states and territories. A council would then be answerable to its local constituency rather than the state for its taxation policy.

Recommendation 27 -28: Financial Assistance Grants

The Commonwealth Government increase its financial assistance grants (FAGs) to Local Government by 20 per cent (\$300 million in 2003/04 values) and then set them at a fixed percentage of:

- **Gross domestic product (0.22 per cent); or**
- **Total Commonwealth collected taxes, including GST (0.86 per cent); or**
- **Total income taxes (1.27 per cent). See 9.5.12, 9.5.13 and 11.5.9**

This would restore part of the reduction in the Commonwealth's Local Government funding as a proportion of GDP in the last two decades. It would also partially address the vertical fiscal underutilisation (VFU) between the Commonwealth and the lower tiers of government, especially in relation to Local Government (see Access 2004).

Strengthen governance

Recommendation 32: Governance Structure

The State Government amend the LG Act to provide for a choice of governance structures as outlined below. See 10.3.6

(a) Corporate Board structure

The standard structure would be similar to the current structures except that:

- The maximum number of councillors would be seven, so they could interact like a board rather than a parliament;
- The standard position would be for an electorate of the whole with a referendum being required for a division into wards; and
- The election for mayor would be for the full term of the council (four years) instead of annual, with the option of a direct election of mayor, subject to a referendum.

Corporate governance principles, with appropriate modifications, would apply to the performance of a council. The mayor would be like a non-executive chair of a board without the power to direct the general manager between meetings of the council, which is the present situation.

(b) Parliamentary/Executive structure

Large councils (say over 50,000 people) would have the option of a structure that applied the separation of powers doctrine as between the legislature and the executive:

- Up to 15 councillors may be elected on a ward basis;
- Popular election of the mayor at the same time as councillors are elected;
- The mayor may appoint an executive committee of three persons selected from the councillors with the option of secondments from outside the council; and
- The general manager, selected by the mayor and endorsed by council, would report to the mayor.

The role of council under this structure would be to:

- Approve the strategic plan, the management plan and the budget;
- Approve the policies and development controls of council; and
- Question the executive and hold inquiries into policy and performance issues.

In the first model the council would act as a governing board chaired by the mayor with a general manager as CEO, while in the second model the council would be a

representative chamber that held the mayor and an executive committee (council ‘cabinet’) to account for the management of the council. This dual structure would resolve the present dilemma that councils often have too many councillors to act as a board, yet can’t act as a parliament because there is no political executive to hold to account.

Improve strategy and efficiency

Recommendation 34: Long-Term Planning

All councils develop and adopt a long-term strategic and financial plan in close consultation with their communities that would be subject to annual external compliance audits and updated in the first year of each council’s term. See 10.2.4

This would be akin to the New Zealand Community Plan, a 10-year strategic and financial plan that would subsume existing services, infrastructure, social, cultural, environmental, land use, stormwater, economic and other plans. It would contain measurable outcomes that reflect community wishes, are financially sustainable and subject to external compliance audits. There would still be an operational plan – the existing annual management plan with a detailed three-year operating and capital budget. See also recommendations 11 and 16.

Recommendation 37: Resource Sharing

The DLG and the LGSA jointly undertake a functional analysis to determine which, if any, of the services that councils deliver would benefit from being provided by contractually-based resource sharing or outsourcing arrangements including jointly owned shared service centres and sizeable third party providers (e.g. regional electricity authorities). See 10.5.9

Initial survey work by the Inquiry (in conjunction with the University of New England) has demonstrated that this line of research could deliver tangible results that might encourage further resource sharing and outsourcing either to tap economies of scale or access scarce professional skills.

Achieve financial sustainability

Recommendation 38: Financial Data

The DLG amend its Code of Accounting Practice and Financial Reporting for councils to standardise key accounting and reporting policies, especially in relation to asset condition assessment, asset valuation, depreciation rates, capital expenditure (including the distinction between asset maintenance, renewal and expansion), a high-level chart of accounts, a workforce profile database (each with agreed definitions of terms as exists in the NSW general government sector) and key financial indicators. See 11.2.1

Any such changes should be made in close consultation with the DLG’s Accounting Advisory Group which includes members of the LGFP and LGAA.

Recommendation 39: Financial Benchmarks

The LGMA reissue its Sustainable Financial Health Check Manual with an expanded list of financial KPIs and an appropriate range of lower and upper benchmarks for each KPI along the lines shown in the table below. See 11.3.4

The expanded list should be determined collaboratively by the LGMA, LGSA, DLG, LGPP, LGAA and other relevant bodies.

Financial Key Performance Indicators	Average Council Actual	Proposed Council Target	Proposed Upper limit	Proposed Lower limit
Net debt as % of total revenue	10.5%	100%	150%	50%
Net financial liabilities as % of total capital employed	2.2%	10%	15%	5%
Net interest expense as % of total revenue	0.6%	15%	20%	7%
For general govt activities: Operating surplus as % of own-source revenue	-4.5%	5%	10%	0%
For commercial activities only: EBIT as % of non-financial assets	0.9%	5%	7%	3%
Net borrowing as % of capital expenditure on new or enhanced assets	1.3%	50%	60%	30%
Annual renewals deficiency as % of renewals capital expenditure	40.2%	0%	10%	-10%
Infrastructure backlog (\$M) as % of total infrastructure assets (estimated at fair value)	8.1%	0	1%	-1%

Recommendation 41: Financial Responsibility

The State Government amend Section 232 of the LG Act to clarify that councillors are responsible and accountable for a council's financial governance in general and its financial sustainability in particular. See 11.6.12

This would enshrine in legislation that a council's financial governance and sustainability at a policy level is the responsibility of its politicians.

Recommendation 46: Surplus Budget

All councils make a concerted effort to achieve within three to five years a surplus on their operating budgets (excluding capital grants as income). See 11.7.18

By adopting such a balanced-budget ‘golden rule’ each council would give public notice of the size of the revenue boost and/or expenditure saving necessary for it to become financially sustainable and ensure intergenerational equity by ensuring that today’s citizens meet the full cost of their use of services and infrastructure.

Recommendation 47: Financial Governance

Each council include in its annual report a Financial Governance Statement as outlined in Appendix B plus a comparison of the results for its key financial ratios against the targets and upper/lower limits shown in the table in recommendation 39 above. In addition, each year the DLG or LGSA prepare and publish a consolidated version of this statement for each of the metropolitan, regional and rural categories of councils as well as for Local Government as a whole. See 11.7.19

This short statement encapsulates in one table all the key financial variables, results and indicators necessary for councillors, managers and the public to adequately assess the financial health and progress of a council.

Next steps

What can Local Government do to kick start this process? The Inquiry would suggest two initiatives:

Recommendation 48: Summit Conference

Stage a Local Government summit to which all interested parties would be invited. The purpose of this conference would be to consider, debate and hopefully endorse all or most of the recommendations of the Inquiry. See 1.13 – Recommendations.

A leadership team under the guidance of the LGSA plus a firm timetable for achieving tangible outcomes should also be an outcome of this event

Recommendation 49: Independent Commission

The summit propose to the State Government an Independent Commission consisting of equal representation from the LGSA and the state to assess the gravity of the problems facing Local Government, to recommend urgent action to be undertaken, to help implement such changes in cooperation with Local Government and to monitor progress in achieving agreed outcomes. See 1.13 – Recommendations.

Such a vehicle is necessary to assist the State Government to coordinate its own response and actions to the Inquiry’s Final Report. An important task of such a commission would be to prepare a draft intergovernmental agreement (IGA) for both the State and Local Government to consider.

A separate private briefing paper to the LGSA goes into more detail about the next steps that should be taken to secure the sustainability of Local Government through

seeking the cooperation and support of the state and Commonwealth Governments, individual councils and local communities throughout NSW.

2. INDEPENDENT INQUIRY

2.1 INTRODUCTION

On 19 October 2005 the Local Government and Shires Associations of NSW (LGSA) announced the establishment of an Independent Inquiry into the Financial Sustainability of NSW Local Government. A panel consisting of three persons with extensive experience in public policy and management, but independent of Local Government or its Associations, was appointed to undertake the Inquiry over a six-month period ending on 30 April 2006.

2.2 INQUIRY'S PURPOSE

Terms of reference

The Inquiry's task was:

- To assess the current financial position and performance of the NSW Local Government sector and its individual councils;
- To assess the adequacy of existing NSW Local Government physical infrastructure and service delivery in terms of (i) its statutory obligations, (ii) community, State Government, and Commonwealth Government expectations of its role and functions, and (iii) challenges posed by changing demographic, economic, social, environmental, technical and governance trends;
- To assess the financial capacity of Local Government to meet its statutory obligations, expected functions and emerging challenges; and
- To identify possible financial, administrative, governance and intergovernmental reforms that could address any shortcomings and gaps uncovered by the above research.

Specific Local Government issues that were to be addressed as part of this Inquiry included:

- The condition of Local Government infrastructure and other assets, including environmental assets;
- Responsibility and cost shifting from other tiers of government;
- Impact of rate pegging and rate exemptions compared with other jurisdictions;
- Implications of the Sydney Metropolitan and other urban planning strategies;
- The House of Representatives 'Hawker Committee' recommendations;
- The accountability, effectiveness and efficiency of Local Government;
- Appropriate fiscal and other performance benchmarks for Local Government;
- Intergovernmental fiscal, legal and administrative arrangements, including a comparison with other states; and
- Regional cooperation and partnerships between individual councils.

2.3 COUNCILS' CONCERNS

The Inquiry issued questionnaires to each of the 400 or so participants (mainly mayors, councillors, general managers, staff and others closely associated with councils) that attended

its 12 regional workshops throughout NSW (Purcell 2006, p9). One question was *What do you consider to be the top three issues for Local Government generally?*

Of the 254 participants who responded, the order of concerns was as follows (when like answers are grouped together):

1. Rate pegging, revenue restriction and insufficient funding: 192 (25.2%)
2. Infrastructure adequacy and maintenance: 126 (16.5%)
3. Intergovernmental relations and constitutional recognition: 111 (14.6%)
4. Government cost shifting and excessive reporting requirements: 106 (13.9%)
5. Managing community expectations and maintaining services: 77 (10.1%)
6. Department of Planning red tape and environmental issues: 54 (7.1%)
7. Staff and councillor skills shortages and training: 33 (4.3%)
8. All other issues (e.g. amalgamation, ageing population, etc): 63 (8.3%)

Total issues listed: 762 (100%)

It is clear from the above answers that councils were looking to the Inquiry to address seven Local Government issues in particular: Revenue; Infrastructure; Government Relations; Cost Shifting; Services; Planning and Skills.

2.4 GOVERNMENT CONCERNS

The Inquiry interviewed 23 senior officers in the following 11 State Government agencies. In one case (LG Grants Commission) the meeting was with the chair in his private capacity:

1. Department of Local Government
2. Department of Environment and Conservation
3. Independent Pricing and Regulatory Tribunal
4. Roads and Traffic Authority
5. Local Government Grants Commission
6. Department of Energy, Utilities and Sustainability
7. Treasury
8. Department of Planning
9. Department of Community Services
10. Cabinet Office
11. Department of Ageing, Disability and Home Care.

The Inquiry also met with the State Minister for Local Government on two occasions and with senior officers of the Department of Transport and Regional Services that handles Commonwealth relations with Local Government.

The feedback was strictly confidential, but certain views were common across some, but not all state agencies. They are that Local Government:

1. Is vital in complementing state services;
2. Is not strategic in engaging with the state;
3. Is not strategic on asset and land use planning;
4. Is too slow and inconsistent in processing DAs;
5. Varies greatly in its management capacity;
6. Has pursued too ambitious a services agenda at the expense of infrastructure;

7. Looks too often to the state rather than itself to solve its problems; and
8. Is not as pressing a policy priority as other state concerns.

While some believed Local Government could not be trusted to manage itself, others on reflection acknowledged that if councils were not given the revenue flexibility to fix deteriorating local infrastructure this problem could eventually rebound on the state.

2.4 INDEPENDENT PANEL

Membership

The Independent Panel appointed to conduct the Local Government Inquiry comprised:

- **Percy Allan AM** (Chair and Research Director)

Public finance and management consultant, Chair of a Government board and two commercial boards, Visiting Professor (Macquarie Graduate School of Management and University of Canberra) and former Secretary, NSW Treasury.

- **Libby Darlison**

Social policy and change consultant, Company Director, Chair of Premier's Council on Active Living and member of two Government Boards, former Chair of Premier's Council for Women, and formerly an academic and senior Commonwealth official.

- **Diana Gibbs**

Management and economic development consultant, CEO of Riverina Woolgrowers Pty Ltd, Company Director, Chair of NSW Regional Communities Consultative Council, and a former winner of Rural Women's Award (NSW).

The joint views of the Inquiry Panel as expressed in the Final Report were made in a private capacity so do not necessarily reflect the views of any other organisation to which a panel member belongs.

Independence

Although the Inquiry was appointed and funded by the LGSA, the Inquiry was its own master in terms of managing its agreed budget, arranging and directing its research, consulting widely with stakeholders, gauging general public opinion and producing findings and recommendations. Independent Panel members were guided only by their contracts of appointment, the formal Terms of Reference of the Inquiry and an agreed maximum Inquiry budget.

Responsibilities

To ensure that the panel remained at all times independent, but received the full cooperation of the NSW Local Government sector, it was agreed within and between the panel and the

LGSA from the outset that the following division of responsibility, authority and accountability should apply. The Independent Panel was responsible for:

- Determining the tasks, timelines, costs and appropriate external expertise to undertake the work of the Inquiry based on advice from the Chair;
- Reading submissions from and consulting with relevant stakeholders and interested parties throughout NSW;
- Questioning and ‘brainstorming’ Inquiry findings and recommendations so as to test their validity and relevance;
- Reviewing the draft *Reports* produced by the Chair (in conjunction with external experts) and making any necessary changes thereto; and
- Formally approving each of the Inquiry’s *Reports* after reaching agreement on format, contents and presentation.

The Chair and Research Director was responsible for:

- Obtaining agreement between panel members on the way the Inquiry would be conducted, its findings and recommendations;
- Contracting and coordinating external expertise to undertake research, surveys and analysis on behalf of the panel;
- Preparing drafts of the Inquiry’s three public documents for consideration and approval by the panel;
- Ensuring that the total expenses of the Inquiry remain within the budget determined by the LGSA;
- Keeping the LGSA informed of Inquiry progress against the Terms of Reference; and
- Making any public statements on behalf of the panel after consulting with the panel.

The Inquiry’s Administrator was responsible for:

- Answering daily phone, email and postal enquiries to the Inquiry;
- Arranging workshops and other meetings for the panel;
- Undertaking research for the Inquiry when time permitted;
- Organising the printing of the Inquiry’s reports;
- Receiving and distributing all submissions to the Inquiry;
- Obtaining relevant external publications for the panel; and
- Providing other logistical support to the Chair and the panel.

The LGSA was responsible for:

- Assisting the Inquiry to obtain necessary information from councils;
- Supporting the Inquiry with start-up logistics (e.g. obtaining public documents relating to Local Government, leasing the Inquiry’s serviced office, establishing the Inquiry’s own website, providing photocopying facilities for bulk copying needs);
- Coordinating council feedback on the Interim Report; and
- Undertaking primary research for the Inquiry when requested.

Any confidential information made available to the Inquiry was respected as such by the panel as outlined in the section on confidentiality below.

2.5 INQUIRY'S PROGRAM

Timelines

The Inquiry was conducted over the period from 20 September 2005 to 30 April 2006.

The Inquiry's Chair and Research Director worked full-time on the Inquiry while the other members of the panel worked part-time.

Workshops with key stakeholders and meetings with state agencies were conducted between October and December. Public and council opinion polls were undertaken in November and December.

Public submissions were invited in October 2005 in response to the *Background and Issues Paper* and were accepted up to mid December 2005.

The Inquiry sought written responses (feedback) on its *Interim Report* before the end of March 2006.

The Inquiry requested that all submissions and responses be lodged with the Inquiry as a hardcopy or preferably by email or on CD-Rom in PDF or Word format to help the Inquiry post them on its website. Priority of listing on the Inquiry's website was given to submissions in PDF format.

Inquiry reports

The Inquiry produced three public documents:

- *Background and Issues Paper*, which was released on 22 October 2005;
- *Interim Report: Findings and Options*, which was released on 3 March 2006; and
- *Final Report: Findings and Recommendation*, for release in early May 2006.

Inquiry consultations and research

The Inquiry conducted 12 stakeholder workshops with about 400 participants, eight of which were held in regional and rural centres and four in the Sydney metropolitan area. It polled over 900 NSW residents and over 250 councillors and council staff. It received over 160 written submissions and responses from councils and other interested parties.

It met with the Minister for Local Government twice, once before and once after the Interim Report came out (but was not successful in obtaining an appointment with the Minister for Planning) and interviewed 26 senior officials in eleven state and two Commonwealth Government agencies.

As part of its investigations, the Inquiry benchmarked the administrative capacity of nine councils - three metropolitan, three regional and three rural. It compared the back-office costs of 58 councils. It mapped the outcomes hierarchy for three typical councils to identify their key results areas. With the help of 19 councils it attempted to measure the amount of cost shifting by other tiers of government.

The Inquiry also commissioned research to analyse the financial situation of all 152 councils. It surveyed the condition and management of assets in over 100 councils. It also commissioned over 30 research reports and papers that are reproduced in Volume 2 of both the *Interim and Final Reports*.

Table 2.1: Inquiry Local Government and related party meetings (in order held)

1. Coffs Harbour	7. Wagga Wagga
2. Armidale	8. Sydney CBD (1)
3. Dubbo	9. Sydney CBD (2)
4. Queanbeyan	10. Hurstville
5. Thornton	11. Blacktown
6. Jerilderie	12. Lismore

Table 2.2: Inquiry State Government meetings (in order held)

1. Department of Local Government	7. The Treasury
2. Department of Environment and Conservation	8. Department of Planning
3. Independent Pricing and Regulatory Tribunal	9. Department of Community Services
4. Roads and Traffic Authority	10. The Cabinet Office
5. NSW Grants Commission	11. Department of Ageing, Disability and Home Care
6. Department of Energy, Utilities and Sustainability	12. Minister for Local Government

Table 2.3: Inquiry Commonwealth Government Meetings

1. Department of Transport and Regional Services – Local Government section	2. Office of the Minister for Local Government, Territories and Roads
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Professional assistance

The Inquiry is indebted to a large team of experts who assisted it with preparing research reports and papers and writing the *Interim Report* and assisting with the *Final Report*. While researchers are exclusively responsible for the content and recommendations of their own reports and papers, the panel takes full responsibility for the *Background and Issues Paper*, the *Interim Report* and the *Final Report*, whose content and directions it controlled.

The Inquiry's Chair in his capacity as Research Director was intimately involved in all stages of project planning, research coordination, report writing and document editing while all Members of the panel framed, brainstormed and edited the *Background and Issues Paper* and the *Interim Report* and determined the conclusions and recommendations of the *Final Report*.

The Inquiry's administrators arranged the printing of the *Interim Report* and the *Final Report* and the LGSA assisted with the posting of all documents on the Inquiry's website. The LGSA kindly assisted with organising Inquiry workshops, distributing questionnaires to councils, doing bulk photocopying of all submissions, answering Inquiry queries about NSW Local Government, and undertaking primary research such as an interstate comparison of Local Government.

Background and Issues Paper:

- Brian Dollery
- Sascha Moege
- Graeme Sansom

Interim Report:

- Peter Abelson
- Brian Dollery
- Tony Gilmour
- Carolynne James (in a private capacity)
- Alan Tregilgas
- Catherine Watson (in a private capacity)

Research Reports:

- John Brooks (Proteus Management Group)
- Joel Byrnes
- David Maxwell (DG & AB Maxwell)
- David Pettigrew (QMI Solutions)
- Simon Pomfret (IRIS Research)
- Jeff Roorda (Jeff Roorda & Associates)
- Shaun McBride
- Sascha Moege
- Alan Tregilgas (Access Economics)
- Laurie Young (in a private capacity)
- Greg Purcell

Research Papers:

- Peter Abelson
- Joel Byrnes
- Peter Cranko
- Brian Dollery
- Tony Gilmour
- Wolfgang Kasper
- John Mant
- Peter McKinlay
- Michael Paddon

Administration:

- Sascha Moege (Administrator: Sep – Dec, Mar - May)
- Greg Purcell (Administrator: Dec – Feb)
- Kendi Burness (Editor – *Final Report*)
- Diana Mounter (Web and Graphic Designer)
- John Tracey (Administrative Assistant: Dec and Feb)

LGSA Liaison:

- Shaun McBride

Confidentiality

All confidential information made available to the Inquiry was respected as such by the panel and its administration.

Unless already in the public domain, the data collected and assembled on each of the 152 councils in NSW was not used to show the position or performance of individual councils.

The purpose of such data was to examine and demonstrate the distribution of strengths, weaknesses, opportunities, threats and risks across the whole of NSW Local Government or particular sections of it (e.g. metropolitan, urban and rural), not to single out particular councils for praise or criticism.

Inquiry's Budget

The Inquiry had a budget of \$600,000 inclusive of GST, but its true cost was much higher if account is taken of the additional support and primary research provided free of charge by the LGSA and the huge effort by councils and others in preparing over 150 written submissions and responses to the Inquiry.

The Inquiry's own budget was spent as follows:

Table: 2.4: Local Government Inquiry's Expenses

Function	Expenses (inc. GST)
3 Panel Members (including Chair and Research Director)	\$169,000
Administrative costs (inc. administrator, serviced office and travel)	\$56,000
Preparation of 30 Research Reports and Papers	\$289,000
Preparation and Printing of 3 Inquiry Reports	\$86,000
Total	\$600,000

Contact details

The Inquiry's office will remain open until the end of May 2006 and can be contacted as follows:

- Website: www.lgi.org.au
- Email address: panel@lgi.org.au
- Phone number: 0407 410 691
- Fax number: 02 9375 2353
- Postal address:
Local Government Inquiry
GPO Box 5470
Sydney NSW 2001

Thereafter, only the Inquiry's website will continue for an indefinite period and any enquiries about the LGI should be directed to the LGSA (shaun.mcbride@lgsa.org.au).

2.6 RESEARCH METHODOLOGY

Basic premises

Section 8 of the *Local Government Act (NSW) 1993* (LG Act) provides a charter for local councils. Its key points are:

- Adequate and appropriate services to be provided after due consultation;
- Community leadership and engagement;
- Cultural diversity;
- Environmental management in accordance with the principles of ecologically sustainable development;
- Consideration for the long term and cumulative impacts of decisions (i.e. effective strategic planning that would need to go well beyond the current provisions of the *Environmental Planning and Assessment Act (NSW) 1979* (EPA Act)) and;
- Stewardship of assets.

Section 24 of the LG Act states that ‘a council may provide goods, services and facilities, and carry out activities, appropriate to the current and future needs within its local community and of the wider public, subject to this Act, the regulations and any other law’.

The main legislation dealing with land use planning in NSW is the EPA Act. Under Section 23(1)(d) of the EPA Act the Minister for Planning or the Director-General of the Department of Planning may delegate any of their land use planning or control powers to a local council. This has resulted in councils being given the authority to prepare Local Environment Plans (subject to the endorsement of the Minister) and Development Control Plans that deal with matters raised in Local Environment Plans (LEPs), but in greater detail.

Under their delegation, councils are also the consent authority for most local development applications other than complying developments that may be approved by an accredited private certifier. Much of a council’s meeting time is taken up with considering development applications, especially of a controversial nature. Hence, along with service and infrastructure provision, regulation (particularly of land use) is an important function of Local Government.

Accordingly, given the terms of reference of the Inquiry, the *Interim* and *Final Reports* assume that state legislation has determined that the main role of Local Government in NSW is the provision of services and infrastructure (under the LG Act) and the planning and control of land use (under delegation pursuant to the EPA Act).

In order to adequately achieve these objectives, Local Government in NSW must exhibit financial capacity (in respect to financial position and performance), good governance (by serving the needs of the community, yet avoiding potential conflicts of interest) and managerial capacity (in terms of effective and efficient implementation of policy).

The *Interim* and *Final Reports* take the provisions of s8 and s24 of the LG Act and the delegations under s23 of the EPA Act as the starting point regarding the operation of Local Government in NSW.

Research material

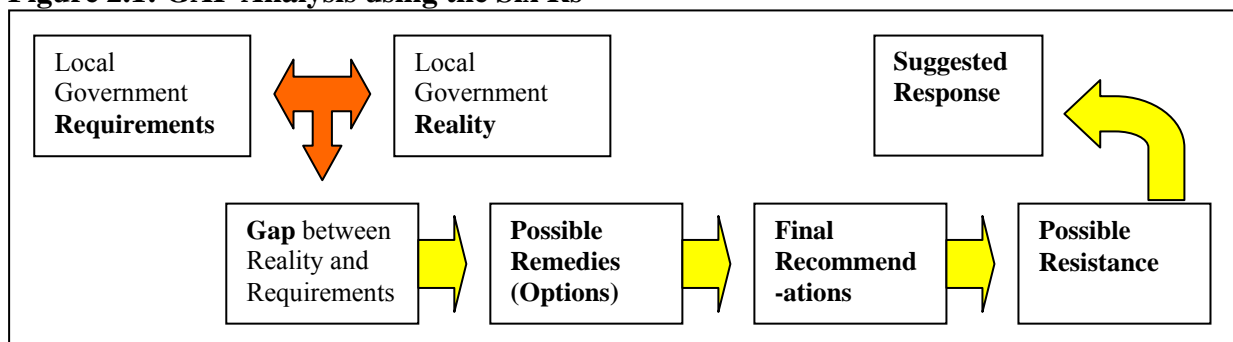
The Inquiry's *Interim* and *Final Reports* are based on both primary and secondary research involving opinion polls, stakeholder workshops, council consultations, expert panels, council questionnaires, performance benchmarking, statistical analysis, public reports, public submissions and commissioned research.

Gap analysis

The Inquiry used 'gap analysis' as its primary methodology. Gap analysis is simply identifying the difference between 'what should be' and 'what is' and then devising solutions for closing or at least narrowing the gap between reality and the ideal.

This is illustrated in Figure 2.1.

Figure 2.1: GAP Analysis using the Six Rs



Source: Percy Allan and Associates Pty Ltd.

Following this procedure, the Inquiry has attempted to determine the current situation in NSW Local Government for each issue under investigation, seek to identify the expected standard, and then ascertain the 'gap' between the existing and the desired position. Once this was done, the Inquiry explored various options for addressing this gap (such as boosting the supply of a service or reducing its demand) and debated the pros and cons of each option.

Hence, Chapters 5 to 11, which each deal with a particular facet of Local Government, follow a common format:

1. *Requirements*: A statement of 'ideal' outcomes for the chapter's topic based on first principles, recognised standards and best practice.
2. *Reality*: What is the current situation in councils with regards to the subject matter of the chapter and to what extent does it fall short of requirements identified under 1?
3. *Remedies*: What are possible ways to narrow the gap between reality and requirements? Also, what are the pros (advantages) and cons (downsides) of each option canvassed?

The Inquiry's consultations found that citizens expect many qualities of Local Government (see table 2.3). Most, though not all, of these outcomes are reflected in the council's charter in Section 8 of the LG Act. These principles helped shape the 'ideal' requirements against which each Local Government activity was judged by the Inquiry.

Table 2.4: Expected qualities of Local Government

1.	Local – identity
2.	Democratic – representative
3.	Honest – impartial
4.	Accessible – open
5.	Consultative – responsive
6.	Visionary – strategic
7.	Relevant – prioritised
8.	Prudent – sustainable
9.	Effective – satisfying
10.	Efficient – economical
11.	Equitable – fair
12.	Accountable – transparent and communicative

The purpose of the *Interim Report* was to make interim findings and propose possible remedies, not to make firm recommendations.

Following the release of the *Interim Report* the Inquiry, reviewed the possible options in the light of public feedback and then decided which measures, including others that were brought to its attention, should qualify as firm *Recommendations* in its *Final Report*. These are listed in Chapter 12. Their selection was heavily influenced by further research undertaken by the Inquiry as well as public responses to the *Interim Report*.

In a separate briefing paper to the LGSA, the Inquiry proposes a way for the LGSA to assess the potential *Resistance* (‘roadblocks’) to improvement and formulate a *Response* (‘Action Plan’) for overcoming such obstacles and winning support for change. This separate paper completes the Inquiry’s 6Rs approach to Gap Analysis.

3. LOCAL GOVERNMENT PROFILE

3.1 INTRODUCTION

Local Government has been in existence since the 1840s with the creation of the Adelaide Corporation in 1840 and the incorporation of the City of Sydney and the Town of Melbourne two years later.

In New South Wales, the *Municipalities Act 1858* established a system for the permissive constitution of municipalities leading to the establishment of 50 Local Government areas. These Local Government structures initially delivered only property-based services (such as building and maintaining roads and the collection and disposal of rubbish). However, this role has changed dramatically in the last few decades.

Local Government now plays an important role in Australian society. An analysis of Local Government expenditure over the period 1961-62 to 1997-98 shows that the composition of services has shifted markedly towards the provision of human services at the expense of traditional property-based services. In particular, the historical expenditure on road and transport infrastructure has declined from almost half, to less than a third of total Local Government outlays (CGC 2001, p.ix-xiv).

The current 152 councils in NSW provide for the diverse needs of rural, regional and metropolitan communities and are involved not only in the provision of infrastructure such as roads and drainage, but also in regional and economic development, environmental management, culture, education, and social services in areas such as health, safety and welfare.

3.2 LOCAL GOVERNMENT'S ROLE AND FUNCTIONS

Constitutional status

Local Government is commonly seen as the 'third sphere of government' in the Australian Federation

Despite its existence for more than 160 years, Local Government is not recognised in the Australian Constitution; neither does the Constitution specifically confer legislative power on the Commonwealth Government with respect to Local Government. The residual legislative power therefore lies with the states and territories. Local Government is established under state and territory legislation and there are references to Local Government in the State Constitutions.

Legislation

In NSW, Local Government is recognised in Section 51 of the *Constitution Act (NSW) 1902*, which ensures the existence of a system of Local Government, democratic or otherwise. More than 100 Acts extend this system, which is administered by the Minister for Local Government through the Department of Local Government. The principal act providing the regulatory framework for councils, their function, responsibilities and governance is the *Local*

Government Act (NSW) 1993 (LG Act). The *Environmental Planning and Assessment Act (NSW) 1979* is also an important piece of legislation since it controls councils' land use regulatory powers.

The LG Act of 1993 replaced the old *Local Government Act (NSW) 1919*. The intention of the LG Act was to widen local autonomy and flexibility by moving to a less prescriptive approach in terms of councils' role and function. Greater public accountability (council's charter, LG Act, section 8) and stricter regulation for corporate planning and reporting were introduced (CoA 1994, p95). A clearer distinction between the role of councillors and that of management was established and a general manager with genuine chief executive powers replaced the municipal or shire clerk.

At the same time the discretion of councils' operations was expanded such that a council may provide "goods, services and facilities, and carry out activities, appropriate to the current and future needs within its local community and of the wider public..." (LG Act, section 24). This power of 'general competence' allows councils to determine service provision in accordance with the local needs (Mant 2005c).

The NSW Department of Local Government's role is to monitor councils' compliance with the LG Act and to respond to complaints about performance. The Minister for Local Government also exercises considerable control over Local Government resources through powers to approve variations to rate pegging arrangements.

While the LG Act provides for continuity and democratic operations of local councils in NSW, the State Government has significant powers to intervene in council operations. Most significantly, the LG Act allows the State Government to dismiss a council and delegate powers to an administrator. For example, following independent public inquiries between March 2003 and Sept 2004, four councils were dismissed on grounds of financial mismanagement and/or governance issues. Several other councils were placed under administration pending boundary changes and amalgamations (DLG 2004d).

Through the Country Towns Water Supply and Sewerage Program and sections 56 to 66 of the LG Act, the Minister for Water Utilities is responsible for overseeing the performance of NSW country councils in the provision of appropriate, affordable and sustainable water supply and sewerage services to the community. The program provides guidance and support to councils in the strategic areas of planning and management, operation and maintenance of their water and sewerage services, as well as providing financial assistance towards the capital cost of backlog water and sewerage infrastructure.

Roles and activities

Councils undertake a broad range of representative, policy, service, development and commercial activities. It can be argued that councils have three main roles: advocate and policy maker, service provider, and regulator.

As democratic bodies, councils are charged with developing policies that reflect their council obligations under state legislation and are consistent with the preferences of constituents. Councils are often seen as closest to the public and as such they act as the advocate of local constituents to other levels of government.

In principle, councils are strategic policy makers, shaping the environment and amenity of their local area in consultation with the community. Councils have significant planning powers to determine the local area's characteristics through land zoning and development controls, not withstanding requirements for compliance with state and federal planning laws and processes. Councils can designate where business and residential development will take place across the council area down to the control of development of private properties. Councils, through the services and programs provided and the facilities developed, substantially influence community character and quality of life.

Secondly, councils are a direct service provider to their communities. Services are prioritised depending on available resources and community needs and composition. Statutory service responsibilities, set out in Chapter 6 of the LG Act, specify the minimum services required from each council. Additional services, some offered on a commercial basis, are now frequently provided by councils.

The range of service and infrastructure commonly provided by NSW councils includes:

- Planning and development services;
- Domestic waste management and recycling services;
- Environmental management services (including natural areas, pollution control, application of the principle of ecologically sustainable development);
- Health and safety services (including water and food sampling, animal control, noise control, public toilets, immunisation, building inspections);
- Community services (including child care, elderly care and accommodation, refuge facilities, counselling and welfare);
- Recreation and leisure services (including management of parks, sport, camping facilities);
- Cultural and educational services (including libraries, art galleries, museums);
- Local economic development and tourism promotion;
- Water supply and sewerage services⁵; and
- Infrastructure necessary for general transport and communication purposes, as well as for the provision of the described services (roads, footpaths, drainage and sewerage systems, waste management infrastructure, recreational infrastructure, public buildings, etc).

Thirdly, councils are regulators, empowered to make orders and enforce certain civic controls. Councils issue approvals and licences for a variety of activities, such as building approvals, as well as providing oversight of the compliance with these requirements. They can also impose fines for a broad range of offences including breach of approval conditions, parking, dumping of rubbish and public disturbance.

Councils are also property owners with substantial portfolios of community land and infrastructure used to provide services to the community. Councils have vested property rights in items such as residential waste, which induces their obligations for management of waste disposal. Prudent asset management is therefore a substantial obligation for councils.

⁵ Councils in the Hunter, Sydney and Wollongong areas do not provide water and sewerage services.

Some Local Government activities and services are also provided by, or integrated with, services provided by other tiers of government and the private sector. The most common coincidences of services between providers are highlighted in Table 3.1.

Table 3.1: General divisions of service provision across levels of government and private sector

Policy Area	Function	Local	State	Federal	Private
Law and Order	Police and courts	x	✓	✓	x
	Traffic management	✓	✓	x	x
	Private security	✓	x	x	✓
	Public health and occupational safety	✓	✓	x	x
Health care	Hospital/acute care	x	✓	✓	✓
	Medical/dental services	✓	✓	✓	✓
	Aged care	✓	x	✓	✓
	HACC	✓	x	✓	x
Community Services	Public Transport	✓	✓	x	✓
	Welfare services	✓	✓	✓	✓
Environment	Industry regulation	x	✓	✓	x
	Private property regulation	✓	✓	x	x
	Natural environment	✓	✓	✓	x
	Fire services	✓	✓	x	x
	Waste management	✓	✓	x	x
Transport and roads	Local roads	✓	x	x	x
	Regional/ major roads	✓(RTA contractor only)	✓	✓	✓
	Air and rail transport	✓(Regional airports only)	✓	✓	x
Planning	Individual properties	✓	x	x	✓
	Large developments	✓	✓	x	✓
	Specific infrastructure	x	✓	✓	✓
Public Utilities	Water and sewerage	✓ (Rural and regional only)	✓	x	x
	Energy	x	✓	✓	✓
	Telecommunications	x	x	✓	✓
Recreation and Cultural Services	Sporting facilities	✓	✓	x	✓
	Library, gallery, museums	✓	✓	✓	✓
	Cultural events	✓	✓	✓	✓
	Nature/ park facilities	✓	✓	✓	x
	Childcare services	✓	x	x	✓

Source: Adapted from Kasper (2005).

Two distinctive schools of thought have traditionally dominated debate over the appropriate role for Local Government. Firstly, the ‘Minimalist’ view holds that councils are the body corporate of a local community and thus should foster the community’s common property and regulate what owners may do with their own properties. The alternative perspective is the ‘Maximalist’ view. This view holds that councils are the governments of their LGAs and should thus be concerned with the welfare of the whole community even if this means duplicating the roles of other tiers of government.

It has been argued in the literature that the LG Act embraced the ‘Maximalist’ position, particularly the council’s charter. However, by retaining rate pegging, the new LG Act effectively constrains councils (via financial restrictions) to a ‘Minimalist’ role. This raises

financial capacity issues, as Table 1 indicates that the contemporary activities of councils clearly exceed simple 'property service' model (the Minimalist role).

3.3 PROFILE OF COUNCILS

Number of councils

There are currently 152 general-purpose councils in NSW. This number has fallen over the years, essentially as a result of structural reforms. Of the 324 councils in 1910, only 177 were left in July 1993 due to voluntary mergers or compulsory amalgamations. This number was further reduced to 172 by July 2001.

In September 2003, the NSW Government commenced a further reform program aimed at achieving an appropriate structure for Local Government and improving the efficiency and efficacy of councils' service delivery. Based on the work of regional facilitators and of the Local Government Boundaries Commission, 42 councils were dissolved and 22 new councils commenced operation between February and September 2004, bringing the total number down to the current 152 councils.

Council area and population

Councils in NSW differ significantly in terms of population, area, and economic structure. For example, councils like Blacktown, Parramatta or Newcastle are major cities in their own right whereas large area rural councils, like Balranald or Bourke Shire, are almost entirely characterised by agricultural activity. Remote councils such as Central Darling Shire are sparsely inhabited with an average of only five people per 100 square kms whereas Waverley Council in urban Sydney has a population density of about 6,700 people per square km.

The area of councils varies considerably from under 6 square km (Hunters Hill Council) to almost 53,511 square km (Central Darling Shire Council) with an average area size of 4,660 square km. However, about 25 per cent of all council areas are smaller than 200 square km.

Populations within councils also vary greatly - from less than 1,400 (Urana) to almost 280,000 (Blacktown City Council). Average population size is 44,277. This compares to an Australia-wide average council population of approximately 27,700, ranging from just over 3,100 in the Northern Territory to 61,000 in Victoria, the state that has easily the largest average council population in Australia following a radical restructure of its Local Government in the mid 1990s by its then Premier Jeff Kennett.

Table 3.2 compares population ranges and numbers of NSW councils in 1997/98 and after the recent amalgamations in August 2004. The reduction of the total number of councils was essentially achieved by amalgamating medium to small, rural and agricultural councils into larger jurisdictional units. Even so, nearly half the councils in NSW still have populations less than 20,000.

Table 3.2: Population of councils in NSW

Population	Number of Councils 1997/1998	Number of Councils 2004/05
Less than 5,000	47	25
5,000 to 10,000	32	28
10,001 to 20,000	23	20
20,001 to 50,000	32	33
50,001 to 100,000	24	26
100,001 to 150,000	11	8
150,001 to 200,000	6	10
More than 200,000	2	2
Total Number of Councils	177	152
Average Population of Councils	About 36,000	44,277

Source: DLG (1998), LGGC (2005).

While the overall population in NSW grew by about 50,000 people from June 2003 to June 2004, different councils experienced very different growth rates, and even slight decline in some cases. The largest absolute growth occurred in Blacktown Council with 5,500 new residents per year, followed by Sydney City Council with a change of 5,100, rendering it also the fastest growing council in terms of rate of population increase, which was 3.6 per cent.

NSW population growth and demographic predictions for the next 30 years show some interesting trends for council regions. For example, while only having a small portion of the total NSW population today, South Eastern and Illawarra, and Richmond Tweed populations are expected to increase their regional populations by over 30 per cent in the next 30 years. Mid-North Coast and the Hunter are expected to increase their populations by over 20 per cent in the next 30 years. With the exception of some large rural centres, the Far West region and small rural population areas are expected to continue to decline (DIPNR 2005, p75). These varied population changes pose challenges for the councils supporting them.

While Greater Sydney remains the largest population growth area with over half the total population of NSW, substantial growth is predicted in coastal areas. In the five years from 1999 to 2005 the average annual estimated growth rate for NSW was 1.0 per cent. In coastal areas during this period the growth rate was 1.3 per cent, 30 per cent higher than the state average (NST 2005, p20).

Furthermore, the proportion of the national population aged over 65 is expected to increase from 12 per cent in 1999 to 22 per cent by 2031 (ABS 2001, p3). In NSW some high concentrations of elderly, (in some cases more than 25 percent), are expected in coastal council areas. This will have significant impacts on the service demands and revenue raising capacity of those councils (NST 2005, p20).

Council representation

Voting in NSW local council elections is compulsory for residents, but optional for non-resident taxpayers, occupiers and rate paying lessees. A multiple property owner may vote

only once in each council jurisdiction in which they have properties. There are approximately 1,760 councillors in NSW, democratically elected by the community in their Local Government area.⁶ Each council has an elected mayor (Lord Mayor in Sydney, Newcastle, Parramatta and Wollongong) and a general manager appointed by the council.

Over a quarter of councillors are women and about two per cent of councillors are of Indigenous descent. Councillors have a four year term. Mayors may be chosen from within the council for a term of one year or elected by popular vote for a term of four years.

Councillor representation rates are not uniform throughout the state. Unlike the NSW State and Commonwealth Parliaments (excepting the Commonwealth Senate and NSW State Government upper house), representation for councils is not based on a standard ratio of population size to elected representative.

The average population per NSW councillor is 4,712 residents although the difference in populations per council ranges from less than 1,400 to 280,000. The average number of NSW councillors per council is 10.6, with a statutory minimum of five and a maximum of 15 councillors. The number of councillors is not automatically adjusted when area populations change. A referendum of electors in the area is required to change the number of councillors.

Councillors are not paid salaries but receive payment in the form of allowances and fees. The NSW Local Government Remuneration Tribunal categorises councils by size and other characteristics to determine fee levels. For 2004-2005, fees for NSW councillors ranged from a minimum of \$5,857 to \$25,850 per annum. Additional fees for mayors ranged from \$6,241 to \$141,900 per annum.

Council decision-making

Local Government decision structures are unique. Councils do not mirror state and federal arrangements nor do they strictly parallel corporate decision-making processes.

Under the LG Act, each council is a state statutory corporation, something that the Department of Local Government and the Minister for Local Government were quick to remind the Inquiry in regards to councils' aspiration to be an independent third tier of government.

The councillors are the governing body of the corporation and have responsibility for directing and controlling council affairs. In some ways councils operate like a board of directors or body corporate with requirements for public and professional liability insurance. However the protocols for council meetings mimic parliamentary procedures⁷.

In terms of council decision-making, the LG Act gives the administrative heads of councils (general managers) the normal executive powers of management, and councillors the task of setting strategic policy directions. However, in practice most councillors are engaged in making decisions on individual matters, not simply high-level policies. For example, a

⁶ Furthermore there are three other local governing bodies, Silverton, Tibooburra, and Lord Howe Island, as well as a large unincorporated area in the far west of NSW.

⁷ Meeting procedures (i.e. frequency of meetings, notice of meetings, quorum, voting committee, etc) are standardised in Chapter 12 of the LG Act.

council may determine land zoning and particular building specifications for the Local Government area as a whole as well as assess individual building development applications.

In state governments and the Commonwealth Government the 'separation of powers doctrine' requires that law making is undertaken via the parliament and policy direction determined by the executive (Prime Minister/Premier and Ministers). Government agencies are then responsible for implementing law, administering decisions and providing for the delivery of related services and infrastructure.

In effect, council decision-making mixes elements of the parliament, the executive and corporate decision-making processes. Councils have the power to make both municipal laws (although limited to the scope under the LG Act) and set policy directions. In addition, councils will also consider individual cases in administrative capacity (Mant 2005b).

Council administration

Councils have two components: the council, consisting of the mayor and councillors, and the administration, consisting of the general manager and employees.

The mayor is the chair of council and is empowered to carry out civic functions. In NSW, the mayor does not have statutory powers over other councillors. Prior to the LG Act 1993, the mayor was also effectively the general manager of the council. The LG Act created the separate, non-representative position of the general manager, employed by the council.

The functions of a council and its general manager are prescribed in the Chapter 5-8 of the LG Act. Various functions of council are delegated to the general manager or council officers. Key functions that cannot be delegated by a council include: the making of a rate or charge, the borrowing of money, the compulsory acquisition of land, the adoption of financial statements and the classification of public land as operational land. As noted above, councils regularly deliberate on administrative decisions such as development approvals, though they are not obliged to do so.

The general manager's role is the management of council administration to meet its legislative responsibilities and achieve the council's vision and goals. This includes the discretion to determine the organisational structure of council administration such as business unit structures and staffing arrangements.

As of February 2004, councils in NSW employed about 51,600 people (about 42,000 full time equivalent positions). NSW councils employ a wide variety of skilled and unskilled labour, technicians and generalists on full, part time and contracting bases. Councils' largest component of expenditure is employee costs (39 per cent).

In recent years, Local Government has seen a very considerable improvement in the qualifications and skills of its workforce. However, councils are now facing significant skills shortages. Strong economic growth, buoyant labor markets and demographic trends have created skills shortages throughout the Australian economy, including metropolitan areas. Nowhere is this shortage felt more acutely than in rural and regional areas of NSW, where Local Government is one of the single largest employers.

The ageing of the Local Government labour force is another concern. A survey of councils' skills shortages (DLG 2005f) found that the average age of employees was 42. Over 92 per cent of councils reported existing or emerging skill shortages with the greatest deficiency being in planning and engineering. Less severe shortages were evident in certain trades (e.g. mechanics and building), finance and other areas (e.g. environment, health and building inspectors and surveyors). This poses significant workforce management and knowledge transfer challenges for council administrations. Demand for certain council occupations related to aging populations, such as disability support workers, are also likely to increase.

Interstate comparisons

Table 3.3 highlights some key features of councils in NSW and where they differ by comparisons with other states/territories.

Table 3.3: Summary of key features of NSW against variance in other states

Feature		NSW	Min	Max
Population		6,719,800	199,200 (NT)	6,719,800 (NSW)
State area	Sq km	800,642	68,401 (Tas)	2,529,875 (WA)
Number of Councils		152	29 (Tas)	157 (Qld)
Average Council population		44,277	3,122 (NT)	60,906 (Vic)
Average Council area	Sq km	4,660	951 (NT)	17,515 (WA)
Average Councillors per Council	Councillors	10.6	7.7 (Qld)	11.6 (NT)
Population per Councillor	Residents	4,712	273 (NT)	7,965 (Vic)
Local Government employees		51,600	3,300 (NT)	51,600 (NSW)
Population served per employee		130	60 (NT)	196 (SA)

Source: McBride and Moege (2005). This Research Report provides an extensive comparative analysis of Local Government arrangements and data between jurisdictions.

While NSW Local Government has much in common with Local Government elsewhere in Australia, some important differences remain. For example, while all Australian councils levy rates based on land valuations, land valuation methodology differs between states. Notably NSW utilises unimproved capital value for its rates base. By contrast, other states rely on valuation bases such as gross rental value and net annual value for rating purposes. Furthermore, NSW is also the only jurisdiction to apply rate pegging which has been in practice since 1977. Comparative interpretation and analysis of NSW rates revenue information should recognise these differences.

3.4 LOCAL GOVERNMENT FINANCES

While Local Government has a significant impact on daily life and activities of local communities, it represents only about five per cent of total own-purpose outlays of all Australian governments. State governments and Commonwealth Government account for around 39 per cent and 56 per cent respectively.⁸

Local Government's relative share of the Australian public sector is even smaller on the tax side. In 2004/05 Local Government received only 2.9 cents in every tax dollar raised across the three spheres of government. This is a fall on the 3.1 cents share that existed only three

⁸ Includes general government, public trading enterprises and universities and is based on each government's own purpose outlays after deducting grants to other tiers of government. Calculations made from government finance data provided in the ABS *Yearbook of Australia*.

years earlier. By comparison the Commonwealth and state governments received 82.3 per cent and 14.9 per cent respectively of the total tax take in 2004/05.

Revenue sources

In order to fulfil their role and functions councils require an adequate revenue base. Local Government revenue derives from three main sources:

- Council rates (taxes on property calculated on the basis of land value);
- User charges and regulatory fees (mainly for services and infrastructure provided);
- Funding from the Commonwealth Government in the form of Financial Assistance Grants pursuant to the *Local Government (Financial Assistance) Act (Cth) 1995* and Specific Purpose Payments and from the State Government in the form of financial grants for specific purposes and services;
- Other sources of revenue include interest income, dividends, and fines.

Financial Assistance Grants from the Commonwealth Government include a general-purpose component and untied local roads component aimed at equalising councils' capacity to deliver general services. These payments, assessed by the Commonwealth Grants Commission, are made to the states and territories and administered and distributed to Local Government by the State Local Government Grants Commissions. Specific Purpose Payments are made directly by the Commonwealth Government to Local Government to enable it to implement particular policies or deliver specific services on behalf of the Commonwealth Government. Specific Purpose Payments include, among others, funding for childcare and disability services as well as the Roads to Recovery program. Financial grants from the State Government include grants towards the capital cost of backlog water and sewerage infrastructure under the Country Towns Water Supply and Sewerage Program.

In 2003/04 Local Government in NSW had total revenues of \$6.6 billion, up from \$6 billion the previous year (DOTARS 2003 and 2005), making Local Government in NSW the largest in the Australian federation with respect to total revenue, and the third largest on a per capita basis after Queensland and Tasmania. See table 3.4.

Table 3.4: Local Government revenue sources by state, 2002-03

Source	NSW	Vic	Qld	WA	SA	Tas	NT	Total
Rate/Taxation revenue	\$2,346m 35.6%	\$1,826m 45.9%	\$1,423m 27.6%	\$752m 45.6%	\$629m 58.8%	\$175m 34.6%	\$49m 26.1%	\$7,201m 37.7%
Sale of goods and services	\$2,223m 33.8%	\$790m 19.9%	\$2,316m 45.0%	\$351m 21.3%	\$201m 18.8%	\$208m 41.1%	\$65m 34.6%	\$6,152m 32.2%
Current grants and subsidies	\$765m 11.6%	\$516m 13.0%	\$465m 9.0%	\$187m 11.3%	\$152m 14.2%	\$72m 14.2%	\$46m 24.5%	\$2,202m 11.5%
Capital grants	\$109m 1.7%	\$35m 0.9%	\$165m 3.2%	\$93m 5.6%	\$12m 1.1%	\$9m 1.8%	\$3m 1.6%	\$426m 2.2%
Interest	\$210m 3.2%	\$47m 1.2%	\$91m 1.8%	\$38m 2.3%	\$14m 1.3%	\$12m 2.4%	\$4m 2.1%	\$415m 2.2%
Other revenue	\$933m 14.2%	\$763m 19.2%	\$691m 13.4%	\$227m 13.8%	\$61m 5.7%	\$31m 6.1%	\$21m 11.2%	\$2,727m 14.3%
Total	\$6,586m 100.0%	\$3,977m 100.0%	\$5,151m 100.0%	\$1,648m 100.0%	\$1,069m 100.0%	\$506m 100.0%	\$188m 100.0%	\$19,124m 100.0%
Total per capita	\$997ph	\$822ph	\$1,406ph	\$861ph	\$705ph	\$1,072ph	\$951ph	\$996ph

Source: DOTARS 2005, tables 1.17 and 1.18.

In 2003/04, more than two-thirds of the total revenue of NSW councils (69.4 per cent) came from rates, user charges and fees, with rates being the biggest component (35.6 per cent).

Urban councils levied an average residential rate of \$624 compared with rural councils that levied an average rate of \$400. The overall state average was \$605. Councils received a total of \$179 million from farmland rates (eight per cent of total rates revenue), and approximately \$573 million from business rates (26 per cent of total rates revenue) (DLG 2003 and 2005b).

Grants and subsidies made up 13.3 per cent of the total revenue, indicating a considerable level of self-sufficiency overall, but with very significant differences between councils. Metropolitan and regional councils typically received only eight to 17 per cent of total revenue from grants, whereas rural councils are generally more grant-dependent, sourcing 26 to 41 per cent of revenue from grants and in a few cases over 50 per cent.

The main proportion of Local Government funding, namely 71.6 per cent of all grants and specific purpose payments, came from the Commonwealth Government (\$346.6m general purpose grants, \$131.0m local roads grants, and \$122.7m Specific Purpose Payments) (DLG 2005b).

Key revenue trends for NSW Local Government from 1995/96 to 2003/04 have been estimated as follows (Brooks 2005):

- Total revenues of NSW Local Government grew faster than price inflation as measured by the Sydney Consumer Price Index (CPI), but more slowly than the state economy as measured by Gross State Product (GSP);
- Total rates and annual charges revenue have also grown in excess of the CPI, but were in line with GSP growth up to 1999 and then grew slower than GSP. All states' and territories' total rate revenue growth rates are significantly in excess of CPI increases;
- Over the period NSW experienced the lowest increase in council rates, possibly due to rate pegging. However, when analysis is extended (examining trends over 11 years), Victoria⁹, ACT and Tasmania all had lower rate revenue increases than NSW;
- As at 2003-04, NSW had the lowest rates per capita of any jurisdiction other than the Northern Territory. NSW rates per capita grew by an average of only 2.8 per cent per annum in the in the five years to 2003-04;
- User charges revenue has grown at a significantly higher rate than CPI, but below GSP growth;
- Total Commonwealth and state grants have grown in excess of CPI, but lower than GSP rises;
- General Purpose Grants (GP component of FAGs) have grown in line with CPI, but significantly lower than GSP. A similar trend is observed for Local Road Grants (LR component of FAGs) and Roads to Recovery Grants;
- Over the period there have not been major changes in the composition and share of revenue sources: rates and annual charges representing nearly half (48 per cent) of total revenue, followed by user charges and fees (whose share fell from about 18 to 17 per cent) and grants revenue (that fell from around 18 to 16 per cent), and donations and contributions, interest and other operating revenue (rising from approximately 16 to 20 per cent);

⁹ Victoria was subjected to a period of rate pegging in the mid 1990s, when the State Government mandated a 20 per cent decrease in rates.

- The composition of revenue varies between urban, regional and rural councils. Rural and regional councils tend to have a lower proportion of rates revenue and a higher dependence on grants than urban councils.

Expenditure patterns

Equipped with these funds NSW councils manage \$66 billion worth of public infrastructure and in 2002-03, Local Government expenditure amounted to about \$5.7 billion (DOTARS, table 1.22, page 33). This represents an average expenditure of \$857 per capita, compared to \$916 nationwide, with the lowest figure of \$709 in South Australia and the highest average spending per capita of \$1,226 in Queensland (DOTARS, tables 1.19 and 1.20, page 31).

The most significant areas of Local Government expenditure continue to be transport and communication with 29.2 per cent and housing and community amenity with 25.6 per cent (see Table 3.5, these figures do not include capital outlays, mainly on local roads).

Table 3.5: Local Government expenditure by purpose, by State, 2002-03

Purpose	NSW	Vic	Qld	WA	SA	Tas	NT	Total
General public services	\$860m 15.2%	\$464m 11.7%	\$882M 19.6%	\$153m 9.6%	\$184m 17.1%	\$71m 13.9%	\$108m 38.0%	\$2,722m 15.5%
Public order and safety	\$222m 3.9%	\$75m 1.9%	\$45m 1.0%	\$59m 3.7%	\$16m 1.5%	\$4m 0.8%	\$2m 0.7%	\$422m 2.4%
Education, health and welfare	\$374m 6.6%	\$778m 19.6%	\$90m 2.0%	\$122m 7.6%	\$63m 5.9%	\$28m 5.5%	\$13m 4.6%	\$1,469m 8.4%
Housing and community amenity	\$1,448m 25.6%	\$729m 18.4%	\$1,355m 30.2%	\$232m 14.5%	\$199m 18.5%	\$186m 36.3%	\$78m 27.5%	\$4,228m 24.0%
Recreation and culture	\$634m 11.2%	\$680m 17.1%	\$481m 10.7%	\$362m 22.7%	\$186m 17.3%	\$63m 12.3%	\$19m 6.7%	\$2,423m 13.8%
Transport and communication	\$1,656m 29.2%	\$879m 22.1%	\$1,268m 28.2%	\$525m 32.9%	\$264m 24.6%	\$119m 23.2%	\$39m 13.7%	\$4,751m 27.0%
Other	\$469m 8.3%	\$365m 9.2%	\$371m 8.3%	\$143m 9.0%	\$162m 15.1%	\$41m 8.0%	\$25m 8.8%	\$1,576m 9.0%
Total	\$5,662m 100.0%	\$3,970m 100.0%	\$4,492m 100.0%	\$1,597m 100.0%	\$1,074m 100.0%	\$512m 100.0%	\$284m 100.0%	\$17,591m 100.0%
Total per capita	\$857ph	\$821ph	\$1,226ph	\$834ph	\$709ph	\$1,084ph	1,437ph	\$916ph

Source: DOTARS (2005), tables 1.19 and 1.20.

In the last decade, council expenditure has increased at a greater rate than the CPI. Spending on certain policy functions, particularly people and environmental services grew much faster than traditional property related services. In the last decade, in aggregate, the greatest comparative growth in expenditure categories has occurred in housing and communities amenities, followed by public order and safety, and economic affairs. It should be noted that some of these items are increasing from a low proportion of total expenditure and that transport and communication (primarily road maintenance and depreciation) still dominates as the greatest expenditure item. However, as we shall see later the level of road renewal does not match the level of road depreciation.

Expenditure patterns also vary when urban and rural councils are compared. Urban councils appear to have higher proportions of expenditure on housing and community amenities,

possibly reflecting the demands of greater population concentrations. Rural councils have a high proportion of expenditure on transport and communications, possibly reflecting the burden of road maintenance and depreciation in large rural areas (Brooks 2005).

Expenditure, in terms of administrative functions, is 39 per cent for employee costs, 25 per cent for materials and contracts, 20 per cent for depreciation, 15 per cent for other expenditure and one per cent for borrowing costs (Brooks 2006). These values are for 2003/04 and are aggregated across NSW councils. This breakdown will also vary between individual councils.

Procurement processes

Councils are significant purchasers of infrastructure, goods and services. Procurement processes vary from direct purchase to complex contracts.

NSW councils undertake an estimated 1,880 tenders each year valued at around \$331 million. About 33% of tenders (i.e. 622) are greater than \$150,000. The annual costs to councils of preparing, managing and assessing tenders worth more than \$150,000 each is about \$2.1 million and the costs to industry of responding to such tenders is estimated at \$4.4 million a year. (Cranko & Paddon 2005, p1)

Councils also use collaborative procurement processes such as joint tenders across networks of councils (e.g. LGSA and ROCs) or in partnership with state agencies under State Government purchasing contracts. (Cranko & Paddon 2005, p1)

Service delivery arrangements

Service delivery varies depending on types of services provided. Front desk, administrative, planning and financial services have historically been provided in-house. Some divisions within councils are structured on business or purchaser/provider models and some services are provided commercially in competition with private providers. For example, council building inspectors now compete with private building inspectors (known as private certifiers) for inspection services. Under competitive neutrality requirements set by the National Competition Commission, these competitive services must be priced and marketed in a commercial manner without any cross subsidy from other services or divisions within councils.

Outsourcing and contracting models predominate for garbage collection, infrastructure and environmental services. Due to scale and risk issues and some recent controversy with failed projects, private/public partnerships have had very little application in the NSW Local Government sector.

In general, rates, fees and charges are allocated to councils' general revenue although water and sewerage service revenues are 'ring fenced' and may only be applied for those services. The LG Act allows councils to apply special rates or levies for particular services such as waste levies. However, apart from water and sewerage services, few services are priced according to their unit costs of provision so the main portion of rates revenue is not hypothecated.

Some charges, such as building application fees and fines, are set externally by state regulation. The NSW Independent Pricing and Regulatory Tribunal sets fees for electricity

utility services and also fees for water and sewerage services for Gosford and Wyong Councils. Some services, such as leisure and recreational services, are operated as commercial activities on a full cost recovery basis.

Infrastructure assets

Councils are responsible for a diverse suite of physical infrastructure. Up to 80 per cent of Australian roads are classified as local roads and managed by councils. Roads management encompasses footpaths, kerbing, bridges, signage, street lighting, drainage and traffic controls. Councils also manage public facilities, stormwater and parks/recreation infrastructure. In addition, NSW regional and rural councils are generally responsible for the management of water and sewerage services (outside Sydney, Wollongong and Hunter regions).

For some time the capacity of councils to maintain and renew existing infrastructure and fund future infrastructure needs has been a concern. It has been argued that due to increases in demand for other services, maintenance and renewal of infrastructure has been deferred, causing a gradual but marked decline in infrastructure condition. This is exacerbated by the fact that a large portion of council infrastructure is reaching the end of its usable life. Additionally, insufficient funding was set aside for renewal of infrastructure because capital revenue (in the form of grants, contributions and asset sales proceeds) is being used in place of external borrowings to fund operating deficits.

Infrastructure management practices vary extensively across councils. In some cases councils have insufficient knowledge of the extent and condition of their infrastructure. This may be due to a lack of resources and expertise, inadequate asset registers, and the absence of consistent methodologies to audit infrastructure. Only 20 per cent of councils have implemented ‘best practice’ asset management systems for planning, acquiring, operating, maintaining, disposing of and renewing or enhancing infrastructure assets (Roorda 2006).

The use of different criteria for condition assessment, valuation and depreciation of infrastructure assets has complicated councils’ understanding of their infrastructure position. A huge gap has emerged between what councils should be spending on infrastructure renewal (based on its annual depreciation) and what they actually spend.

Due to differences between councils in asset condition and accounting practices, estimates of the value of Local Government infrastructure and future requirements for infrastructure vary considerably.

For example, studies commissioned by this Inquiry estimate the infrastructure gap ranges from \$400 million per annum to \$600 million per annum across NSW Local Government. These estimates rely on replacing existing assets only – a ‘like with like’ replacement. They do not reflect the extension or substantial expansion of assets such as an increase in the capacity of a water treatment plant or the replacement of a single lane road with dual lanes.

Debt levels

The level of debt among NSW councils is low and continues to fall. In 2003/04 the debt service ratio¹⁰ averaged 5.2 per cent for all metropolitan and regional councils and 4.1 per cent for all rural councils, and ranged from a high of 20.5 per cent to a zero or negative debt for 18 councils (up from 14 in 2001/02, and eight in 1997/98), indicating that for those 18 councils at least there was no long term debt or significant revenues committed to servicing long term debt. Almost 64 per cent of councils had a debt service ratio of less than or equal to five per cent, compared with about 55 per cent in 2001/02. Only about nine per cent of councils, (down from 14 per cent in 2001/02 and almost 27 per cent in 1997/98), had a debt service ratio of more than or equal to 10 per cent. (DLG 2004d)

Overall, Local Government in NSW is debt free and a net lender on the money market; its current financial assets exceed liabilities. However, this does not take into account the contingent liabilities associated with a backlog of over \$6.3 billion in infrastructure renewals.

These low levels of debt also raise concerns as to the intergenerational equity of Local Government projects, particularly long-lived infrastructure and environmental assets. Low levels of borrowings can be inappropriate where projects are funded through rate increases and thus current ratepayers bear the full costs of facilities and services that will benefit future users. Debt financing, however, allows the cost of such projects to be shared between present and future generations. However, it should be noted that the present low levels of debt provide councils with the ability to borrow to fund forthcoming infrastructure expenditure without the need to significantly increase their existing charges.

At present, infrastructure obligations are neither being met by current taxpayers (since asset renewals fall short of asset depreciation) nor future ones (since debt levels are being kept extremely low).

3.5 COUNCIL COOPERATION AND ALLIANCES

Structural reforms such as the recent amalgamations are not the only way to increase the efficiency, efficacy, and financial sustainability of service delivery and infrastructure provision. Other forms of cooperation between councils themselves as well as arrangements with the other spheres of government are becoming more evident.

Councils have established cooperative (and voluntary) partnerships with adjacent councils, commonly called regional organisations of councils (ROCs), seeking mutual benefits from working together. At present, there are 19 of these voluntary groups of councils in NSW operating a variety of joint projects, like joint purchasing and resource pooling.

There are also other forms of cooperation among Local Government. For instance, more than 70 councils in NSW are currently engaged in wider strategic alliances containing a wide range of cooperative activities from joint purchasing and use of assets to sharing the administrative services of specialist staff. In the Hunter region, for example, 13 councils share training and human resources operations, environmental surveying, procurement, and run joint regional

¹⁰ This indicator assesses the degree to which revenues from ordinary activities are committed to the repayment of net debt. It is generally higher for councils in growth areas where loans have been required to fund infrastructure such as roads and water and sewerage works. Net debt service costs include net debt redemption from revenue, transfers to sinking funds and bank overdraft interest.

records storage. Under the New England Councils Strategic Alliance, councils undertake joint tendering, and share core support functions and plant utilisation. Five councils and a business partner under the councils' Online Program provide 24-hour service via the internet to cater for flexible resource allocation, effective use of capital and improved risk management.

Other examples of councils' cooperation include a Local Government superannuation fund (administered by FuturePlus Financial Services), pooled insurance arrangements (mainly provided by Jardine Thompson) and a bulk-contract procurement service (administered by the LGSA).

Inter-agency partnerships to facilitate more efficient and effective service delivery are an important trend internationally and elsewhere in Australia. In the UK, for example, councils are required to establish local strategic partnerships with a range of key stakeholders and service providers. In Tasmania, the State Government has entered into individual partnership agreements with all councils to pursue agreed priorities. State governments in Queensland, South Australia, Western Australia and the Northern Territory are all actively pursuing partnership approaches with individual councils.

NSW is less advanced in this regard, but a number of formal and informal partnerships exist between the State Government and councils, in the form of bilateral, regional or statewide arrangements, with councils often being represented by the Local Government and Shires Associations of NSW (LGSA). A successful example of bilateral cooperation between State Government and councils is the long-standing arrangement for councils to access State Government supply contracts. Significant proportions of council purchases are made this way. Other examples include protocols on environmental management and cultural activities.

It is also noteworthy that the NSW Department of Local Government's guidelines for social plans highlight the need to explore possible partnerships with state agencies and other organisations for service delivery.

Councils generally see Local Government relations with the State Government as very poor compared to other states (Purcell 2005). There is no regular forum to discuss policy issues such as financial sustainability, and there appears to be limited appreciation of common interests. For example, Local Government is an integral part of the state public sector and rate pegging is therefore 'public sector revenue capping' with attendant consequences for the standard of public services provided in NSW relative to other states. The exception to the above is water and sewerage services where the DEUS/LGA and SA Liaison Committee for Local Government Water Supply and Sewerage meets at least four times per year and the Minister for Water Utilities has regular meetings with the Associations to discuss strategic water and sewerage issues.

The primary forum for relations among all spheres of government is the Council of Australian Government (COAG) where NSW Local Government is represented through the Australian Local Government Association (ALGA) whose members are the states' and Northern Territory's Local Government Associations. Furthermore, in 2004 Local Government of all states and the Northern Territory agreed with the state and the Commonwealth Government on the commencement of negotiations for an intergovernmental agreement to address issues such as the adequacy of funding, and on cost shifting, as well as functional reform to allow resource sharing and reduce duplication of services and administrative functions. On

completion, this intergovernmental agreement will be a further step in the development of sustainable Local Government in Australia.

4. DRIVERS OF LOCAL GOVERNMENT

4.1 INTRODUCTION

Local Government in New South Wales is subject to various external factors which impact directly upon its financial sustainability. These factors fall into four broad categories: statutory obligations imposed by State and Commonwealth Government; stakeholder expectations; independent standards; and emerging other challenges. The impact of all of these factors, termed ‘drivers’, is discussed in this chapter.

4.2 STATUTORY OBLIGATIONS

New South Wales councils are subject to various statutory obligations. It is well accepted that these requirements have expanded significantly over time, and added dramatically to the administrative workload (and budget demands) of councils. Most of these activities are legislatively mandated by the state.

State Government statutory obligations

Following the introduction of the new *Local Government Act (NSW) 1993* (LG Act) councils have been required to conform to various additional planning and reporting responsibilities, as determined by the State Government, for which they do not believe that they have been adequately funded. As a result of the 1993 changes, councils are now required to prepare: management plans; State of the Environment reports; plans of management for public land; storm water management plans; and social/community plans.

In addition to these, a number of other regulatory and compliance type responsibilities have either been created or devolved to councils over time by the State Government. While some of these new responsibilities have allowed councils to impose and collect fines, most would argue that, apart from parking fines, these penalties usually represent only partial cost recovery.

New responsibilities have included:

- **Private Certification Provisions** – record keeping and issuing of orders to rectify defects relating to private building certifiers;
- **Environmental Protection** – including a range of new environmental enforcement responsibilities under the *Protection of the Environment Operations Act (NSW) 1997*;
- **Public Health** - inspections of premises under the *Public Health Act (NSW) 1991* and the *Local Government Act (NSW) 1993*, a proposed amendment to the *Public Health Act (NSW) 1991* would also require councils to prepare public health plans in conjunction with area health services;
- **Food** - various activities including inspections, granting approvals for food premises and complaint investigation and handling under the *Food Act (NSW) 2003*;
- **Brothels** - regulation of brothels under the *Restricted Premises Act (NSW) 1943*;
- **Companion Animals** - registration requirements under the *Companion Animals Act (NSW) 1998* including the monitoring of dangerous dogs;
- **Parking Police functions** – involving enforcement of parking regulations;

- **Occupational Health and Safety** - registration of clothing manufacturers and certification of spray booths under the *Occupational Health and Safety Act (NSW) 2000* in addition to councils' own requirement to comply with the standards;
- **Abandoned vehicles** – these had previously been the responsibility of NSW Police;
- **Contaminated Lands** - councils have been required to expand and modify their contaminated lands register, prepare contaminated lands maps and policies and consider contamination in development applications and Section 149 Certificates under *Contaminated Lands Management Act (NSW) 1997* and SEPP 55¹¹;
- **Heritage** - responsibilities for Interim Heritage Orders, demolitions and minor alterations to state listed items under the *Heritage Act (NSW) 1977* and the *Environmental Planning and Assessment Act (NSW) 1979*;
- **Waste** - responsibilities including preparation of a landfill environment management plan (LEMP) under the *Waste Minimisation and Management Act (NSW) 1995* and preparation of a waste management approvals policy and conducting a waste audit under the *Waste Avoidance and Resource Recovery Act (NSW) 2001*;
- **Energy** – under the *Energy Administration Amendment (Water and Savings) Act (NSW) 2005*, energy savings plans (ESPs) are compulsory from 30 September 2006 for councils with populations over 50,000. REROC estimates that the cost of developing and implementing such a plan will be \$70,000 per council plus ongoing annual reporting costs; and
- **Water** – under the *Energy Administration Amendment (Water and Savings) Act (NSW) 2005* any council designated a water user has to prepare a water savings plan and possibly contribute to a water savings fund.

The recently released New South Wales Government's Metropolitan Strategy, designed to manage and direct population growth and economic development over a 25 year period in an area bounded by Port Stephens, Penrith and Kiama, will also place a greater workload on affected councils. These councils will be required to prepare new Local Environment Plans that conform to what has been agreed for the immediate sub-region within two to five years. Councils will need to allocate additional staff to the tasks of negotiating on the details of the sub-regional strategies, ongoing monitoring of targets set by the strategy and to carry out strategic reviews every five years (Gilmore 2005).

It has been argued that the pattern of changes that could flow from the strategy is likely to be uneven and that in some areas, such as the Parramatta Road corridor, those councils facing the biggest changes may not be the best financed or of a large enough size to cope easily with much higher requirements for providing services and granting planning consents (Gilmour 2005, p4).

One of the affected councils in its submission to this Inquiry argued that the additional 95,000 dwellings planned before 2031 in the Sydney West Central sub-region would represent a 42 per cent population increase and as a consequence "this huge planning responsibility will create a significant extra workload for council" (Bankstown City Council 2005, p13).

¹¹ State Environmental Planning Policy 55.

Commonwealth Government statutory obligations

In recent years councils have also been required to implement reforms as a result of National Competition Policy. These include corporatisation of business undertakings, adoption of full cost pricing, reform of water pricing, contracting out of service delivery and adoption of the Code of Competitive Conduct.

The rationale for reforms is the generation of efficiency benefits across the national economy. Under the agreement, state governments receive payments over a period of years on the basis they achieve satisfactory progress against their obligations. Payments are made on a per capita basis and started in 1997/98 with \$396 million provided to NSW. The most recent payment to the NSW Government was \$724million in 2004/05 and around \$834 million is promised for 2005/06 (NCC website, NCP payments, 2006). This will be the last tranche of payments under the agreement.

Local Government is not a direct party to the National Competition Principles Agreement that requires these reforms and despite the extension of requirements to Local Government; payments are not made directly to them. The NSW Government accepted the reform obligations on behalf of its local governments and it keeps the NCC payments.

Since the commencement of reforms the National Competition Commission has assessed that the NSW Local Government sector is making satisfactory progress. However, the NSW Government does not pass on any payments to councils. While it is difficult to quantify the benefits derived from the application of competition reforms to Local Government, the Victorian, Western Australian and Queensland governments have passed on a portion of payments to their Local Government sectors in recognition of their compliance and the cost burden involved in revising their arrangements. The value of these payments varies greatly being four per cent in Western Australia, nine per cent in Victoria and almost 20 per cent in Queensland.

Councils are also now subject to some requirements of the *Trade Practices Act (Cth) 1974*. This has required specialist economic, accounting, negotiation and business skills that councils have not always had in-house. The implementation of systems to comply with Goods and Services Tax return requirements¹² have also imposed further costs on councils.

Council views regarding statutory obligations

In their submissions to the Inquiry, councils continually expressed concern about the amount of legislative requirements now imposed upon them. The general feeling of councils was that they were unnecessarily over-regulated. Blue Mountains City Council, for example, argued for an incentive based approach rather than a mere prescriptive one:

There should be a philosophical shift to accountability and transparency to the community by Local Government rather than regulation and legislation being forcibly imposed by State and Federal Government at great cost. The emphasis should be more on incentives that make local governments accountable to deliver “outcomes” rather than on defining and prescribing how they do this. (Blue Mountains City Council 2005, p2)

¹² Under the *A New Tax System (Goods and Services Tax) Act (Cth) 1999*.

Bega Valley Shire Council included a list of 94 activities they now undertook which had not been required in 1992 (Bega Valley Shire Council 2005, p1). Bombala Shire Council singled out reporting costs to other tiers of government as a significant financial imposition. The council believed that, as this information was provided for free to the Commonwealth and state governments, there was probably a tendency to ask for more than was actually necessary. A user pays system was suggested to ensure “that information is only collected when the value outweighs the cost” (Rawlings 2005, p7).

Naturally, NSW Local Government is also claiming a portion of the competition payments received by State Government for their part in meeting National Competition requirements.

Responsibility and cost shifting

Over recent decades Local Government has continually increased the amount of human services it provides. Some of these new services have been council initiatives or a response to altered community expectations. However, many have been mandated by State and Commonwealth Government as a way of shifting responsibility and thereby associated costs to Local Government. In other cases they have come about as a result of Local Government backfilling gaps left by other tiers of government that have reduced their traditional obligations whether statutory or not.

The Commonwealth House of Representatives Standing Committee on Economics and Finance, also known as the Hawker Inquiry, concluded that the majority of cost shifting has been from state governments onto Local Government. There was also some evidence of cost shifting by the Commonwealth Government onto Local Government.

The major types of cost shifting were identified as:

- The withdrawal or reduction of financial support once a program is established therefore leaving Local Government with the choice of continuing the program or suffering potential political backlash if the service is cancelled;
- The transfer of assets without appropriate funding support;
- The requirement to provide concessions and rebates without compensation payments;
- Increased regulatory and compliance arrangements; and
- Failure to provide for indexation of fees and charges for services prescribed under state legislation or regulation.

The Hawker Inquiry considered that most cost shifting occurred in the following five major areas: community security; fire services; health and welfare; libraries and airports (Hawker 2003, p3).

Submissions received from councils echoed these findings. Guyra Shire Council provided the following examples of cost shifting: increasing Rural Fire Service costs; subsidised housing in order to attract a local doctor; community safety committees; pensioner concessions; and library funding (Guyra Shire Council 2005). Bombala Shire Council was likewise spending funds to upgrade a doctor’s surgery and residence in an attempt to attract more doctors to their area. Council considered that it was being forced make up for a shortfall in service provision, which was the responsibility of other levels of government. Although it was noted that doctors and housing are traditionally areas of Commonwealth and state responsibility

Bombala Shire Council felt that they had no choice but to step in to provide a service other levels of government were unwilling to provide (Rawlings 2005, p6).

Cost shifting is occurring at a time when the level of states' grants is failing to keep pace with changing responsibilities and cost increases. A Commonwealth Grants Commission Report in 2001 found that on ABS data state transfer payments had fallen as a proportion of Local Government revenue from around 15 per cent in 1974-75 to about seven per cent in 1997-98. The reason for this was that Local Government own-source revenue had grown four per cent per annum in real terms, but state assistance had only grown 0.4 per cent per annum (Commonwealth Grants Commission 2001, p5). It is not clear how the ABS obtained this data for all states for reasons discussed below.

The Australian Bureau of Statistics does not produce data on state transfers to Local Government. The NSW Government does not disclose data on total state grants to Local Government in either the State Budget Papers or the DLG's compendium of Comparative Information on NSW Local Government Councils. By contrast, in almost every other state, budget papers report on state-Local Government relations and grant funding paid to Local Government (DOTARS, 2003-04, p.22).

Fortunately the NSW Treasury was able to extract data from its whole-of-government financial database to assist the Inquiry develop a time-series on state grants to councils. The Treasury data shows that state grants (excluding pensioner rate rebates, physical asset transfers, council rate payments, interest rate subsidies, assumption of HIH Insurance Ltd liabilities, disaster relief capital and welfare grants) increased by an average annual rate of 4.6 per cent from 1996/97 to 2003/04. It was not possible to get data from before 1996/97.

One council, Bombala Shire Council, claims that grant funding from both Commonwealth and state sources has fallen from 68 per cent of its total revenue in 1979 to 42 per cent in 2005 (Rawlings 2005, p2).

Any fall in grants revenue is aggravated by the restrictions placed upon Local Government to raise its own revenue. Such restrictions include rate pegging; legislative constraints on the fees and charges councils are allowed to levy; non-payment of rates to councils on certain types of property by some state trading enterprises (e.g. State Forests on forest landholdings); and restrictions on borrowings (though loan restrictions are currently not active in NSW, perhaps because most councils have low debt). The generally held view is that the direct consequence of cost shifting without adequate funding means that councils have been forced to make off-setting savings such as under-spending on infrastructure renewal.

Financial effects of responsibility and cost shifting

The extra financial burden placed upon councils by cost shifting is largely unknown. While a substantial amount of literature on the empirical dimensions of cost shifting exists in the United States, actual estimates of the aggregate monetary impact vary widely. It has been further argued that within Australia cost shifting remains a 'thorny issue' and calculating its magnitude is made exceedingly difficult due to the fact that councils keep inadequate financial records and productivity increases must be included (Dollery 2005b, p2).

A number of submissions to the Hawker Inquiry attempted to systematically measure the financial burden placed on councils by cost shifting. The Local Government Association of

Queensland conducted a detailed survey of member councils and reported a net cost to councils of \$47 million annually. The Municipal Association of Victoria provided a detailed analysis of cost shifting in the area of human services and calculated a total cost shift over recent years of approximately \$60 million per annum. Some individual councils also provided estimates.

The Australian Local Government Association (ALGA) estimated that Australia-wide cost shifting from higher tiers of government costs Local Government between \$500 million and \$1,100 million a year (ALGA 2006). However, it is not clear how it arrived at these numbers.

Few councils in their submissions were able to determine an accurate dollar value for all their examples of cost shifting. Exceptions were Newcastle City Council, Dubbo City Council, REROC, Wagga Wagga City Council, Deniliquin Shire Council and Guyra Shire Council.

Newcastle City Council claimed cost shifting amounted to \$4,481,000 annually, which equated to approximately 3.1 per cent of its total revenue (Newcastle City Council 2005, p4).

Guyra Shire Council valued its own examples of cost shifting (Rural Fire Service, unfunded mandates, provision of a doctor, public safety, pensioner concessions, library grants, state government fees and charges) as having a recurrent (as opposed to one-off) cost of \$255,000 per annum. This was equivalent to three per cent of its total revenue (Guyra Shire Council 2005, p3).

One state agency complained that councils were not averse to cost shifting themselves. It gave as an example a council that forced a public-private partnership (PPP) funded school to incorporate a community hall before approving its plans. Nevertheless it is clear from the many discussions the Inquiry had with both state and council officials that almost all the complaints about cost shifting stemmed from Local Government.

The Inquiry commissioned a survey of a representative cross-section of councils to assess the extent of cost shifting from state to Local Government in NSW (Moege 2006).

Councils were asked to estimate the value of cost shifting in each of 20 frequently cited areas and to sum these values as a percentage of total ordinary revenue. The survey determined that total ordinary revenue was the most appropriate denominator to use because all councils define it the same way. The survey used total revenue from ordinary activities before capital revenues as shown in the statement of financial performance of councils' annual reports 2004/05.

Of the 19 councils that responded to the survey, four are classified metropolitan; nine regional and six rural, according to the Australian Classification of Local Government.¹³

The cost shifting areas used by the survey were identified from submissions to the Inquiry as the most financially significant and most often mentioned. Councils were invited to add further financially significant areas of cost shifting if they were important too. These additional areas were accepted where they were considered consistent with the survey's definition of cost shifting. Cost shifting areas included:

¹³ The classification metropolitan councils includes the sub-classifications 'metropolitan developed' and 'capital city'; the type regional includes the sub-classifications 'regional town/city' and 'fringe'; and the type rural includes all rural sub-classifications (see LGI 2005, Appendix B).

- Waste levy;
- Water access licence fee;
- Licence fee for sewerage treatment systems and waste management sites;
- Contribution to the NSW Fire Brigade and the Rural Fire Service;
- Cost of functions under the *Rural Fires Act (NSW) 1997*;
- Discrepancy of actual public library funding to the initial equal share funding agreement between Local Government and State Government;
- Reporting functions under the *Local Government Act (NSW) 1993* (LG Act);
- Cost related to reduction in the funding from the state and/or Commonwealth Government for particular programs (e.g. community and human service programs, flood mitigation program and road safety program);
- Cost related to the reclassification of roads;
- Proportion of mandatory pensioner rate rebates not funded by the State Government;
- Cost related to retaining general practitioners, dentists, nurses and other medical services; and
- Cost related to the expansion of state imposed functions in various areas (e.g. on site sewerage management, *Companion Animal Act (NSW) 1993*, contaminated land management, *Protection of the Environment Operations Act (NSW) 1997*, noxious weed control).

Table 4.1 below shows the surveys findings for each council. The findings are expressed as (1) total amount of cost shifting and (2) as a proportion of council's total revenue from ordinary activities excluding capital revenues.

Table 4.1: Proportion of cost shifting in relation to total ordinary revenue for a cross-section of 19 NSW councils, 2004/05

Council	ACLG Cl.	Total revenue from ordinary activities before capital amounts (annual report 2004/05) in \$	Total amount of cost shifting (excluding corporate overheads) in \$	Proportion of cost shifting in relation to total revenue figure in %
<u>METRO</u>				
Pittwater	UDM	49,027,000.00	4,152,136.00	8.47
Willoughby	UDM	63,758,000.00	3,901,016.33	6.12
Bankstown	UDV	105,968,000.00	7,381,582.00	6.97
Warringah	UDV	98,869,000.00	8,941,000.00	9.04
<u>REGIONAL</u>				
Campbelltown	UFV	93,830,000.00	4,544,063.00	4.84
Hornsby	UFV	93,225,000.00	7,026,500.00	7.54
Dubbo	URM	56,600,000.00	4,096,489.00	7.24
Eurobodalla	URM	57,795,000.00	3,068,129.00	5.31
Lake Macquarie	URV	117,722,000.00	9,324,867.00	7.92
Port Stephens	URM	69,303,000.00	2,236,000.00	3.23
Wagga Wagga	URM	58,828,000.00	2,341,217.00	3.98
Richmond Valley	URS	28,328,000.00	1,150,082.00	4.06
Wollongong	URV	142,408,000.00	13,795,326.00	9.69

<u>RURAL</u>				
Cootamundra	RAL	9,990,000.00	536,787.00	5.37
Dungog	RAL	8,702,000.00	872,164.00	10.02
Bombala	RAM	6,312,000.00	343,670.00	5.44
Hay	RAM	6,584,000.00	461,578.00	7.01
Gunnedah	RAV	21,429,000.00	1,321,528.00	6.17
Inverell	RAV	26,053,000.00	1,200,000.00	4.61
Total sample		1,114,731,000.00	76,694,134.33	6.88

Source: Moege 2006

The cost shifting ratio for the complete survey sample is 6.9 per cent of total ordinary revenue. The ratio for individual councils ranges from 10 percent to below four per cent. The findings are reasonably consistent among the three groups of councils (metropolitan, regional and rural).

The cost shifting ratios established from the findings can be regarded as conservative for several reasons. Firstly, although councils were encouraged to add financially significant examples, councils basically worked with the 20 examples listed in the survey. Secondly, the survey asked councils to exclude corporate overheads from the individual cost estimates for each cost shifting item. The addition of corporate overheads could increase costs by around 10 per cent based on the average corporate overheads ratio established by the Inquiry in a separate survey (see Maxwell 2006a and table 10.2). Thirdly, some councils were not able to reliably estimate the cost of individual areas of cost shifting so these areas got a zero costing.¹⁴

The total amount of cost shifting in NSW can be established by applying the figure of 6.9 per cent to the financial data of all NSW councils. The total revenue from ordinary activities before capital amounts for all NSW councils in 2004/05 was \$6,297 million.¹⁵ The total amount of cost shifting in NSW would therefore be about \$430 million.

Council views on cost and responsibility shifting

There was a large amount of concern expressed by councils throughout the Inquiry regarding the impact of cost shifting upon their finances and its direct impact upon infrastructure provision and maintenance. This latter point is particularly relevant given the stakeholder expectations revealed by the IRIS survey, and discussed in section 4.2 following.

Many council submissions argued for a co-operative approach between all tiers of government towards the issue. Councils believed that the Commonwealth, State and Local Governments should work together to establish broad principles regarding the allocation of responsibilities between the different levels of government. There was also a call for more

¹⁴ For example, Wollongong City Council could not estimate the cost related to reporting requirements pursuant to the LG Act. Cootamundra Shire Council could not estimate the figures related to contaminated land management, functions under the *Protection of the Environment Operations Act (NSW) 1997*, *Rural Fires Act (NSW) 1997* and LG Act.

¹⁵ The data was provided by the NSW Department of Local Government on 20 April 2006. The exact figure is \$6,296,801,000.00. The figure does not include data from three councils whose financial data were not available. For one council the total revenue figure for 2003/04 was used.

consultation and impact assessments concerning the effects of new legislative reforms and policies, which involve Local Government.

However, the Northern Sydney Regional Organisation of Councils (NSROC) in its submission to this Inquiry, argued that while steps are currently underway at a Commonwealth level to develop an inter-governmental agreement to address the issue, many facets of cost shifting are subtle, take place over long periods of time, and have multiple drivers which are difficult to identify or refute (NSROC 2005, p4).

The *Subordinate Legislation Act (NSW) 1989* requires the responsible Minister to commission a regulatory impact statement (RIS) on the economic and social costs and benefits of replacing existing regulations with new regulations. An example of such a RIS was one undertaken by Hassall & Associates Pty Ltd for the Department of Local Government on the Local Government (General) Regulation 2005, which was designed to replace 10 existing regulations (NSW DLG 2005e). It disclosed its methodology, presented and analysed various options and consulted widely with stakeholders.

RISs provides some safeguard against the introduction of poorly thought out regulations, but they are subject to exemptions, do not appear to take account of any net costs to Local Government, and do not apply to new legislation that might impact on Local Government. Also, they are not a guarantee that cost shifting will not occur or that third parties such as Local Government will be compensated for any net costs involved.

Remedies

Given that cost shifting is the single issue considered most important by local councils (as reflected in submissions and the questionnaire commissioned by the panel – see Purcell 2006), the panel’s view is that LGSA should consider undertaking an annual survey of the costs imposed in this way.

Option 1: The LGSA undertake an annual survey of all councils to establish the total cost to Local Government of the main regulatory and policy responsibilities imposed by other tiers of government and any changes thereto over the previous year.

Such a survey would obtain estimates of the costs to each council of items including statutory imposts, state or Commonwealth service gaps that have been filled by Local Government, unexpected reductions in the real value of government grants, transfers of assets without compensation for future operating costs, obligations to provide unfounded concessions and rebates, and non-indexing of fees and charges for mandated services. Each council’s chief financial officer would be required to verify that the council’s estimates were soundly based.

The results of such a survey could be furnished to the State Government and those of its agencies that interact most with Local Government. It could also be posted on the LGSA’s website. Each council could also disclose its own results in its own annual report.

Pros

- The LGSA must develop a better understanding of the magnitude of and trends in cost shifting if it is seek any redress under an Intergovernmental Agreement (IGA) with the state and Commonwealth;

- Would encourage all councils to more closely and consistently monitor responsibility and cost shifts by other tiers of government and thereby be in a better position to resist such moves; and
- Would make state and Commonwealth agencies more conscious of the cost burden of regulatory and reporting requirements they impose on Local Government.

Cons

- Cost shifting has proven difficult to measure for those who have attempted it;
- Unless the calculations for each council were done by an independent third party the results might not be credible; and
- State and Commonwealth Governments may pay no more attention to the results than they do to estimates by industry groups of the cost of red tape associated with doing business in Australia.

Another important gap in information is data on State Government grants to Local Government. Ideally, the annual NSW Budget Papers should include a section on State-Local Government relations including state grants to Local Government. This is provided in Victoria, Queensland, South Australia and Tasmania. Alternatively, the NSW Department of Local Government could collect this data as part of its returns from councils and make it available to interested parties including the LGSA.

If neither the NSW Treasury nor the NSW Department of Local Government is prepared to provide this information on an ongoing basis, the LGSA should consider collecting and publishing this data itself since it will be difficult for the LGSA to negotiate a meaningful intergovernmental agreement with other tiers of government if it is not aware what its constituents receive from the State sphere.

Options for dealing with this problem are canvassed under Remedies in section 9.5 of Chapter 9.

Finally, all governments should subject all new legislation or regulations that affect other tiers of government to cost/benefit analysis and include the impact on Local Government. If the Commonwealth and state are not prepared to do this, then the LGSA should consider undertaking a cost/benefit analysis of the likely impact on local councils of any proposed bill or regulation that might significantly affect them so that it could request compensation (even if only in terms of adjustments to rate pegs) for any net costs identified.

4.3 STAKEHOLDER EXPECTATIONS

Councils which made submissions to the Inquiry all argued that changing community expectations placed significant pressure on them to provide new services. Most demands appeared to be in the areas of social, community and economic development services as well as tourism facilities and cultural development. Many of these areas have traditionally been the responsibility of the State Government. Willoughby Council, as an example, identified a demand for increased children's services such as before and after school care, pre-schools and a more secure environment, which involved council employing security firms and installing cameras.

As part of this inquiry IRIS Research was commissioned to conduct a deliberative telephone survey to canvass community expectations on the role of local councils across New South Wales. The survey, which was undertaken in November 2005, specifically addressed issues such as community satisfaction with the delivery of Local Government services and facilities; the willingness of the community to pay higher rates and charges to finance council services and facilities; the perceived value of current levels of residential rates and charges; and attitudes toward community engagement and the process of determining development applications (IRIS 2005).

A total of 912 households, randomly selected from the White Pages, across metropolitan, regional and remote areas of New South Wales, agreed to participate in the survey. Prior to the actual survey each participant received a letter inviting them to participate and explaining the types of activity currently undertaken by Local Government. This avoided the traditional problems associated with 'cold call' phone polling.

The survey asked people to rank council services both by their degree of importance and by their satisfaction with them. The Inquiry was particularly interested in finding out whether there were services that were thought important, but for which there was lower than normal satisfaction.

Importance of council responsibilities

Respondents ranked the following traditional property related services of local councils as most important:

- Waste management;
- Construction and maintenance of local roads, footpaths, kerbing and guttering;
- The provision of commercial services and facilities such as water and sewerage in regional and rural areas, caravan parks, aerodromes, sales yards and gas supply;
- The appearance of public areas including provision and upkeep of local parks and gardens, street cleaning and litter collection and the streetscape; and
- Environmental management including storm water, bush care, maintenance of drains and waterways, noxious weed control and protection of heritage sites.

The following responsibilities were ranked to be of secondary importance:

- Health and human support services including aged, child and youth services, immunisation, community centres, disability and migrant services; and
- Traffic management and parking facilities including council provision of street and off street parking and local road safety.

The less important responsibilities of councils were considered to be:

- Economic development including business and tourism promotion and attracting new business;
- Town planning and processing of development applications;
- Enforcement of orders including food and health, noise, animal control, parking and fire prevention;

- Recreation services and facilities including swimming pools, sporting fields, skate parks and playgrounds;
- Culture and education facilities including libraries, art centres, festivals and playgrounds.

The importance of a number of the key responsibilities varied significantly across locality. For example, culture and education were perceived to be less important in regional areas while economic development activities and the delivery of commercial services were ranked higher than in metropolitan areas.

The poll findings need to be interpreted carefully. The poll has an inherent bias in that it could be expected that highly visible services used by a large proportion of the population on a frequent basis would tend to rate more highly in such a poll.

It is also significant that all services included in the poll were rated as being of high importance by over 50 per cent of respondents. Even the lowest rated service overall, economic development, was rated as either high or medium importance by 78 per cent of respondents. Therefore, it cannot be concluded that any of the services are considered unimportant by the public.

Satisfaction with council activities

The following areas of council activity received high satisfaction ratings:

- Waste management;
- The provision of commercial services and facilities such as water and sewerage in regional and rural areas, caravan parks, aerodromes, sales yards and gas supply;
- Culture and education facilities including libraries, art centres, festivals and playgrounds;
- Appearance of public areas including provision and upkeep of local parks and gardens, street cleaning and litter collection and the streetscape; and
- Recreation services and facilities including swimming pools, sporting fields, skate parks and playgrounds.

Respondents recorded slightly below average satisfaction with:

- Enforcement of regulations including food, noise, animal control, parking and fire prevention;
- Environmental management including storm water, bush care, maintenance of drains and waterways, noxious weed control and protection of heritage sites; and
- Health and human support services including aged, child and youth services, immunisation, community centres, disability and migrant services.

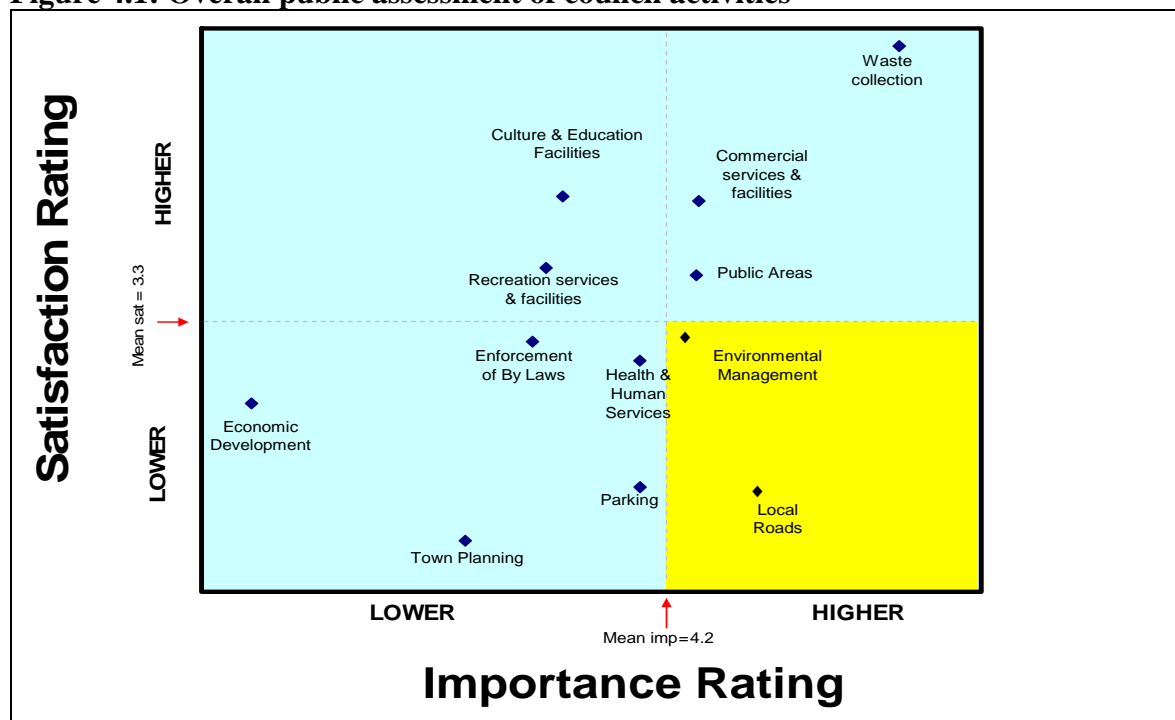
The following council activities received the lowest ratepayer satisfaction ratings:

- Town planning and processing of development applications;
- Construction and maintenance of local roads, footpaths and kerbing;
- Traffic management and parking facilities including council provision of street and off street parking and local road safety; and

- Economic development including business and tourism promotion and attracting new business.

Minimal differences in the level of community satisfaction were evident across different localities. The major difference which existed between metropolitan and regional and rural areas was that metropolitan residents were the least satisfied group in relation to traffic management and parking, economic development and town planning.

Figure 4.1: Overall public assessment of council activities



Source: IRIS 2005, p33.

The above diagram represents a quadrant analysis of the stated importance of a service by residents against their satisfaction with the provision of that service. This diagram shows that waste collection, commercial services and facilities and the appearance of public areas were all activities of councils which residents felt were meeting their expectations.

Important service areas where resident expectations were not being met to the same extent were construction and maintenance of local roads and to a lesser extent environmental management. This is perhaps not surprising since roads, bridges, pavements, kerbing, street lighting and storm-water drains account for most Local Government infrastructure, which the Inquiry has found to be seriously degraded and in need of renewal (see Chapters 6 and 11).

The public clearly wants higher priority given to traditional council activities, especially the upkeep of roads, streets, pavements, kerbs and related infrastructure. A 'back-to-basics' sentiment is evident in the polling results. However, the poll results do not support a conclusion that the public wants councils to withdraw or curtail any of the other services they currently provide. As noted above, the majority of respondents considered all services important and as discussed below, only 24 per cent support a cut in services rather than an increase in rates.

Local Government performance and value

Overall, 50 per cent of residents surveyed rated their level of satisfaction with their local council as high while 35 per cent rated their satisfaction levels as medium and 15 per cent rated it as low. The majority of residents (80 per cent) considered that what their councils provided represented good value for money vis-à-vis rates and charges.

Around 70 per cent of residents had a medium to high level of support for the idea of raising rates rather than cutting services, although it must be noted that support for this proposal was strongly related to the income of the household, with highest support amongst residents with a combined household income of \$100,000 or more. However, only 24 per cent of residents strongly supported a cut in services over a rise in rates. It is clear from these results that the majority of stakeholders in the community would rather pay more for services than have the level of services cut back.

There was a mixed response to whether councils should set their own rates and charges. 36 per cent of residents said that they trusted their councils to perform this task while 37 per cent disagreed with the concept. The remaining 25 per cent were indifferent. Residents were reluctant to nominate areas in which they believed their councils could spend less. The majority (41 per cent) was, however, critical of the level of community consultation councils undertook. From these results, the Inquiry could draw one of two conclusions: either that there is no clear consensus as to whether councils should be free to set their own rates and charges or that a clear majority (61 per cent) would support or feel indifferent about the removal of rate pegging.

On the contentious issue of how building and development approvals are handled by Local Government, almost 36 per cent of respondents supported the option of an independent panel of planners to assess and process building and development applications while 26 per cent supported the option of councillors performing the task following receipt of advice from an independent panel. While 22 per cent of respondents supported professional council staff undertaking the approval task, only nine per cent supported the existing arrangement in most councils, where councillors alone determine important building and development applications.

The LGSA's response to these findings was:

These findings provide a valuable insight, but are inconclusive. While 36% have indicated a preference for some sort of independent panel, 57% have indicated a preference for determination by other means (i.e. by councillors after advice from an independent panel, by council professional staff or by councillors only). This could be interpreted as majority support for current processes, as all three of the latter methods are currently employed by councils. The majority of DAs are already determined by council staff under delegation, a number of councils already utilise independent advisory panels and only a very small proportion of total DAs are determined by councillors.

The Inquiry's view is that the survey results show a strong public preference for councillors not to arbitrate on DAs or to do so only after advice from an independent panel.

Other polling evidence

The IRIS results can be supplemented with the findings of a smaller opinion poll conducted by McGregorTan in March 2004 (LGSA 2004).

This survey examined the perceptions of 500 randomly selected NSW residents on a range of issues including trust, performance and value for money of the three tiers of government in Australia. The main findings were:

- 45 per cent placed greatest trust in councillors, 36 per cent in Federal MPs and 20 per cent in State MPs;
- For the best performing sphere of government, 41 per cent chose the Commonwealth Government, 35 per cent Local Government, and 24 per cent State Government;
- In terms of which sphere of government provides the best value for money, 42 per cent nominated Local Government, 33 per cent Commonwealth Government and 25 per cent State Government;
- Services people wanted Local Government to spend more on were road maintenance (31 per cent), crime prevention (14 per cent) and home care services for the elderly (13 per cent);
- Of those respondents who wanted councils to spend more money in certain areas, 44 per cent indicated they were prepared to pay higher rates, nine per cent were uncertain and 47 per cent were opposed to contributing extra;
- Services that councils are best placed to provide in order of nomination by respondents were libraries (86 per cent), child care (66 per cent), home care services for the elderly (65 per cent), monitoring pollution (54 per cent), managing school grounds/buildings (45 per cent), crime prevention (39 per cent), food safety inspections (38 per cent) and business services/economic development (37 per cent); and
- Residents clearly wanted to know about development applications and the closer the proposal was to their home, the more insistent they were about notification.

The McGregorTan results reinforce the IRIS Research findings on the high level of confidence that people have in their local council and the interest they take in development applications. By contrast McGregorTan found less support for raising rates to pay for extra services. It should be stressed that the McGregorTan poll covered a smaller sample size than the IRIS Research poll so its results are not as statistically significant.

4.4 INDEPENDENT STANDARDS

In tandem with legislative and regulatory obligations, Local Government has increasingly been required to conform to a number of key professional standards and practices. These include:

- The Australian Accounting Standards Board's financial reporting standards;
- The NSW Local Government Managers Association Health Checks; and
- Standards Australia's Standards.

Australian Accounting Standards Board (AASB) Standards

The AASB Standard, *AAS 27: Financial Reporting by Local Governments* is the mandated accounting reporting standard for Local Government in NSW. It therefore guides the financial reporting of all local governments in NSW.

The AASB is currently in the process of withdrawing this Standard (along with *AAS 29 - Financial Reporting by Government Departments*, and *AAS 31 - Financial Reporting by*

Government). Given improvements in the quality of financial reporting by local councils since AAS 27, AAS 29 and AAS 31 were issued the AASB has decided to allow other Australian Accounting Standards on their own to apply to Local Government. The AASB intends to seek comment on the date of withdrawal of Local Government specific accounting standards, which is proposed as the year ending 30 June 2007.

Local Government Managers Association (LGMA) health checks

The LGMA provides local councils with two ‘health checks’: the *Sustainable Finances Health Check Manual*, and the *Governance Health Check self-audit guide*. A third, the *Sustainability Health Check* is currently in draft form.

The Health Checks are internal self-assessment tools developed with the relevant stakeholders. They are not mandatory.

The *Sustainable Finances Health Check* is designed to provide a snapshot examination of Local Government finances looking at revenue sources and various indicators such as cash liquidity position; operating result; asset renewal expenditure; debt collection ratio; collection performance; re-votes of expenditure; accuracy/timeliness of financial data/budget/compliance. The tool provides indicators and rating guidelines (red, amber, green) for each indicator. It acts as a diagnostic tool, which assesses actual performance.

The *Governance Health Check* has been prepared in partnership with the NSW Independent Commission Against Corruption and looks at areas such as ethics, values, risk management, internal control, decision-making, monitoring and review. It assesses and rates councils against best practice criteria.

The *Sustainability Health Check* is still in draft form. It is a result of collaboration between the LGMA and the Department of Environment and Conservation. It aims to identify and measure council performance against best practices processes and benchmark outcomes. It has a holistic focus on sustainability and adopts a triple bottom line reporting approach. A discussion paper has been developed and circulated to the membership and key stakeholders. Pilot councils have been selected to review the SHC Manual from November 2005 to February 2006.

Australian Standards

Australian Standards (produced by Standards Australia) which are used by Local Government are divided into two basic categories: standards used to guide works and infrastructure services and maintenance; and standards for management improvement which help Local Government improve its management capability and deal with issues such as quality management, risk management and governance. They are not mandatory unless backed by government legislation. In the case of councils some public works technical standards become mandatory because they are a condition of funding (e.g. RTA payments for maintenance of roads).

Australian Standards used for works and physical infrastructure services

The key standards used in relation to works and physical infrastructure are:

AUS-SPEC – this standard is published jointly by Standards Australia and the IPWEA. AUS-SPEC is a suite of over 150 specifications most of which have state based variations, bringing the total number of specifications to over 800 for Australia. The AUS-SPEC suite directly references over 500 standards.

Works undertaken by, or on behalf of, councils need to be compliant with these standards. The standards include a host of maintenance standards as well as broader management standards particularly a Quality Management System, an OHS Management System, and an Environmental Management System. AUS-SPEC is being extended in its coverage from the current design, construction and maintenance to cover other elements of the asset life cycle including planning, operations and renewal.

Where used for road works, AUS-SPEC complements AUSTROADS and state authority specifications.

AUSTROADS – this is a suite of approximately 360 specifications which represent consensus amongst the state and territory road authorities of Australia. Each state road authority has hundreds more individual specifications. Local Government and state authorities for road construction use the AUSTROADS and NSW Roads and Traffic Authority (RTA) specifications. These specifications reference over 500 Australian Standards. The RTA requires conformance with these guidelines by its contractors, including councils, before they are paid. Like AUS-SPEC, AUSTROADS and RTA specifications include maintenance standards and broader management standards particularly on Quality Management, OHS Management, and Environmental Management Systems.

Australian Standards for management improvement

The key standards here are:

- AS/NZS ISO 9001 & 9004 Quality Management Systems;
- AS/NZS 4801 & 4804 Occupational Health and Safety Management Systems;
- AS/NZS ISO 14001 & 14004 Impact on the Natural Environment;
- AS/NZS 4360 Risk Management;
- AS 8000 Corporate Governance;
- AS 5037 Knowledge Management;
- AS/NZS 4581 Management System Integration;
- AS/NZS 7799 & AS 13335 IT Security; and
- AS ISO 15489 Records Management.

They are expected to be applied by all organisations whether public, private or not-for-profit, including councils.

Views on standards

A study undertaken on behalf of the Inquiry (Cranko 2005) has identified a number of key issues in relation to councils' use of standards.

Firstly, it is argued that there is a dichotomy between compliance and performance improvement. It is suggested that most councils comply with standards to limit potential liability. However, this does little to encourage actual performance improvement.

Secondly, due to the fact that local councils are subject to such a multitude of standards related checks and reviews, councils tend to respond to them all in a piece-meal way, with different parts of each council responding to different sets of standards. Therefore standards are not used strategically as tools to help achieve better performance.

Thirdly, it is argued that whilst there is widespread consensus that standards and best practice guidelines are important to set base-line benchmarks and drive improvement, it is difficult to be definitive about the most appropriate standards for Local Government management and operations.

This study also points out that irrespective of the particular combination of standards used, there is a correlation between performance and the use of integrated management frameworks. Leading councils in NSW have tended to demonstrate the use of a broad organising framework such as the Australian Business Excellence Framework (ABEF) to help them integrate their preferred standards, health checks, etc. in a way that helps them improve their performance.

The absence of relevant financial and non-financial performance information is also noted. It is felt that many of the tools go some way to assisting with the development of outcome focused good practice frameworks. However, there is a strong view that these tools do not provide adequate financial and non-financial performance information that could be used for benchmarking an organisation's results against best practice.

Councils which submitted to this inquiry generally recognised the importance of compliance with standards. However, many appeared to be struggling with the additional financial and administrative burden they imposed. Narrandera Shire Council, for example, submitted that:

While these standards were part of a process aimed at achieving better outcomes, funding to implement, monitor and report on systems has not been in proportion to the costs incurred by councils. (Narrandera Council 2005, p6)

The extra financial and administrative costs of meeting increasing numbers of more sophisticated standards are further exacerbated by skills shortages, particularly in regional and rural areas. For example, Dungog Shire Council argued that attracting and retaining qualified and experienced staff was becoming extremely difficult given that the council was situated within a mining belt and could not possibly compete with the remuneration levels offered within the mining sector:

This council does not have the financial flexibility to compete with the private sector and other government instrumentalities and the loss of experienced staff is a major blow in terms of council delivering services in the future. This is aside from the inability to recruit staff into senior professional roles within council. (Dungog Council 2005, p6)

A study of corporate overheads costs of councils by this Inquiry found that they were very lean compared with best practice benchmarks used in State Government. (Maxwell 2006a) This would suggest that councils are either super-efficient (since middle and back-office costs tend to be high in poorly run organisations) or they are seriously understaffed to meet

expanding statutory requirements and professional standards and to introduce good management practices (e.g. strategic planning and budgeting, total asset management and management information systems). This problem may be most acute in smaller and more remote rural councils that have difficulty recruiting professional help. The DLG has done a recent survey that bears out that there is a skills shortage in Local Government, especially of planners, but the survey did not distinguish between back, middle or front office staff (DLG 2005f).

4.5 EMERGING CHALLENGES

There are major changes and trends occurring that will pose difficult challenges for Local Government in New South Wales in future years. Most of these challenges have already begun to emerge and impact upon councils and will require careful planning and management.

Demographic changes

It is a well-known fact that Australia's population is ageing. Over the previous 100 years the proportion of over 65-year-olds in the population has increased from four per cent to 12 per cent. If the current trends in fertility rates (low) continue, and life expectancy also remains constant, it is predicted that by 2031 the number of over 65 year olds will rise to 22 per cent of the population. (ABS 2002)

At the same time, a trend has emerged which sees retirees moving away from metropolitan areas to coastal or regional areas. This trend is accompanied by a general drop in younger entrants into the workforce as well as a consistent pattern of young adults moving from country and coastal areas to main regional urban centres or metropolitan areas such as Sydney. (National Sea Change Taskforce 2005b, p3)

Changing demographics have also been associated with other social issues in coastal and country communities such as lower incomes and higher rates of unemployment, particularly amongst youth, which are exacerbated by rises in local property prices in areas popular with tourists.

There have been a number of initiatives undertaken to attempt to address the demographic challenges facing governments due to the ageing population. Those relevant to New South Wales include:

- **The National Strategy for an Ageing Australia** – this strategy aims to provide a co-ordinated national response to issues around population ageing and to ensure quality of life for older people, harmony between the generations and positive outcomes for the whole population.
- **The Australian Local Government Association Population Ageing Action Plan 2004-08** – This plan has been developed with support from the Commonwealth Department of Health and Ageing and in consultation with state Local Government Associations and individual councils. Its key elements involve: building awareness; encouraging Local Government action; fostering partnerships; improving information access; and monitoring and evaluation.

- **LGSA Ageing and Place 2004** - *Planning the Local Government response to ageing and place*. This paper offers a possible framework to assist councils begin to plan for the population ageing unique to their area. It provides information on what is happening with general population trends and access to population projection information for each Local Government area.

While many of the costs of ageing will fall to the Commonwealth and state governments, the Department of Transport and Regional Services has identified major challenges for Local Government in the following five areas:

- Planning for strong growth in ageing populations in certain localities;
- Providing an adequate standard of basic infrastructure;
- Providing an adequate and appropriate range of Local Government services;
- Managing the financial impact of the growing number of retirees; and
- Harnessing the skills, wealth and business acumen of older people. (DOTARS 2005, p112)

Demands for better infrastructure and service standards

The ‘seachange’ and ‘treechange’ phenomena of older metropolitan populations moving to coastal and rural areas generates not only an increased demand for new infrastructure and services, but also an expectation of higher quality infrastructure and services, as highlighted by Bega Council in its submission to the NSW Standing Committee on Public Works (2005, p15)

In coastal areas where growth is driven by an exodus from large metropolitan centres a significant elevation of community expectation follows. From towns and villages council is constantly bombarded with calls for improved roads, footpaths, kerb and gutter, cultural facilities, heated swimming pools, better libraries, parks and recreation areas... In the rural areas the winding gravel road to an idyllic retreat for weekends away soon becomes the bane of that same person’s existence as a new resident. Potholed and corrugated to shake vehicles apart, dust to invade every nook and cranny, and soon the calls on council to ‘fix up the road’ begin.

In addition, age-specific planning is required by these councils for items such as the provision of aged care facilities and aged access to public buildings. The mobility needs of this segment of the population will also have to be given more focus in building and town design.

Local Government is responsible for a large amount of basic infrastructure such as water and sewerage, storm water drainage, waste disposal, and roads and footpaths which will need to be either replaced or upgraded to deal with an older population. Many inland country councils and coastal fringe and regional councils do not presently have the quality of infrastructure to deal with a rapid influx of older residents. Neither are they equipped to deal with the corresponding environmental impacts.

The National Sea Change Task Force found that few coastal locations across Australia have adequate infrastructure or access to potable water to handle their growing populations. The task force estimated that coastal population is expected to increase by one million in the next 15 years with coastal growth rates at two per cent a year compared to the 1.2 per cent national average.

Councils will need to ensure that as the population ages the types of services that they provide continue to match demand. Such services will include home and community care services, health care and promotion, safety and security, and appropriate recreational services.

Managing the financial impact of the growing number of retirees

Demographic change will affect not only council expenditure, but also revenue raising capacity. This will be in the form of rates and other pensioner concessions. In New South Wales all councils are currently required to provide concessions to pensioners on their council rate charges. This can be contrasted with South Australia where only three per cent of councils offer rate concessions. (Productivity Commission 2005, p12) In New South Wales pensioners are allowed a maximum flat rebate of \$250 on general council rates and \$87.50 each for water and sewerage charges. Only 50 per cent of the rebate is recoverable from the State Government.

Pensioner concessions therefore impact directly upon councils' ability to provide infrastructure and services, especially in areas with rapidly growing retiree populations. Eurobodalla Shire Council, for example, submitted that 24 per cent of properties within its area are currently subject to pension rebates and this is growing at a rate of five per cent each year. (Eurobodalla Council 2005 p16) A recent report by a NSW Parliamentary Committee recommended a State Governmental review of funding options relating to coastal councils including the impact of pensioner rebates on council revenue (NSWPLA 2005, p.xvi).

Harnessing the skills, wealth and business acumen of older people

Currently around 20 per cent of retirees are self-funded. Many retirees are also well educated, skilled and have significant business experience. It will become increasingly important for councils to deepen their understanding of the skill base of their local communities and to improve their methods of community consultation in order to capitalize on what retirees can offer to their communities. Harnessing the skills, wealth and business acumen of older people using government by network models (Goldsmith and Eggers 2004) should be fully explored by councils, particularly in coastal and other growth areas that attract retirees.

Economic changes

Rapid economic change, and changes in the structure of the Australian economy, pose considerable challenges to all tiers of government, including Local Government (O'Connor, Stimson and Daly 2001). The decline in manufacturing industries and rise in knowledge-based activities have resulted in an uneven distribution of wealth and economic activity across regions, and even changes in the concept of 'employment' and resulting demands for specifically zoned growth centres.

There is now a demand for Local Government to take a lead in stimulating economic growth in areas affected by economic decline and to manage economic growth in regions enjoying economic prosperity. This requires the formulation of coherent development strategies to harness regional strengths in declining areas and encourage the growth of new industries.

It was evident in many of the submissions to the Inquiry that councils are currently grappling with these issues. Shoalhaven Council, for example, has adopted an economic strategy which focuses on: infrastructure; development; liveability; and economic capability. Outcomes are

aimed at fostering business growth and capability, jobs growth, the encouragement of public and private investment and higher levels of tourist visitation. (Shoalhaven City Council 2005, p8)

However, councils outside metropolitan areas argued that they required assistance to broaden their economic base in the form of industry friendly infrastructure such as telecommunications, transport and freight facilities, and skilled local workforces. This is particularly pertinent in the light of increased levels of home-based employment, including 'telecommuting', which sees professionals increasingly choosing residential locations to suit lifestyle goals rather than proximity to work. Lifestyle choices made by those still in the workforce are as much part of the 'sea/tree change' population shift to coastal areas, and regional areas with good access to cities, as is the increasing proportion of retirees in the population (NSW Standing Committee on Public Works 2005)

Environmental challenges

Environmental concerns and environmental protection already form part of the core business of NSW Local Government. This area is not only characterised by legislative complexity, but also by its policy dilemmas and the financial impost of acquiring specialised staff to tackle environmental issues. The difficulties experienced by Local Government are likely to become more acute, especially as the imperatives of growing urbanisation and demographic shifts clash with environmental goals.

Legislative requirements and community demands already ensure that Local Government has a strong focus on environmental issues. However, growth management strategies are essential in regions with fast growing populations to ensure carefully planned and sustainable development. These environmentally sensitive growth strategies must also ensure that lower income residents are not displaced.

Environmental requirements place additional costs on traditional infrastructure provision. As noted in the NSW Parliamentary Committee on Public Works (2005, p59):

New infrastructure often causes degradation so that supplementary infrastructure is demanded to mitigate these effects. For example, new road infrastructure now has to be supplemented with recreational and wildlife corridors and specialist stormwater solutions to limit downstream runoff contamination into waterways.

The National Sea Change Task Force observed that current levels of development are placing many coastal environments at risk of serious degradation. Concern was also expressed about the loss of agricultural land and other significant environmental challenges in relation to availability of potable water and the disposal of wastewater and solid waste (National Sea Change Taskforce 2005b, p37). For instance, coastal growth areas traditionally dependent on septic tanks (e.g. Manyana on the south coast) have experienced the appearance of slimy green algae on seaside rock platforms, possibly as a result of sewerage contamination of the groundwater.

The Task Force considered that these issues could only be addressed through a commitment on the part of local, state and Commonwealth governments to work collaboratively to ensure that development occurs in a sustainable way.

The complexities of the future environmental demands facing Local Government are manifold. Two salient examples serve to illustrate the onerous problems that will have to be confronted. Firstly, environmental concerns over water and wastewater issues loom large. According to the Australian Bureau of Statistics (2003), 49 per cent of all water emissions and 42 per cent of land emissions were produced by the water supply, sewerage and drainage services sector. Similarly, 72 per cent of Australia's waste water (used for some purpose then usually treated) was disposed of into coastal waters, 17.5 per cent to inland waters, 9.5 per cent to land and only one per cent was directly reused.

This costly and complicated problem will have to be resolved in future. In 1999/2000 Australia-wide, current expenditure on wastewater management was \$649m, with capital expenditure at \$394m. Obviously, greater future efforts will impose much larger costs (ABS 2003).

Secondly, solid waste management also presents a difficult challenge. For instance, 21.2 million tonnes of solid waste were received and disposed of at landfills throughout Australia in 1996-97. This amount was approximately evenly distributed between privately operated and Local Government operated landfills. Future solid waste disposal will thus have to embody a greater recycling component (ABS 2003). In 1991, two councils collected steel cans for recycling. By the end of the year 2000, 375 councils were participating in steel can recycling. This represented an increase from 0.01 per cent in 1991 to 40 per cent in 2000.

In sum, in 1999-2000, Australian Local Government current expenditure on solid waste management was \$1,048m, while capital expenditure was \$96m. Total current environmental protection expenditure by Local Government was \$1,899m, while capital expenditure was \$607m (ABS 2003). Additional efforts in this area will clearly produce substantial benefits but will also impose financial costs on councils.

Community issues and challenges

Australian society is undergoing a process of fundamental change that will also pose severe challenges for Local Government in future (Smyth, Reddel and Jones 2005). For instance, the decline of the traditional family and associated social trends means that the number of people per household is falling steadily. With more households as a proportion of the population in any given municipality or shire; per capita council costs of providing property related infrastructure and services must rise as a consequence.

Moreover, the emergence of an urban 'underclass' of poorly paid or unemployed single parents will increase demands on councils in areas outside of their traditional service provision, especially in terms of human services. Changes in the composition of the population as a result of large-scale immigration will mean changes in the mix of council services, particularly to meet diverse demands for the recreational needs of different cultures.

In addition, public concern over rising crime and disorder in public streets and municipal facilities have already led to demands for councils to appoint security personnel and install security cameras and this process seems likely to intensify. In sum, Local Government will require additional capacity and flexibility in future to cope with social challenges of this kind.

Finally, rapid technological change and the so-called information revolution present NSW Local Government with interesting challenges and opportunities. Considerable progress has

already been made in adopting IT processes, developing online service delivery, and fashioning ‘virtual Local Government’, but in this rapidly changing field new methodologies constantly emerge that could be useful to councils and thus require ongoing assessment. Also, the poor quality of broadband internet services in rural shires is a problem for many councils and their residents.

5. THE ROLE OF LOCAL GOVERNMENT

5.1 INTRODUCTION

This chapter considers the role of Local Government in relation to various aspects of the Australian federation.

The chapter is divided into six main parts. First it explores how Local Government fits into the overall federal system of government from both financial and functional perspectives. Next it discusses the question of national constitutional recognition of Local Government. Then different views on the most appropriate role for Local Government are examined. This leads into a consideration of whether Local Government should be financially self-sufficient and under what conditions it should receive financial assistance from higher tiers of government. Finally the chapter looks at the potential for Intergovernmental Agreements (IGAs) in settling the role of Local Government in NSW and the extent to which it should control its own destiny.

5.2 LOCAL GOVERNMENT IN THE AUSTRALIAN FEDERATION

Requirements

The central problem that must be faced by all federal countries is the assignment of expenditure functions and revenue raising powers between the different tiers of government. A solution to this problem exists in the form of the well-established theory of fiscal federalism and the principle of 'subsidiarity' (Dollery 2005c; Kasper 2005). According to this model, each level of government should be assigned expenditure functions that most affect their area of jurisdiction. Thus, central government should cover matters that are best dealt with nationally such as national roads, defence, macroeconomic policy, social security, labour markets, corporate regulation and interstate and global environmental issues.

State governments should tackle issues with a statewide or major regional benefit, such as regional roads, public transport, police, prisons, courts, major teaching hospitals and tertiary education institutions whereas Local Government should deal with services that impact local communities, like local infrastructure (particularly roads), recreational facilities, parks, local planning and development approvals, waste disposal, primary and secondary schools, local hospitals and local emergency services.

A guiding principle in the assignment of expenditure functions is the subsidiarity principle, which holds that any given function should be assigned to the lowest tier of government compatible with its efficient operation. This principle further suggests that where uncertainty exists as to the assignment of a particular function, it should be allocated to the lowest tier of government that can effectively provide the service.

Regarding the financing of expenditure functions, the theory of fiscal federalism advances the 'correspondence' principle. This holds that each tier of government should finance its own expenditure functions since the beneficiaries of given public services should meet the costs of those services. That also ensures that the level of government that faces the pressure to increase or contain services similarly faces the pressure to reduce or contain taxes and thereby

needs to balance both sides. Where an expenditure function generates benefits (or harmful consequences) for people outside the jurisdiction of the government providing the services, then other governments should assist in financing the provision of the service through financial assistance in the form of subsidies (or taxes) and intergovernmental grants. For example, State Government should assist in funding Local Government infrastructure with statewide benefits, such as important interconnecting roads.

Similarly, where a higher tier of government obliges lower levels of government to provide stipulated services or prescribed service levels on equity or efficiency grounds, then it should finance those services. For instance, if state governments force councils to meet specified state regulatory standards or mandate them to provide a new service, then the state should meet the resultant cost.

In sum, in a democratic federal system the role and expenditure functions and associated regulatory and revenue raising powers of each tier of government should be clearly stated in the national constitution or in legislation agreed between each tier. Under the principle of 'subsidiarity' the lowest possible tier of government, except where other levels of government can undertake these functions more effectively, should deliver all public functions.

Moreover, under the correspondence principle each tier of government should have revenue raising and regulatory powers commensurate with its expenditure functions. In other words those who do the spending should do the taxing.

Finally, the revenue level and hence expenditure capacity of each individual unit of Local Government should be decided by its elected representatives, unless restrictions have been put on their authority through local referenda.

Reality

In common with several other advanced countries, including Canada, Germany and the USA, Australia's political structure is organised along federal lines, with a dispersion of governmental functions between the Commonwealth Government, state and territory governments and the various state local government systems. Moreover, Australian federalism exhibits both the common problems of vertical fiscal imbalance (VFI) and horizontal fiscal imbalance (HFI) between the three tiers of government, although VFI is especially acute in Australia's case, with the Commonwealth Government collecting more than 80 per cent of all government revenue.

Australian Local Government has traditionally had a narrow focus delivering a comparatively limited range of services and spending only about five per cent of total government own purpose outlays. By contrast in most other federal systems Local Government accounts for a much larger share of the public sector; USA (25 per cent), Canada (18 per cent), Germany (14 per cent) and Brazil (12 per cent) (Brown 2002b, p28)

Because Australian Local Government has no formal constitutional status, it has been described as a 'creature of statute' at the mercy of State Government legislation. Its role and functions thus depend on legal foundations that can be readily changed to alter the purpose and focus of Local Government.

In an ideal world, the principles of fiscal federalism would ensure the most effective assignment of governmental roles possible in a federation. However, in practice, all countries inherit constitutional structures that embody historical compromises that deviate from the fiscal federalism model. Under the Australian Constitution, Local Government is a state responsibility, and each state provides the legislative and regulatory framework for its own Local Government system. As a result, substantial differences exist in the role of local authorities in the respective states. The Commonwealth Government has recognised the importance of Local Government, and provides funds for various municipal activities through the *Local Government (Financial Assistance) Act (Cth) 1995*.

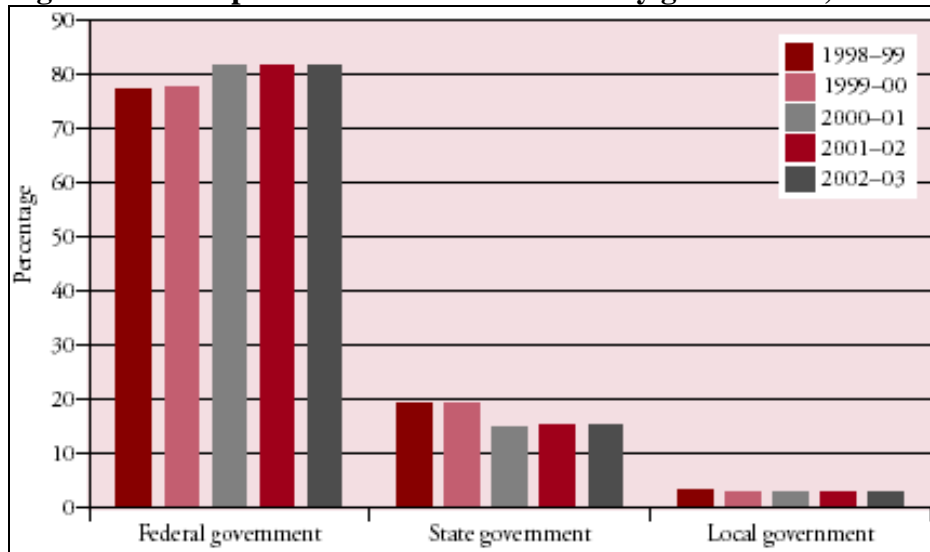
The existence of acute VFI and HFI in Australian fiscal federalism, and attempts to ameliorate these problems, have introduced a high degree of complexity into determining the roles and functions of the three tiers of government. VFI occurs when one level of government raises more revenue than it requires for its own purposes (i.e. Commonwealth Government) and another level of government raises less than it needs (i.e. local and state governments). HFI occurs if different governments at the same level in a federation (e.g. different councils) possess unequal capacity to provide public services.

Figure 5.1 illustrates the composition of taxation revenue accruing to Commonwealth, State and Local Government. Recently released ABS data (ABS 2006) shows that in 2004-05 Local Government taxation comprised just 2.9 per cent of total taxation revenue, down from 3.1 per cent in 2001-02. Commonwealth taxation revenue, including taxes from other levels of government and Commonwealth public corporations, on the other hand, rose 9.3 per cent from \$210bn in 2003-04 to \$229bn in 2004-05. In 2004-05 Commonwealth taxation represented 82.3 per cent of taxation revenue for all levels of government.

Since the Commonwealth Government collects over 80 per cent of tax revenue, but spends much less, revenue (tied to GST collections) is passed onto the states under an allocation system determined by the Commonwealth Grants Commission.

The Commonwealth Government also finances Local Government activities indirectly through financial assistance grants (FAGs) passed on to the states whose Local Government Grants Commissions then distribute them to councils. Direct financial assistance is provided through specific purpose payments (SPPs), most notably the Roads to Recovery program. Similarly, because different councils in each state have different capacities in terms of revenue accrual, and since different councils face different costs in service provision, HFI between individual councils is often pronounced. Local Government Grants Commissions have devised formulae in attempts to alleviate this problem and enable all councils to meet minimum service levels.

Figure 5.1: Composition of taxation revenue by government, 1998/99 to 2002/03



Source: ABS 2004, table 2.

Although Australian Local Government raises around 80 per cent of its own revenue, which would suggest that it is not as severely affected by VFI as state governments (which raise only just over half their own income), it is not the master of its own destiny within Australian federalism.

Firstly, Commonwealth and state governments can exert pressure on councils to take on additional responsibilities on an ad hoc basis, often duplicating service delivery. For example, the Commonwealth Government decision to transfer responsibility to Local Government for local airports was accompanied by only initial (and not ongoing) funding.

Secondly, state governments do not always pass on additional revenue intended for Local Government that they receive from the Australian Government. For instance, national competition policy (NCP) payments are shared with Local Government in some states, but not in NSW.

Thirdly, ‘cost-shifting’ can occur when new responsibilities are introduced, funding arrangements are altered, mandated responsibilities under-funded, or when funding simply ceases (e.g. long-term reduction in state grants for council libraries).

Fourthly, financial incentives derived from inter-governmental funding arrangements can generate perverse incentives for local governments to expand service provision to secure additional monies, often with time limitations. For example, state governments often run programs providing ‘seed funding’ to councils for an initial period to set up specific projects. Councils are thus encouraged to start programs they might not be able to finance over the longer run.

Finally, many small municipalities in rural and remote areas have become heavily dependent on grant income, especially where roads constitute the largest expenditure responsibility - a problem discussed in more detail below.

In NSW, these complexities are extended through state government constraints on the revenue-raising capacities of councils, especially through the imposition of rate pegging¹⁶ and the regulation of the levels of charges and fees¹⁷, as well as the need to seek NSW government approval for substantial borrowing. Together with the extensive externalities associated with many Local Government services that necessitate financial assistance from the Commonwealth and state governments, in terms of fiscal federalism anyway, these income constraints mean that the correspondence principle cannot be presently applied to councils in NSW because many councils simply cannot raise adequate funds.

The existence of VFI and HFI prevents the full application of the correspondence principle and makes intergovernmental grants between the tiers of government in Australia essential for the operation of the public sector.

But what about the principle of subsidiarity? A critical justification for this principle resides in the belief that lower tiers of government are ‘closer’ to their constituents and therefore more able to determine what they want. Since this allows service provision to mesh more closely with public tastes, service effectiveness is enhanced. In terms of this principle, public services with uncertain benefit distribution impacts should be devolved to the lowest tier of government capable of delivering them, regardless of the ability of those governments to fund service delivery themselves, since gains in effectiveness can justify intergovernmental grants and other monetary transfers from higher tiers of government.

A second justification for subsidiarity, adopted in the 1985 European Charter of Local Self-Government, holds that local governments should be as small as possible so as to allow local communities to enjoy local democracy.

These theoretical considerations aside, contemporary Australian Local Government trends are awash with examples of the principle of subsidiarity in practice. For example, in NSW the Commonwealth and State Governments often oblige councils to implement new regulatory regimes, such as the *Companion Animals Act (NSW) 1998*, and to offer new services as envisaged in the requirement on councils to have a social and community plan.

In addition, in NSW the withdrawal of many State Government and private services from rural areas has obliged councils to provide services such as medical centres and banking facilities themselves. Similarly, despite efforts by state governments to amalgamate small councils, most councils remain small. In other words, subsidiarity thrives in contemporary Australia, despite its negative financial implications.

Should Local Government be entrusted with additional responsibilities in terms of subsidiarity? Two lines of argument suggest not. Firstly, given the present capacity of Local Government (as mentioned earlier it is only five per cent of the Australian public sector), it is doubtful that it could take over many of the functions traditionally undertaken by the NSW State Government, such as hospitals, schools, police and courts. Moreover, evidence exists

¹⁶ Rate pegging refers to the NSW Government determining the amount by which councils can raise their annual income from rates set as a fixed proportion of council’s total rate revenue. The limit is set by the NSW Minister for Local Government pursuant to his or her powers under the LG Act; see Chapter 9, section 9.2.

¹⁷ The upper level of certain charges and fees is determined by regulation, mainly to the *Local Government Act (NSW) 1993* and the *Environmental Planning and Assessment Act (NSW) 1979*.

that councils may be more prone to ‘government failure’ than their state and Commonwealth counterparts (Byrnes and Dollery 2002b).

Secondly, the IRIS Research Report (2005) commissioned by the Inquiry indicates that most people feel functions of ‘primary importance’, which coincide with the traditional ‘services to property’ orientation of Australian Local Government, should form the core of council service provision. There is therefore no popular demand for Local Government in NSW to take over additional roles from other tiers of government.

Remedies

It is evident that the Australian system diverges from an idealised conception of federalism in several ways, most obviously in terms of the mismatch between expenditure functions and revenue raising capacity. This has prevented the application of the correspondence principle and has allowed for subsidiarity only through intergovernmental grants and other financial assistance. Apart from exceedingly unlikely and sweeping constitutional change or the implausible and voluntary handover of substantial funds by higher tiers of government, little can be done about this state of affairs.

However, four more limited policy options present themselves:

Option 1: Free councils to determine their own income by removing statutory limitations on their rates, charges and certain fees (e.g. development application processing fees).

Pros

- Would give councils the flexibility to adjust their rates, charges and fees to meet their service and infrastructure obligations without running an operating deficit;
- Voters, not the State Government should decide what should be the revenue raising capacity of their local council as they do in all other states; and
- The Inquiry’s poll (IRIS 2005) shows that a majority of residents (61 per cent) have either high or medium confidence in their councils setting their own rates and charges and spending the money efficiently on relevant local services.

Cons

- Councils are monopolies, especially in areas where one party dominates local politics, so if they controlled their own rates they might increase them excessively;
- Councils may be less cost conscious without rate pegging and other revenue controls exercised by the state; and
- According to the Inquiry’s poll (IRIS 2005) a significant minority of people (37 per cent) would prefer the state to continue controlling council revenue raisings.

Option 2: Tie rate pegging and regulated charges and fees to a published price or cost index such as the Sydney CPI, NSW GSP cost deflator index or a Local Government cost index.

Pros

- Would make rate pegging more objective and transparent than it is at present; and
- Would prevent a real erosion of rates revenue in years when the Minister might be inclined to put up rates by less than price inflation.

Cons

- Would still deny a council its democratic right to set its own revenue base; and
- Would prevent a catch-up in rates where they have fallen behind other councils or are not sufficient to meet the services demanded by ratepayers.

Option 3: Transfer the decision about rate pegging and regulated charges and fees to the electorate that elects a council.

This could involve rating decisions being made by referenda held in tandem with council elections (to save money). An outgoing council would put a revenue proposal to the community for approving a management and financial plan for the subsequent (say) three years, or even longer.

Pros

- Would ensure that rates, charges and fees were set by the people who pay them; and
- Would force councils to publicly justify why rates and charges need to rise.

Cons

- Could make it difficult to raise rates for initiatives that are not visible (e.g. storm water drains) or whose benefits are not direct (e.g. back-office automation);
- Effective and unbiased communication to the electorate of the merits attached to rate increases could be difficult because a council financial plan and budget is extremely complex;
- Such referenda could become political auctions with candidates promising rate reductions irrespective of actual council needs;
- Unless retiring councillors who supported rate rises not only stood for re-election, but also championed such rises it is doubtful they would be approved;
- An incoming council could find itself bound by the rating policy of an outgoing council although the rating policy may be inappropriate for the policy objectives of the new council;
- Instead of referenda, community engagement and adequate direction as to community priorities in decision regarding rates, charges and fees should be achieved through ongoing consultation about council's budget in the framework of its strategic and management planning process; and
- Might be impractical as councils have to budget annually and need to be able to react in a timely manner to changing situation in order to effectively manage council's function.

Option 4: Deregulate councils' ability to fund capital projects.

This would involve the removal of rate pegging with respect to funding of capital projects. Councils would identify what share of its general income should be reserved for maintenance

and renewal of existing assets and construction of new or upgraded physical assets. A council itself would then adjust this component annually while the remainder of its general income would remain subject to rate pegging.

Pros

- Would encourage councils to dedicate a higher proportion of their general income for fixing the infrastructure renewal backlog, addressing the ongoing annual renewal gap as well as current and future infrastructure enhancement needs (see Chapter 6) while keeping a tight rein on non-infrastructure related operating expenses; and
- Would substantially reduce the need for council to make special variation application and thus reduce the associated cost and administrative burden to both councils and DLG.

Cons

- Might be difficult to quarantine infrastructure spending from other forms of spending without state audits and penalties for transgressions. These could add a layer of complexity to existing revenue controls.

Option 5: Permit rate catch-up.

If deregulating rates was not acceptable, the State Government instead could permit councils whose rates were relatively low when rate pegging started or whose rates did not match peg rises to bring them into line with those councils whose rates are in the top quartile.

Pros

- This would assist the financial viability of those councils that got trapped with relatively low rate levels when rate pegging was introduced in 1977 or which forfeited rate increases in certain years (e.g. periods of drought or economic recession) when their residents' capacity to pay was constrained.

Cons

- Could result in sharp rate increases over a very short time-period.

5.3 NATIONAL CONSTITUTIONAL RECOGNITION

Requirements

A central theme in this chapter is that the assignment of functions between Commonwealth, State and Local Governments should follow the prescriptive principles developed in the standard model of fiscal federalism. Apart from the legitimacy deriving from regular democratic elections, each tier of government should provide those services whose benefits fall within their jurisdictional areas. Thus the Commonwealth Government should provide services with nationwide effects, state and territory governments' services with statewide impacts, and local governments should tackle local service provision. In accordance with the correspondence principle, each tier of government should finance its own service delivery through a mix of taxes, fees, charges and other levies, as it sees fit.

Various exceptions to this general rule exist. For example, where the benefits of services affect people living in adjacent local or wider jurisdictions, intergovernmental grants are justified. In principle, the magnitude of these grants should depend on the magnitude of the benefits involved. Similarly, if higher tiers of government oblige lower levels of government to provide particular services on equity grounds, then these higher spheres should meet the costs of this service provision.

Under ideal circumstances, the constitutional embodiment of these principles in Australian federalism would allow all three democratically elected tiers of government to offer whatever services they desired subject to their ability to raise sufficient revenue to pay for these services. Moreover, each tier of government could impose whatever taxes, charges, fees, and other revenue instruments it wished, in order to fund its activities.

Reality

For historical and other reasons, no country operating under a federal system meets these ideal fiscal federal criteria. Australia is therefore no exception. For instance, in practice, all federal countries exhibit varying degrees of VFI and HFI. This necessitates tax-sharing arrangements of various kinds, including intergovernmental grants and GST sharing in the Australian case.

Historical compromises in the process of nation building have also led to formal constitutional structures that often embody trade-offs, which diverge from theoretical principles. The Australian Constitution is replete with examples. For instance, the founders of the Australian federation followed the American model by enumerating a relatively limited list of exclusive Commonwealth powers, together with a considerable number of concurrent ones, leaving various unspecified residual powers to state governments.

At the time, it was believed that the assignment of taxation powers would guarantee the financial independence of the states from the Commonwealth Government. This proved erroneous and VFI began almost from the inception of federation. With the passage of uniform taxation legislation in the Commonwealth Parliament in May 1942 income tax powers passed over to the Commonwealth. This worsened VFI substantially – a process that has accelerated over the past 60 years (Dollery 2002c).

It must be stressed that the emergence of VFI between the Commonwealth and states occurred despite the fact that the states themselves were intimately involved in designing and negotiating the Australian Constitution, and were formally recognised in the Constitution from the outset. In other words, explicit constitutional recognition has not protected the financial self-sufficiency of the states.

The historical position of Australian Local Government is different from that of the states since Local Government enjoys no national constitutional recognition at all. Aulich and Piestch (2002 p15) contend that the omission of Local Government from the Australian Constitution can be ascribed to five main factors:

- The anxiety of the colonies over the transfer of powers to a national government;
- Acceptance of the status quo between colonial government and Local Government;
- Local Government not being regarded as ‘sufficiently important’;
- Concern over the potential threat posed by ‘strong’ Local Government; and
- The national rather than local ‘focus’ of the federation movement.

Other writers have advanced alternative plausible explanations. For instance, McNeill (1997, p18) argues that ‘local taxpayer reluctance’ and the ‘primacy of financial considerations’ in Local Government have dominated Australian local governance from its very beginnings. This view suggests that Australian Local Government has not been formally recognised in the national Constitution because higher tiers of government do not want to extend financial independence to Local Government. This reluctance to entrust Local Government with financial independence would appear to be a view shared by 31 per cent of NSW residents (IRIS 2005). However, 39 per cent indicated that they have more confidence in their local council than the State Government when it comes to revenue raising and spending.

It has been argued by many commentators that Australian Local Government remains in an anomalous position in the absence of constitutional recognition. For example, Brown (2002b, p27) contends that a tripartite rationale exists for formal recognition. Firstly, there is ‘growing evidence of a new era of restlessness within the attitudes of Local Government’. Secondly, Local Government reforms have not solved the problems confronting Australian councils. Thirdly, Local Government is ‘an unsolved problem of constitutional theory’. Brown (2002b) and others argue that these problems can only be resolved through formal recognition of Local Government within the Australian Constitution.

Finally, parts of the organised Australian Local Government community maintain that the ongoing financial stress experienced by many councils across the country can best be removed through constitutional recognition. This argument is premised on the view that with recognition will come financial autonomy in the form of a wider funding base and additional sources of revenue.

Remedies

The argument that a democratically elected sphere of government in a federal system enjoys the intrinsic legitimacy to raise its own revenue in an unencumbered manner undoubtedly carries weight. Moreover, the apparent inability of Australian Local Government to generate greater income, including tax revenue, clearly impairs its capacity to deliver services.

But the contention that national constitutional recognition is essential to the amelioration or even elimination of these problems is illusory for at least two reasons. Firstly, despite formal recognition, states continue to suffer from VFI and must thus rely on the Commonwealth for funds. Why would the fate of Local Government be any different?

Secondly, given the historical record of the Australian electorate on referenda, including previous failed referenda on constitutional status for Local Government, there is limited hope of success. As Brown (2002b, p39) has observed: ‘Every 14 years or so, Australians seem destined to dwell on the constitutional position of Local Government. Thus it appears from the failed referenda of 1974 and 1988’.

However, others have argued that these two attempts to change the Constitution failed because the proposals were included with unrelated proposals that provoked a ‘Vote No’ campaign from the Opposition against all proposals as that was easier than singling out the Local Government proposals for different treatment.

If this interpretation is correct, then any future proposal to have Local Government recognised as an independent tier of government in the Australian Constitution must be put on its own.

To guarantee the passage of such a proposal the Australian Local Government Association (ALGA), with the assistance of each state Local Government association, might consider a nation-wide petition aimed at getting a majority of registered voters in each state pledged to supporting such a move.

A more pragmatic and promising policy option would simply be to forego further attempts at constitutional recognition and to pursue some kind of intergovernmental agreement (IGA) instead. Such a measure would go further than a constitutional amendment by defining the role, responsibilities, authority, funding and accountabilities of Local Government and the limits of intervention by the state. It is canvassed and assessed later in this chapter.

Of course constitutional recognition would not be incompatible with an IGA. Indeed it could reinforce Local Government's standing within an IGA by giving it a legal identity of its own.

Option 6: Seek recognition of Local Government as a separate independent tier of government in the Australian constitution through a national campaign by ALGA and its state members aimed at obtaining the signed pledge of a majority of voters in a majority of states to supporting such a course of action if a constitutional referendum was held.

Pros

- Would enable Local Government to claim a legal status independent of the state; and
- Would accord with public sentiment that Local Government is the third tier of the Australian federal system, not just a subsidiary of State Government.

Cons

- Would be an expensive exercise that could backfire if the public rejected such an amendment for the third time;
- Would have little impact on the current financial situation unless the constitutional recognition includes a reworking of financial support from the Commonwealth and State Governments; and
- If it succeeded it might amount to no more than a symbolic victory with the result that Local Government would do better to focus its energies on an IGA.

5.4 LOCAL ROLE OF COUNCILS

Requirements

In an ideal world, a financially autonomous Local Government would operate on the principle of subsidiarity under the monetary discipline imposed by the correspondence principle. Moreover, if Local Government obtained a democratic mandate from its 'citizens', it could undertake additional functions, subject to its budget constraint.

Given the extreme diversity of NSW Local Government, where population size ranges from 1395 (Urana) to 278,532 (Blacktown) residents (LGI 2005, Appendix A), geographical area from 6km (Hunters Hill) to 53,510km (Central Darling), and climatic conditions from very hot and arid to cool and wet, it is hardly surprising that different councils assume very different responsibilities. Indeed, provided this does not involve costly duplication,

divergences in roles between councils are entirely justifiable if they reflect local preferences and are not just a hangover of historical expenditure relativities locked in by rate pegging when it was introduced almost 30 years ago.

Broadly there are three different types of roles that a council may embrace:

- **Minimalist:** Councils are the body corporate for the local community and as such should look after the common property and regulate the usage of private properties. This role would ensure that councils live within their meagre resources dictated by a single tax base (land rates) subject to a state imposed ceiling.
- **Maximalist:** Councils are the governments of their areas and as such should foster the welfare of the whole community even if this means duplicating work of other tiers of government. They should undertake such services that local communities want and are prepared to pay for.
- **Optimalist:** Councils are champions of their areas and as such should take a leadership role in harnessing public, NGO and private resources to promote particular outcomes rather than attempt to fund and operate local initiatives on their own. Because of funding constraints an ‘optimalist’ approach may allow a minimalist council to exercise maximum leverage.

Reality

In practice councils in NSW do not have a free choice as to which role they may adopt.

Local authorities in NSW are governed by the *Local Government Act (NSW) 1993* (LG Act), which contains a power of general competence enabling councils to undertake a very wide range of activities (Mant 2005c). Over time, this has seen councils provide a greater range of services, with a growing emphasis on human services.

Powers relating to certain types of human services can be traced back to the *Local Government Act (NSW) 1919*. Thereafter they expanded slowly and episodically every ten years or so. In 1983 s298A was belatedly gazetted. It stated ‘the council shall have and shall be deemed always to have had the power to provide community welfare services’. This legitimised the shift from property to human services that was already evident.

In essence, NSW councils have moved away from their traditional narrow ‘minimalist’ emphasis on ‘services to property’ towards embracing a broader ‘maximalist’ approach that emphasises ‘services to people’. This process has largely occurred in an ad hoc incremental manner, due to legislative requirements imposed by other levels of government, new professional standards, socio-economic pressures, rising public expectations, the devolution of activities from higher tiers of government, technological progress, and many other factors (Chapter 4 and Dollery 2005c).

Particularly areas with strong population growth, such as coastal areas, experience manifold community expectation beyond “traditional services”. For example, Clarence Valley Council explains that (2006, attachment, pp6-9):

Cultural development has been identified as a central component of council's Sustainability Framework, the Economic Development Strategic Plan ...; Clarence Valley Council along with other councils in the Northern Rivers has identified the need ...to address the supply of affordable housing; local hospitals and community health facilities lack the capacity to handle the demand created by the combination of a low socio-economic profile and a high population growth; the area has limited specialist facilities to provide social and health support services for young people...; the area has an undersupply of hostels and nursing home accommodation ... and no palliative care facility.

Over the same time period, NSW Local Government has been severely circumscribed in terms of its ability to fund its activities. In particular, rate pegging has limited the capacity of councils to use the only tax available to them to raise money, apart from various user charges and fees. In other words, while councils can now provide a 'maximalist' range of services, they must perform these additional tasks subject a 'minimalist' budget constraint.

In effect, the shift to 'maximalist' service provider has been funded at the expense of maintaining and renewing essential municipal infrastructure (Access 2006), much of which is reaching the end of its economic life (Roorda 2006). This process is obviously unsustainable over the long term. Moreover, this shifting of funds away from infrastructure provision (which is predominantly roads) would appear to be contrary to the priorities of stakeholders (IRIS, 2005).

A feature of the change in orientation of NSW Local Government that accelerated in the post-World War II era and was reflected in the *Local Government Act (NSW) 1993* is that the 'expansive' process ('maximalist' agenda) has occurred by default, with no public discussion on the desirability or otherwise of the change. This is in stark contrast to the vigorous debate in New Zealand when Local Government reforms were first proposed there.

Such a debate is needed in NSW, particularly about whether Local Government should (1) maintain its 'maximalist' approach; or (2) embrace an 'optimalist' agenda that seeks to facilitate 'maximalist' outcomes with minimal public resources; or (3) return to a 'minimalist' model where the primary focus is on 'roads, rates and rubbish', as it once was. The merits and demerits of each of these alternative visions is discussed below

'Maximalism' is fueled by the relentless pressure from various interest groups for councils to broaden their range of services. Many submissions to the Inquiry explicitly call for a wider ambit. For instance, the NSW Centre for Overweight and Obesity (2005) desires a more active role in health promotion and the promotion of a 'healthy environment'. Community Cultural Development NSW (2005) similarly observes that Local Government should enhance its community development activity, especially in the areas of 'cultural diversity', 'youth' and 'indigenous' affairs.

Along similar lines, the Country Public Libraries Association of NSW (2005) highlights the need for internet education and services, including support for local online businesses. COTA National Seniors Partnership (2005) underlines the importance of Local Government infrastructure, particularly 'urban design' and 'streetscaping', for older Australians and their ability to remain active in the community.

However, a Local Government regional organisation of councils (SSROC 2006, p9) disputes that public pressure was the primary driver of 'maximalism':

There has been a perception that Local Government has been solely responsible for moving beyond core services, yet the Council's Charter under the Local Government Act expects councils to actively embrace such concepts.

'Minimalism' in Australian Local Government is the view that councils should adhere to their traditional 'services to property' functions and avoid branching out into either more complex 'services to people' functions characteristic of higher tiers of government or any commercial activities that could be undertaken by the private sector. This view rests on the belief that councils are more prone to 'government failure' than higher tiers of government, not least because of weaker accountability and insufficient technical capacity (Byrnes and Dollery 2002b).

Councils should thus deliver only those limited 'services to property' where they enjoy a comparative institutional advantage over other public agencies or private firms, such as superior local knowledge. 'Minimalists' argue that more complex 'activist' functions by councils will generate inefficiency, 'capture' by special interest groups, wasteful expenditure, unnecessary regulation, invasive infringements on property rights and needless service duplication (Kasper 2005).

In stark contrast, the 'maximalist' or 'activist' view holds that councils possess several comparative institutional advantages over other organisational arrangements, including strong democratic legitimacy, capacity to foster local 'social capital' and develop 'trust' and co-operation with their manifold 'communities', superior knowledge of local needs, and better ability to 'network' with other public agencies, nonprofit organisations and private firms.

Local authorities are thus particularly well placed to expand their range of functions from the present limited 'services to property' focus to embrace a far wider 'services to people' approach because they are ideally suited to handling many competing pressures, demands and expectations from their various 'publics'. In sum, councils are the 'real' governments of their jurisdictions and should thus foster the welfare of the whole community through all possible avenues, even if this means duplicating work of other public agencies

A third way, 'optimalist' approach, argues that it is possible to be both minimalist (on resources) and maximalist (on objectives) by regarding councils as the champions of their respective areas. In this capacity they should take a leadership role in harnessing public sector agencies, nonprofit organisations, and private companies to promote particular outcomes, like local economic development and public-private partnerships (PPPs) (Mant 2005c). This view combines the notions of 'steering rather than rowing' (Osborne and Gaebler 1992) as well as 'governing by network' (Goldsmith and Eggers 2004). These two concepts are amongst the most novel ideas in public policy literature in the past 15 years.

A criticism of this school of thought is that 'social entrepreneurship' involves a combination of legal, financial and political skills that are rare in public bureaucracies and that delegating considerable power to public employees to negotiate outcomes with third parties entails considerable risks. Nevertheless, views from New Zealand (McKinlay 2005) would appear to support the 'optimalist' concept of involving other agencies and groups which share local interests in the tasks of providing Local Government – the concept of 'glocalism'.

Critics argue that 'optimalism' simply represents cost shifting by Local Government onto other players, especially NGOs, but international evidence would suggest that there are willing takers who see opportunities in such a role (see Goldsmith and Eggers 2004). But to

realise this vision, the NSW State Government would need to grant councils far more autonomy in their range of activities, methods of raising revenue and capacity to enter into partnerships.

How do these competing views on role of councils meet with the realities of the contemporary NSW Local Government milieu?

In the first place, it has already been observed that whereas the *Local Government Act (NSW) 1993* allows councils to adopt a ‘maximalist’ stance, financial constraints impose a ‘minimalist’ monetary straitjacket on these ambitions that have only been advanced at a heavy cost of infrastructure depletion. Moreover, we have seen that the prospects for substantial additional funding for Local Government is slim at best. Thus from a financial perspective it would seem ‘maximalism’ is unsustainable.

We have already noted that the IRIS Research report (2005) indicates that traditional ‘services to property’ were rated as being of higher importance than other services. This might suggest that public opinion rejects ‘maximalism’.

However, the IRIS report also indicates that 65 per cent of respondents have a high to medium preference for better services even if it means paying higher rates. Only 24 per cent supported strongly the notion of cutting services and facilities as a means to keep rate rises to a minimum. Hence, although people want more emphasis on basics such as waste collection and roads, they are not seeking a bare-bone ‘minimalist’ role for Local Government.

Secondly, the less ambitious ‘optimalist’ position already has several of its essential preconditions in place. For instance, the *Local Government Act (NSW) 1993* grants powers of general competence to councils enabling them to take a leadership role and deal with public organisations, private firms and the not-for-profit sector. Regional organisations of councils (ROCs) and strategic alliances could play an effective role in taking on leadership for outcomes that entail benefits across councils. Also, the *Local Government Amendment (Public Private Partnership) Act (NSW) 2004* provides useful guidelines and safeguards for PPP arrangements and could be applied as the basis for successful dealings with the private sector.

Furthermore, although an ‘optimalist’ approach would require councils to advance community interests through leadership by marshalling resources from many different sources, it does not necessarily imply that councils themselves should engage in service provision in excess of the traditional ‘services to property’ range. Put differently, the ‘optimalist’ approach is potentially compatible with the current ‘minimalist’ financial regime in NSW. It would, however, require a more enterprising type of public servant to the risk-averse bureaucrat normally associated with government.

It should also be stressed that the superior knowledge and local legitimacy possessed by local councils on local preference articulation obviously makes them natural advocates for local communities, whether this be for greater or less economic development. However, in common with the ‘maximalist’ or ‘activist’ view, the IRIS Research poll (2005, p33) showed that respondents ranked ‘economic development including business and tourism promotion and attracting new business’ low as a function. However, this general finding must be qualified by observing that non-metropolitan respondents ranked economic development significantly

higher than city residents, presumably reflecting greater perceptions of need for development in rural areas.

Finally, the ‘minimalist’ approach is perhaps the only one that can both coexist within the current legislation and survive the present financial constraints on NSW Local Government. Moreover, it seems to meet the higher order priorities expressed in the IRIS Research poll (2005, p33) for councils to give greater stress to ‘services to property’ functions, though would clash with people’s desire to also keep all other services.

Most respondents to the *Interim Report* rejected ‘minimalism’ out of hand, but the professional body representing council engineers (IPWEA 2006, p5) did not:

In the absence of additional funding being available to Local Government, IPWEA supports the implementation of a minimalist approach to ensure that sufficient funding is allocated to the existing infrastructure backlog. This would involve the clear identification of the backlog problem by each council and a reduction in non-core functions to realise the necessary funds.

We have argued above, Local Government is both the natural and legitimate avenue for the expression of local leadership on questions involving the future lifestyles of local residents. The question of leadership is neglected in the ‘minimalist’ approach. Also, given the diversity of Local Government across NSW, a ‘one-size-fits-all’ model may not be acceptable, especially in rural and remote communities, where the local council is often the service provider of ‘last resort’ when public and private services disappear.

Remedies

Both the ‘minimalist’ and ‘optimalist’ approaches are perfectly compatible with the current legislative framework and do not necessarily require far greater financial resources than presently available. However, it appears that the ‘minimalist’ stance enjoys much public support, although the ‘optimalist’ approach respondent scores are higher outside the major cities. This suggests two possible policy options.

Option 7: All councils voluntarily agree to a ‘minimalist’ approach until they get their infrastructure in order.

Pros

- Would send a powerful signal to the community that councils will reorder their policy and spending priorities to address the infrastructure crisis (see Chapter 6) which is the most pressing financial problem facing them; and
- Would not only help address the infrastructure crisis, but would also accord with the popular view that roads, pavements, kerbing, etc should be the second highest local priority (after waste collection), but have been given the least attention by councils (IRIS 2005, p33).

Cons

- It is not clear what exactly a ‘minimalist’ back-to-basics approach would constitute in actual policy priority and expenditure terms given that a large majority of citizens do not want councils to abandon their existing activities, but simply to give some higher priority than others;

- The minimalist approach is contrary to local democracy and the principle of subsidiarity; and
- Despite its public appeal, a ‘minimalist’ option would reduce the critical role of councils in regional, rural and remote NSW in articulating community needs and acting as provider of ‘last resort’ when public and private services are reduced.

Option 8: All councils embrace an ‘optimalist’ approach and at the same time call on the state for a relaxation of ‘minimalist’ financial constraints sufficient to allow councils to regain financial sustainability.

Pros

- Would be a more pragmatic approach than embracing a ‘minimalist’ agenda since it would allow councils to seek broad outcomes as long as they harnessed support and resources from third parties at minimal cost to themselves; and
- Would still enable councils to devote more resources to renewing infrastructure, but it would attempt to fund it by a combination of revenue hikes, efficiency savings, expenditure reordering and new borrowings rather than putting most emphasis on cutbacks to recurrent costs, especially human services.

Cons

- Risks sending a mixed message to the public at a time when a brake needs to be put on the fast growth of human services to free up resources for a renewal of infrastructure, especially roads and streetscapes;
- Might not be a feasible option for rural councils when there are rarely viable and sustainable organisations, such as private partners and NGOs, available or sufficient substance to allow for partnering agreements to occur; and
- Miscasts the ‘minimalist’ approach as a ‘slash and burn’ exercise when in fact it is no more than a diversion of future growth revenue towards traditional core council services and infrastructure services that have been neglected while councils have expanded into human services, funding of which should be the province of the state.

5.5 LOCAL COUNCILS AND FINANCIAL SELF-SUFFICIENCY

Requirements

The question of whether councils should be financially self-sufficient is complex and can be tackled from various points of view. While reflection on this question is intimately bound up with the role of Local Government, and therefore must be examined in this context, it also requires extensive analysis of the financial magnitudes involved and will thus also be explored in Chapters 9 and 11.

As we have seen, under the theory of fiscal federalism the correspondence principle normally holds sway implying that councils should finance all of their own expenditure (Bailey 1999). However, at least four exceptions to this general rule are granted.

Firstly, intergovernmental grants and other subsidies are justified when the services provided by a council bestow benefits on the larger community outside its jurisdiction. In this case, the magnitude of the grant should equal the value of the external benefit.

Secondly, where higher tiers of government force councils to offer services and impose regulations, they should pay for these imposts.

Thirdly, where state services that citizens are legally entitled to (e.g. primary education) or expects the state to provide (e.g. medical attention) are withdrawn from Local Government areas, then the state should bear the cost of either bringing people to the services in larger centres or subsidising local councils to deliver these services.

Fourthly, according to the principle of horizontal equalisation unequal capacities to provide public services among different units of government at the same level (e.g. different councils) needs to be addressed through financial assistance for disadvantaged units.

Reality

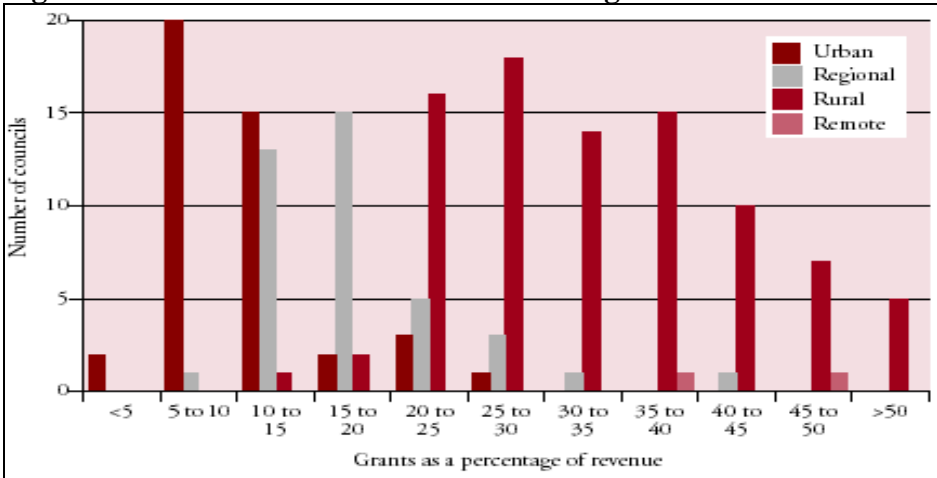
Despite serious imperfections in application, many of these principles are currently employed in NSW Local Government.

As we have seen, councils receive substantial financial assistance in the form of grants from the Commonwealth (financial assistance grants (FAGs) containing of a general-purpose and a local roads component and specific purpose payments (SPPs)) as well as from the state (grants for specific purposes and services). FAGs, particularly the general purpose component, address the issue of VFI and thereby recognise that Local Government functions bestow benefits on the larger community. Commonwealth SPPs and state grants are tied to and assist councils financially with specific services (e.g. roads, aged care, child care, disability services). The adequacy of grants is discussed in Chapter 9 and 11.

Furthermore, the NSW Local Government Grants Commission (LGGC) seeks to improve the degree of HFI by distributing the general-purpose component of Commonwealth FAGs to financially stressed councils according to a nationally prescribed formula so that they can provide minimum service levels under ‘effort neutrality’.

This has led to the emergence of heavily dependent ‘grant’ councils, predominantly small rural councils with low populations and large spatial areas. Figure 5.2 illustrates the problem below.

Figure 5.2: Distribution of revenue from all grant sources for NSW councils, 2002-03



Source: DOTARS 2005, fig. 1.4.

Is the degree of dependency on grants problematic in the light of the information in Figure 5.2? Various responses to this question are relevant. Firstly, if we consider the relative magnitudes involved, for NSW the average general purpose component of FAGs per capita in 2003/04 ranged from \$15.84 for urban capital city councils to \$735.37 for rural remote medium councils, with a state average of \$52.81 (DOTARS 2005, Table 2.9).¹⁸ There are thus significant differences between different types of councils, with rural councils securing by far the biggest per capita grants.

Secondly, in principle a problem exists if allocations of FAGs consider only equity issues and neglect efficiency criteria since they then form an implicit subsidy to inefficient councils and thus waste public resources. Limited Australian empirical evidence indicates that in NSW FAGs may have this effect (Worthington and Dollery 2000) since according to the principle of 'effort neutrality' the size of grants is independent of council policies and behaviour.

The NSW Local Government Grants Commission (2006, p2) takes a different view:

The grants are allocated on the basis of an average level of efficiency for a service in the state. This means that councils that are more efficient than average are able to provide more services from available revenue (or have lower rate imposts) and the less efficient are able to provide fewer services (or have higher rate imposts). Thus, efficient councils are already rewarded for their improved performance.

Horizontal fiscal equalisation (relative needs) is built on a premise of addressing those very issues that affect a council's ability to perform efficiently. This is currently achieved by the Commission's independence and comprehensive assessment of relative disadvantage with respect to revenue raising capacity and expenditure needs in the framework of effort neutrality. Because of the limited level of funds, councils receive a grant that amounts to around forty-five per cent of their assessment need. The Commission is not subsidising inefficiency, rather it is attempting to meet the recurrent needs of councils.

Uralla Shire Councils (2006, p2), a rural council, notes that the general conclusion that grants form an implicit subsidy to inefficient councils and thus waste public resources needs to be specified. Uralla Shire Council expects 52.1 per cent of its budget for 2005/06 to come from grants. However, almost half (45 per cent) of these grants relate to funded activities for delivered services and applied grants, where

...funding is competitive, dependent upon efficient and effective delivery of services.

Whatever side one takes in the efficiency versus equity debate, one thing is clear: given the dependence of many rural councils on grants, there appears to be a limit to any reduction of equity funding, otherwise these councils would not survive.

Thirdly, if it is argued that grants should be abolished, then the full consequences of withdrawing LGGC subventions to NSW councils should be carefully considered. For instance, many small rural councils, and especially those with large spatial jurisdictions containing many bridges and roads, which are very expensive to maintain, rely heavily on grant revenue. Indeed, more than half of all NSW local roads (around 82,419km) are unsealed and fall mostly in rural areas.

¹⁸ The categories Urban Capital City and Rural Remote Medium refer to the Australian Classification of Local Government. See LGI (2005, Appendix B).

If FAGs ceased, these councils would, at a minimum, be unable to maintain existing road infrastructure to the detriment not only of their own residents, but also the broader travelling population and larger national security objectives. A more probable outcome would be the complete financial collapse of most of these rural councils and their service provision.

To maintain essential services, state agencies would therefore either have to replace bankrupt councils or recommence grants. The abolition of grants to local councils is thus not feasible unless state governments are prepared to see rural Australians go without vital municipal services, and suffer the financial consequences of a major population shift from towns to cities, and the corresponding need to provide management for large areas of land in more remote areas which became de-populated.

Remedies

Economic theory prescribes intergovernmental grants where Local Government service provision has spill over effects beyond the boundaries of a given council jurisdiction. Since Australian councils are multi-functional, providing a range of different services each with a different benefit region, spill over effects are inevitable. This means that grants can be justified on efficiency grounds alone. However, State Government policy contains significant equity considerations, not least that all citizens are entitled to minimum levels of municipal services. Given the socio-economic and spatial characteristics of country shires, without grants minimum service levels are not financially possible in many rural councils. Consequently, equity considerations require the maintenance of grants.

However, under current NSW LGGC funding arrangements, efficiency considerations are not explicitly taken into account under the principle of ‘effort neutrality’. This may mean that grants act to subsidise inefficient councils using public funds – a practice hard to justify on sound public policy grounds, except perhaps in special cases, like grant dependent rural shires with a very low rate base. There is thus a case for re-examining grant funding arrangements in NSW.

Four broad possibilities stand out. The first is that grants could be abolished altogether. As we have seen that this would lead to catastrophic consequences in rural areas that would be unacceptable. The second would be to maintain the status quo regardless of its possible flaws. If neither of these are attractive two other remedies are possible:

Option 9: The basis for calculating the distribution of FAGs by the LGGC is reconsidered so as to introduce efficiency promoting elements.

See also Chapter 9, option 14.

Pros

- Would give councils a stronger incentive to be efficient in their operations.

Cons

- Could divert funding from councils that because of their low population density are not capable of achieving the efficiencies of urban and metropolitan councils (see Chapter 10 for a discussion of the factors affecting council costs per resident);

- Would undermine council autonomy because the LGGC would indirectly determine or influence which council policies and practices, services and projects were worthwhile;
- Efficiency is already rewarded as the efficient council can allocate grants to other areas according to its priorities; and
- May result in inequitable outcomes.

Option 10: Restrict FAGs to those councils whose rate base is so low that they are not financially sustainable unless they get considerably more external assistance.

In other words, grants would be abolished in general for most councils and retained for a special category of rural council that would never be able to achieve financial self-sufficiency regardless of its performance.

Pros

- If the Commonwealth was not prepared to increase FAGs considerably then restricting these grants to the most disadvantaged rural councils is their only hope of achieving financial sustainability since their rate base is too narrow to provide sufficient revenue even without rate pegging; and
- If these councils are not given special assistance their infrastructure (mainly local roads) will become inoperable which would have adverse consequences for the state's economy.

Cons

- Would to some extent mean dropping the recognition that there is VFI among spheres of government, which is expressed in the minimum grant of FAGs for every council;
- Would reward councils regardless of whether or not they used their money efficiently and effectively;
- Would forestall necessary resource sharing by such councils by giving them financial assistance to maintain outmoded structures and practices;
- Would upset residents of other Local Government areas that have an expectation that a proportion of the taxes they pay to the Commonwealth should be returned to their communities;
- Would force other councils to rely solely on own source revenue, which would require offsetting increases in their rates, fees and charges; and
- It may create financial difficulties for other councils.

5.6 INTERGOVERNMENTAL AGREEMENTS AND LOCAL GOVERNMENT AUTONOMY

Requirements

Intergovernmental agreements

Intergovernmental Agreements (IGAs) or Partnership Agreements (PAs) have become an important mechanism for closer cooperation between the different tiers of government in the Australian federation. For instance, the Tasmanian State and Local Government Partnership Agreements program was launched in late 1998 to engender trust between the two levels of

government and improve working relationships between the Tasmanian State Government and Tasmanian councils. Under this program, three types of PAs exist through which a council can simultaneously enter into a bilateral, regional and statewide agreement (Government of Tasmania 2005).

Similarly, in 2004 the South Australian State and Local Governments entered into a PA known as State-Local Government Relations that set out guidelines for mutual cooperation (Government of South Australia 2004). The aims of this PA included improved coordination of activities, increased effectiveness of service delivery and infrastructure, improved integration of strategic planning processes, and the promotion of open and accountable government, to foster more consistent approaches to the framing of policies and legislation, and to provide guidance for contact between the two levels of government.

Finally, at the national level, a working group including representatives from the state and territory LGAs has been drafting an IGA to guide relations between states and territories, the Commonwealth and Local Government. A special meeting of the Ministerial Council on Local Government and Planning will consider the draft in autumn 2006 (LGPMC 2006). This initiative arose from the Hawker Report (2003), and the Commonwealth Government response to the recommendations of that report, especially its views on the problem of cost shifting and its deleterious impact on Local Government.

In terms of scope and content, three different types of IGAs can be distinguished: partnership; Allocative; and Determinative (LGSA 2006, p11)

A partnership IGA basically contains a commitment of each party to work together and also might establish collaborative mechanisms to ensure parties are doing so. A partnership agreement would set out responsibilities of each party in a very general way and establish broad benchmarks against which performance can be assessed. In this respect such an IGA is rather tentative as it does not allocate specific functions and corresponding funding arrangements or revenue raising capacities. It would therefore represent a weak instrument to address issues such as cost shifting. However, a partnership IGA could assist in the building of relationships as it emphasises co-operations and allows for flexibility.

Very distinctly, a determinative IGA sets out precise functions of each party as well the method of allocating funds. The obvious advantage of such an agreement would be that each sphere of government would know exactly which functions it was responsible for and which funds were available for fulfilling them. That would avoid any form of cost shifting as well as wasteful duplication. The problem with a determinative IGA is that it assumes that it is possible to precisely determine the functions each sphere of government should provide.

General government involves the inherent notion of uncertainty as to individual functions and requires the existence of default levels of government in order to address new needs and priorities according to the principle of subsidiarity. The set of functions might constantly shift with changes in the needs and priorities of the electorate. Government requires the flexibility to respond to such changes. Especially given Local Government's diversity with respect to size, geography, climate, socio-economic circumstances, etc, it is difficult to say that every council undertake a particular set and standard of functions.

The allocative IGA attempts to address these difficulties by developing a set of principles as to how functions should be divided among spheres of government in any given scenario,

without itself determining responsibility for individual functions. Such an IGA nevertheless identifies the body that will determine, pursuant to the set of principles, which sphere of government should deliver a particular service in a given scenario. Also, the allocative IGA will ensure that the sphere of government which is given the responsibility for a particular function is also given corresponding adequate funding or revenue raising capacity. A transparent compliance mechanism ensures that any breach of the agreement is remedied. The only real disadvantage of an allocative IGA is the cost involved in the formalistic decision making process to determine the responsible sphere of government. However, that should be outweighed by its ability to inhibit cost shifting and reduce unnecessary duplication of services.

Of these options an allocative IGA between the NSW State Government and NSW Local Government represented by the LGSA looks most feasible. However, a Partnership IGA could represent a constructive first step in this direction, particularly through the establishment of communication and consultation processes and agreed action towards implementing an allocative IGA.

Communication and consultation processes should include a State/Local Government consultative forum, with perhaps regional sub-forums to identify strategic issues and resolve outstanding problems at both a state and regional level, with an outline of who should attend, chair and service such forums. Alternatively, Local Government could simply be made part of any existing state public sector regional forums that are usually chaired by officers of the Premier's Department. Provision would also have to be made for periodic reviews of the operation of the IGA.

Finally, given the fact that Commonwealth, State and Local Governments are all involved in service provision and the financing of services, an ideal outcome would be an IGA dealing with the 'whole-of-Australian-government' that could be negotiated between all three tiers of government. While the success of a national IGA of this kind is obviously beyond the ambit of individual state and local governments, present negotiations on a draft national IGA look promising. Time will tell whether these deliberations are successful.

Local Government autonomy

There are two Australasian jurisdictions that are showcases of successful autonomous local governments.

In South Australia, Local Government has been entrusted with a far more freedom than in New South Wales. In the period between 1990 and 2004 the South Australian State Government has signed two Memorandums of Understanding with Local Government, which have effectively dismantled the South Australian Department of Local Government and virtually abandoned state oversight of its affairs.

South Australian councils are also now required to deal with all complaints themselves at first instance and to agree on a collective view through the Local Government Association of South Australia in their dealings with the Minister. A State-Local Government Relations Agreement outlines model consultation processes between the two tiers of government where amendments to legislation are proposed which could impact on Local Government (Russell 2005).

New Zealand also offers a strong model of Local Government accountability over state intervention coupled with the power for councils to set their own rates. All New Zealand local councils are now required to undertake a process of identifying community outcomes for the intermediate and long-term future of their region every six years. Council plays a facilitative role in this process in consultation with a wide range of stakeholders. The community outcomes underpin councils' key planning document, the long term council community plan (LTCCP), which is prepared on a three yearly basis. The LTCCP contains two important accountability requirements.

Firstly, local councils cannot significantly diverge from their declared activity and expenditure plans without first going through further consultation. Secondly, the LTCCP must contain a report from the council's auditor on the extent to which the local authority has complied with all the relevant legislative requirements as well as the appropriateness of the performance measures regarding quality of service delivery.

Changes to rating legislation have further reinforced the autonomy of New Zealand local authorities. Councils are now allowed to rate either on the assessed value of a property or as a fixed amount. Accountability to the community, rather than government intervention, is seen as the appropriate means of protecting the ratepayer. Provision is made for postponement of rates until the property is sold in cases of financial hardship (McKinlay 2006).

Reality

Intergovernmental agreements

The 'maximalist' agenda driven by community needs and expectations as well as increasingly complex service delivery arrangements, and the funding mechanisms underlying these arrangements, see many councils in NSW moving into areas outside their traditional realm by offering services customarily provided by state and Commonwealth governments. A result of this is that service duplication, cost shifting (see Chapter 4), and many other undesirable consequences seem to have increased. For example, rural councils have been obliged to take over some State Government services (health and aged care) that have been unilaterally withdrawn from small centres.

Given these developments there is clearly a need with any IGA for a 'whole-of-government' approach to avoid cost shifting and costly duplication. Moreover, it is self-evident that a cooperative basis for such a 'whole-of-government' approach is preferable to State Government dictation. An IGA thus appears to be an excellent vehicle for facilitating a 'whole-of-government' approach that will endure through time. Not only is an IGA ideally placed to restore Local Government trust in the NSW State Government in the aftermath of its policy reversal on forced amalgamations in 2003, but it can also be used as a platform for setting principles as to how to allocate the respective functions and corresponding funds of State Government and councils.

For example, given State Government's constitutional responsibility for health in NSW, should small rural councils be engaged in seeking and financing medical centres and housing for general practitioners when the state health authorities cannot supply outpatient services? If this widespread practice is to continue, should the State Government bear the financial burden? Or, because it involves general practitioners, should the Commonwealth make a

special contribution? Similar questions can be raised in respect of many other areas of state and Commonwealth government service provision, especially in the area of human services.

Secondly, if unnecessary overlap and duplication could be identified through IGA processes, then resources might be freed up for other legitimate purposes. These funds could not only be used to finance the IGA process itself, but yield a social surplus beyond this impost.

Thirdly, the recent stream of legislated rules and regulations flowing from the NSW Parliament (as documented in Chapter 4) has imposed significant compliance and reporting costs on councils across the state. These costs fall most heavily on small councils with limited staff and often mean that key managers spend an excessive proportion of their time dealing with State Government regulation. This is especially ironic in those councils where it is difficult to recruit expertise for normal essential tasks. An IGA can assist Local Government to bring home to the State Government the 'hidden' costs of regulation and may even induce the recent British trend towards 'one-in-one-out' regulation, where each new enactment must replace an old law.

While much could reasonably be expected from an IGA in NSW, the difficulties involved should not be underestimated. For example, it is easy to imagine circumstances under which an IGA forum could readily deteriorate into a 'blame-shifting' exercise by representatives of both the State Government and Local Government, with the 'court of public opinion' rather than cooperative problem solving becoming the real focus of attention. In an analogous vein, the mere existence of an IGA will not by itself generate additional financial resources from either party. Since financial assistance and constraints on councils' revenue raising capacity, especially rate pegging, traditionally form the nub of arguments between the two tiers of government in NSW, this issue will have to be faced in a spirit of cooperation.

These considerations notwithstanding, an IGA offers realistic prospects of substantial progress in 'whole-of-government' service provision in NSW. Even if an IGA failed to generate positive results, then the costs involved would not be prohibitive. Moreover, a failed IGA process is reversible in the sense that the 'eggs can be unscrambled' and the status quo readily resumed.

Local Government autonomy

In NSW's case an IGA is also an opportunity to give Local Government greater autonomy in its affairs so that the state's role was either removed (as in New Zealand and South Australia) or changed from that of a 'nanny' that intervenes whenever a council misbehaves or cannot cope to that of a 'mentor and monitor' who sets best practice guidelines and keeps citizens informed of how well councils comply and perform.

NSW is by far the most interventionist state in Australia in relation to its Local Government. One council (June 2006, p1) chides the Inquiry for being too polite in its analogy:

Describing NSW as a 'nanny state' is charitable, and harsher terms would not be inappropriate. The State Government just doesn't 'nurse', it is a severe, forbidding, rule bound 'governess' as well.

Local Government models elsewhere demonstrate that with greater accountability mechanisms such as long term strategic and financial planning frameworks complemented by performance indicators for key results areas, councils can arguably be entrusted with greater

operational autonomy and self-regulation. External watchdog agencies such as the Independent Commission Against Corruption and the NSW Ombudsman retain power to provide external independent scrutiny.

Remedies

In the light of the above discussion, an obvious option for consideration involves an IGA that outlines respective roles and funding obligations as well as the future limits of State intervention in council affairs.

Option 11: That the State Government and NSW Local Government and Shires Associations enter into an intergovernmental agreement (IGA) that draws on the experiences of Tasmania, South Australian and New Zealand.

The final IGA should be based on the allocative model. However, the parties should initially enter into a partnership IGA with the goal to implement an allocative IGA. The partnership IGA should assist in building a meaningful relationship between State Government and Local Government and introduce proper communication and consultation processes. An IGA should also include an integrated system for long term strategic and financial planning as well as performance measurement.

Pros

- Would provide greater clarity of role, financial security and autonomy for Local Government;
- Would tackle the issue of cost shifting;
- Would minimise gaps and overlaps in service provision and thereby reduce wasteful resource spending;
- Would provide financial savings for the State Government since fewer resources would be devoted to regulating Local Government; and
- Would mean State Government was no longer held to account for failings of another tier of government.

Cons

- Councils given their diversity could have difficulties forming a united view and ‘voice’ in negotiating and implementing an IGA with the state;
- Would mean greater financial and operational costs to councils of implementing complaint procedures and other accountability and review mechanisms;
- Public might not allow the State Government to wash its hands of Local Government given that it was created by state legislation not the federal constitution; and
- Increased consultative mechanisms could lift councils’ expectations of state assistance rather than force them to chart their own destiny.

6. LOCAL GOVERNMENT INFRASTRUCTURE

6.1 INTRODUCTION

NSW Local Government is struggling to manage and renew its infrastructure. The cause and extent of the infrastructure shortfall is a combination of various factors discussed in this chapter. The information presented shows that simply boosting funding for infrastructure would not be a sufficient solution without complementary reform of council asset information and management systems.

This chapter has three sections. The first outlines the NSW Local Government infrastructure portfolio and current condition including infrastructure backlog and renewal gap, the second examines how councils account for and manage their infrastructure, and the last details funding sources for infrastructure.

Several special reports were commissioned by the Inquiry to inform its understanding of infrastructure issues, especially those by Roorda and Associates and Access Economics.

6.2 INFRASTRUCTURE PORTFOLIO AND CONDITION

Requirements

Local Government infrastructure should effectively serve the needs and priorities of the community within the agreed role of Local Government. Such infrastructure should be of a satisfactory standard in terms of providing services in a relevant, functional, safe, reliable and cost efficient manner.

As noted in Chapter 5, the theory of fiscal federalism prescribes that the most effective provision of infrastructure by Local Government should be confined to items within a council's area. When a council provides regional infrastructure it should either be compensated by neighbouring councils, or by a higher tier of government representing a wider constituency. The current allocation of infrastructure managed by Local Government should provide a 'best fit' that meets constituents' needs, but is also within a council's financial capacity.

Ensuring that the right tier of government provides the right infrastructure is highly complex, particularly for infrastructure with a long life. Initial allocations of infrastructure responsibilities between levels of government may not reflect the evolution of the infrastructure asset. Over time, new technologies and additional requirements can change the asset's functionality, characteristics and operational costs. For example, a water infrastructure system may over time be integrated with a storm water recycling system or co-used for multi-purpose communication cabling system thus changing maintenance costs, management requirements, and replacement value.

Successive policies and management changes can also shape the way infrastructure can be provided. The question to consider is whether the management of infrastructure by councils is satisfactory and whether the infrastructure itself meets current and future community requirements.

Reality

Common infrastructure items

NSW Local Government is the custodian of \$48.5 billion of community assets (i.e. property, plant and equipment) according to councils' audited 2003/04 financial statements. However, this estimate would appear to be based mostly on outdated values (Roorda 2006 p4). A more realistic up to date calculation of the 'fair value' of these assets would be \$77.8 billion (Access Economics private correspondence, 17 March 2006)

Currently the infrastructure portfolio of NSW councils commonly includes the following items: roads, pavements, traffic lights, bridges and other transport facilities, stormwater and drainage systems, libraries and sporting fields, council chambers and administrative buildings, town and community halls, car parks, works depots, childcare and aged care facilities, plant and equipment, office equipment and furniture, and property holdings. In addition, councils in rural areas may also be responsible for infrastructure such as livestock sales yards, airports, and caravan parks. Accounting requirements for NSW councils (detailed in section 6.3) introduced in the 1990s have grouped such common council assets into classes and sub-categories (DLG, 1999, Appendix 6).

Differences in council infrastructure

Each council has a different combination of infrastructure and infrastructure financing pressures. A notable difference in NSW occurs between councils in rural and metropolitan areas. Rural councils are responsible for water and sewerage assets whereas water utilities in Sydney, Wollongong, and the Hunter areas have been corporatised by State Government. The value of water and sewerage assets is around \$8 billion (on published, but outdated values).

The geographical size of some rural communities has a marked bearing on the composition of the council's infrastructure. Inland and coastal councils have different types of assets to manage, which are directly related to their environment, be they river levees in rural areas or marine wharves in coastal regions.

A critical example of the differences is the substantial variation in road assets between rural and metropolitan councils. Rural councils often cover large areas of land with substantial road networks. Many rural councils also have ageing road, water and drainage infrastructure, and coupled with small population subsequently have a small rating base from which to fund maintenance and renewal. In stark contrast, most metropolitan councils have lesser road infrastructure to maintain, denser concentrations of people, a high rating base and no responsibility for water utilities.

Another difference between rural and urban councils' responsibilities concerns certain types of infrastructure such as libraries and sporting fields. Rural councils with small populations may have less wear and tear on these facilities. However, rural councils may be required to provide multiple facilities across a shire because of a scattered distribution of communities. Urban councils may provide larger, concentrated facilities, but the higher usage from a larger population may drive costs for more extensive infrastructure and servicing.

A further difference is a council's access to skill and expertise in infrastructure management. Attracting skilled management to rural areas is difficult. Rural councils are concerned that their capacity to provide infrastructure is further compromised by workforce shortages.

A council's infrastructure profile may also be influenced by its population changes. Population 'growth' councils have more variety of new and old infrastructures with new infrastructure funded through developer contributions. Established councils with 'static' or declining populations have greater concentrations of existing, ageing infrastructure (Roorda 2006 p12).

Councils with declining or ageing populations are still under pressure to provide and maintain infrastructure to a certain standard, but do not have access to new funds from developments. However, such councils are hesitant to take on long-term loans that their future populations may not be big enough to service (Broken Hill City Council Submission 2005, Hay Shire Council Submission 2005).

Infrastructure legacy

Historically many Local Government assets were originally funded and built by other tiers of government. Substantial assets such as roads, public buildings, and drainage and water assets were transferred with the coming into operation of the *Local Government Act (NSW) 1919*. Many of these assets are now over 100 years old. In addition, much of the infrastructure developed by councils is also reaching the end of its useful life – the average lives of total NSW council assets is 50 to 80 years (Roorda 2006, p41). A snapshot of the aging infrastructure situation is highlighted by Bega Council in its submission:

Much of the urban sealed road network, particularly those streets in the older parts of the main towns, has an age in the order of 40 years or more, which is approaching the age where rehabilitation will be needed. Similarly, the oldest sealed roads in the rural road network are 50 or more years old and in need of rehabilitation. There are a total of 229 bridges and major culverts on the road network, of which 72 are timber. All of the timber bridges are more than 40 years old, and most are significantly older than that. Older timber bridges require a lot of funding for their maintenance to keep them serviceable (Bega Submission, App2, p12)

Ongoing changes to Local Government responsibilities and activities have seen the addition of more assets to council's portfolios. Most recently, in 1995, NSW councils have experienced substantial asset transfers when the responsibility for regional roads was passed from State to Local Government.

Growth booms that occurred in the 1950's resulted in rapid expansion of infrastructure funded by developers or government, then transferred to Councils. These development booms will result in a series of peaks or aftershocks that reflect initial patterns of construction. Most councils have not yet fully experienced these aftershocks and have renewed only a small proportion of this infrastructure (Roorda 2006, p41)

NSW Local Government therefore finds itself responsible for a legacy of major infrastructure that is expected to reach the end of its usable life in the next few decades. It has been argued that the current revenue mechanisms available to Local Government were not designed to meet the financial burden of 'second generation' infrastructure renewal. Councils are also facing competing expenditure pressures due to cost shifting and to increased service demands on councils. A common response by councils has been to strip expenditure on asset

maintenance and not match asset depreciation with spending on asset renewals. This has induced an infrastructure backlog and an ongoing, annual infrastructure renewal gap.

Infrastructure backlog

Section 6.3 outlines specific reporting requirements for Local Government and various issues about the definitions and accuracy of data. Nevertheless, while the precise magnitude is not always clear, it is widely recognised that NSW councils have a backlog of infrastructure repairs and renewals stemming from inadequate past expenditure on maintenance and replacement.

Council annual reports estimate that \$6.3 billion or about 13 per cent of the total reported asset value is required to bring existing assets up to a “satisfactory standard”. In addition, a further \$14.6 billion is needed over the next 15 years to replace existing assets already identified for renewal (Roorda 2006, p4).

This backlog measure of infrastructure condition is retrospective - reflecting the ‘catch up’ needed to get infrastructure up to an acceptable condition today. It does not take account of new infrastructure needs generated by a growing and shifting population, changing profile, likely changes to building and construction standards or rising community expectations and demands.

This backlog or *costs to bring assets to a satisfactory standard* varies dramatically depending on the council asset and revenue bases. Some examples submitted to the Inquiry are summarised in Table 6.1 while Table 6.2 aggregates the total backlog by category of assets, broken into rural and urban councils.

Table 6.1: Snapshot of different council infrastructure ‘backlogs’

Council (Year 2004/05)	Total asset base (Written down value)	Costs to bring to satisfactory condition	Backlog as percentage of asset base
Bankstown	\$989m (\$591m)	\$81m	8% (13.7%)
Blacktown	\$1732m (\$1275m)	\$275m	15.8% (21%)
Dungog	\$179m (\$122m)	\$32m	17.8% (26%)
Eurobodalla	\$621m (\$406m)	\$160m	25.7% (39%)
Liverpool	\$1083.2m	\$169.5m	15.6%
Port Stephens	\$405m (\$312m)	\$14m	3.5% (4.5%)
Tweed	\$983m (\$636m)	\$117m	11.9% (18.4%)
Willoughby	\$512 m (\$268m)	\$58.8m	11.5% (21%)

Source: Council Submissions and ‘Condition of Public Works’ Special Schedule 7 (SS7) Reports provided in councils’ annual reports.

Table 6.2: Costs to bring assets to a satisfactory standard for all councils

Asset Categories	Maintenance / Renewal Backlog \$millions	
	Rural	Urban
Water	127	238
Sewerage	162	428
Transport	940	2819
Buildings	62	361
Drainage	52	1081
Total All Asset Categories	1343	4928
Total Rural and Urban Assets	6271	

Source: Roorda 2006, table 7, p23

Infrastructure renewal gap

The extent to which annual capital expenditure on renewing councils' existing assets falls short of the annual amount by which those assets depreciate is referred to as the 'renewal gap'.

The gap is calculated on replacing existing assets only – a 'like with like' replacement. The gap does not reflect additional costs of extension or substantial expansion of assets, which may be required or demanded by the community.

The renewal gap estimated by reports to this Inquiry shows that council's renewals expenditure falls short of requirements by between \$400 - \$600 million each year (Access 2006, p.iv and Roorda 2006, p5).

This means that there is a constant under funding of asset renewal over the long term by up to 50 to 60 per cent, which is the equivalent of seven to nine per cent of councils' total revenues or 11 to 12 per cent of their total rates and charges revenue (Roorda 2006, p8).

Table 6.3 shows the renewal gap ratios, that is, the ratio of current average renewal expenditure to depreciation. This analysis, which assumes that maintenance spending is satisfactory, reveals that councils are only funding between 50 to 60 percent of the required depreciation each year.

Table 6.3: Renewal gap ratios per asset category

Asset Categories	Renewal Gap Ratio %	
	Rural	Urban
Water	53	43
Sewerage	51	43
Transport	50	50
Buildings	53	43
Drainage	24	26
Total All Asset Categories	65	43

Source: Roorda (2006, table 5, p21).

For an explanation of the different methodologies used for calculating the infrastructure renewals gap see Section 11.4 (Reality – Infrastructure spending) of Chapter 11.

Challenges to Inquiry's infrastructure findings

Some responses to the Interim Report have criticised the estimates of backlog and renewal calculated in the Roorda and Access studies (e.g. Maxwell 2006b and DEUS 2006). The concern has been that the primary data relied upon, such as that reported by councils in Special Schedule 7 (SS7) and provided by other statutory and independent analysis, may contain significant inaccuracies. It is further argued that the values generated are a magnification and/or distortion of the true asset position in Local Government. Roorda has formally responded to each of these criticisms (Roorda 2006a and 2006b), while Access Economics responded by email.

Maxwell's view

Maxwell (2006b) raises particular concerns about the calculations of the \$6.3 billion infrastructure renewal backlog arguing that enhancement estimates have been incorrectly aggregated into the backlog estimates. Specifically:

In relation to an infrastructure network we contend that a network in a *satisfactory condition* will contain components that are in perfect condition, and components in such poor condition that replacement is imminent and it is the *average* condition of the network that should be assessed. Indeed, this automatically follows from the fact that infrastructure components are only replaced when they are in unsatisfactory condition – it can never be cost-effective to replace them when they are satisfactory. It follows therefore that the renewal backlog of an infrastructure network must be defined as the cost required to be incurred to bring the *average condition* of the network to satisfactory. Costs to increase the capacity of the network, or to meet standards adopted subsequent to construction of components, may form part of an *enhancement backlog*, but do not form part of a *renewal backlog*.

The costs to bring to a 'satisfactory condition' water and sewerage infrastructure of two councils, Eurobodalla Shire and Ballina Shire, are used by Maxwell to demonstrate these arguments. Maxwell asserts that Eurobodalla has incorrectly included enhancement backlogs in their renewal backlogs while Ballina's data since 2001 would suggest an extraordinary deterioration in assets with the result that:

... the so called renewal backlog for water and sewerage infrastructure is overstated by something of the order of \$117 million of a total of \$156 million by just two councils- an overstatement of some 74%.

Maxwell extrapolates these examples to argue that:

...if the level of overstatement applies across the board then the renewal backlog for water and sewerage amounts to \$250 million and not the \$955 million of the Roorda Report.

Moreover Maxwell feels that if a failure to distinguish enhancement backlog from renewal backlog is extrapolated to other types of council infrastructure the entire \$6.3 billion infrastructure renewal backlog arrived at by Roorda must be called into question. Maxwell refers to a study in 2001/02 that suggested a renewal backlog of \$3.7 billion and says that Roorda's estimate represents a 70 per cent jump on this estimate in just 4 years.

Overall Maxwell asserts that:

... all the evidence points to a major, material, over-statement of the renewal backlog, which again is more likely to be in the order of 100% - 200% of councils' annual rates revenues, and that reduces the renewal backlog to more manageable levels.

Finally, Maxwell argues that since enhancements have been included in the backlog calculations, they are also captured in Roorda's estimated \$14.6 billion renewal bill because \$14.6 billion is actually a combination *renewal and enhancement bill*. Maxwell argues that on his calculations the annual renewal gap is 50 per cent less than Roorda's and therefore the renewal gap will grow to only \$7.5 billion in 15 years.

The Inquiry sought responses from the councils used as examples in these criticisms as well as a response from Roorda.

Eurobodalla Council rejects Maxwell's analysis and the conclusion that it has incorrectly included enhancement spends in its assessment of renewal backlog for water and sewerage:

[Our renewal spend proposal] represents a renewal backlog required to maintain infrastructure assets at the same level of service, with the service design or standard altered only to reflect contemporary standards by government. The renewal spend does not deliver additional services or capacity for a population different from that which existed at the time of the survey (Eurobodalla Shire Council private correspondence 2006).

Ballina Council's answer to Maxwell is that the sharp rises in its renewal backlog figure between 2001 and 2004 simply reflect a quantum improvement in its engineering judgements of what it would cost to bring its assets (especially sewer assets) to a satisfactory standard. It also believes that when its asset management plans are developed these will show its current estimates to be an understatement of the true cost of renewals. However, it agrees with DEUS (see below) that the water and sewer component of its assets has been established to be self-funding and so is not reliant on Council support. In other words all capital and renewal works associated with its LWU will be funded by a combination of reserve accumulation and loan funds that can be serviced from existing water charges (Eurobodalla Shire Council private correspondence 2006).

Following is Roorda's response to Maxwell's assertions (Roorda private correspondence 2006):

- The concept of applying 'average condition' of an infrastructure network is flawed. Condition cannot be averaged across sets of infrastructure but carried out per asset in order to make a meaningful assessment of satisfactory.
- Our analysis relies on four sources of asset data: council annual reports SS7 information (2003/04); survey results from a specially commissioned Inquiry survey (December 2005); data submitted to the NSW Grants Commission for Roads and Assets (Dec 2005); and the NSW IPWEA Transport Asset survey (Dec 2005). All of these data sources have explicit separation requirements for renewal and enhancement items. SS7 has a statutory requirement for separation of renewals and enhancement items. The Inquiry's commissioned survey of Councils also explicitly sought a separation of enhancement and renewal values. Primary reliance was placed on SS7 data as it was the most complete set across Councils. Of the four data sets used, SS7 was the most conservative and provided the lowest overall estimates of renewal backlog and future renewal gap.
- Maxwell's assumption about the inclusion of enhancements in Council backlog estimations is unsubstantiated. It is based on a very small sample of Councils (2 of 150) and is insufficient to extrapolate to all Councils. Moreover the Councils in question dispute the assumption outright. This is not a sound basis to argue that there are errors in the renewal backlog estimate.
- The \$14.6 billion renewal gap was directly based on 100 Councils survey responses to this Inquiry. Councils were specifically instructed to separate enhancement and renewals. The renewal gap estimates are therefore not overstated by any incorrect inclusion of enhancements.
- 80 per cent of Councils have no asset management plans or risk management plans. This means their capacity to foresee peaks in renewals, make planned adjustments to service levels and understand the cumulative consequences of decisions is limited.
- There is no link between revenues and service costs for all assets other than water and sewer (approximately 90 per cent of total assets by value across NSW). Our detailed sampling shows that (most) Councils don't know the life cycle cost of service provision.

Morrison Low Consultants Pty Ltd, an asset management practice that specialises exclusively in Local Government in Australia and New Zealand challenges Maxwell's proposition that 'There is NO future \$14.6 billion renewal bill' (Morrison Low 2006, p4):

Our detailed analysis appended to this submission clearly demonstrates that there is a large future renewals bill that could even exceed \$14.6 billion. Our opinion is based on a combination of extensive engineering and accounting analysis in the specialist field of asset management.

DEUS's view

The DEUS criticisms of Roorda's findings are confined to water and sewerage assets. It argues (DEUS's private correspondence 2006):

The central issue is that a Local Water utility (LWU) which has prepared a sound 30 year strategic business plan and financial plan (SBP and FP), and has determined that it needs say a Typical Residential Bill (TRB) of \$400/a in current dollars to meet all its projected capital and operating expenditures for delivering its sewerage services over the next 30 years has effective control of the sewerage business.

Providing it continues to levy a real TRB of \$400/a it will have the necessary funding to manage its sewerage business, including meeting all its capital works needs for growth, levels of service and renewals. Accordingly, there is no renewal gap for such an LWU, as all its renewals needs can be funded from its future revenue stream.

This is the reason DEUS has focussed on getting all LWUs to have a current SBP and FP by June 2009. As noted in the DEUS submission 77% of LWUs have now prepared a sound SBP and FP and 58% of LWUs have a current SBP and FP.

Further confirmation that LWUs are not running down the levels of service of their water supply and sewerage systems is provided in the annual *NSW Performance Monitoring and Benchmarking Reports*, which are on the DEUS website. These show good levels of service, with significantly better performance than the other states in many important areas, such as a consistently lower incidence of odour complaints, watermain breaks, sewer chokes and sewer overflows. In addition:

- The economic real rate of return is significantly higher than the country utilities in the other states, and
- The annual operating cost/property for water supply and the residential consumption per property are significantly lower than the country utilities in the other states.

In addition, it is important to note that the NSW LWUs now have a total of \$1.1B in cash and investments for application towards funding their future capital works needs.

Roorda says this of DEUS's arguments (Roorda private correspondence 2006):

In the case of water and sewer, projections for substantial future increases in renewal expenditure may well be able to be met if Councils have cash reserves or the capacity to raise and repay loans when renewals are needed. DEUS has raised the important issue of Councils having cash reserves and so Council's may well be able to fund these renewals. We have not concluded that they can't – only pointed to the scale of the future renewal and the need for good asset management plans.

DEUS is correct in saying that the asset management plan (SBP / FP) regime for water and sewer is in place and we agree that it is very comprehensive. It is very different and much better than the requirements for other infrastructure.

We were therefore surprised to get Councils' responses to the survey on the low levels of asset management plans and risk management plans for water and sewer – but that is how they (100 Councils) responded.

Our report defines the renewal gap as “The difference between the average annual renewal expenditure and annual depreciation. There is no relationship between the ‘renewal gap’, the long-term service cost, and the expenditure needed at any point in time”.

Councils have identified that future renewal will need to be much higher than current levels. Current renewal is also much lower than depreciation. There must therefore by our definition be a renewal gap.

We agree with what we understand DEUS to be saying in that if LWUs have a funding model for future renewal expenditure then the current renewal gap exists, but is no cause for concern.

(However), Councils are reporting a substantial gap between renewal expenditure and the rate of asset consumption (whether in LWUs or their other operations). We didn’t invent the renewal gap – we simply reported what Councils themselves are saying in their annual reports, audited financial reports, returns to Grants Commission and returns to our survey.

Even if LWUs have no funding gap (something we can’t accept at face value given our findings) this does not affect our conclusions because around 90 per cent of infrastructure assets are not on a user pays model. For these assets there is no relationship between revenues and service costs.

Councils have no funding models, no substantial cash reserves, no future plans yet are reporting they are renewing assets at half the rate they are being used up. The renewal gap is simply an indicator of an underlying problem. Our recommended solution is precisely what DEUS is arguing – a funding model, but one that applies to all Council activities, not just LWUs.

We do not agree that “there is no renewal gap” if that means everything is OK. If that was true then Councils audited financial reports should be significantly amended to show they have enough revenues to provide all services plus renewals. This is not the case.

Access Economics has this to say about DEUS’s criticisms:

In practice with regard to the amount of annual renewals expenditure that is undertaken and that should be undertaken, the DEUS attack on using accounting depreciation as a proxy for the required (“desired”) amount of annual renewals expenditure to be undertaken is overstated at best.

DEUS overlooks the failure of LWUs to publish direct estimates of the actual amount of annual renewals expenditure (let alone publish estimates of the desired amount), and the fact that our analysis (and Roorda’s) is in relation to asset registers in total.

For a total asset portfolio remaining asset lives vary considerably, with the tendency of accounting depreciation to over- and under-estimate the required (“desired”) amount of annual renewals expenditure increasingly likely to be cancelled out as the organisations under consideration get bigger and/or the longer they have been in operation.

Finally, Morrison Low commenting on the view held by both Maxwell and DEUS that there is no relationship between depreciation and asset renewal makes this observation:

In our opinion there is a correlation between financial depreciation (which we think the authors are referring to) and consumption of the asset. Consumption requires renewal and replacement funds to be expended in order to sustain an asset in its current level of service.

While it is not a direct one to one relationship (consumption is an engineering based forecast of the future cost of sustaining the asset whereas depreciation is an accounting based assessment to recognise that assets fail over time) it is our belief that, if there is no other reliable information, depreciation at least is an approximate measure of consumption. Therefore in NSW depreciation is a useful starting point.

The Inquiry's view

The Inquiry and the commissioned consultants (Roorda and Access) were aware of the limitations of the primary asset data and caveats have been clearly stated in this report. The following section 6.3, Asset Accounting and Management, outlines the current deficiencies in Local Government asset valuation and information in detail. However the Inquiry is confident that the estimates of infrastructure backlog and renewal have taken these limitations into consideration and are as robust as possible.

To be cautious the Inquiry is prepared to accept DEUS's assurance that all LWUs have sufficient reserves and future income streams (with current pricing policies) to be able to both fund their reported renewal backlog of \$955 million and their average annual renewal gap of \$77 million over the next 15 years without achieving excessive debt/equity ratios (Roorda 2006, figure 2, p6). However, the Inquiry's view is that this is made possible because DEUS is not insisting on LWUs paying councils a commercial rate of return on their equity (as the State Treasury requires from state enterprises).

Assuming that LWUs can fully fund their \$955 million renewal backlog this still leaves funding to be found for councils' remaining \$5.3 billion backlog in non-water and sewer assets. As for the Inquiry's estimate of an annual renewal gap for Local Government of \$500 million, it believes this figure is already so conservative that it does not warrant an adjustment for any ability by LWUs to internally fund their own gap (see section 11.4 – Reality – Infrastructure spending).

How did the infrastructure crisis happen?

A question the Inquiry is often asked is, why did councils allow infrastructure to fall into disrepair before they raised an alarm? IPWEA (2006, pp 4 and 10) provides a list of 'fundamental issues' that perhaps provide a clue:

- A lack of knowledge and understanding of the infrastructure management problem by elected Councillors, General Managers, Finance Professionals and some Engineers;
- A propensity for Councils to forego maintenance to provide funding for new capital works;
- A general lack of understanding of Whole of Life Costing and the minimisation of long term costs by the use of timely maintenance;
- A lack of asset management expertise within the majority of Councils, but particularly those in the western region of the state;
- A reluctance by Councils to allocate resources to improving the asset management expertise within their organisations (we can't afford to carry out our existing functions – how can we fund an asset management system and / or staff?); and
- The current trend towards 'de-engineering' of critical technical positions and the loss of community standing and identity (caused) many to look elsewhere for professional and personal satisfaction in their career development.

Two ratepayers groups each saw politics as the main culprit:

To some extent (the under-funding of infrastructure) has been driven by Local Government pandering to perceived ratepayer expectations or those views of dominant Counsellors of select political or social justice persuasion, that it can deliver non essential services that are really beyond its means (Lake Macquarie Ratepayers Action Group , p1)

The present unsatisfactory state of infrastructure reflects the collective decisions of Councils to use their available resources for purposes other than the maintenance of infrastructure. Instead, they have chosen

to undertake more attractive activities, including the enlargement of their service range. That kind of thinking may well reflect inadequate accounting information about the state of roads and drains, but it also reflects deliberate choice by people elected on particular platforms or none (Vaucluse Progress Association, p2).

Whatever the reasons, the challenge now for Local Government is how to fix its failing infrastructure.

Remedies

The reality is that councils have an infrastructure portfolio they are struggling to maintain and renew under the current allocation of Local Government responsibilities and revenue mechanisms. This is due in part to a legacy of infrastructure from other tiers of government along with different circumstances of rural, urban, growing and declining councils to respond to pressures being placed on particular infrastructure items.

Current infrastructure is not being maintained or renewed to satisfactory standards. Funding for the costs of future infrastructure is well short of what is required for sustainability. This appears to be a consequence of cumulative poor information and understanding of asset management, shortfalls of operating revenue and use of capital grants, contributions and asset sales proceeds to cover operating deficits instead of the purposes for which these funds were intended.

A debate is required as to whether the current infrastructure portfolio of Local Government is best managed by Local Government. While Local Government is primarily responsible for its infrastructure portfolio through ongoing funding contributions made to Local Government, there is an implicit acknowledgement of Commonwealth and State Governments' co-obligations. Since a substantial portion of Local Government infrastructure that originated from other tiers of government is now reaching 'second generation' renewal, it is appropriate for infrastructure and management funding practices to be reviewed.

Different infrastructure obligations are also placed on rural and metropolitan councils. The capacity of different councils to meet these obligations is being affected by whether they are experiencing growth or decline in their populations. These circumstances should be considered in the allocation of future infrastructure responsibilities and systems for revenue and funding. (See Section 6.4- Infrastructure Funding).

Infrastructure items should be examined on a type-by-type basis considering future technologies and demand, management expertise and funding capacity that 'best fit'.

An outcome of 'best fit' analysis could be formal agreements between various tiers of government that define shared responsibilities and relationships for various types of infrastructure. These would form the foundation for revising approaches to joint funding. Another outcome could be the reduction or transfer of responsibilities from Local Government to other levels of government or even to the private sector. These agreements may form a subset to Intergovernmental Agreements or Partnership Agreements discussed in Chapter 5 or they could operate unilaterally between infrastructure agencies and NSW councils.

Option 1: Review and revise local infrastructure obligations between all tiers of government through an intergovernmental agreement (IGA).

Pros

- Would clarify respective responsibilities of and corresponding funding for infrastructure provision;
- Would enable each level of government to align revenue and funding arrangements to their recognised obligations; and
- ‘Best fit’ management would be matched to the type and scale of particular infrastructure.

Cons

- Such analysis would be a very expensive process with a great deal of coordination and negotiation required between governments; and
- Agreements regarding councils’ responsibilities would not, in themselves, generate revenues to fix the infrastructure shortfall.

6.3 INFRASTRUCTURE ACCOUNTING AND MANAGEMENT

Requirements

Infrastructure spending can take various forms, though in practice these distinctions are rarely recognised in council accounts. The first is annual routine maintenance of physical assets. The second is rehabilitation of assets that have prematurely degraded because they were not routinely maintained. This is sometimes colloquially called ‘backlog maintenance’. Orderly or emergency repairs may either be routine or backlog depending on their size of expenditure. Thirdly, there is asset renewal where money is set aside for renewing an asset periodically to reinstate its original service potential or replacing an asset when its economic life expires. Ideally, such funding for a portfolio of assets should equal the portfolio’s annual rate of financial depreciation (which as we saw earlier is different to its annual rate of physical degradation). Finally, there is asset enhancement where an asset’s service capacity is expanded beyond what it was originally.

These concepts can be illustrated with an example, say a one-lane steel bridge. Routine maintenance involves painting it each year so it does not rust. Rehabilitation may involve undertaking major repairs to it because it got rusty from neglect. Renewal would mean bringing its service capacity back to what it was when it was first built. This could involve replacing all its components other than those that might last indefinitely (e.g. waterproof concrete foundations). Enhancement could involve adding a second lane to the bridge so that it can cope with increased traffic.

Accurate accounting for infrastructure assets is very important to all levels of government. The public sector is generally more capital asset intensive than the private sector - Australian Local Government holds assets of around \$150 billion (IPWEA Submission 2005, p5). As indicated above, it is estimated that NSW Local Government holds around \$50 billion in assets, or one third of this national total. These asset values are at book value, not fair value.

Appropriate infrastructure accounting is a major factor in every council's financial operations. Local Government should be operating consistent accounting practices across the sector. Each local council should have a total asset management system for the whole of life planning, funding, acquisition, registration, accounting, operation, maintenance, disposal and renewal or enhancement of each component of its infrastructure.

Reality

The significance of the infrastructure renewal problem is undisputed although the precise amount of funds required to address it cannot be adequately calculated because of accumulated accounting and infrastructure management inconsistencies.

The current infrastructure accounting and reporting requirements for NSW Local Government are not consistent and are interpreted differently between councils. Unlike the rest of the NSW public sector, there is no mandated requirement for total asset management principles and practices to be adopted by NSW councils.

Current accounting and reporting requirements

The NSW council's charter in Section 8 of the *Local Government Act (NSW) 1993* (LG Act) says that a council has:

...to bear in mind that it is the custodian and trustee of public assets and to effectively account for and manage those assets for which it is responsible.

Since the introduction of the LG Act in 1993, NSW councils have been required to report on asset condition in a template format in their annual reports. Section 428(d) of the LG Act requires councils to report in their annual financial statements on the "*Condition of Public Works*" (Special Schedule 7) under their control.

The condition report focuses on the estimate of the amount of money required to bring council infrastructure up to a satisfactory standard and must include estimates of the following for each asset class (IPWEA Submission 2005, p14):

- Cost of the asset;
- Written down value;
- Depreciation rate;
- Depreciation expense;
- Accumulated depreciation;
- An estimate of asset condition;
- Estimated cost to bring to a satisfactory standard;
- Estimated annual maintenance expense; and
- Program maintenance works.

However, little guidance is provided on what these terms mean or the timeframe involved.

NSW councils have also been required to comply with AAS27 - *Accounting Standards for Government*, which has been progressively rolled out for existing infrastructure assets since 1993. AAS27 and the *Condition of Public Works* report are the only mandatory requirements imposed on NSW councils for infrastructure reporting. NSW councils are not required to

apply specific asset management processes or standards such as AAS 4536 Life Cycle Assessment or AAS4360 Risk Management. Nor are councils required to adopt any of the many existing infrastructure management processes such as *International Infrastructure Management Manual* (IIMM) or the NSW Government's *Total Asset Management* (TAM) system that applies to state agencies.

The NSW Department of Local Government (DLG) is responsible for monitoring compliance with annual reporting requirements including the infrastructure reporting components. The DLG also publishes the *Local Government Asset Accounting Manual* to guide councils in accounting compliance. The manual sets out key elements for effective asset accounting such as Asset Ownership Determination, Capitalisation Principles, Asset Recording Principles, Valuation Principles and Components, Depreciation Methodologies and Useful Life Assessment Issues.

Yet according to one interested party (IPWEA 2006, p7):

Since 1993 there have been appropriate standards (AAS27, IIMM, etc), but no reporting standards and no external auditing of reported asset management data (Special Schedule 7). This has resulted in the current unsatisfactory situation.

The IPWEA National Asset Management Strategy (NAMS) Committee, which originally prompted the IIMM, is currently developing National Asset Condition and Financial Reporting Guidelines for use by council asset managers Australia-wide. They should be ready by the end of 2006.

Accounting and reporting deficiencies

While the *Condition of Public Works* report provides a point of reference for understanding the infrastructure position of councils, the Inquiry has been told that the quality of infrastructure reports is generally poor, and the auditing by the Department of Local Government minimal (IPWEA Submission 2005). Overall infrastructure accounting and reporting by NSW councils is regarded as inconsistent and deficient in various aspects including:

- Recording and classification of assets;
- Defining 'satisfactory' assessments;
- Asset valuation approaches;
- Determining depreciation expenditure;
- Determining maintenance and capital expenditure;
- Infrastructure renewal gap; and
- Asset management systems.

Each of these topics is discussed in turn.

Recording and classifying assets

Asset registers provide the foundation for good asset management. Councils' capacity to effectively manage infrastructure is limited if asset registers are incomplete or inconsistent. Prior to the introduction of *Condition of Public Works* and AAS27 requirements in 1993 there was no uniform council method of asset information recording. Many councils were not

comprehensively identifying or registering their assets (Ryan 2003, p67). Asset construction dates and costs of original construction were not necessarily recorded by councils (Maxwell 2005, p11).

The introduction of relevant requirements through the LG Act compelled councils to establish asset registers to record and value assets¹⁹. However, the structure and detail of information in these registers is still not uniform and there is no requirement imposed on councils to audit the registers.

The lack of consistent recording of Local Government assets is an ongoing concern for Local Government. The Inquiry has found that 80 per cent of NSW council asset registers created have not been indexed or re-valued since 1993. Also, four per cent of water and sewerage registers have not been re-valued since 1997 or earlier (Roorda 2006, p10).

The reasons for this widespread failure of Councils to update asset records was not examined by the panel, however in the NSW Standing Committee on Public Works Inquiry into Infrastructure Provision in Coastal Growth Areas completed in 2005, Councils' capacity and resources to maintain asset records was considered. This report noted that Councils cited difficulties in accessing resources and expertise to audit and update records of infrastructure condition. The report recommended that State Government provide assistance to fast track and resource Councils infrastructure audits as a means to improving coastal region planning and identifying infrastructure priorities for coastal areas (LASCPW 2005 p117-118)

Defining 'satisfactory' assessments

Each council is required to assess whether assets are at a 'satisfactory' standard. No common definitions of 'satisfactory' are attached to the report requirements (Byron Council Submission 2005). What is deemed a 'satisfactory' standard differs from one council to another. For example, some councils regard a satisfactory standard to be ultimately sealing all roads in their local area whilst other councils adopt a view that an unsealed road of a particular standard is satisfactory depending on the circumstances. Based on aggregated condition reports, NSW councils have a current backlog of infrastructure renewal of \$6.3 billion to bring assets to a satisfactory condition (Roorda 2006, p10).

Council assessors usually base the determination of a 'satisfactory' standard for asset related services on engineering estimates or analysis. Analysis of 'satisfactory' based on community outcomes such as level of service, life cycle, functionality, risk and safety are applied by less than 20 per cent of NSW councils (Roorda 2006, p11). Very few councils consult with residents to determine satisfactory measures or benchmarks²⁰. However, polling conducted by this Inquiry reveals residents feel that the levels of service relating to assets (especially roads, pavements and kerbing), many of which are deemed 'satisfactory' should be higher than that applied by professional council assessors (IRIS Research 2005).

Asset valuation approaches – 'at cost', 'fair value' and special asset valuations

There are two approaches to valuation of infrastructure being used by NSW councils. The majority of councils are reporting on assets 'frozen' at their original or historic values when the current reporting requirements commenced. These values are described on a 'at cost' basis

¹⁹ Section 163 of the Roads Act 1993 required all NSW Councils to have a local road asset register.

²⁰ Section 402 of the Local Government Act does require councils to survey communities on local road service standards as part of its rates determination process.

rather than a 'fair value' (fair value is the present market value or replacement cost). This valuation method is permitted under Australian Standards. Therefore many councils adopted this approach to avoid the need and cost of revaluation of assets each year²¹. However, it appears that 'at cost' valuations was not the long term approach envisaged by the NSW Department of Local Government whose Asset Accounting Manual recommended revaluation of infrastructure assets every five years. By comparison, NSW state agencies are now required to revalue their assets every three years.

The Inquiry's survey of councils reveals that even today only 13 per cent of NSW councils are measuring and reporting the 'fair value' of their assets. The vast majority (85 per cent) of councils still apply the 'at cost' valuation method (Roorda 2006, p11). Even council water and sewerage assets, which have additional reporting requirements under state legislation, are predominantly valued on an 'at cost' basis (i.e. 60 per cent of councils are still reporting water and sewerage values at cost) (Roorda 2006, p10).

These inconsistencies in asset valuation approaches are important because it changes the interpretation of councils' financial position and performance. 'Fair' valuations of asset items tend to be higher than 'at cost' valuations. Hence if council assets were valued at 'fair' valuations then the value of assets would be generally greater and subsequently depreciation expenses higher (Ryan 2003, p69). In the analysis commissioned by this Inquiry it has been estimated that depreciation expenses may be up to 20 to 30 per cent higher than currently reported by most NSW councils (Access Economics 2006, p16; Roorda 2006, p4). The percentage applied is an average from three different sources of suggested depreciation adjustments.²²

As long as councils (85 per cent) continue with 'at cost' valuations, the vast majority will be underestimating their true asset values, and therefore also understating the extent of depreciation expenditure in their financial reports. For example, Lake Macquarie Council recently revalued all its assets from historical cost to replacement cost or 'fair' value. The impact of the revaluation was an increase in asset value by \$424 million. A consequence of the revaluation is that depreciation expenses have increased from \$9.7 million in 2000 to \$20.46 million in 2005. (Lake Macquarie City Council 2005, pp2-3)

These variations and inconsistencies in asset reporting and valuations have wider implications for infrastructure provision across levels of government. If councils are not consistently recording and valuing their infrastructure then any aggregation of regional infrastructure needs are distorted. Consequently, it is difficult for the State and Commonwealth Government to allocate funds and to coordinate complementary infrastructure effectively.

Revising asset values to either 'at cost' or 'fair' valuation does not resolve all valuation concerns. Some argue that special 'unique' public assets such as heritage assets and 'land under roads' should not be valued like other infrastructure assets.

Some believe that heritage assets are not owned by councils, but are held in perpetuity for the community and as such are not available for sale like other assets. Furthermore, the notion of replacement/renewal cost and 'useful life' for historic 'irreplaceable' assets is not relevant. On

²¹ This approach is permitted under AAS38, which was introduced in 1999.

²² The 30 per cent understatement of depreciation is based on two sources: CPI based escalation of asset replacement values and a midpoint between the IPWEA estimate of 41 per cent revaluation and the NSW Grants Commission estimate of 15 per cent revaluation.

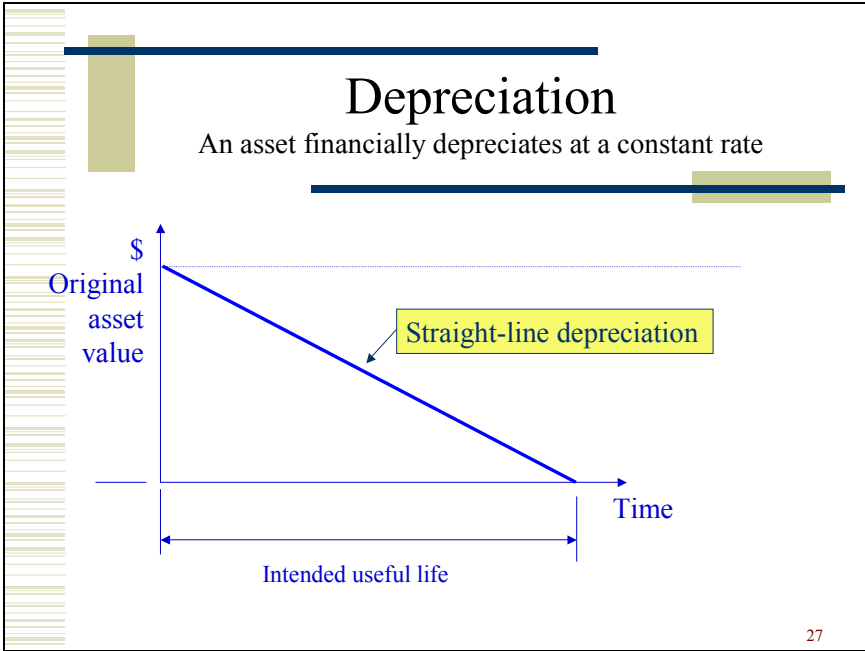
this basis, while it is recognised that heritage assets require maintenance expenditures, it is argued that depreciation concepts should not apply and these items should be treated differently from other infrastructure in financial reports (Ryan 2003, p70).

The valuation of the corridors of land on which roads are built is also controversial. While accounting standards initially required councils to value 'land under roads', councils have been able to opt out of this requirement. This is because when councils did value land associated with roads, pavements and kerbsides, they found it dominated their asset values. Depreciation of roads often shifts councils into deficit, particularly rural councils with large road networks (Riverina East ROC Submission 2005, p6). There is also debate about whether councils have a genuine capacity to separate and sell 'land under roads'. Most councils sensibly only value roads in terms of surface replacement and renewal, not the land on which they are built (Ryan 2003, p71).

Determining depreciation expenses

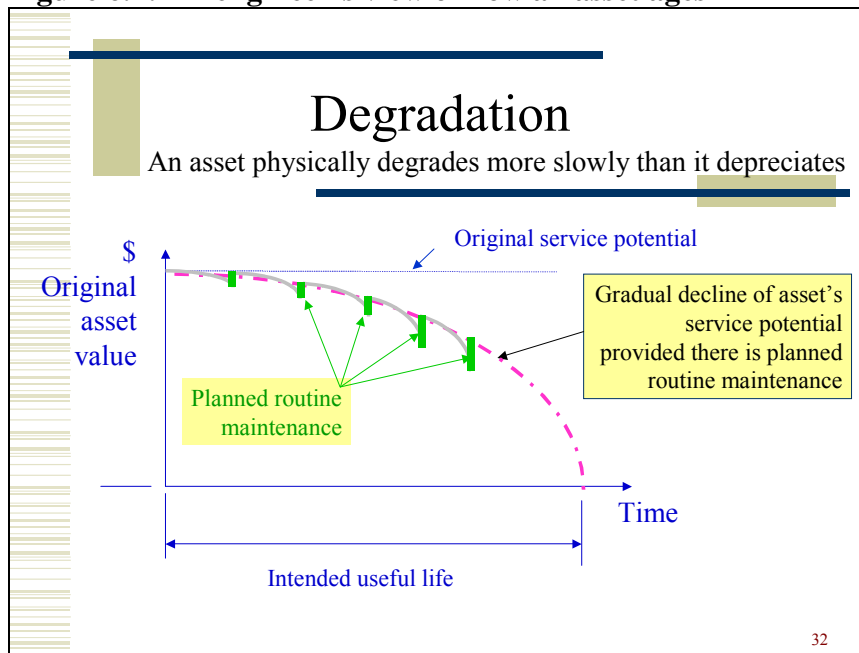
Depreciation is the financial representation of the consumption of the asset over its useful life. Depreciation is commonly standardised by accountants to a fixed percentage rate that assumes the value of the asset declines by a straight line to nil by its life end. Depreciation is not a measure of the required maintenance expenditure on an asset in any given year. Nor does it reflect the actual deterioration pattern of an asset as monitored by an engineer. In reality, most assets deteriorate exponentially towards the end of their useful life with little expenditure needed in the first 50 per cent of asset life (Roorda 2006, p18). Rather than collapsing in a straight line from birth to death, they hold up well for much of their life and then deteriorate rapidly even if given ongoing care and attention.

Figure 6.1: An accountant's view of how an asset ages



Source: Percy Allan & Associates Pty Ltd.

Figure 6.2: An engineer's view of how an asset ages



Source: Percy Allan & Associates Pty Ltd.

The reason that accountants depict assets as depreciating by an equal percentage each year is to prompt their owners to set enough money aside for their eventual renewal, a bit like owning a car that is designed to last 10 years and then saving 10 per cent of its fair value each year for its eventual replacement. Of course, if one owns a fleet of 10 cars each bought a year apart then renewing them by 10 per cent per annum would ensure they maintain their service capacity. Council assets are not dissimilar where they have a large portfolio of assets with staggered lifecycles. Spending the same amount on renewals each year as the assets depreciate by ensures that they remain serviceable. It does not improve or expand the number of assets, but simply keeps them up to standard.

For discrete lumpy assets such as a water supply main, annually renewing it by an amount equal to its depreciation would not be cost effective. Yet if the main's owner, a LWU, was to annually contribute to a reserve an amount equivalent to its depreciation this would ensure that at the end of the assets life those who had benefited from it would have fully met its replacement cost.

If councils were to use an engineers' asset degradation path for funding assets they would not get around to depreciating them and thereby setting aside money for their replacement until they showed real wear and tear. By then it would be necessary to fund most of the renewal cost in a short time span, something beyond the resources of all but the richest councils. Unfortunately, this is the quandary most councils now find themselves in. They have left it very late to start funding the renewal/replacement of long-life assets that are nearing the end of their useful economic life – the point at which maintaining them gets more expensive than the services they generate. Vintage cars are a hobby, not an economic proposition. Vintage council assets can become too risky and expensive to sustain.

AAS27 and the requirement to account for depreciation (AAS116) were introduced so that councils could focus on the cost of depreciation and the quantum of funds required to replace or renew ageing infrastructure. Despite the availability of accounting standards, the

depreciation assessment remains a subjective process reliant on the interpretation of council assessors.

Accurate calculation of depreciation relies on accurate estimates of each asset's value, residual value and useful life. Apart from water and sewerage services, where the NSW Reference Rates Manual provides guidance for depreciation of water supply, sewerage and stormwater assets, asset valuation approaches by NSW councils are not consistent. Neither are their definitions and interpretations of depreciation.

Depreciation is the cost of an asset, less its residual value at the end of its usable life. Simplified, residual value is the expected value of an asset on disposal at the end of its usable life (after deducting disposal costs). Applying this concept to items like plant and equipment is simple, yet there are different interpretations made in the assessment of the residual value of infrastructure:

...use the example of the wearing surface of a sealed road...One such approach assumes that the useful life of the seal extends only until it is re-sealed. Because the reseal is applied directly over the original seal, the residual value of the remnant of the original seal is high [in some instances this has been set at 90%], and is incorporated into the cost of the resealed surface. The other approach assumes that the wearing surface is a compound asset with staged acquisition at intervals of a number of years and a long useful life until no further reseals can be applied and the amalgam of a number of coats of seal must be broken up and recycled. The appropriate residual value of the recycled material is the cost of an equivalent quantity of new material less the future cost of recycling, and is therefore very low [usually nil]. At the moment there is neither a correct answer nor consensus as to the preferred approach. (Maxwell 2005, p12)

There is also debate about the 'useful life' of infrastructure assets. As noted earlier the notion of useful life may not have relevance for infrastructure like heritage items. Also, new technologies may extend initial estimates of useful life. For example, new roads sealing compounds for pavement cracks can increase the life of road paving without the need for replacement (Lane Cove Council Submission 2005). This may mean that depreciation costs have been overestimated.

Various responses to the Interim Report have argued that there is a misplaced emphasis on depreciation. For example, the LGSA argues that councils should not be required to allocate depreciation expenditure according to the AAS116 requirements unless corresponding additional revenue can be accessed. If revenue is made available the LGSA also suggests that the funds be 'prioritised for' but not 'exclusively used for' asset renewal. The LGSA argues there may be instances such as asset rationalisation which means the funds are not necessarily consumed in the long term for asset renewal purposes. Similar views were expressed by WESROC, the Local Government Managers Association and North Sydney Council in feedback to the Interim Report.

A further issue raised is the appropriateness of the application of straight line depreciation. IPWEA supports the inclusion of cash funded depreciation, but argues for the use of a depreciation scale which aligns closer to actual engineering degradation of particular assets. While the Inquiry acknowledges the distance between the two depreciation interpretations, it believes a degradation depreciation scale would prevent uniformity and comparison of asset evaluations across councils. It is also inconsistent with the principles of accrual accounting and the appropriate allocation and planning for asset renewal needs.

The main reason that councils now have a financial crisis is that insufficient funds were set aside in the past for the eventual renewal of physical assets. Now that much infrastructure is reaching the end of its useful life councils are faced with the daunting task of finding the necessary funds. Effectively, councils funded renewals using more an engineer's degradation path (which sees most decline in old age) than an accountant's depreciation accrual path (which spreads the provision for decline equally over the asset's lifecycle) and are now feeling the pain for having done so.

Determining maintenance and capital expenditure

The relationship between depreciation, maintenance and capital expenditure can be explained as follows:

The charging of depreciation does not cover the maintenance requirement to keep an asset in its normal condition. Thus, in addition to the charging of depreciation, any maintenance expenditure should be charged as an expense of the period in which it occurred. However any expenditure to increase the service potential of an asset is a "capital expenditure" and should be added to the asset value (Ryan 2003, p71)

While separation of maintenance and capital expenditure is required, councils in their *Condition of Public Works* description of annual expenditure apply different interpretations of these terms. For example, the expenditure on renewal of an existing bridge and the higher level of service provided by an additional lane should be reported separately as required by the Local Government Asset Accounting Manual, but may be regarded erroneously as renewal by one council and enhancement by another (Roorda 2006, p38). Such errors mean that different estimations of asset value and allocations of depreciation may be made across councils for similar items.

In physical terms, councils are also choosing not to undertake required maintenance on their infrastructure. For example, the Great Lakes Shire Council notes that in its rural roads maintenance program, sealed roads are resurfaced once every 23 years compared to a desirable standard of once every 7-10 years (Great Lakes Council 2005, p2). Singleton Council has over 700km of road networks within its responsibility, but also another 100 km of unsealed public roads that it simply does not maintain (Singleton Council 2005, p5).

Around seven per cent of rural councils and 25 per cent of urban councils are renewing less than 30 per cent of the infrastructure that should be renewed each year. This can accelerate the deterioration of assets in the medium term and raise councils' risk exposure. A snapshot of councils' estimated maintenance needs and actual maintenance expenditure is provided in Table 6.4.

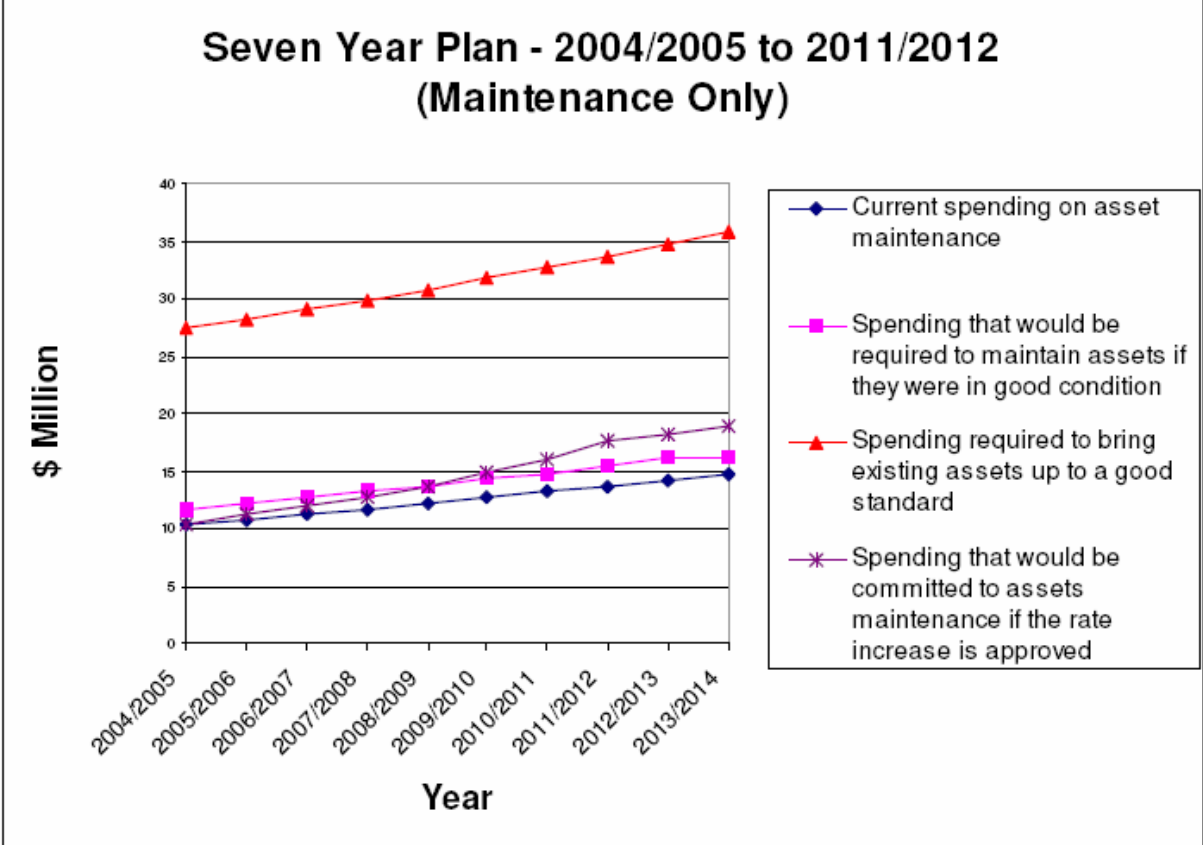
Table 6.4: Snapshot of different council maintenance needs and expenditures

Council (year 04/05)	Estimated annual cost of maintaining asset	Actual annual maintenance expenditure	Maintenance expenditure shortfall (%)
Bankstown	\$11.587m	\$11.353m	\$0.234m (-2%)
Blacktown	\$43m	\$28m	\$15m (-34%)
Dungog*	\$3.625m	\$2.332m	\$1.293m (-35%)
Eurobodalla	\$10.286	\$7.442m	\$2.844m (-27%)
Liverpool	\$25.4m	\$16m	\$9m (-35%)
Port Stephens	Na	Na	Na
Tweed	\$23.37m	\$25.605m	\$2.235m (+ 9%)
Willoughby	\$5.095m	\$4.894m	\$0.200m (-3.9%)

Source: Council submissions and 'Condition of Public Works' Special Schedule 7 Reports provided in councils' annual reports. Dungog Council figure excludes maintenance on public buildings*

An illustration of the combination of backlog maintenance expenditure and shortfall in current asset maintenance was provided by Bega Valley Shire Council, which identifying a projected ongoing maintenance shortfall of approximately \$15 million over the next seven year planning period.

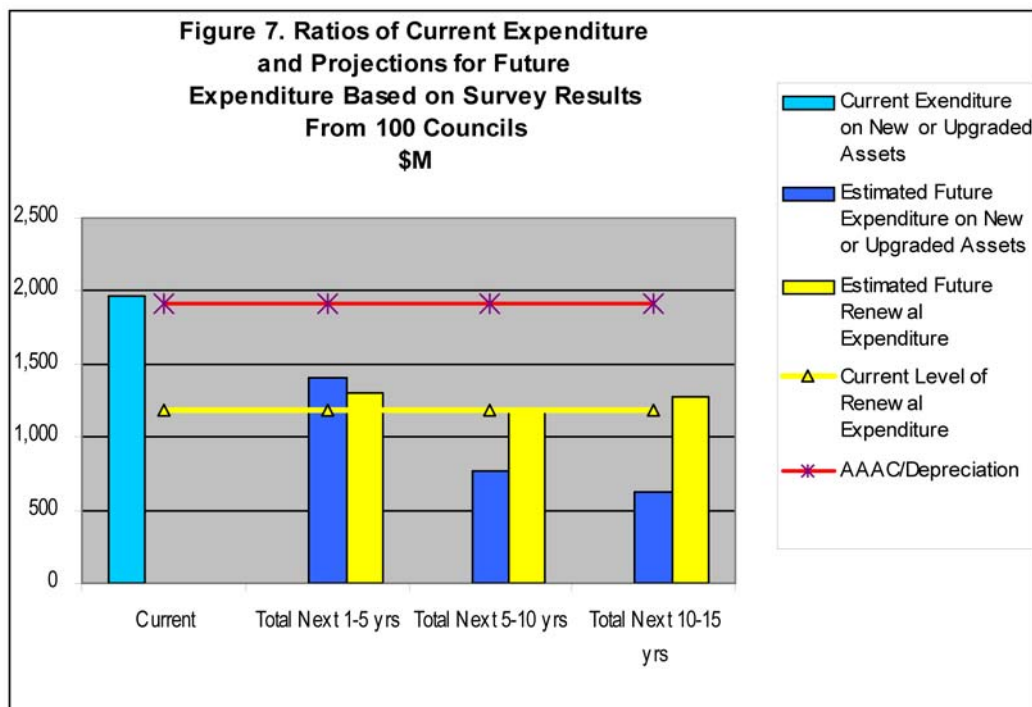
Figure 6.3: Bega Valley Shire Council’s seven-year maintenance and expenditure plan



Source: Bega Valley Shire Council 2005, App. 2, p. 13.

The projected expenditure pattern of Bega Valley Shire Council is typical of most councils. Figure 6.4, which summarizes the situation across 100 councils, reveals that expenditure on new and upgraded assets is projected to progressively reduce.

Figure 6.4: Ratios of current expenditure and projects of future expenditure



Source: Roorda 2006, fig. 7, p. 28

Asset management

Asset Management refers to a process for ‘whole of life’ asset management from planning, purchase, operation, maintenance to disposal of assets. It also encompasses integration of asset and service outcomes. Common components or tools in asset management systems include: asset registers, asset condition assessments, asset maintenance and management systems, strategic planning capabilities, predictive modelling, deterioration modelling, risk analysis and lifecycle costing.

Asset management by NSW councils is limited. Only 18 per cent of councils have asset management policies in operation. A further 29 per cent have plans to establish asset management practices. The balance (47 per cent) have no plans and, most importantly, no intention to develop any plans. The lack of systems update is attributed to the resource limitations of councils who are already struggling with the volume of mandatory management and reporting tasks already prescribed (Roorda 2006, p8).

By contrast, in Victoria benchmarking studies in 2001 and 2002 showed that councils were deficient in asset data collection, information, planning, maintenance, operating and reporting policies, processes and systems (DFVC 2003, p7). The Municipal Association of Victoria (MAV) responded by developing a staged asset management improvement program to increase the capability of the Local Government sector to manage its infrastructure.

The Step program has been building infrastructure asset management capacity over the last four years by promoting awareness of asset management obligations to all councils, and by providing tools and templates to assist in developing asset management policies, asset management strategies, asset management plans and operational plans. This voluntary program funded by the councils is delivered through six-monthly visits to them by MAV

appointed consultants who identify priority deficiencies in asset management, score each council in respect of asset management adequacy through a series of questions and provide targeted training and improvement recommendations to be completed by the next visit.

NSW could make quick progress on this front by utilising existing asset management tools such as GHD's Gap-Ex, which is a web enabled gap analysis tool that facilitates identification of an organisation's asset management capability, benchmarks this against comparable organisations and automatically generates a basic asset management improvement program. The process is relatively simple, provides for consistent evaluation and can be repeated to measure actual improvement over time.

Remedies

Unlike state agencies, local councils are not required to regularly estimate the fair value of their physical assets (e.g. replacement costs of roads). Nor do councils use consistent depreciation rates for estimating the annual consumption of their assets. As a result, their accounts significantly understate the true magnitude of their infrastructure problem. Furthermore, most councils do not have asset management systems or formally adopted service levels to monitor and assess their infrastructure position.

Improving asset management and unifying infrastructure accounting is critical to addressing infrastructure problems. Asset management is the foundation for consistent evaluation of infrastructure issues, enabling individual councils, and state and Commonwealth governments, to effectively provide infrastructure solutions.

A common asset management system needs to be adopted and complied with by NSW councils. The system should resolve accounting inconsistencies by requiring:

- A standard format for asset registers;
- Regular three-year valuation of infrastructure at 'fair value';
- Common definitions of 'satisfactory' standards for assets, depreciation, routine maintenance, backlog maintenance (rehabilitation), renewals and enhancements; and
- A standard depreciation schedule for assets whose total life has not been personally estimated by an expert assessor.

Additional reporting requirements in council annual reports should be introduced to deal with infrastructure renewal, in particular, proposed funding models for closing the renewal gap, and statements on benefits and costs of renewal of infrastructure items. The report by Roorda (2006) provides more details on the integration and items to be provided in an improved asset management regime and reported in annual reports.

The adoption of existing voluntary asset management planning and risk management practices, which have been available to councils for over five years, is inadequate at 20 per cent of councils (Roorda 2006, pp7, 31-32). Minimum asset management requirements should be mandatory although phased in over time and with additional requirements added progressively. South Australia currently has draft legislation before parliament which is similar to that adopted some years ago in New Zealand which imposes financial obligations on councils regarding the development of long term financial plans for the management of infrastructure.

The revision of the asset register, revaluation and establishment of assessment management systems will require substantial resources and access to expertise for councils already stretched to capacity. It has been suggested that the average council may have around 100,000 individual asset entries in a comprehensive asset database (Maxwell 2006b, p16). However, this volume of entries is far in excess of what is initially required for a functioning council asset management system. An immediate focus on critical data would be sufficient to enable councils to improve their asset management (Morrison Low Consultants 2006, p4).

External funding and programs will be required to support councils. The financial burden on small rural councils will be particularly harsh and may require specific funding. It has been suggested that a portion of the Roads to Recovery funding could be allocated to improve asset management practices (Roorda 2006, p30). However, the NSW Department of Local Government should also be required to assist in capacity building of expertise in councils. Within the government, policy responsibility for total asset management (TAM) now resides in the NSW Treasury following its transfer from the Department of Public Works and Services.

Option 2: Require all councils to adopt a total asset management (TAM) system and consistent accounting practices within two years with the technical and financial assistance of the State Government.

Pros

- Improved asset management would give councils and the community a better understanding of the infrastructure challenge;
- Rigorous asset management would force a council to check the cost/ benefits of replacing worn out assets (e.g. wooden bridges) and the public liability risk of not adequately maintaining them (e.g. people getting injured on uneven pavements); and
- Consistent systems would improve the reliability and comparability of councils' infrastructure information. This would strengthen the basis for funding submissions to other tiers of government.

Cons

- Asset management would impose significant implementation and ongoing compliance costs;
- The cost of a mandatory arrangement would need to be subsidised by other tiers of government for some rural councils; and
- Adoption of asset management practices would not generate the revenues to address the infrastructure backlog and ongoing renewal gap.

A standard TAM system across NSW councils would benefit the Commonwealth Government grant system by providing robust comparable information for funding decisions. The Commonwealth Government could also assist with implementation funding so the cost burden was not borne only by state and local governments.

Some of the extra resources would be necessary for increased scrutiny and auditing of asset management by the Department of Local Government. The review of mandatory and non-mandatory components and introduction of additional requirements would be managed by the

department. The department would also play the lead role in capacity building of council members and staff expertise in asset management.

Option 3: Increase monitoring and development of council infrastructure management by the NSW State and the Commonwealth Governments.

Pros

- Councils would become more accountable for the use of their grant funding to state and Commonwealth governments;
- Councils would have consistent practices, measurable results and improved skill levels; and
- Since, the voluntary approach has failed to deliver significant tangible results, TAM needs to be mandated in all councils if it is to become a reality.

Cons

- Increased compliance activity by state and Commonwealth governments would have additional costs for both governments and councils;
- Councils would have less discretion and autonomy to institute a TAM that would best met their needs; and
- TAM could be cooperatively introduced by the LGSA with the assistance of council engineering (IPWEA) and financial (LGAAG) professional groups, the NSW Treasury and the DLG provided the state offered support funding.

6.4 INFRASTRUCTURE FUNDING

Requirements

Under TAM principles sufficient funds should be earmarked each year by councils for routine maintenance, backlog maintenance (rehabilitation) and renewal of existing infrastructure, as well as expansion of the asset stock (enhancement) to meet the short to medium term future needs of the local community. Funding for asset renewal should equal its rate of depreciation. For instance, if a road has an expected life of 40 years then 2.5 per cent of its replacement cost should be set aside each year and spent periodically for its renewal.

As we have already seen this is also true for discrete assets such a water supply main. While renewal spending on such an asset would not be practical each year, funds equivalent to its straight line depreciation should be set aside annually so that raising the capital for its eventual replacement was not bunched towards the end of its useful life. Otherwise there would be an inequitable offloading of costs from the initial beneficiaries of the water main to its future users. Simply planning for future generations to bear the burden of its replacement cost does not make the asset financially sustainable in terms of the officially accepted definition of that term (see box 11.1 in Chapter 11).

Reality

The major sources of ordinary revenue for the total NSW Local Government sector in 2003/2004 were:

Table 6.5: Major sources of ordinary revenue

Sources	2003/04	2003/04
Rates and Annual Charges	\$3,132m	47.6%
User Charges and Fees	\$1,108m	16.8%
Interest	\$252m	3.8%
Grants	\$1,053m	16.0%
Contributions and Donations	\$758m	11.5%
Other Revenues	\$279m	4.2%
Total ordinary revenue	\$6,582m	100%

Source: Abelson 2005, p2.

Insufficient revenues are being allocated to infrastructure needs largely as a result of capital funds being used for supporting operating budget deficits (Access 2006). Funding for Local Government for the maintenance and renewal of infrastructure assets traditionally utilises the following revenue sources.

Grants

Untied funding is provided to councils by the Commonwealth Government through financial assistance grants (FAGs). FAGs comprise two components – for general-purpose uses and for local roads (though legally the roads component need not be spent on this purpose). Additional funding from the Commonwealth Government is provided by Specific Purpose Payments directly to Local Government. This is tied funding directed towards priority projects such as Roads to Recovery.

Total grants funding from the Commonwealth to NSW Local Government has kept pace with the Consumer Price Index (CPI), but fallen well short of Gross State Product (GSP) growth over the last decade. This is also true for each of the major components of grant funding, namely the FAGs' General Purpose, and Identified Local Roads components, and Roads to Recovery funding (Brooks 2005, pp11-14).

The general view is that grants provided are inadequate for the renewal of legacy infrastructure now managed by councils. As argued by the Local Government Auditors of NSW:

When the time comes to replace or renew these assets (as opposed to the ones constructed solely by council) there is a genuine need for funding from above (Local Government Auditors of NSW Submission 2005, p4).

Various councils question the criteria for grant allocations. For example, Bankstown City Council argues that allocation of the FAGs discriminates in favour of 'growth' councils and exacerbates infrastructure problems for 'static' councils. This is because the local roads component of FAGs is based on a council's population, road and bridge length. Accordingly, growing urban fringe councils receive extra FAGs funding to meet the costs of new residents and new roads. In contrast, established urban councils receive no significant growth in FAGs funding in spite of the increasing cost of maintaining and renewing ageing assets.

Byron Shire Council argues that the 'implied wealth' and disabilities factors considered for grants allocations can have unintended distortions. Implied wealth is measured by property values in a council area rather than economic activity. Byron Shire Council points out that property booms in coastal areas have increased the implied wealth, however:

It is assumed that because property values are high, ratepayers have a higher disposable income and as a result councils receive a lower allocation of this portion of the grant [FAGs]. Byron Council is severely disadvantaged by the assumption that higher property values are a reflection of disposable income. The disposable income of the region is considerably lower than the state average and unemployment is significantly higher (Byron Shire Council Submission 2005, p2).

Even where councils may have affluent ratepayers with high disposable incomes, councils are limited because of rate pegging. They cannot automatically raise additional revenues from these ratepayers to compensate for lesser funds received from FAGs.

Another problem is that council revenue from capital grants, developer contributions and asset sales is being heavily used to fund operating deficits rather than exclusively used for the purpose for which they were intended, namely to fund infrastructure renewal and enhancement (Access 2006).

However, the tied funding provided by the 'Roads to Recovery' program has made a significant difference in reducing the backlog on necessary road maintenance and renewal. But it must be emphasised that at no time has the Commonwealth Government committed to a permanent R2R funding stream. The present program will finish in 2008-09 (Roorda 2006, pp29-30).

NSW State Government funding for infrastructure, particularly regional roads, comes in the form of specific purpose grants and financial assistance from the Roads and Traffic Authority (RTA). In NSW, 'local roads' and 'regional roads' are the responsibility of Local Government. The classification of a regional road is an administrative process, for which the RTA has authority under the *Roads Act (NSW) 1993*.

Block grants from State Government for regional roads are provided on an agreed formula basis. All councils get a share of the available pool of funding on the same basis and can apply the funds to works on regional roads, according to council priorities (RTA Submission 2006, p1).

Funding assistance from the RTA to Councils for regional and local roads was \$151.9 million in 2003/04. A further \$9.5 million was provided for natural disasters, \$13.4 million for traffic route lighting, and \$18.5 million for other road safety and facilities purposes. Between 1993/94 and 2003/04 the RTA's total grants to Councils doubled from \$96.5 million to \$193.3 million, an average annual rate of growth of 7.2 per cent. However, half of this growth occurred in the first two years of this decade (RTA private correspondence, 19 April 2006)

Under the Country Towns Water Supply and Sewerage Program, financial assistance is provided to councils by the State Government for up to 50 per cent of the backlog component of water and sewerage infrastructure. Backlog works are defined as those works required to meet water and sewerage demands and/or standards as at 1996.

General rates revenue, user charges and fees

As noted in 6.2, councils were not necessarily involved in the initial creation of many large assets so the revenue basis for the original funding of assets may not be in existence. Council funding for infrastructure has historically been drawn from grants and general rates revenue. In the last decade rates revenue averaged around 48 per cent of total revenues received by NSW councils whereas grants revenue was around 17 per cent (Brooks 2006, p16). At the

same time, rates revenue for NSW councils has grown in excess of CPI, but well short of GSP. However, NSW has experienced the lowest increases in rates of any jurisdiction. This is attributed to rate pegging (Brooks 2006, p9).

General revenue should be able to fund routine maintenance and renewal of existing infrastructure. General revenue is also an indicator of a council's debt servicing capacity - when councils borrow for new infrastructure then net interest payments should be met by a council's annual revenue at the existing rating effort (Access Economics 2006, p12). Therefore, the predictability of rates revenue, as the major portion of current revenue, is significant.

Councils may directly levy annual (user) charges for water and sewerage, drainage and waste management services separate from ordinary or special rates. These charges are not limited by rate pegging so there is the capacity for user charges to be set at cost recovery levels, that is, a level which includes a return on capital equal to the cost of capital. Analysis undertaken on cost recovery ratios by this Inquiry shows that cost recovery by local water utilities could be improved to provide a source of additional financial capacity (Access Economics 2006, p38). Further discussion of variation of utility service charges is included in Chapter 7, section 7.4.

In addition to annual (user) charges, councils may also charge fees for their services (apart from services such as waste collection, water and drainage to which annual charges apply). Fees may be charged for admissions, applications, inspections, approvals and supplies of information, services or commodities. When setting fees councils must take into account the cost of the service, its importance to the community and the cost recommendations of an industry body or government department (Sections 608-609 LG Act).

Councils argue for the removal of rate pegging to increase revenue for infrastructure funding, but this is not a panacea for funding shortfalls. While it has been estimated that an increase of between 11 to 12 per cent of Local Government total rates and charges revenue per annum would cover the aggregate shortfall in renewals across the state (though not the renewal backlog), sourcing all infrastructure funds from rates revenue is not a financially or politically viable option (Roorda 2006, p9). Different councils will have vastly different rate changes if they were to own-source the revenue shortfall from rates rises. For example, Urana Shire Council estimates it would be required to more than double its current revenue from general rates to adequately address its infrastructure needs (Urana Shire Council Submission 2005, p3).

Sections 555 and 556 of the LG Act exempt NSW Crown land from council rates. The scale of the revenue lost from Crown exemptions may not be significant to large urban councils, but it does raise concerns for smaller councils (Dungog Shire Council submission 2005; Urana Shire Council submission 2005). However, the Inquiry found that while general government agencies do not pay rates, government trading enterprises pay rates on their commercial premises, but not on water and sewerage pipes under ground, electric poles in the ground bearing wires overhead or land used commercially by State Forests.

Special rates

Councils are increasingly levying special rates for specific infrastructure needs. For example, submissions from Dubbo, Eurobodalla, Lake Macquarie and Bega Councils all noted the use of special rates to fund infrastructure costs.

Councils argue that the current Ministerial approval process for special variations takes significant time, cost and effort for councils, particularly when an application may be refused. This piecemeal approach is not regarded as the preferred solution for large scale infrastructure financing (WSROC Submission 2005, p4).

External borrowing

Analysis commissioned by this Inquiry has found that councils are under-utilising debt as an option for infrastructure funding. During 2004-2005, it was found that, on average, councils undertook minimal net borrowing, externally financing just two per cent of their annual net additions to non-financial (infrastructure) assets. Consequently about half of all NSW councils were net lenders to the other sectors of the economy in the 2004-2005 year (Access Economics 2006, p22).

Overall, NSW Local Government's debt servicing capacity appears sound, although there are significant variations in the debt-servicing ratio with different councils (Access Economics 2006, p23). External borrowing can be appropriate for the acquisition of new infrastructure or the enhancement of existing capital stock, but councils are reluctant to borrow even when it is prudent to do so. Borrowing for the development of long-lived assets has a sound economic basis when consideration is given to intergenerational equity. This means that the current ratepayers should not have to 'fund up front' new assets that may have a life of 100 years.

There also appears to be a significant drawback for infrastructure maintenance emerging from the low borrowing behaviour of councils:

Excessive borrowing is not the issue for NSW Councils. Rather than incurring debt in order to finance their annual operating deficits, most NSW Councils have instead been relying for some time on capital revenues that do not appear in the operating statement for this purpose. In effect Councils typically have been running surpluses on their capital accounts in order to fund deficits being run in their operating accounts. Such capital surpluses are only possible by deferring capital spending that should be undertaken on existing and new infrastructure and for which purposes the collection of capital revenues such as capital contributions and capital grants) can only be justified. Hence, instead of the usual net borrowing (and accumulated debt) consequences of operating deficits, an infrastructure-spending backlog has emerged for many Councils (Access 2006, p30).

Section 94 developer contributions

Under Section 94 of the *Environmental Planning and Assessment Act (NSW) 1979*, developers are levied to help provide for infrastructure that is required as a result of the new development. The operation of these levies, which have been fully utilised only since 1989, was generally a lump sum payment at the time of development. The sum made no provision for the ongoing maintenance or upgrade of those assets. Furthermore, the sums were tied directly to supplying supporting infrastructure to the new development. As a consequence of this system, councils argued that developer contributions in effect 'gifted' councils with additional assets to maintain.

In 2005, reforms to developer contributions allowed for the creation of developer planning agreements. These agreements are far more flexible for councils and may include a component to cover recurrent costs of infrastructure. This component is currently a flat rate percentage levy on development. There does not have to be a direct nexus between the development to which a planning agreement relates and where infrastructure contributions are

spent. This gives councils more capacity to direct funds to the infrastructure in most need of renewal within the council area, but is also open to council abuse since the link between user pay and benefit is broken.

However, there are unresolved concerns about appropriate pricing of developer contributions. This is due to a variety of factors including: the uncertainty about costing of infrastructure; debate about the appropriate attribution of direct and indirect development benefits; and the equity issues surrounding charges passed from developers to new residents.

On a purely technical level, there is also debate on pricing techniques and the current rigour of council administrations to optimise developer contributions. A research paper commissioned by the Inquiry examines this issue and suggests that best practice pricing should be based on the principles of marginal cost pricing rather than a flat percentage (Dollery 2005a).

Although developer contributions add to council revenue, they do not provide a substantial proportion of infrastructure funds. Furthermore, they are not a revenue source for 'static' councils with no development demand:

The catch with S94 contributions is also that they are only collected when there is development occurring. When there is no development, there are no contributions; however the need for infrastructure renewal still remains (LGMA submission 2005, p 8).

Finally, it should be noted that the Minister for Planning has introduced legislation to give him the authority to curb the amount of developer contributions that can be charged by a council. This is likely to limit the extent to which developer contributions will contribute to overcoming Local Government's infrastructure problems.

Development application fees applied by councils also generate revenue. Submissions have noted that when the State Government acts as the consent authority for certain developments, fee revenue and infrastructure maintenance for councils is affected. For example, Singleton Shire Council conservatively estimates a loss of \$200,000 in application fees since mining development consents were assumed by the State Government in 1999:

The State Government set consent conditions on the mine, however the recurrent operation of the venture impacts local infrastructure and community amenity, without compensation being received at a local level (Singleton Shire Council submission 2005, p8).

Private public partnerships (PPPs)

Private public partnerships are a relatively new option for Local Government infrastructure provision. The distinguishing feature of PPPs (compared to external borrowings) is that the private sector has some level of funding, management and ownership of the council infrastructure.

Research commissioned by the Inquiry examines the pros and cons of PPPs, and the recent controversy and reforms for PPPs use in delivering Local Government infrastructure. Management and performance improvements to PPP arrangements for councils have been identified in guidelines released by the NSW Government, which require (effectively) Treasury vetting and consent to this form of financing

Given the need for major infrastructure renewal and limits on alternative revenue sources, greater use of PPPs is being encouraged (Dollery 2005d). Insufficient parking facilities, a key council issue for residents of built-up areas (IRIS 2005, pp28-29), is one area where PPPs might offer a solution (e.g. building car parks under large public spaces). However, there are major risks and management challenges with such financing solutions for councils.

PPPs enable government to transfer risk to the private sector. The private sector charges a premium for taking on this risk. Few councils have the expertise and resources to structure PPPs and unload risk effectively (Cranko and Paddon 2005, p5). It should be noted that the PPPs have significant development, probity and compliance costs that mean they are better suited to larger infrastructure projects. The NSW Guidelines for Council PPPs propose that the scale of projects be considered before PPPs are undertaken.

Remedies

Consistent asset management across councils will improve understanding of infrastructure needs and generate efficiencies, but it will not solve the underlying shortfall between infrastructure costs and revenue and will not make councils financially sustainable. Revenue enhancement is required to close the infrastructure backlog and renewals gap.

There are various revisions and reforms to existing revenue mechanisms that can be undertaken to enable councils to increase revenue.

Grant increases are one option to close the gap. The infrastructure legacy and revenue constraints faced by Local Government need to be recognised by all tiers of government and grant enhancements need to be provided. As noted, there is debate about current funding formulas not reflecting contemporary circumstances of councils.

Many councils have proposed the removal of rate pegging and subsequent rate increases as the answer. Councils argue that the current special rate variation arrangement is too piecemeal and cumbersome. For many councils with rates below the top quartile of all councils the removal of rate pegging might give them the revenue flexibility to gradually tackle both their backlog and ongoing infrastructure renewal gap (Access 2006, p37). But for those councils that already have high rates and generous services, the capacity to lift rates further may be politically constrained not only by the State Government, but also by their own communities.

Small rural councils that are heavily dependent on grant funding are not likely to be able to raise sufficient revenue from a narrow rate base to overcome their infrastructure problems even though these councils generally charge much lower rates than larger urban councils. These councils are generally afflicted with a declining and ageing community less able to meet funding demands and reluctant to support infrastructure such as sporting facilities that no longer meet their needs. Also, rural councils may have a large proportion of impoverished ratepayers as a result of the harsh drought conditions that have afflicted outback NSW for many years.

Roads dominate council infrastructure and a high proportion of roads are in under-populated rural shires. Without a substantial boost to grant funding (which seems unlikely) the only hope for rural councils is to be relinquished of their legal and financial responsibility for regional roads since they do not have the financial capacity to maintain let alone renew them. This would require the State Government to assume responsibility for both sealed and

unsealed regional roads in rural councils. The problem is highlighted in the report into Local Government infrastructure commissioned by the Inquiry (Roorda 2006, p18):

Councils in areas of static or declining population are experiencing the end of the asset lifecycle. The rural boom of the past generation is over and Councils are left to deal with deteriorating infrastructure without an adequate revenue base or a national policy framework for determining a way forward. When the long term becomes unsolvable the focus becomes managing the short term....These factors make the funding of infrastructure a whole-of-government issue. This report covers Local Government infrastructure, but it is invariably the case that Councils place high priority on road infrastructure.

Based on council reports (RTA 2005, p5), local government in 2003/04 accounted for only 6 per cent of all maintenance, renewal and enhancement expenditure on all regional roads, bridges, safety and traffic works. The RTA contributed 77 per cent, the Commonwealth 15 per cent and other sources 2 per cent. This shows that although regional roads are a council responsibility, they are struggling to make a meaningful contribution to their upkeep. This is particularly true for rural councils, whose share of regional roads far exceeds their share of state ratepayers.

A welcome development is the State Government's decision to provide a 50 per cent contribution towards the cost of replacing or upgrading council managed timber bridges on regional roads from 2006/07 (RTA 2005, p6). This is an acknowledgement that councils need further help to cope with their regional roads infrastructure.

A politically appealing way to deregulate rates could be for the state to permit councils to set up an 'infrastructure fund' linked to a dedicated rates revenue stream. This is already occurring on a case-by-case basis where councils obtain permission for special variations to fund specific infrastructure items. The increased rates revenue would be hypothecated for assets renewal and to servicing debt for a portion of assets enhancements (see Chapter 11 for a discussion of the appropriate share of enhancements that could be funded from debt). With improved integrity provided by consistent asset management, both parties could explore private public partnerships with greater confidence.

Increased revenue through a revision of developer contributions mechanisms could be another option. However, this is limited to communities that are experiencing growth. Also, as stated earlier, the Minister for Planning recently foreshadowed limits to this source of revenue.

Other options for councils are to switch revenue away from non-core service provision and rationalise/dispose of surplus or low priority assets. Many councils have expanded their services on the basis of increased community expectations and/or cost shifting from other tiers of government. Reprioritising expenditure to infrastructure (largely roads) may require councils to reduce the supply of other services or at least slow their growth.

The Inquiry's polling would suggest that while people don't want existing services cut, they do want future income growth focused on traditional council services, especially roads, pavements, kerbing, street lighting, storm water, bush care, drains and waterways, etc. (IRIS 2005, pp32-35). Also, the pollsters ventured the view that those services that received relatively higher satisfaction ratings, but were accorded a relatively lower priority (e.g. cultural and education facilities, recreation services and facilities) might be possible candidates for pruning without significantly upsetting voters. (IRIS 2005, p33)

Replacing historical duplication of infrastructure with modern multiple function assets may also generate revenue savings. An example would be the rationalisation of community buildings to provide multiple functions such as a combined childcare/library service. These opportunities for councils would be identified via a total asset management (TAM) process.

To minimise the impact on council rates, fees and charges of overcoming the \$6.3 billion infrastructure backlog and closing the \$0.5 billion annual infrastructure renewals gap, the Inquiry would suggest the following course of action:

1. Borrow around \$5,300 million to fund renewals to overcome the infrastructure backlog (other than in water and sewerage which DEUS says has sufficient reserves and income to deal with a \$955 million backlog itself). This would generate about \$400 million in debt charges annually;
2. Raise an extra \$900 million per annum in revenue to both close the renewals gap (\$500 million) and meet the new debt charges (\$400 million) in 1.
3. Derive the extra \$900 million in revenue by seeking \$200 million in extra grants (say \$100 million from the Commonwealth and \$100 million from the state), \$200 million in council expenditure savings and \$500 million in extra income from rates, fees and charges.

If neither increased annual grants or savings were forthcoming and the entire \$900 million had to be sourced from additional rates, fees and charges, then each of these levies would have to rise by about 23 per cent. Also, the longer the solution is deferred the higher the ultimate cost will be to the community.

Option 4: Increase council funding by \$900 million per annum through a combination of increased Commonwealth and state grants (\$200 million), council expenditure savings (\$200 million) and higher rates, fees and charges (\$500 million).

Pros

- Accessing increased revenue is the only way to address the infrastructure backlog and renewal gap;
- If the state does not let councils adjust their rates and fees to fix the local infrastructure problem it may inherit the problem itself;
- Inquiry polling would suggest citizens are prepared to pay more for tangible improvements to infrastructure;
- Polling would also suggest that a ‘back-to-basics’ policy that involved reordering priorities from recurrent services to infrastructure renewal would be welcomed; and
- Councils have considerable scope to increase borrowings for overcoming their infrastructure renewals backlog if they could boost their revenue to service more debt.

Cons

- Additional rates may not be acceptable to the Minister for Local Government or council constituents unless their necessity was properly explained;
- Increased grants may not be forthcoming from other tiers of government unless they were convinced of the gravity of the infrastructure crisis;
- Inquiry polling would suggest a sizeable and vocal minority (possibly a quarter of residents) would resist increases in rates, fees or charges regardless of their merit – this

group wants smaller Local Government even if it means less services and worse infrastructure; and

- Unless councils strictly adhered to the financial liability limits proposed in Chapter 11, they could become fiscally profligate and succumb to debt addiction.

Councils have been grossly under-funding depreciation in their operating accounts and as a result the infrastructure renewal gap has been growing by around \$400 million per annum on one estimate (Access Economics 2006, p.iv) and \$500 to \$600 million per annum on another (Roorda 2006, p5). In the Inquiry's view the gap is at least \$500 million (see section 11.4 – Reality – Infrastructure spending).

One solution to this shortfall would be to make cash funding of depreciation a mandated requirement as is done in New Zealand and Queensland. Moneys sequestered for depreciation could be put in an 'infrastructure trust fund' that could not be used for any purpose other than infrastructure renewal or enhancement.

To ensure that such a trust fund was not borrowed for operating expenditure (a practice detected by Access in the case of existing grants, contributions and asset sales proceeds) it could also be made mandatory that its proceeds be spent on capital purposes within a limited period so that it could not accumulate excessive reserves. This proposal is distinct from the 'infrastructure funds' that councils have been creating through special rate variations that are used for both asset maintenance and capital expenditure.

Option 5: Make cash funding of asset depreciation mandatory and require that such funds be used exclusively for asset renewals.

Pros

- Would ensure that sufficient money was set aside each year for infrastructure renewal to match infrastructure depreciation;
- Would improve fiscal understanding and accountability by providing a direct and transparent link between funding depreciation and funding infrastructure renewal;
- Would make it harder for councils to expand short term operating expenditure at the expense of long term infrastructure; and
- Would discourage councils from borrowing money set aside for capital purposes to cover operating deficits.

Cons

- Would reduce councils' flexibility to use general revenues for urgent short term needs;
- Would result in a sharp cut in ordinary services unless the measure was accompanied by a significant increase in general revenue (rates, charges and grants) or it was gradually phased in over several years;
- Would be difficult to quarantine an infrastructure trust fund given that the distinction between asset maintenance and rehabilitation (which are operating expenditures) and asset renewal and enhancement (which are capital expenditures) is difficult to distinguish in practice; and
- Would require separate budgeting, accounting and auditing treatments.

Option 6: The NSW Government assume responsibility for all regional roads in rural shires since such councils do not have the financial capacity and asset management systems to maintain and renew them.

Pros

- Would ensure that sealed and unsealed roads that are important to the NSW rural economy were adequately maintained and renewed which is not possible at present;
- Would place legal ownership and funding responsibility with the State Government, which has the financial resources to undertake this role;
- Would put all regional roads under the care of the RTA, which has the engineering skills to apply modern asset management practices to the administration of such roads; and
- Would solve a rural council financial crisis that neither increased FAGs nor rate deregulation could fix on their own.

Cons

- Would strip shire councils of a responsibility, which under the ‘subsidiarity’ principle (see Chapter 5) properly belongs to Local Government;
- Would discriminate against regional and metropolitan councils since they would still have responsibility for regional roads within their boundaries; and
- Would put an extra financial burden on the State Government without additional financial assistance from the Commonwealth Government.

7. LOCAL GOVERNMENT SERVICES

7.1 INTRODUCTION

This chapter covers four topics. The first section looks at the nature of council services and examines trends in the range and level of services provided by councils. This is followed by an evaluation of the standards of municipal service provision, including public priorities and satisfaction with services. The procurement and sale of Local Government services is considered next. The final section discusses the question of future service needs.

7.2 NATURE OF COUNCIL SERVICES

Requirements

Chapter 5 argued that in a federal system of government the theory of fiscal federalism accurately explains the most effective assignment of functions between national, state and local governments. Accordingly each level of government should be assigned those expenditure functions that sit best with its area of jurisdiction. Thus, central government should perform services that affect the entire nation, such as macro-economic policy, state governments should address issues and provide services that have a state-wide benefit and Local Government should deal with local issues.

However, in a large country with vast distances between population centres such as Australia it is economically unrealistic that Commonwealth and state governments can effectively provide all services for all areas.

This necessarily implies that where distances from larger centres are great, Local Government should act as ‘agents’ for other tiers of government in delivering essential services that would be more expensive to administratively coordinate from either Sydney or Canberra. Moreover, Commonwealth and State Governments should meet the costs of any services delivered on their behalf by Local Government. However, the corollary of this proposition also holds true: Local Government should not needlessly and expensively duplicate the work of Commonwealth and state agencies where adequate services are already provided by other levels of government.

These principles appear to accord with public sentiment. For example, the overall tenor of the public opinion poll (IRIS 2005) conducted for this Inquiry suggests that the respondents took a ‘commonsense’ functionalist view of government. The availability, quality and cost of services mattered more than the level of government that actually provided the service. Commonwealth, State and Local Government should thus provide coordinated essential services in the most cost effective manner possible. Where local councils have to deliver services normally provided by higher tiers of government, then this should be done in cooperation with these higher tiers without wasteful duplication. Coordinated service delivery across three tiers of government needs to be adequately financed and underpinned by carefully crafted intergovernmental agreements (IGAs) and/or specific partnership arrangements.

Finally, divergences in the range and levels of councils’ services should reflect the different political preferences of councils’ electorates, rather than the individual preferences of

councillors, the vested interests of lobby groups and other forces that may obstruct or distort what ratepayer and resident really want.

Reality

As the lowest tier of government in the Australian federation, Local Government has traditionally provided a relatively narrow range of local ‘services to property’ aptly caricatured in the old ‘roads, rates and rubbish’ refrain. However, changes to the Local Government Acts across all Australian Local Government systems, including the *Local Government Act (NSW) 1993* (LG Act), have created the legislative basis for a much larger role for councils. As a consequence, the composition of Local Government services has changed dramatically, with a change in emphasis away from traditional ‘services to property’ towards ‘services to people’.

The Hawker Report (2003, p9) described this expansion of services as essentially twofold. In the first place, councils are adopting growing ‘responsibility for social functions, such as health, alcohol and drug problems, community safety and improved planning and accessible transport’. Secondly, Local Government has been ‘playing an increasing regulatory role in the areas of development and planning, public health and environmental management’.

The reasons for this change in emphasis and breadth in the provision of services by Local Government are complex and multi-faceted. However, the Commonwealth Grants Commission (CGC 2001) has identified five main reasons for the services expansion:

- ‘Devolution’ – where Commonwealth and state governments give Local Government responsibility for new functions;
- ‘Raising the bar’ – where a higher tier of government raises the complexity and/or standard at which Local Government services must be provided;
- ‘Cost shifting’ – either where a local authority agrees to provide a service on behalf of a higher level of government (with funding subsequently reduced or stopped) or where some other tier of government ceases to provide an essential service thus forcing a local authority to take over;
- ‘Increased community expectations’ – where a given community demands improvements in existing municipal services or the provision of a new service; and
- ‘Policy choice’ – where individual councils voluntarily expand their services.

The NSW Department of Local Government (DLG) has developed a detailed classification of Local Government functions in *Special Schedule No. 1: Net Cost of Services* of its *Code of Accounting Practice and Financial Reporting* (DLG 2005a) that must be completed by each council for its annual report. It covers both operating and capital outlays. These dozens of functions have been aggregated into a more manageable list under major item headings in Table 7.1 below. This follows the analytical procedure adopted by Byrnes (2005f) in his survey for the Inquiry of the views of NSW general managers on which functions are best provided by smaller councils on their own rather than jointly with other councils.

However, it differs from the more limited ‘12 key service areas’ investigated by the IRIS (2005) opinion survey. IRIS included ‘local roads, footpaths and kerbing’, ‘health and human services’, ‘culture and education facilities’, ‘waste management’, ‘appearance of public areas’, ‘traffic management and parking facilities’, ‘enforcement of bylaws’, ‘economic

development', environmental management', 'town planning', and 'commercial services', presumably because these are 'high profile' service areas readily amenable to public scrutiny.

Table 7.1: Major functions of councils in NSW

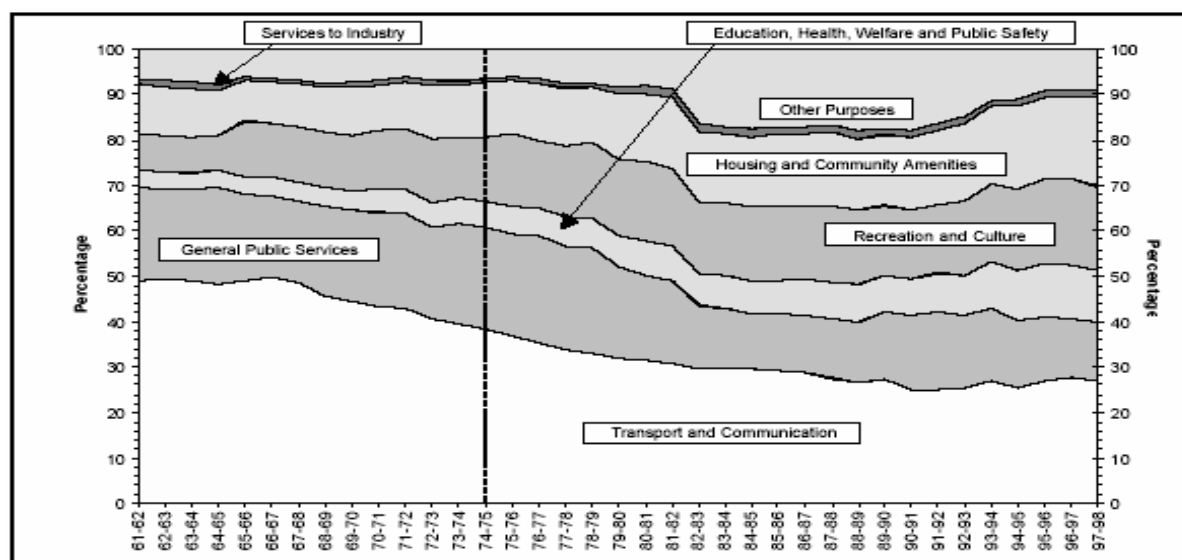
Council Function	Examples
Governance	Costs of democratic local government, including elections, members' fees and expenses, subscriptions to local authority associations, meetings of policy making committees, area representation, public disclosure, compliance, and related administration costs.
Administration	Corporate Support: Financial management, GIS system, IT, payroll, accounts receivable, account payable, records management, purchasing, human resource management, internal auditing. Engineering and Works: Fleet management, asset management, technical & design, works coordination, and risk management.
Public Order and Safety	Fire protection, animal control, beach control, and enforcement of Local Government regulations, community safety, and emergency services.
Health	Administration and inspection, immunisations, food control, insect/vermin control, noxious plants and health centres.
Community Services and Education	Administration, family day care, child care, youth services, other families and children, aged and disabled, migrant services, aboriginal services, other community services and education.
Housing and Community Amenities	Housing, town planning, domestic waste management, commercial waste, waste disposal management, sanitation service, public cemeteries and public conveniences.
Water Supplies	Domestic and industrial reticulation.
Sewerage Services	Treatment and management.
Recreation And Culture	Public libraries, museums, art galleries, community centres, public halls, other cultural services, swimming pools, sporting grounds, parks and gardens (lakes) and other sporting and recreation.
Fuel and Energy	Gas supplies.
Mining, Manufacturing & Construction	Building control, abattoirs and quarries and pits.
Transport and Communication	Urban roads, sealed rural roads, unsealed rural roads, regional roads, bridges, aerodromes, parking areas, bus shelters and services, water transport, RTA works and street lighting.
Environment	Sustainable management of rivers, creek corridors, coastal wetlands, bushlands etc.
Economic Affairs	Camping areas, caravan parks, tourism and area promotion, industrial development, promotion, saleyards and markets, real estate development, commercial nurseries and other business undertakings.

Source: Byrnes, J. L. 2005f.

The set of services contained in Table 7.1 embraces both 'external' services (outputs) provided to the public, such as 'transport and communication', as well as 'internal' services (inputs) necessary for the operation of councils, like 'administration'.

Figure 7.1 shows trends in the composition of Local Government expenditure across Australia by function for the period 1961/62 to 1997/98. It is evident that Local Government has expanded its 'services to people' function sharply at the expense of traditional 'services to property' over this period.

Figure 7.1: Local Government expenditure by function



Source: Commonwealth Grants Commission 2001, p. 173.

A more recent analysis of the change in composition of NSW Local Government operating expenditure (Brooks 2006, p19) is provided below. Under each function it includes infrastructure maintenance and depreciation (which are both operating expenditures), but not the renewal of existing infrastructure or the construction of new or upgraded infrastructure (which are both capital outlays).

Table 7.2: Comparative growth in Local Government operating expenditure (1995/96 Index 100)

Function	2003/04	CPI	GSP
<i>Housing & Community Amenities</i>	187.6	120.9	158.8
Public Order & Safety	179.2	120.9	158.8
Economic Affairs	175.5	120.9	158.8
Transport & Communication	170.1	120.9	158.8
Community Services & Education	158.4	120.9	158.8
Recreation & Culture	152.0	120.9	158.8
Water Supplies	130.0	120.9	158.8
Administration	130.2	120.9	158.8
Sewerage Service	128.5	120.9	158.8
Health	108.7	120.9	158.8
Mining, Manufacturing, Construction	107.0	120.9	158.8

Source: Brooks, J. 2006, p19.

The CGC (2001, pp53-54) observed that changes in the composition of Local Government outlays up to 1997/98 had the following major characteristics: (1) A move from ‘property-based services to human services’; (2) A marked ‘decline in the relative importance of road expenditure’ from more than 50 per cent in the 1960s to slightly more than a quarter by the 1990s; (3) An expansion in the relative importance of recreation and culture and housing and community amenities to around 20 per cent of expenditure in each instance; and (4) An increase in education, health, welfare and public safety services. In sum, ‘analysis of Local Government expenditures over the period 1961/62 to 1997/98 shows that the composition of services being provided by Local Government has changed markedly over the past 30-35

years. Local Government is increasingly providing human services at the expense of traditional property-based services (particularly roads)'.

The changes since 1995/96 can be summarised as follows: (1) the fastest growing activities have been housing and community amenities, public order and safety, and economic affairs, particularly with Sydney City; (2) transport and communications (largely road maintenance and depreciation, though not necessarily renewal) had a marked increase in 1996/97, but has stabilised since then; and (3) health and mining, manufacturing and construction expanded by less than the CPI.

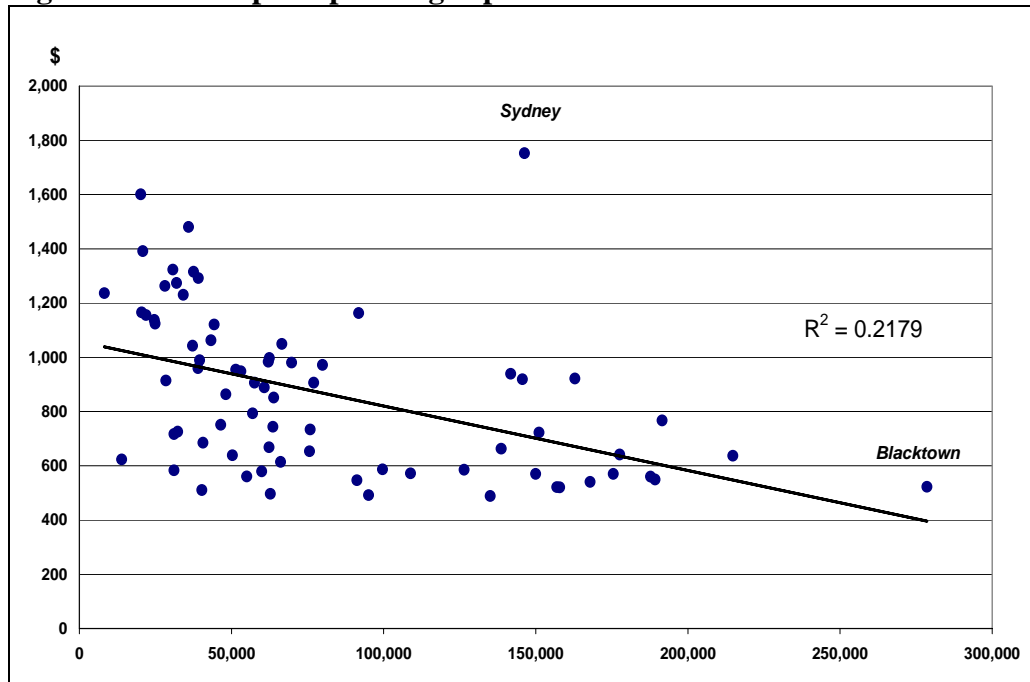
While the above observations accurately reflect aggregate trends in the composition of Local Government activity, it must be stressed that significant variations exist between metropolitan, regional, rural and remote councils. In general, rural and remote councils situated far from major centres provide services previously supplied by Commonwealth and State Government bodies. For example, rural councils in NSW now routinely operate aged care facilities, airports, banking services, Centrelink agencies and postal services and even provide surgeries and accommodation for doctors and nurses involved in general practice. In a telling comment to the Hawker Inquiry (2003, p8), a rural council general manager noted that 'Local Government in our region is the last man standing'!

Substantial differences between the 22 different categories of councils in the Australian Local Government Classification System, as well as big differences within the same category of council, mean that it is difficult to identify particular types of services that have grown most quickly beyond noting that, in general, the fastest growing activities have been housing and community amenities, public order and safety and economic affairs. In addition, it must be observed that these areas represent services normally provided by Commonwealth and State Government agencies.

A further important question arises: Do service levels vary greatly between councils? If service levels do vary significantly, why should this be so? No direct evidence is available on differences in service levels.

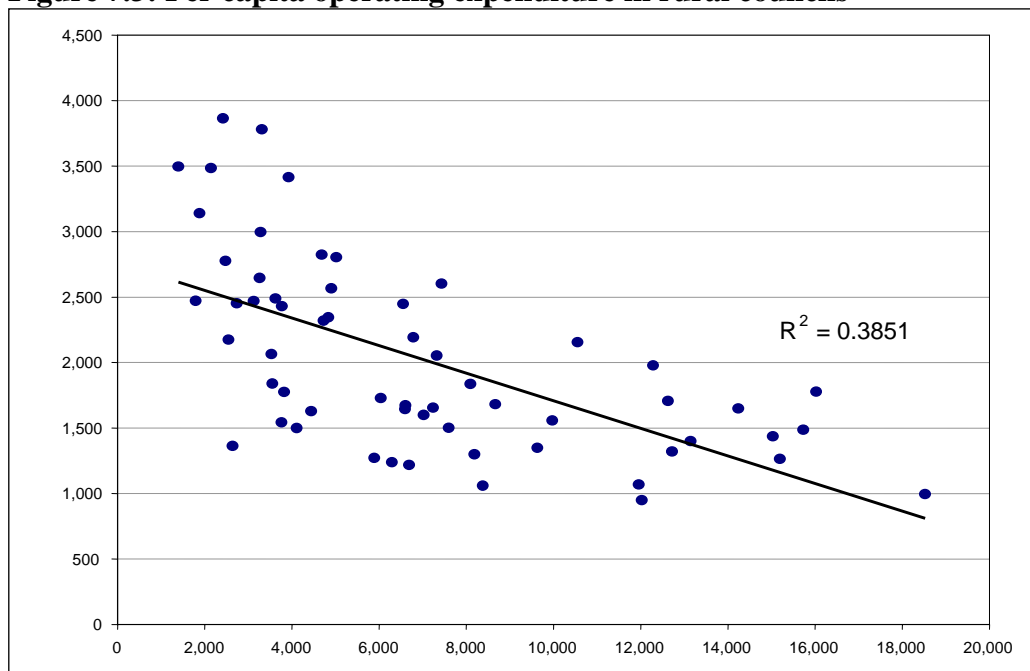
However, information does exist on differences in per capita operating expenditure between councils and between councils in similar categories. For example, Byrnes (2005c) produced various charts containing this kind of information. Two are reproduced below as Figure 7.2 and Figure 7.3.

Figure 7.2: Per capita operating expenditure in urban councils



Source: Byrnes, J. L. 2005c.

Figure 7.3: Per capita operating expenditure in rural councils



Source: Byrnes, J. L. 2005c.

On face value, Figure 7.2 and Figure 7.3 both demonstrate huge variations in per capita operating costs for councils with similar population sizes, but with a tendency for such costs to be higher for smaller councils. Yet, this tells us very little about differences in service levels for several reasons. Firstly, the straight-line (arithmetic) correlation coefficient (R^2) is very low showing little statistical significance²³. Next, no environmental factors, like type of

²³ Chapter 10 explores the curvilinear (logarithmic) correlation coefficients for these charts. While stronger than the straight-line (arithmetic) coefficients they are still weak by statistical standards suggesting that

country (i.e. 'flat' versus 'hilly') are considered at all, even though these have a major impact on the costs of service provision.

Also, population density is ignored, a factor which evidence provided in Chapter 10 would suggest is the most convincing explanation of variations in per capita expenditure between councils with fewer than 30 residents per square kilometre. Moreover, no account is taken of differences in input costs, which can obviously vary enormously across NSW. For example, acquiring professional services, telecommunications, petrol, office equipment, building materials and other supplies and services in remote rural areas is much more expensive than doing so metropolitan or large regional centres. Differences in operating efficiency due to management policies and practices rather than scale are also ignored. Finally, the service mix is also completely overlooked. Byrnes (2006c) himself was at pains to stress these caveats.

In any event, variations in the range and levels of council services are to be expected in a vibrant democracy where some Local Government areas will have a greater need or preference for services than other areas. However, political preferences may be distorted if a particular area is dominated by an entrenched party or group that has become impervious to public opinion; if there is a high share of council income derived from large commercial properties whose owners have few votes; if a high proportion of voters are tenants who may not see a nexus between the services they access and the rates paid by their landlords; or if rate pegging has locked in an historical expenditure level that no longer reflects community needs or wishes (see Chapter 9, section 9.3 for a discussion on rate levels locked in by rate pegging).

Remedies

The observed growth in non-traditional human services by Australian Local Government raises concern, if (as appears to be demonstrated by available data) this growth has come at a cost of depleted and degraded local infrastructure. Moreover, except in comparatively isolated rural councils, it suggests considerable duplication and overlap with state service responsibilities in particular.

Australians seem to believe that services themselves matter more than the tier of government through which they are delivered. This suggests that urgent steps are required to more clearly define the respective roles of the different levels of government in Australia and more carefully synchronise the activities of Commonwealth, state and local governments.

One response would be to follow the advice offered in the Hawker Report (2003, p16). In essence, 'if Local Government were involved earlier in the process of determining service delivery, this could reduce areas of unnecessary overlap or duplication between the spheres of government. Moreover, 'the reduction of duplication in advice and service delivery between spheres of government would improve overall cost effectiveness of government services and achieve significant savings'.

As pointed out above and in Chapter 5, inter-governmental agreements (IGAs) and specific partnership arrangements could facilitate the delivery of more efficient services by Local Government. An alternative option, in the absence of an IGA or partnerships, would be for

factors other than council size (e.g. population density) are more important determinants of variations in councils' per capita expenditures.

Local Government to define the limit of its own services mandate and adhere to those limits so that any extra resources in future could be directed towards infrastructure renewal and enhancement, which both public and council opinion, as well as financial analysis, identify as the most pressing expenditure priority.

Option 1: All NSW local councils agree to sign a compact that unless rate pegging was removed and Commonwealth and state funding was substantially increased to enable Local Government to fulfil the broad social, environmental and economic agenda envisaged in the *Local Government Act (NSW) 1993*, *Environmental Planning and Assessment Act (NSW) 1979*, *Protection of the Environment (Operations) Act (NSW) 1997* and other statutes and regulations, Local Government will cease funding the expansion of any human, environmental, economic and other service that is the traditional responsibility of the state and/or Commonwealth governments.

Under such a compact Local Government would vow to devote any future real growth in its total revenues to renewing and enhancing local infrastructure associated with a council's traditional functions, such as roads, kerbing, pavements, street lighting, bus shelters, bridges, storm water, seawalls, parks and gardens, public amenities (like public places, libraries, swimming pools and camping grounds), waste management, water and sewerage. At the same time each council would continue to strive for better social, environmental and economic outcomes for its community provided the additional resources required for non-core council functions were provided by external public, private or not-for-profit sources as envisaged in an 'Optimalist' approach (see Chapter 5).

Pros

- Such a compact would enable Local Government to set its own destiny and thereby avoid becoming ensnared in attempts by other tiers of government to shift their responsibilities and associated costs onto individual councils;
- This approach would free up funds to address infrastructure maintenance, renewal and enhancement, which have been identified by public opinion polls, councillors, general managers and technical analysis as the top spending priority for councils;
- A compact along these lines would reshape public expectations of Local Government and thereby put more pressure on state and Commonwealth governments to meet their social, environmental and economic obligations at a regional and local level either directly or by fully funding Local Government to be their service delivery agents; and
- Unless councils are prepared to go on 'strike' and reject demands to undertake new responsibilities that they can't afford, their financial predicament may grow worse.

Cons

- It is unlikely that all councils would agree to a 'solidarity charter' that would commit them to a minimalist services agenda as such a compact would compel councils to immediately cease dealing with important community issues that fall outside such a contract (e.g. retaining a general practitioner). Moreover, they might not agree on what are core council services;
- State and Commonwealth governments might refuse to fill the gap, which would particularly disadvantage rural residents who may have no one else to turn to for human, environmental and economic services if their councils went on 'strike';

- Such a compact would not stop Commonwealth and state governments from imposing additional responsibilities on councils (e.g. inspecting for smoke alarms in all dwellings) by passing new legislation or regulations;
- Since voters do not care which tier of government provides a public service as long as it is provided they may resent councils halting the expansion of services they have become accustomed to receiving (e.g. funding doctors' surgeries); and
- Brinkmanship by declaring a 'strike' against expanding council services might politically backfire rather than elicit extra funding from other tiers of government.

7.3 STANDARD OF COUNCIL SERVICES

Requirements

Local Government service provision covers a wide range of local goods and services, despite the relatively narrow traditional focus of Australian Local Government. Moreover, these services can be classified in many different ways, as Table 7.1, Figure 7.1 and the IRIS Report (2005) categories above indicate.

Several alternative approaches can be used to gauge the standard of these services. These relate to whether a council's services are:

- Appropriate, meaning they are relevant to its citizens' real needs and would not be produced or consumed at a desired level if left to normal market forces;
- Effective, in so far as they either (1) meet agreed volume, access, quality, timeliness and price targets that are consistent with their stated goals and/or (2) satisfy client expectations as measured in consumer satisfaction surveys;
- Efficient, because their unit costs of production (including corporate support costs) are comparable to what could be achieved if they were outsourced in a competitive market tender; and
- Prudent, since neither they nor the activities associated with their production pose a serious risk to the council, its employees or clients.

There are various ways these concepts are applied in practice.

Service standards can be assessed relative to various objective criteria. For instance, domestic waste management can be gauged according to the number of garbage collections per week, water quality against measured levels of impurities, the adequacy of parking in terms of the number of parking places in a CBD relative to the number of vehicles, etc. This type of standards assessment exists independently of public perceptions.

In Australian Local Government, Australian Standards (AS) are universally regarded as the appropriate community standards on service performance, safety and compatibility requirements. AS consist of two basic categories: (1) Standards used to guide works and physical infrastructure services/maintenance. These standards govern 'the development of land, roads, parks and gardens, water supply, sewerage and drainage services' (Cranko 2005, p4); and (2) Management improvement standards that guide councils in quality management, risk management and governance.

Together with mandatory state and Commonwealth legislation on service standards, with which Local Government must legally comply, AS prescriptive guidelines under (1) constitute the non-discretionary legal framework for council service provision. Discretionary AS not backed by law are also difficult for councils to reject or ignore without inviting criticism of their professional conduct.

Service standards can also be evaluated using ‘subjective’ indexes to measure either the ‘appropriateness’ of service provision or public ‘satisfaction’ with service provision. In this context, ‘appropriateness’ gauges whether the recipient population considers a particular service ‘relevant’ or ‘important’, whereas ‘satisfaction’ levels indicate the degree of public ‘contentment’ or ‘happiness’ with the quality of services delivered. These measures of service standards are thus concerned with the ‘effectiveness’, rather than the ‘efficiency’ of service provision, and fall squarely within the economists’ concept of ‘allocative efficiency’.

Various methods have been developed to assess public perceptions on ‘appropriateness’ and ‘satisfaction’. Apart from ‘politics as usual’ mechanisms, like periodic elections, referenda, program reviews and formal consultative processes involving the public, modern techniques include direct methods, such as focus groups, public opinion surveys, public hearings, and citizen’s juries, as well as indirect approaches, like ombudsmen and citizens’ charters (Bailey 1999).

Discussion of service standards in this chapter focuses mainly on ‘appropriateness’ and ‘client satisfaction’ as measured in a public opinion poll (IRIS 2005) specially conducted for this Inquiry. The questions of ‘effectiveness’ against ‘best-practice’ benchmarks in organisations outside NSW Local Government and ‘efficiency’ in terms of a general proxy measure such as the relative size of corporate overheads in councils are considered in Chapter 10.

Reality

The DLG publishes 30 key performance indicators (KPIs) in its publication called *Comparative Information on New South Wales Local Government Councils* (DLG 2004a). These indicators are financial (e.g. debt service ratio), volume-based (e.g. recyclables, kilograms per capita per annum), price-based (e.g. average rate per assessment), expense-based (e.g. community service expenses per capita) or time-related (e.g. mean average days for determining development applications). Insofar as these indicators can be used to benchmark a council against its peers within its own category (e.g. regional councils) they may highlight areas of strength and weakness in selective council activities. However, these KPIs are rather weak in measuring community outcomes. Also, the basis for their selection as key indicators is not clear.

To overcome this weakness the Inquiry commissioned an exercise (Young 2006) to identify the key drivers of council performance, putting three councils (one metropolitan, one regional and one rural) under the microscope. The study employed ‘logics analysis’ in an effort to build a council’s outcomes hierarchy for a sustainable local environment, economy, society and governance. The result was myriad key result outcomes tied to critical underlying final and intermediate outputs, with indicators for each layer.

Young concluded that the DLG indicators were a satisfactory apex of key indicators, but could be improved with a ‘logics analysis’ type exercise showing how they related to peoples’ key concerns on the one hand and the key determinants of performance in these areas of

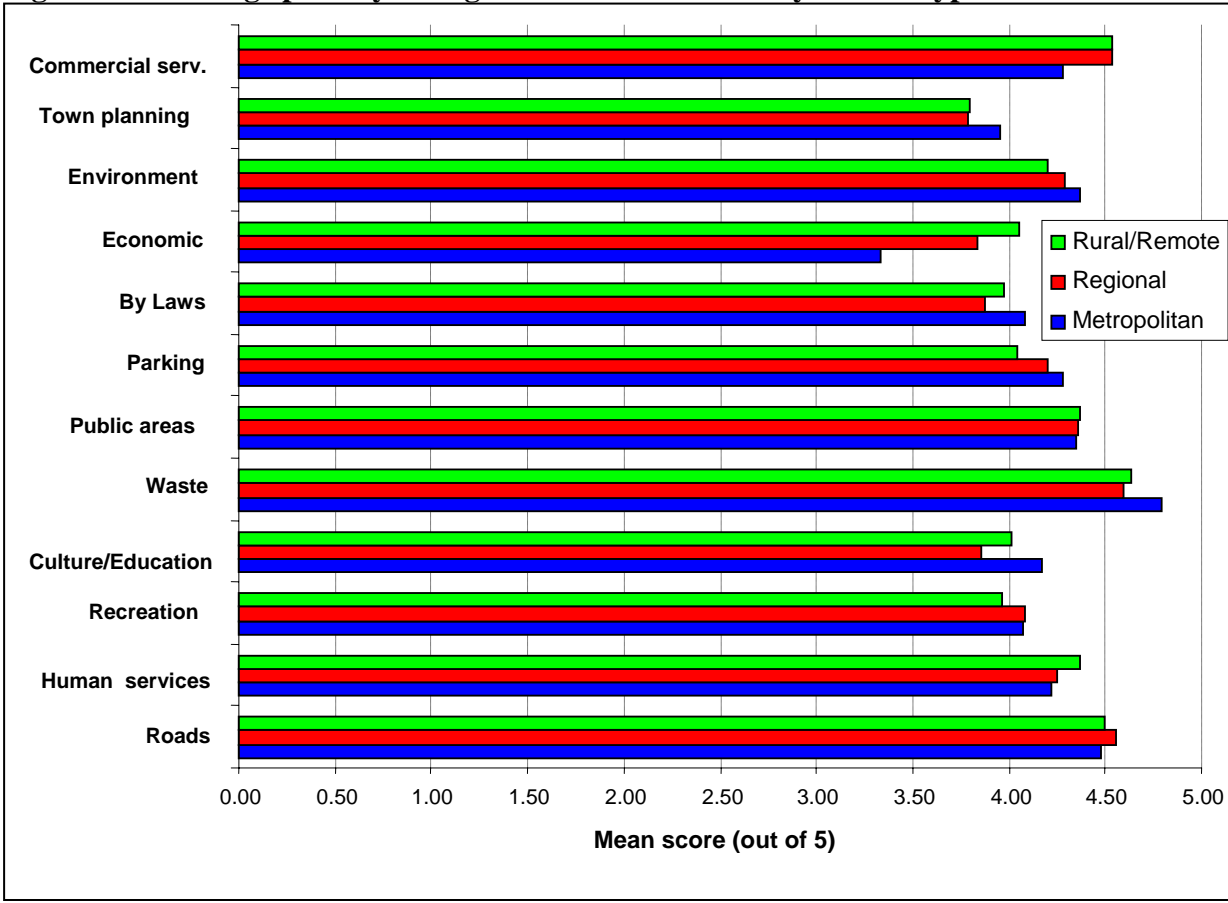
concern on the other. Involving councils in such a study could produce more robust indicators and win wider acceptance of their relevance by Local Government (see Chapter 10).

For indicators to lift council performance it would also be useful to publish minimum acceptable standards for each indicator and to conduct spot audits of councils' results.

Appropriateness

Using the IRIS Report (2005) classification of council functions, the relative importance of different types of services was gauged according to council type (i.e. 'regional/remote', 'regional', and 'metropolitan'). The results provide an insight to the 'appropriateness' of Councils' services as seen from a users' perspective. They are illustrated in Figure 7.4.

Figure 7.4: Average priority ratings of council functions by council types



Source: IRIS Research (2005).

The results in Figure 7.4 indicate not only differences between the appropriateness of the various types of services, but also differences between the three categories of council, though not between different types of respondent in terms of age, gender, and income. Nevertheless, the IRIS Report (2005, p24) drew the following generalisations:

The analysis found that culture and education facilities were perceived to be less important roles for Local Government in regional areas. Waste management activities and the enforcement of orders were perceived to be more important roles for Local Government in metropolitan areas. Finally economic development activities and the delivery of commercial services and facilities were rated higher in importance by regional and rural areas.

Furthermore, as identified in Chapter 5, traditional ‘services to property’ were preferred on average to ‘services to people’.

In essence, the IRIS (2005, p5) survey established that ‘waste management’ (waste), ‘construction and maintenance of local roads, footpaths and kerbing’ (roads), ‘the provision of commercial services and facilities such as water and sewerage in regional and rural areas, caravan parks, aerodromes, salesyards and gas supply’ (commercial services) and the ‘appearance of public areas including provision and upkeep of local parks and gardens, street cleaning and litter collection and the streetscape’ (public areas) were regarded as the most important councils services. These were followed by, ‘health and human services, including aged, child, youth, disability and migrants services and community centres’ (human services).

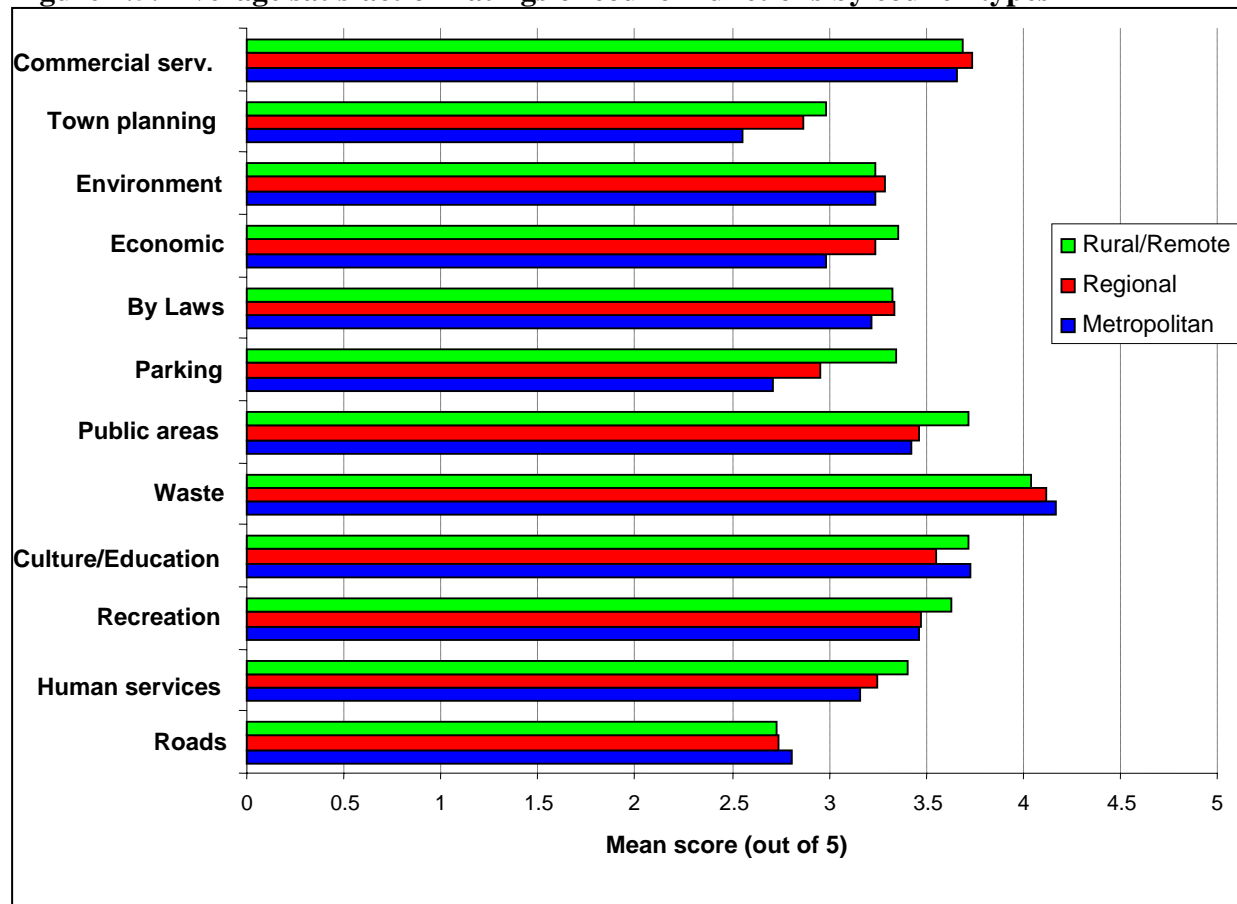
Economic development including ‘business and tourism promotion and attracting new business’ (economic), ‘town planning and timely processing of development applications’ (town planning), ‘enforcement of by laws including food and health, noise, animal control, parking and fire prevention’ (by laws), ‘recreation services and facilities including swimming pools, sport fields, skate parks and playgrounds’ (recreation) and ‘culture and education facilities including libraries, art centres, festivals and playgrounds’ (culture/education) ranked lowest in importance. However, it should be noted that all services were ranked as being of high importance by over 50 per cent of respondents. There were (as discussed in following sections) significant differences in these rankings between metropolitan and rural/regional councils.

Satisfaction

The comparative satisfaction with different types of services was gauged, according to council type. The results are illustrated in Figure 7.5 below.

From this analysis, the IRIS Report (2005, p31) observed that ‘the major statistical differences in ratings were identified for metropolitan areas’, where ‘residents ...were least satisfied in the delivery by their local council of services in traffic management and parking, economic development and town planning’. Survey findings on service satisfaction levels were as follows: ‘Overall, 50 per cent per cent of residents across New South Wales rated their level of satisfaction with their local council as high, 35 per cent per cent as medium and 15 per cent per cent as low. This translated into a mean score of 3.4 out of 5. In relative terms, this result compares well with the 2005 Victorian Local Government community survey results, which reported a mean performance score of 3.2 out of 5’.

Figure 7.5: Average satisfaction ratings of council functions by council types



Source: IRIS Research (2005).

Remedies

The service standards obtained by NSW councils in terms of consumer satisfaction, as measured by IRIS Research (2005), should be regarded as excellent except for town planning, roads, and urban parking and traffic management. With only small differences between different localities, all councils performed well. The McGregorTan opinion survey (LGSA 2004) found that public confidence in Local Government on a range of measures was generally higher than any other tier of government. These findings represent a strong vote of confidence in Local Government as a whole. It would thus appear that if councils can maintain this performance, no further action is necessary except in terms of land use planning, the condition of public thoroughfares and the adequacy of car parking.

By contrast, the outcome of the IRIS opinion survey in terms of service appropriateness, while by no means cause for alarm, is less sanguine. In general, respondents ranked traditional ‘services to property’ functions as particularly important, suggesting that NSW Local Government as a whole should ‘return to its roots’ regarding the focus of its attention. Moreover, this finding supports the ‘minimalist’ and ‘optimalist’ schools of thought on the appropriate role of Local Government discussed in Chapter 5.

However, the IRIS report also indicated that the majority of respondents indicated that they would like their council to spend the same or more on all of the services and functions polled. This tends to contradict any apparent support for a ‘minimalist’ or ‘optimalist’ school of thought. It would thus seem that public opinion tends to support ‘maximalism’ with an

emphasis on private and public property services (waste, roads, water and sewerage and keeping public places neat and tidy) rather than other services (economic, recreational, cultural, educational and regulatory). The report also indicated that the majority is prepared to pay more in council rates if the quality of services is increased.

However, a caveat must be added to these reflections. It seems clear from the opinion results that respondents from 'rural/remote' council areas ranked non-traditional service areas (e.g. health and human services, economic development) higher than their counterparts in larger centres. This is hardly surprising since Local Government often plays a vital role in human service delivery and business promotion in these areas. From a policy perspective, this again suggests a bifurcation of policy responses in NSW that acknowledges the unique circumstances of small rural councils.

The disparity in results between what residents consider important and the areas where councils put the most effort would suggest that councils could do more to find out what people really want and how satisfied they are with the results. The Inquiry's benchmarking of nine NSW councils (QMI Solutions 2005) also points to a need for councils to be more client and citizen oriented. This means reaching out to everybody, not just council activists.

For instance, Bankstown City Council (2006, p3) reports:

...we have conducted community satisfaction surveys at least annually since the mid 1990s, initially through consultants and more recently through our own market research team. Over the last two years we have refined this process even further into a series of quarterly surveys, polling 200 randomly-selected households every 3 months....The random nature of polling helps ensure that results are not unduly weighted by the 'vocal minority'.

Option 2: Each council at least once every three years should use its rate notice distribution to conduct an opinion survey of its ratepayers to find out how they rate the importance of each of its major services and how they rate their satisfaction with each service. The survey results should be used to shape the priorities of the council's management plan.

Pros

- Ratepayers are the primary funders of councils and therefore will have the most realistic view of what services give them value for money;
- Regular surveys of ratepayers' opinions would give councils a better idea of what residents really think than the views expressed by local newspapers, lobby groups and other vocal parties; and
- With pressures mounting on councils to divert scarce resources to rehabilitating, renewing and expanding local infrastructure, keeping an accurate tab on local opinion will be essential for knowing which recurrent services could be curtailed to help fund capital expansions.

Cons

- While rate notice distributions might reduce the cost of polling all ratepayers they would overlook the views of tenants whose rates are paid by their landlords. For this reason a well-constructed sample survey of all residents (involving the youth, not just those of voting age) might give better results than an all-inclusive ratepayer survey;

- Three-year intervals between survey might be too long and might not keep pace with changing community priorities;
- Polling captures majority views, but not the intensity of opinions. A minority (e.g. mothers of young children) might have high needs (e.g. child care facilities) that could get overlooked using a general opinion survey;
- Surveys should not be too wide ranging because more targeted surveys are generally more illuminating;
- The methodology of the survey should be left to councils as written questionnaires are not necessarily as effective as, for example, telephone interviews; and
- Polling is not a substitute for councillors showing leadership and deciding what programs should be given higher or lower priority in the management plan.

7.4 PROCUREMENT AND SALE OF SERVICES

Requirements

An important component of Local Government service provision resides in the circumstances under which services are produced, procured and sold. While this question has a crucial bearing on the performance of Local Government – an issue examined in detail in Chapter 10 – it is also significant in the context of service provision.

Discussion in this section is divided into two main parts: the procurement of services by Local Government and the question of ‘commercial discipline’ and its impact on service provision.

Procurement

Various statutory frameworks exist to assist Local Government with adequate procurement procedures. For instance, section 55 of the *Local Government Act (NSW) 1993* (LG Act) obliges councils to tender contracts for works, goods and materials in excess of \$150,000. Procedures must cover both open tendering and selective tendering processes, and contract selection criteria must be disclosed. Available evidence indicates 33 per cent of all tenders fall above the \$150,000 threshold (Cranko and Paddon 2005, p1).

Similarly, the NSW Government *Code of Practice for Procurement 2005* stipulates a number of tendering requirements and the range of criteria on which selection might be based, including ‘whole of lifetime’ costs, quality, innovation offered, relevant social and environmental considerations. These two policy documents adhere to international ‘best practice’ standards and thus represent an ideal benchmark for actual NSW Local Government procurement procedures.

A second dimension of procurement relevant to this chapter deals with procurement in various kinds of ‘shared services’. Section 358 (2) of the LG Act provides that a council may be a member of a co-operative society or a company limited by guarantee. The DLG drew the Inquiry’s attention to the opportunity this affords councils to establish and operate ‘shared service centres’.

Collaborative procurement processes are well established in NSW Local Government. Significant examples include procurement by networks of councils, like regional

organisations of councils (ROCs) and strategic alliances; bulk purchases for councils through the NSW Department of Commerce; purchases made through the LGSA Business Solutions facility; and purchases through the Victorian Strategic Purchasing organisation. Anecdotal evidence suggests that these arrangements have worked well and should continue to expand (Cranko and Paddon 2005).

A third dimension of procurement that should be considered is the extent of competitive tendering and outsourcing in contemporary NSW Local Government. According to the Industry Commission (1996, p.xix), around 10-20 per cent of total council expenditure was contracted out by the early 1990s with the most commonly contracted services being recycling, domestic refuse collection, cleaning community facilities, road maintenance and information services. Local Government contracted out a higher proportion of its recurrent expenditure than either Commonwealth or state governments, but a lower proportion of its capital expenditure.

More than half the studies surveyed by the commission reported savings from outsourcing of between 10-30 per cent while nearly a quarter reported savings of more than 30 per cent. Less than a tenth reported cost increases of any magnitude. The available evidence suggested that most of the savings of compulsory competitive tendering represented efficiency gains as a result of better management and work practices, access to wider knowledge bases, skills or technology and better use of equipment. Unfortunately, the Inquiry is unaware of more recent information on the extent of competitive tendering and outsourcing in NSW Local Government.

Commercial discipline

The post-1993 LG Act era has been characterised by sweeping public sector reform. In particular, two reform measures have decisively affected NSW Local Government: Council of Australian Government (COAG) water reforms and National Competition Policy (NCP).

By way of background, a NSW Government report (NSWG 1988), drawing heavily on New Zealand's public sector reforms, was the first in Australia to specify that a government business should meet the following requirements:

- Have clear and non-conflicting commercial objectives;
- Exercise no regulatory powers;
- Be compensated for externally imposed community service obligations;
- Be controlled by apolitically independent board and management;
- Be subject to 'arm's length' objective performance monitoring;
- Reward and sanction its management according to commercial performance;
- Be exposed to competition in both input and output markets; and
- Be stripped of all government related competitive advantages (e.g. tax exemptions) or disadvantages (e.g. prohibitions on forced staff redundancies).

While the first six listed attributes made an enterprise 'commercial', the final two conditions were essential for it to be 'corporatised' (Allan 1992).

This framework shaped the reform of public trading enterprises not only in NSW, but also throughout Australia after it was adopted by a Special Premiers Conference Task Force (NSWT 1991).

In 1995 COAG developed a nationally consistent framework for ‘competition’ policy in the form of NCP. The NCP agreement launched numerous reforms to enhance the competitiveness of the Australian economy, ranging from governance of government businesses to ensuring ‘third party’ access to monopolised infrastructure. A noteworthy reform entitled ‘competitive neutrality’ aimed to prevent government businesses from enjoying an unfair advantage over the private sector due to tax exemptions and preferential borrowing arrangements. It applied corporatisation principles to government trading enterprises, including Local Government businesses.

NCP required these principles to be applied to category 1 council business activities that earned revenue over \$2m per year. These requirements were (Byrnes 2005a):

- Adopt a corporate model;
- Include debt guarantee fees;
- Factor into prices an appropriate return on capital invested;
- Quantify and make explicit community service obligations;
- Operate in the same regulatory framework as other businesses; and
- Include in costs the same taxes faced by private businesses.

By contrast, council category 2 businesses, with turnover of less than \$2m per annum, had only to meet one condition – the application of full cost attribution to as many category 2 activities as practicable. The extent to which such a business was corporatised and thereby exposed to competition on a level playing field was left to the discretion of the council that owned it.

Reality

Procurement

How well are current procurement practices working? The *Local Government Act (NSW) 1993* specifies competitive contracts in excess of \$150,000; therefore contracts for this value by all councils meet current standards and requirements. In practice, larger councils are likely to comply with the Act because of the scale of their services or to comply indirectly by employing one of the bulk purchasing arrangements outlined above. Smaller councils using these bulk schemes automatically comply. However, outside these arrangements, small councils’ compliance with procurement ‘best practice’ has been described as ‘patchy’. Cranko and Paddon (2005, p3) list ‘key areas’ for improvement as ‘risk assessment’ and ‘better controls’.

Kingsway Financial Assessments Pty Ltd (2005) in its submission to the Inquiry observed:

Local councils do not appear to routinely conduct financial assessments of tenderers. There is no uniform system of financial assessment across local councils with respect to a third party independent and objective test of financial capacity and solvency of tenders.

Local councils (should) adopt the existing State Contracts Control Board Contract 0500969 for financial assessment services as a form of risk management when letting tenders of construction and other goods and services contracts.

David Rosenbaum (2005, p6), a treasury management specialist, in his submission noted:

Of 14 Councils who applied for a (Special Rate Levy) increase, 11 Councils' comparative treasury management performances were assessed. These Councils maintained a total of \$566 million of surplus cash able to be invested as at the 30 June 2004 (published data). The average returns on their investment portfolio were compared to the 90-day Bank Bill Index. This comparison resulted in a collective underperformance of \$1million.

When these returns were then compared to those achieved by the top performing local government authorities, the level of underperformance was \$15.3 million. This compared with the dollar impact of the collective Special Rate Levies sought by these Councils, which amounted to \$14.8 million albeit in different financial time periods.

Rosenbaum's contention is that with better treasury management the 14 councils could have generated more money than they were requesting to raise in special rate variations.

There are further examples of where savings and/or additional revenue could be made through better procurement.

One innovative way to generate extra revenue on the sales side of procurement was reported in the Sun Herald of 5 February 2006 (Sun Herald, 2006). The article says that:

A confidential parking study prepared for Ryde Council said councils can double the revenue from one parking spot simply by using meters that print tickets – called Pay and Display (P&D) meters - rather than meters that display the time left on the machine called Pay by Space meters (P by S).

“P&D machines increase income from parking because parkers often leave before their pre-paid time has expired and the replacement parker pays for a part of the parking duration covered by the previous parker” the study said.

Another example is avoiding litigation. Mediate Today (2005), one of Australia's leading dispute resolution agencies, cited a 1998 NSW Parliament Public Accounts Committee report entitled '*Changing the Culture: Dispute Management in Local Councils*':

... the Committee has no doubt that the implementation of ADR [alternative dispute resolution] has the capacity to reduce legal expenditures incurred by local Councils and at the same time build bridges and strengthen bonds between Councils and their local constituencies.

... (The Committee also) urged Councils to explore the benefits of ADR and relinquish the adversarial approach in their management practices... (and it felt) ...there is a fundamental need to consolidate ADR into Council policy at various stages of the planning process in order to provide Council officers with the option to use ADR in better managing potential and actual disputes.

Mediate Today says that since the release of the report a number of councils have undertaken alternative dispute resolution (ADR); however, its application falls well short of the expectations of the committee.

Cranko and Paddon (2005) underline lost opportunities in Local Government procurement such as exhibited above with the observation that 'the methodologies councils use to procure services have evolved out of the methodologies for the procurement of goods' and may not be adequate for 'complex services'.

Commercial discipline

In NSW, NCP principles are generally well applied with respect to category 1 businesses. However, there is scope for extra revenue for councils through increases in efficiency, moving to full cost recovery and higher dividend payouts.

Category 1 council businesses are typically water and sewerage services since most Local Governments outside of metropolitan Sydney and the Hunter region are responsible for these services. In sum, in 2003/2004 there were 126 local water utilities (LWU) providing water and wastewater services in non-metropolitan regions, 51 of which were classified as category 1 and thus required to apply corporatisation principles to their operations (Department of Energy, Utilities and Sustainability (DEUS) 2005). The average economic real rate of return was 2.7 per cent for water supply and sewerage, which was well below what would be expected by a private commercial water utility.

This low rate of return indicates that water and sewerage operations, if they moved to full cost recovery and improved their efficiency, are potentially a valuable source of extra revenue for councils. However, for the LWU to pay a dividend to its parent council, it must comply with several *Best-Practice Management (BPM) Guidelines* (DEUS 2004). They require:

- Strategic business planning and long-term financial planning;
- Water supply and sewerage pricing and developer charges;
- Demand management;
- Drought management;
- Annual performance monitoring; and
- Integrated water cycle management.

Byrnes (2005e) found these BPM requirements to be more onerous than those applied to state business enterprises that paid dividends, as well as being difficult and expensive to apply in practice. For instance, in 2003/04 only 10 per cent of LWUs complied with the BPM guidelines and could thus pay a dividend. However, DEUS says this is not surprising since the guidelines were first published in May 2004.

DEUS contends that comparison of LWUs with state business enterprises is inappropriate since state enterprises are required to pay a dividend to another party (the State Treasury) whereas councils, without DEUS guidelines, could strike their own dividends with impunity. The Inquiry is not convinced by the argument that councils would be less restrained in setting dividends than is the NSW Treasurer (on the advice of Treasury). After all, excessive dividends flow through to prices, so have a political cost.

DEUS says that in June 2005, compliance with BPM guidelines for water supply ranged from 49 per cent for water conservation to 92 per cent for water performance reporting with 27 per cent of LWUs complying with all the required criteria. DEUS is confident that by June 2009:

- All LWUs will have achieved full cost recovery for water supply and sewerage;
- All LWUs will have completed a 20-year strategic business plan and financial plan; and
- At least 70 per cent of LWUs will be fully compliant with BPM guidelines and so be eligible to pay dividends.

DEUS told the Inquiry that local water utilities (LWUs) have significantly increased their revenues in recent years (mainly through the introduction of appropriate water and sewer usage charges, liquid trade waste fees and charges and developer charges in addition to their annual water and sewerage access charges), a move induced in part by the *BPM Guidelines*, but also by the DEUS water and sewerage performance monitoring report (DEUS 2005). This report has encouraged councils that were undercharging for water services to emulate those that were fully recovering their costs.

According to DEUS almost four out of five LWUs now have long term strategic business and financial plans in place. These indicate that the vast majority of such utilities should be able to meet the levels of service negotiated with their communities and fully recover their operating costs, while also being able to completely meet their future infrastructure needs, with little or no real increases to their typical residential bills.

DEUS says that prior to June 2004, councils were permitted to achieve full cost recovery for their water and sewerage businesses, but not to receive dividends from such businesses. However, after section 409 of the LG Act was amended, an LWU that complied with the *BPM Guidelines* was permitted to pay a dividend from its surplus to its council's general revenue.

Yet it is noteworthy that the legislative amendment puts no obligation on LWUs to achieve a true economic rate of return (i.e. fully recover the opportunity cost of their equity capital in addition to their debt charges). State policy appears to be directed at protecting consumers and the environment rather than ensuring councils get a fair return on their water and sewerage assets.

Maxwell (2006b, p14) takes the view that dividends from water and sewerage businesses should not form part of the general purpose revenue of a councils for:

...there is an equity issue in that water and sewer ratepayers comprise only a sub-set of general ratepayers, and because the General Fund of Council has not contributed any capital to those operations, the water and sewer ratepayers are subsidising the non-water and non-sewer ratepayers.

Yet section 59A(2) of the LG Act makes it very clear that a council is the owner of all works of water supply and sewerage that it installs. As such it is entitled to a return on such assets given that local water utilities have been commercialised and corporatised in accordance with *BPM Guidelines* and *National Competition Policy* (NCP).

Remedies

Procurement

It is thus evident that procurement, corporatisation and commercialisation arrangements in NSW Local Government have improved since the *Local Government Act (NSW) 1993*. But much still remains to be done. The procurement policy proposal to ensure that delivery arrangements actually achieve desired outcomes, advanced by Cranko and Paddon (2005, p7), has much to commend it. They contend that 'a key challenge for Local Government is to ensure that delivery arrangements actually achieve desired outcomes'. In order to 'ensure that policy and implementation are aligned, it is recommended that tools for integrated strategy and service delivery planning and assessment need to be developed and promoted across NSW Local Government'.

However, the first step to improving procurement practices is to start with a survey of all the major inputs of Local Government and then to estimate the total value of each service or commodity involved. Commodity action teams (CATs), comprising procurement officers from selected councils, can then be used to standardise the specifications for each major purchase item. By aggregating council purchases through competitive tenders it should be possible to exploit economies of scale to achieve significant reductions in price and improvement in quality. The LGSA has already established a procurement unit to take matters forward.

Option 3: The LGSA continue to pursue shared purchasing arrangements for all councils, perhaps using commodity action teams, drawn from a representative sample of councils, to identify where savings can best be made. In addition, the LGSA should develop best practice procurement guidelines to assist councils to better align and integrate their service plans and policies with their procurement processes and practices.

Pros

- Should deliver considerable procurement savings to councils;
- Would integrate service provision arrangements with performance evaluation criteria. This would enable councils to better assess their standards of service delivery; and
- Would allow all councils to use the same integrated framework to ensure accurate comparison of service standards between councils.

Cons

- There is a shortage of council staff trained in modern procurement theory and practice;
- While the Cranko and Paddon (2005, p7) recommendation is conceptually appealing, it would be difficult and potentially expensive to implement in a satisfactory manner; and
- Not all councils may agree to use the same integrated framework.

Option 4: Local Government pursue innovative solutions to expenditure saving and revenue enhancing to help boost its infrastructure funding capacity.

To overcome the infrastructure crisis councils will need to find a lot more financial resources. Raising rates, fees, charges and grants and reordering expenditure priorities are not the only ways that councils can make ends meet. Possible other measures submitted to the Inquiry include standard financial capacity and solvency assessments of tenderers, improved treasury or investment management, alternative dispute resolution (e.g. mediation) at various stages of the land use planning process, replacing pay by space parking meters with pay and display ones, and sales of surplus land (e.g. narrow lanes at the back of houses traditionally used for collecting toilet bins).

Pros

- Would make more funds available for councils' general revenue; and
- Would reduce the extent to which existing rates, fees and charges might otherwise have to be increased.

Cons

- Certain investment strategies might not be regarded as prudent by the community and a council's agreed investment strategy; and
- The community might be suspicious and distrustful of indirect revenue enhancing measures.

Commercial discipline

While much has been achieved through the application of business principles and NCP requirements, especially for category 1 enterprises, the position is much less satisfactory regarding category 2 businesses. Byrnes (2005a) has proposed the following two policy options to correct this situation:

Option 5: Councils further commercialise their business operations (especially category 2 business) so that they set their prices to fully recover economic costs, including the cost of capital, and pay dividends like a normal business.

Pros

- The Roorda Report on Local Government infrastructure (JRA 2006) has shown that water utilities need to spend \$955 million to bring their physical assets to a satisfactory condition and because their asset renewals (\$61 million per annum) fall well short of their asset depreciation (\$137 million per annum), this backlog will grow in future. Their renewal requirements over the next 15 years will cost \$900 million at today's prices. The sooner the water utilities achieve an economic rate of return, the sooner they will be able to tackle their infrastructure crisis; and
- Australia is the world's driest continent and water is its scarcest resource. Under-pricing water simply encourages its waste.

Cons

- Regional, rural and remote councils would have to increase water and sewerage charges to prohibitive levels to obtain a true economic rate of return. This was never envisaged when the water and sewerage works were built with subsidised state funds. Improving the rate of return but accepting that it will never be truly commercial is the only viable option if these communities are to economically survive; and
- The Department of Energy, Utilities and Sustainability is confident that with revenue increases since 2002 most water utilities will be able to catch up on their renewals backlog and meet renewal requirements in future. However, the Inquiry is not convinced that these increases are sufficient to generate dividends to councils.

Option 6: The NSW Department of Energy, Utilities and Sustainability reconsider the extent to which council water and sewerage services must comply with *BPM Guidelines* so as to enable more of them to pay dividends to councils.

In particular, ‘drought management’ and ‘integrated water cycle management²⁴’ are very broadly framed and include social and environmental objectives forced upon Local Government by the State Government. This contravenes NSW Treasury’s stipulation concerning government compensation for ‘externally imposed community service obligations’ (Allan 1992). The NSW Government should either financially compensate Local Government for externally imposed community service obligations or abandon these obligations.

Pros

- It is a basic proposition of fiscal federalism that if the NSW Government imposes various ‘equity’ outcomes on Local Government LWUs, in the form of numerous controversial ‘social obligations’ and ‘environmental objectives’, to which the non-metropolitan public seldom subscribe, the NSW Government should bear the full cost of this imposition. This is also a requirement of the state’s own commercialisation guidelines;
- Streamlining BPM guidelines, with full compensation for externally imposed obligations, would enable councils to focus on the efficient operation of LWUs; and
- Full compensation and efficient LWU operation will enable councils to receive dividend payments and thus alleviate financial constraints.

Cons

- It would be difficult to fully cost the impact of community service obligations. Hence it would also be difficult to adequately compensate Local Government for their imposition;
- Even if the State Government was to remove the community service obligations on the LWUs, community pressure might force councils to re-impose them of their own accord;
- DEUS insists that a drought management plan is an integral part of managing a water supply system, not a community service obligation; and
- Ratepayers may prefer to take their ‘dividends’ in lower water and sewer prices than better council services funded from higher LWU dividend payouts to councils.

7.5 FUTURE SERVICE NEEDS

Requirements

A council should be primarily concerned with meeting local needs as identified by local people, subject to the statutory obligations provided by Commonwealth and state governments, as well as its ability to pay. This requires determining public opinion on key community priorities.

²⁴ Financial assistance is available to councils for up to 50% of the cost of preparing an Integrated Water Cycle Management Strategy.

In assessing future service needs it is not sufficient to establish what current residents want by way of local services in future. It is also necessary to estimate the size and composition of the local population in 10 to 20 years' time using demographic projections available from sources such as the Australian Bureau of Statistics.

In addition, scenario analyses should be conducted of the PEEST (political, economic, environmental, social and technological) trends that are likely to shape the community going forward.

A combination of current priorities, demographic directions and future trends should go towards formulating a future services strategy.

Reality

The IRIS Report (2005) canvassed opinion on public perceptions of future services needs on behalf of the Inquiry. These are summarised in Table 7.3.

The IRIS Report (2005, p48) drew three main conclusions from these results. Firstly, 'in line with community satisfaction of the services and facilities delivered by their council, a majority of residents surveyed believed their local council needed to spend more money on roads, footpaths and kerbing and on health and human support services'. Secondly, 'while in general the community was happy on the level of council spending in critical areas, economic development and town planning were identified by more than 10 per cent of the community as areas that their local council could consider to spend less'. Finally, 'culture and education, enforcement of by laws, recreation facilities and traffic management and parking were identified by more than five per cent of respondents as possible areas for reducing council expenditure'.

Table 7.3: Spending on council services and facilities – all council types

Service Area	Proportion of Respondents (%)			
	Spend More	Spend Same	Spend Less	Can't Say
Roads, footpaths and kerbing	68.8	28.8	1.3	1.3
Health and Human Support services	54.5	40.9	3.2	1.3
Economic development	41.9	49.0	8.1	1.0
Environment	39.9	54.5	4.2	1.3
Commercial services	38.0	58.4	1.6	1.9
Recreation	31.8	61.7	5.5	1.0
Culture and Education	30.2	58.8	10.1	1.0
Parking and traffic management	30.2	59.7	7.8	2.3
Public Areas	29.5	66.6	3.2	0.6
By-laws/orders	26.3	65.9	6.2	1.6
Town Planning	26.3	58.8	9.4	5.5
Waste Management	23.1	72.1	3.6	1.3

Source: IRIS Research (2005), figure 5.3.1.

Once again, however, these overall conclusions must be qualified by taking note of the special case exemplified by 'rural/remote' councils. The IRIS Report (2005, p50) observed that residents in these councils 'were reluctant to nominate areas for possible expenditure cuts'. Moreover, 'roads and health and human support services were identified as areas where expenditure should increase', with 'the remaining council responsibilities achieved a majority

of respondents suggesting that spending should remain at current levels'. However, 'culture and education services achieved the highest result at 10 per cent for possible expenditure cuts'.

If future needs are correctly identified in Table 7.3, then the question arises as to whether councils have adequately planned to fulfill these needs. To some extent, given the over-riding view of IRIS Report (2005) respondents that councils should focus on their traditional service areas, it can be argued that if the current expenditure trend towards 'services to people' continues, then this provides de facto evidence that councils have not adequately gauged community preferences in planning future service needs.

A second approach to answering this question would try to determine whether councils are actively planning to meet future service needs in areas where change appears inevitable. Examples include the local needs of an ageing demographic profile and the growth management planning needs for rapidly developing regions. However, unfortunately no generalisations are possible across NSW Local Government because no data exists. For instance, in its annual Comparative Information on New South Wales Local Government Councils, the NSW Department of Local Government examines only council responses to current, not prospective challenges. Similarly, the National Office of Local Government's (NOLG) (2005) Local Government Annual Report, 2003-04 is silent on this question.

The Roorda infrastructure survey found that the proportion of councils that have adopted an asset management plan varied between five per cent for buildings and 38 per cent for sewerage and water supply assets. The latter scores were attributed to the influence of the DEUS BPM water and sewerage guidelines, but for plant (27 per cent), recreation (six per cent), storm water (nine per cent), roads (13 per cent) and other assets (six per cent) the existence of plans was low (JRA 2006, p31). Roorda did not enquire about service planning, but anecdotal evidence suggests its usage is low beyond the three-year horizon of the mandatory management plan.

Indeed the Sproats' Inquiry (2001, p29) found:

The predominant focus for councils as evidenced in their management plans was day-to-day operation. Councils' abilities to think and act strategically need to be enhanced. The ability to take a wider perspective requires encouragement. Several submissions made the point that NSW legislation needs to mandate comprehensive strategic planning. Structures need to be propagated which lift the profile of strategic planning within local government. Strategic planning needs to be resourced so that it is driven both at the community and political level, achieves the necessary import from appropriate professional experts and is adequately funded over the long term.

The situation may improve with the implementation of the NSW Government's Metropolitan Strategy. The strategy's planning requirements for the future development of greater Sydney might force all metropolitan councils to evaluate their long-term service and asset needs to ensure that they mesh with the government's strategy.

Thirdly, the potential for increased duplication of services between different tiers of government is high unless firm steps are taken to reduce current service spillovers. Without an intergovernmental agreement (IGA), such action seems unlikely.

Remedies

The inherent uncertainty in determining and planning for future service needs in Local Government, or any other aspect of the contemporary public sector, should induce a sense of humility in public policy making. Nevertheless, future demographic trends, which largely drive service demands on councils, are known since the population profile changes only slowly. Moreover, in the New Zealand model long-term planning with community consultation became the quid pro quo for councils winning their independence. The New Zealand model might thus hold lessons for NSW (McKinlay 2006) and the DLG's recent integrated planning approach promises to be a step into the right direction (DLG 2005d).

With these caveats in mind, two policy responses appear warranted. In the first place, planning for future service needs should recognise the public wish for Local Government to refocus on meeting its traditional 'services to property' mission. This also accords with the finding of this Inquiry that councils must reorder their spending priorities, obtain more revenues and boost their borrowings to address a serious backlog in their infrastructure renewals which is set to worsen. Secondly, as we have argued elsewhere in this chapter, urgent steps must be taken to reduce the scope of service duplication with other tiers of government, especially the state. IGAs and specific partnership agreements seem to represent the most promising avenues (see Chapter 5).

Option 7: All councils should have a long-term services plan that takes into account demographic, political, economic, environmental, social and technological trends as well as existing community's priorities based on opinion surveys and community consultations that disclose the costs and benefits of alternative scenarios.

This plan should underpin and be prepared in conjunction with the long-term strategic and financial plan as proposed in Chapter 10, option 4.

Pros

- New Zealand has shown that long-term service planning involving close community consultation on available policy tradeoffs can help councils decide competing priorities within a sustainable fiscal framework; and
- 'Demography is destiny' so its implications for councils' future service needs can only be ignored at the peril of Local Government policy makers.

Cons

- New Zealand council planning has gone through several iterations since the original model was seen as too top-down and not sufficiently bottom-up. It is still viewed with scepticism by some public action groups; and
- Smaller councils simply do not have the professional skills in scenario analysis and strategic planning to undertake long-term service plans, though greater resource sharing might be one solution.

8. DEVELOPMENT PLANNING AND CONTROL

8.1 INTRODUCTION

Land-use planning in NSW is going through a period of major change with both a transformation of planning procedures, known as planning reform, and the launch in December 2005 of the latest Sydney Metropolitan Strategy 'City of cities - a plan for Sydney's future'. The strategy proposes planning requirements to accommodate a population increase from 4.2 to 5.3 million people over a 25-year period and the consequent need for 640,000 new homes and 500,000 additional jobs. It will not be until 2006 or 2007 that all the details are decided and plans issued for regional areas such as the Illawarra that are covered by the strategy, but which are outside central Sydney.

This chapter reviews the existing land use planning and development control system in NSW including its purpose, instruments and application at state, regional and site-specific levels. Whilst planning reform and the Sydney Metropolitan Strategy will have major impacts on Local Government throughout the state, the exact implications are not yet known. The conclusions in this chapter must therefore be taken as tentative.

8.2 PLANNING AND CONTROL OBJECTIVES AND INSTRUMENTS

Requirements

A land use planning and control system should provide a vision for an area, identify the *objectives* that need to be achieved if that vision is to be realised, the *strategies* that will be used to achieve the objectives and the resultant *actions* required by the public and private sectors. The strategies often include restricting a landowner's property rights and this is achieved by statutory land use plans that control and regulate the use and development of land.

A robust planning and control system must contain policies and directions supported by a legislative framework containing clearly articulated strategic objectives, provisions and regulatory controls set out in a coherent hierarchy of inter-related regional and local land use plans.

Reality

Planning and regulatory instruments

NSW has a complex planning system with inter-related sets of legislation such as the *National Parks and Wildlife Act (NSW) 1974*, *Heritage Act (NSW) 1977* and the *Transport Administration Act (NSW) 1988*. The principal planning legislation is the *Environmental Planning and Assessment Act (NSW) 1979*, but councils must act within the *Local Government Act (NSW) 1993*, the *Protection of the Environment Operations Act (NSW) 1997*, the *Coastal Protection Act (NSW) 1979* and other statutes.

The planning legislation consists of a multi-layered system of controls. In deciding on the appropriate use and development for a specific land parcel, councils need to comply with a

variety of regulations. State Environmental Planning Policies (SEPPs) and Regional Environmental Plans (REPs) are statutory instruments under the jurisdiction of the state. Local Environmental Plans (LEPs) are prepared by local councils under guidelines issued by the Department of Planning and must be approved by the Planning Minister. Development Control Plans (DCPs) are initiated and approved by councils.

The NSW layered system was originally intended as a logical hierarchy for state, regional and local interests. The complexity of this planning system has created difficulties with respect to consistency in implementing planning policies through the various layers. The objective of the recent planning reform has been to remove some of this complexity and develop an integrated and transparent set of state, regional and local planning policies and controls for each Local Government area. Other states that have been moving towards this objective are Victoria, Queensland and South Australia, the latter jurisdiction having a single control document that enables greater simplicity and consistency in land use decisions.

Because the legislation requires that the planning decision process must have regard to a multitude of environmental issues, the system has become complex and cumbersome. Some assessment reports contain multiple and at times repetitive comments on 'matters for consideration'. For example, the Coastal SEPP, which has been layered over a raft of existing local and state controls, has 28 complex matters for consideration, all of which need to be considered and assessed by council staff dealing with a DA.

The report of the NSW Government's Regulation Review – Local Development Taskforce, also known as the Bird Inquiry (DIPNR 2003, p34) found that:

...there are no guidelines or processes available to assist Councils or State agencies to develop and write their controls. As a result, a mass of development control plans, local environment plans, development policies, best practice guidelines and State and regional environmental plans exist in NSW. Similarly there is no review mechanism for third parties to assess how a particular standard has been developed and whether it is appropriate and understandable.

Planning reform

Under the umbrella of the Sydney Metropolitan Strategy a number of planning reform initiatives have been launched in NSW since September 2004. These initiatives aim to improve strategic planning in Sydney's growth areas, simplify planning controls, streamline the DA process and give greater flexibility in the use of developer levies for local facilities and services (Gilmour 2005, p7).

The state aims to reduce the current level of 5,500 local planning instruments. For example, the number of SEPPs is expected to fall from 59 to around 25 and the number of REPs from 44 to fewer than five. Some 310 zoning categories will also reduce to around 25, and the number of defined terms - such as 'gross floor area' - will fall from 1,700 definitions to around 250. DCPs will be reduced in number and they will only deal with issues that are not covered in other documents, specifically the LEP. If all these changes are achieved there will be a considerable simplification in NSW's planning system, however, the changes will also have the effect of reducing the decision-making powers of Local Government.

The planning reform agenda requires all councils to prepare new LEPs within two to five years. A new panel appointed by the Minister for Planning, comprising representatives of the Department of Planning, councils and external experts will review draft LEPs before they can

be placed on public exhibition. This is to ensure that LEPs conform to what has been agreed for the immediate sub-region within the context of the Sydney Metropolitan Strategy. The previous policy had been for public exhibition of LEPs to proceed before submission to the Department of Planning.

The State Government will supply statistical data on housing, land supply and employment via the Metropolitan and Employment Land Development Program and has issued a standardised LEP template with common development standards. An additional \$5.8 million of State funding has been agreed to allow all 152 councils to prepare new LEPs, a figure considered insufficient to meet the additional costs by the councils themselves. The LEPs will consolidate all the relevant policies and controls for a local area in a single document and become the principal planning blueprint for that area.

The Bird Inquiry (DIPNR 2005, p36) noted that most other states are also moving towards common planning solution templates and in some cases standard legal and administrative provisions in order to provide greater consistency in the format, structure and basic provisions of schemes.

Some critics argue that the planning reforms are motivated to reduce the workload on the state rather than encourage councils to plan effectively and that local communities will have to accept controls that may not be appropriate to their local needs (Mant 2005d, p5). Councils believe that a standard format will be inflexible, as WSROC (2005) noted:

Many of the compulsory provisions are either not relevant or highly unlikely to be relevant to Western Sydney Councils. Most of the compulsory provisions and optimal provisions lack the sophistication required to address varying local conditions ... The format of the template is both simplistic and clumsy.

Zones and land parcels

As part of planning reform, the state released a draft standard template development control instrument for all councils that would standardise land controls for all zoned land (e.g. residential, commercial, industrial). Setting individual controls for individual parcels of land will no longer be permitted. This will make it easier and less expensive for developers of standard commercial premises (e.g. fast food drive-ins such as McDonalds) or project homes (e.g. Masterton Homes) to obtain development approvals from councils.

The proposed standard LEP template uses zones rather than land parcels or collections of parcels as the format for land use controls. This has generated controversy between those who want certainty and simplicity when developing a site and those who want to preserve or shape the character of a community's layout and buildings. Critics say it will stop councils from insisting on special conditions that force a development on a parcel of land within an established area to be compatible with the character of its locality or to properly plan and integrate homes, shops, offices, public places and green space in new areas to create a distinctive user-friendly neighbourhood.

However, supporters of confining land controls to zones point to the success of large housing estates (e.g. Harrington Park which has 25,000 lots with more to come), which use their own master planning to ensure innovative design, adequate green space and diverse social amenities to produce an attractive neighbourhood appealing to prospective buyers (see Duffy 2006 for the case for 'McMansions')

The use of a template format and agreement on a common definition of terms could be of benefit to many smaller under-resourced councils and make it easier for planners and developers to undertake projects in differing jurisdictions. However, it will give councils less discretion in applying controls to specific sites or localities and as such significantly diminish their power. The completion deadline for new LEPs of five years is realistic, but more state funding and staff resources are required to assist the process.

Remedies

The gap between the requirements for an ideal planning and regulatory system and the current procedures in NSW is large. Although NSW planning reform is attempting to reduce the number of separate planning documents in each category of SEPPs, LEPs etc, the layered approach has been retained and the application of council controls will in future apply only to zones not land parcels.

Some other states such as South Australia have a single control plan to which the council, or the state, can initiate amendments, but the Minister approves the final plan. In South Australia the development controls also apply to a parcel of land or a locality (a collection of like land parcels) rather than a land zone (e.g. residential, commercial or industrial). This allows all development controls applying to a particular parcel of land to be consolidated in a single document for that parcel. Could either or both of these approaches work in NSW?

Option 1: Introduce a single planning document to apply to whatever land-use control format is adopted (e.g. land zones, land parcels or localities).

This would replace SEPPs, REPs, and LEPs with a single planning document.

Pros

- By having a single plan there would be less chance of conflicts between individual control documents as happens at present in NSW. Developers will know better in advance what is, and is not, permitted on a particular site. Legal disputes, which are costly to all parties, could be minimised;
- When assessing a development proposal, it would be easier for councils to refer to one single document rather than multiple documents. Decisions could be made faster, which would reduce the number of complaints from architects, builders and the public; and
- Councils could need fewer staff to administer the DA process. This has the potential to keep costs down although the savings might only be modest.

Cons

- The current NSW Government has made a major effort to achieve planning reform. It is extremely unlikely that they would wish to move to a different system, as it is too early to know whether the reforms have worked;
- Councils are facing considerable disruption in moving to the new planning regime. It would involve still further work to implement an entirely new approach. Planning reform has been an expensive process for both the State Government and for councils, and there would need to be proven major benefits in further structural reform. What councils need most is a period of continuity in planning;

- Whilst South Australia is held by some to have a model planning system, it still has problems. Half of the state's architects rate the system as 'poor' and it takes 16 weeks for a DA approval for a new home, which is better than the 22 weeks in NSW, but still worse than Queensland, Western Australia, Tasmania and the Northern Territory (RAIA 2005, p8);
- The layered planning approach of NSW is common across most Australian states and territories, and in many countries such as the United Kingdom. Perhaps the NSW Government's policy of reducing the number of planning layers and reducing conflicts between different planning documents is a more logical way forward than re-designing the entire system; and
- By bringing all relevant planning details for an area into a LEP, the NSW planning reform is achieving some of the benefits of a unitary system.

Option 2: Use a land parcel or locality (collection of like land parcels) instead of a land zone as the format for land use control.

Pros

- By using land parcels instead of zones as the focus of development control it would be possible to take account of the context of each site within its locality when controlling its development. This might be inconvenient for the state, since it could not apply blanket controls to all sites without amending each site-specific plan, but it would allow owners and councils to concentrate on what really matters - the site not a zone;
- Would allow both the state and councils to write contextual controls for collections of land parcels that make up a place or locality. Such a plan would allow for a clear statement of objectives for that area. By contrast a land zone may cover a diversity of unrelated areas so is not a suitable basis for place management planning; and
- Would help protect established neighbourhoods from developments incompatible with their character and enable new suburbs to be uniquely designed by councils.

Cons

- Would require the state to specifically amend controls to each locality instead of applying a single control to all affected localities. This would be more costly and less convenient for the Department of Planning;
- Would result in unnecessary delays to development approvals since each application would be treated as unique even if it was a complying development;
- Would mean that council meetings continued to give much of their time to assessing development applications on individual parcels of land rather than focus on service and infrastructure delivery as desired by constituents (IRIS 2005);
- Would require a very resource intensive planning approach from the perspective of both State and Local Governments; and
- Would discourage private design innovation in established or new areas.

8.3 PLANNING AND DEVELOPMENT APPROVALS

Requirements

There should be procedures for applying to planning authorities for permission to change land use and a right to appeal that decision by applicants and by third parties. The system should be made as straightforward as possible so that processing times can be realistic and both applicants and council staff should have a clear idea of their rights and responsibilities.

Development applications (DAs) should be processed and approved in a transparent, consistent and impartial way. Mechanisms should be in place to minimise the risk of corruption or undue influence, and there should be policies in place for managing conflicts of interest by planning decision makers. The role of elected representatives is to set clearly understood planning rules and their role in deciding on individual DAs should be minimal and transparent. This should be so whether the decision is being made at local, regional or state level.

Reality

Processing DAs

The multiplicity of planning control documents, the complexity of the decision processes and the considerable risks of error increase the cost and delays to applicants, objectors and councils. As a result, local council planning, and the DA process in particular, has become discredited and is the source of the greatest number of complaints to the Independent Commission Against Corruption (ICAC) and the NSW Ombudsman. In the IRIS Research survey produced for this report the public rated town planning as the least satisfactory of all the activities carried out by councils with a significant gap between expectations and delivery. The Royal Australian Institute of Architects (2005, p3) in their most recent DA survey noted:

... the development assessment process across Australia operates inefficiently and generates additional costs (both time and monetary) for architects, other building designers and consultants, building developers and constructors, and finally for the building owner, operator and user.

The Bird Inquiry (DIPNR 2003, p5) said:

...the development approval process in NSW was characterised by a focus on process (rather than outcome), inconsistent policies, varying procedures, timeliness, as well as a pervading sense of frustration and conflict. The process was generally not regarded as strategic, did not appear to focus on the quality of development as an outcome and did not encourage investment in NSW.

In NSW average time delays for approving a DA have according to government figures, increased by 20 per cent during the past four years to an average of 53 days. The RAIA survey found that across Australia in 2004, 61 per cent of architects who responded claimed that the local DA and planning system was performing poorly. NSW was close to average at 63 per cent with SA the best performing state with only 50 per cent rating the system 'poor', which supports the assertion that the a unitary planning regime can make the system more effective (Mant 2006, p3). It should be noted, however, that time delays may be due to skill shortages as much as poor systems. It is in the area of planning that the greatest staff shortages exist in Local Government (DLG 2005f). It is also important to point out that the

Department of Local Government does not record data on staff shortages when reporting on DA processing times.

In a survey commissioned by the Local Government and Shires Associations of NSW (LGSA) in 2003, a more positive position on DA processing was presented. The median processing time was found to be 31 working days and 63 per cent of DAs were approved within the required 60 days. The main reasons for delays were non-compliance with council requirements or applicants supplying incomplete information: 41 per cent of DAs fell into one or both of these categories. The LGSA concluded that bad publicity was related to the few DAs that took much longer to process, and that it was a myth that councils are slow and inefficient in processing applications (LGA 2003, p1).

The RAI and LGA surveys use different methodologies and arrive at different conclusions. To some extent they reflect the views of their sponsors. Delays in processing appear to be driven by poor submissions by applicants, but this could be a result of a complex planning framework mentioned above. Architects and developers would probably feel that insufficient DAs are being approved in the required period, and that 60 days is too long. Councils need to better educate applicants about the process and to lobby the State Government for permission to charge special fees for fast tracking DAs.

The Bird Inquiry (DIPNR 2003, p5) concluded that the “speed and quality of approvals for houses was the ‘big issue’ if we fix this issue we fix approximately 70 per cent of the problem”. It recommended the removal of single houses, alterations and carports, etc from council development assessment systems by the creation of a common set of minimum housing standards that if adhered to would enable a developer to obtain a complying development certificate. That would reduce a housing approval to an average seven days (DIPNR 2005, p6). This recommendation was not acted upon by the state.

The wording of planning regulations is often unhelpful to decision making and makes the process of approving a DA more complicated. There are too many broad issues, such as ‘the environment’, mentioned in each control document that needs to be considered in approving each DA. For example, as noted above, the Coastal SEPP has 28 complex matters that need to be considered and assessed by council staff. The *Environmental Planning and Assessment Act (NSW) 1979* contains vague criteria such as ‘the public interest’ and ‘the circumstances of the case’ for councils to take into account when assessing a DA which expands the obligations of a council beyond that intended elsewhere in the legislation (Mant 2005d, p2).

There are also moves at the national level to improve the DA process. The Development Assessment Forum recently published a leading practice model that proposes ways that internal practices can be streamlined, for example by allowing limited self-assessment of routine DAs (DAF 2005). The Local Government and Planning Ministers Council in August 2005 adopted the model as an important reference document to guide individual jurisdictions.

In February 2006 it was announced that councils that take too long to process DAs will lose their planning powers to either a planning administrator or planning assessment panel appointed by the Minister for Planning. The Minister appears to be aiming for an average DA determination period of under 40 days, a target currently achieved by 40 per cent of councils with a limited number much slower such as Parramatta, which averaged 159 days in 2003-2004. It will be at the sole discretion of the Minister as to which councils are ‘unsatisfactory’ and there are no objective tests to be applied. State-appointed planners could take over the

entire planning process of a council, work on clearing a backlog of DAs or decide on specific complex development decisions. Appeals against a planning administrator will only be allowed on points of law, not on the merits of the development decision.

Taking over a council's planning powers is not entirely new, for example in 2003 the state appointed a planning administrator to make decisions on Gosford CBD, but the new policy has a less stringent test of when the Minister can intervene. The move has been supported by the development industry with the NSW Property Council welcoming a move towards reducing delays in obtaining planning consent. However, there has been strong opposition by the Local Government Association and several councils which fear a diminution of local democratic accountability. Some councils, such as Wollongong and Shellharbour, support the changes as they already work within the state's target determination period. The Planning Minister has stated that he only intends to use the new procedures on an exceptional basis with the vast majority of planning decisions still made by councils.

Corruption

Some commentators believe that there is significantly more undue influence exercised in development control in NSW than elsewhere in Australia, both at council and state level (Mant 2006, p4). Others pointed out to the Inquiry that NSW is regarded as more 'political' in its public administration than any other state and this is most apparent in planning and development. Developers often have formalised opportunities to access State Government Ministers as a consequence of donations to political party funds. At local level, some councils bow to neighbourhood pressures to refuse applications and therefore an appeal to the Planning Minister/Land and Environment Court, or the threat of an appeal, is seen as encouraging more pro-development outcomes. In addition, as part of the NSW planning reforms the Minister now has a much wider discretion to override many planning controls.

The December 2005 ICAC discussion paper on corruption risk in the NSW noted that all those involved in the DA approval process including councillors, council officials and outside consultants could face corruption risks. Councillors have to act in a number of different and sometimes conflicting roles: residents, elected representatives, preparers of LEPs and decision makers on whether to approve a DA. Before council debates a DA, proponents typically lobby councillors with an interest in a development decision. When a decision is made there is no requirement for councillors to say why they reached a particular decision. This lack of transparency and accountability in the planning process makes it easier to conceal corruption and undue influence by interested parties.

Local councillors are required after each election to submit to the Election Funding Authority a list of their political donations. There is, however, no clear guideline as to how they should act if the donation creates a conflict. For example, it is for them to choose whether they should not attend the meeting, attend but not vote, or if the conflict of interest is thought insignificant, to vote as normal. The ICAC would like the position formalised, with a monetary limit set such that donations beyond that figure automatically prevent a councillor from voting (ICAC 2005, p33). Others, such as the Green Party have called for an outright ban on political donations by the property, finance and real estate industries.

Conflict of interest

Good planning systems should be transparent; that is, an applicant for planning approval and third parties should know how and why a decision has been made. The complexity of NSW legislation and regulations provides opportunities for manipulating the system, particularly if the council faces a conflict where it is both a landowner and/or developer and a consent authority. For example, the \$800 million Oasis project was an ambitious public private partnership involving Liverpool Council, a Rugby League club and Macquarie Bank to build sporting facilities and residential accommodation. The council, which lost as much as \$22 million on the troubled project, faced a clear conflict of interest.

The NSW State Government has used examples of failures such as the Oasis project to justify its centralisation of planning decisions for larger development proposals. However, conflicts also exist at state level, typically when a government development corporation both encourages development and makes planning decisions. State-controlled corporations have been the favoured vehicle for the redevelopment of important inner city Sydney sites such as Darling Harbour, Pyrmont, Green Square and Waterloo-Redfern.

Even when councils do not act as developers as they did with the Oasis project they can still face an implicit conflict. With much of the infrastructure proposed in the Sydney Metropolitan Strategy to be financed by developer contributions, it is becoming more difficult to turn down new proposals, which will give councils more cash for roads, services and parks. In addition, development companies are often large and well funded and councils are reluctant to engage in court action with them due to high legal costs. It is therefore easier and financially less risky to approve rather than decline a controversial development scheme.

Having a conflict of interest does not of itself constitute a corrupt practice. However, there is a greater risk of corruption when these interests are not properly disclosed or managed. The Local Government (Discipline) Regulation 2004 requires all councils to adopt formal systems for the management of conflicts of interest, with as a minimum, councillors having a duty to disclose conflicts. It is not clear to what extent councillors are aware of their obligations or whether additional controls and procedures are needed (ICAC 2005, p17).

Independent Panels

Wagga Wagga City Council (2006, pp8-9), while warning of the need to carefully construct the rules, roles, responsibility and constitution of panels to deal with contentious development applications still sees merit in them:

The level of Council involvement in the decision making process varies from Council to Council – it can be anything between a few major applications being reported to Council to all applications. The extent of involvement is dependent on the level of delegation granted to the General Manager.

Criticism of Council involvement in the decision making process has ranged from allegations of corruption, bias, conflict of interest, being pro development or anti development, political point scoring, political deal making – support given for a certain application if another is supported, ignoring of officers recommendations, unlawful decision-making, lack of transparency and denial of natural justice.

The constitution of independent panels has the potential to remove the political bias and associated potential for political influence from the decision making process. It would arguably free Councillors time to address the development of policy and strategy. It would also provide a separation between the policy maker and the implementation of policy – they would not be the same body.

Liverpool Council was one of the earliest NSW councils to introduce an independent hearing and assessment panel (IHAP). The award-winning scheme started in 1997 and is based on a four member panel with specialists in law, environmental issues, urban planning and design together with a community representative. The panel is used when dealing with technical DAs or when there are unresolved objections, and replaces the previous system where matters would be referred direct to councillors. In Liverpool, Fairfield, Warringah and Sutherland the panels report back to councillors in writing, giving reasons for their decisions, but it is the councils that make the ultimate planning decision (Mant 2005b, p6).

The City of Sydney Council has a state appointed 'Central Sydney Planning Committee' which has powers to approve certain DAs, normally over \$50 million, without reference back to the council. Parramatta and Wollongong have planning committees which act as sub-committees of the council, but do not make decisions. These models tend to work for larger urban councils, but would probably not be appropriate for the majority of NSW councils.

The planning assessment panels, which can be appointed by the Minister for Planning for councils that are deemed too slow in processing DAs do not fall within the category of 'independent hearing and assessment panels'. This is because they are appointed by the state, and also will normally be of temporary duration. If independent panels are to be used in NSW, they should be truly independent of both councils and the state, consisting of external experts in land use planning and not politicians or public servants.

The Development Assessment Forum report published in 2005 is generally in favour of independent panels as one of the ways of streamlining the DA approval system (DAF 2005). However, the NSW Government has not been overly supportive of independent panels for Local Government, and neither has the LGSA, which would favour advisory panels (option 4, below) over independent, decision-making panels (option 3, below). If panels were introduced the LGSA believes councils should choose panel members, not the state. Its opinion is as follows:

It is our belief that community control of development assessment is at the foundation of local democracy. ... The underlying theme of local planning systems is that Councillors are elected to implement the wishes of the local community and their removal from the DA process flies in the face of this concept (LGSA 2004b, p3).

This view on independent panels should be contrasted with results of the IRIS Research survey commissioned for this Inquiry. When asked who should determine DAs only nine per cent agreed that it should be elected councillors. There was majority support for the involvement of an independent panel with 36 per cent saying that the panel should make the decision and a further 26 per cent saying that it should be councillors who make the final decision based on advice from the panel. A further 22 per cent said that professional council staff should determine DAs, and the remaining nine per cent were unsure (IRIS Research 2005, p52). Hence the survey would suggest that the public is strongly supportive of a role for independent panels and that most would prefer councillors not to exclusively decide on DAs.

A recent survey by Eureka Strategic Research for the Residential Property Council had a similar finding. In answer to the question "Would you support a new property development application system where the local councils set rules and development guidelines, but the applications themselves are assessed by a separate independent panel, based on the provisions of these rules and development guidelines?" 66.5 per cent in the five main state capitals said 'yes' and only 17.3 per cent said 'no'. The respective results for Sydney were 67.5 per cent

and 16.6 per cent. (Eureka 2006, p8). In all 1,114 adults were interviewed, of whom 326 resided in Sydney.

In response to this survey the LGSA commissioned IRIS Research to poll 640 NSW households on their attitudes to whether the state or Local Government should decide development applications (IRIS 2006). It found that 72 per cent of respondents felt that councils are the most appropriate level of government to hold responsibility for determining building and development applications of local significance. Also, 60 per cent disagreed with moving responsibility for development consent from elected local councillors to a planning panels appointed by the State Government.

What should one make of these differing opinion poll outcomes? The Inquiry's interpretation is that the public wants local rather than State Government to assess and approve development applications of local significance. Furthermore, it wants the approval process within Local Government to be depoliticised by having independent panels (either decision-making or advisory) along with professional staff dealing with such applications rather than councillors on their own.

Remedies

In deciding on DAs it is argued that there is no clear separation of powers within councils between their role in setting land use policies, the administration of planning controls and their arbitral role in deciding specific control exemptions. Transparency in making local planning decisions is weak and there is a risk of corruption or undue influence as a result of the unclear separation between legislative, executive and judicial power.

One proposal would be for the sole planning role of elected councillors to be the development of planning policies, which would be achieved through full consultation with the local community. It would then be the responsibility of the council's own staff to approve DAs, based on these policies, with disputes or situations of conflict of interest referred to an independent planning panel. A further reform would be to allow planning appeals from third parties to the panel, as permitted in a number of Australian states such as South Australia and Victoria.

To counter the criticisms from the state of the slow processing of DAs it would be possible to streamline how councils process applications. More building changes could be classified as 'exempt developments' which do not need a DA. The more radical solution might be to increase the number of 'complying developments' which require DAs, but which can be signed-off by architects or other professional staff. Depending on how extensive the changes introduced, the time spent by councils on DA administration could be reduced by up to 25 per cent. Average processing times would fall and councils could concentrate on more strategic planning decisions.

Dick Smyth, a planning consultant who was Director of NSW Planning and Environment from 1977 to 1987, has floated a proposal along these lines (Smyth 2006).

The ICAC, when commenting in December 2005 on corruption risk in the DA process, noted that a system whereby council officials rather than councillors decide on DAs does not solve the problem, but merely transfers the risk of corruption from one group to another. Council officials could still establish inappropriate relationships with property developers (ICAC

2005, p23). The ICAC do not support ending the involvement of councillors in the DA process, but suggests a way forward would be for them only to decide large or controversial proposals. Many councils have probably adopted this approach already as the LGSA in their response to the Local Development Taskforce noted that only four per cent of DAs in NSW were determined at council level (LGSA 2004, p3).

Option 3: Establish independent panels to consider and *decide* on disputed DAs and to determine appeals from third parties.

Pros

- Planning panels, by including a broad selection of experts would be in a better position to make the right decision than councillors who are not familiar with the detail of environmental planning controls. Independent planning panels are less adversarial than politically charged council chambers;
- There would be a clear separation between councillors, who set planning policies, and the independent panel, who ensure that the policies are implemented. The chances of conflicts of interest would be significantly reduced; and
- The decision making panel system is a tried and tested model that appears to be working well in South Australia where its members comprise a councillor, the council's director of planning, a professional planner and a community representative.

Cons

- Would weaken local democratic accountability since the involvement of councillors would be removed. Local/community input into local planning decisions might be reduced;
- Whoever chose the panel members would exercise influence. If councillors chose the experts then the separation of powers would be lost. If appointed by the state, planning centralisation would increase;
- With a large number of councils in NSW, establishing separate panels for each jurisdiction would increase bureaucracy and cost since panel members would need to be paid;
- There may be insufficient 'experts', and care would need to be taken to ensure that only qualified people were selected. To overcome this panels may need to serve up to six Local Government areas in Metropolitan Sydney, probably based on the new regional council groupings; and
- Excluding experts who work on developments within the region might make it hard to find panel members. One way around this would be for experts to stand aside from a panel when organisations with which they are involved are associated with a DA.

Option 4: Establish independent advisory panels to consider and *advise* councils on disputed DAs and to consider appeals from third parties.

Pros

- Responsibility and accountability for decision-making would remain with the popularly elected council, but councillors would have to consider expert advice from the advisory panel before determining a development application or appeal;

- Advisory panels would help clarify the role of councillors in the planning process and thereby bring much greater transparency to planning decisions. Recommendations made by the advisory panel would be published, so it would be clear to voters if councillors over-ruled the panel's recommendations;
- Public confidence in councillors and council would increase, as there would be less grounds for suspecting them of acting improperly when ruling on DAs. In the four NSW councils where independent panels are in the place, there is claimed to have been a significant improvement in public, staff and councillor satisfaction with the DA process (Mant 2005b, p6); and
- Allowing third party appeals to a panel over disputed DAs would make the process more equitable as the value of their land may be affected by changes of use of a neighbouring plot. At present third parties cannot appeal to the Land and Environment Court to reassess a DA on its merits. They may only do so if councils have failed to comply with their internal rules.

Cons

- The advisory panel would not be truly independent and could be over-ruled by councillors. Therefore, a clear separation of powers would not be achieved; and
- All but the first disadvantage under 'Cons' in option 3 above, would also apply to this option.

Option 5: Increase the number of development decisions that can be delegated by councils to certified planners or architects so as to enable faster processing times of the remaining DAs.

Pros

- Certification of straightforward DAs by architects and planners would be by qualified personnel and they would be professionally liable if errors occurred;
- State support might be forthcoming. Some of the Development Assessment Forum's recommendations are already to be incorporated as part of NSW planning reform. For instance, minor changes to a property's internal finishes will not need a DA; and
- Councils could use freed resources to reduce average DA processing times, which would make intervention by the Planning Minister less likely.

Cons

- There remains a potential for corruption, with architects and professional certifiers dependent for work on the development industry. They could be less impartial in determining DAs than council staff or an independent advisory panel. Corruption risk would be transferred rather than eliminated; and
- With budgets constrained, councils may employ fewer staff processing DAs and the chance to improve average processing times could be lost. The Minister may decide to reduce the processing time target from 40 days to say 20 days; a target council would still have problems meeting.

8.4 REGIONAL PLANNING AND COORDINATION

Requirements

Planning should aim to encourage coordinated, orderly and sustainable development of communities. It should balance the practical demands of local residents with the strategic goals of national, regional and local governments. Plans should be drawn which are relevant for each administrative layer at which they are to be implemented and, if possible, there should be democratic accountability at each layer. There should be consistency between the plans in terms of their broad objectives, timescales and implementation methods.

The planning framework should follow the principle of subsidiarity; that is, matters should be handled by the lowest competent authority. This is particularly true in geographically large or economically diverse countries or states where needs vary between areas. In situations where the smallest administrative area may not have sufficient scale economies or competencies, regional planning is effective. Regions need to be defined that have similar topographic and socio-economic characteristics and interests, so that residents can identify with them.

Reality

NSW regional planning

Population, political influence and economic power are distributed particularly unevenly within the state of NSW. Up until the recent planning reforms, regional planning has been almost entirely focused on Sydney and its surrounding area. Initially the region was defined as the area of the Cumberland Plain, but by 2005 the Sydney Metropolitan Strategy encompassed the cities of Newcastle and Wollongong, covering an area bounded in the North by Port Stephens, the West by Penrith and the South by Kiama. The new reforms involve the roll out of regional plans. For example, the regional plan for the Lower Hunter has been released and plans for the Far North Coast and the Sydney Canberra Corridor are in preparation.

Unlike other countries, particularly in Europe, there is not a policy of true regional planning whereby each region has an equally detailed plan. In NSW there is planning for the metropolis. Rural areas and country towns are treated in an ad hoc fashion, though some strategic planning (in a socio-economic rather than a spatial context) is undertaken by the state-appointed regional development boards, at a regional level. There is no system (formal or otherwise) for linking the separate regional development strategies, which have each been developed in isolation from each other.

It should also be noted that no comprehensive land use plan exists at a state level, which could be of use in determining the relative merits of competitive land uses (e.g. residential development versus agricultural use in urban fringe areas and coastal areas.)

The Sydney region has experienced a series of metropolitan planning strategies since the 'Cumberland Plan' set in motion a farsighted plan for the Sydney basin in 1948. Due to pressure from developers for more land, the plan was progressively weakened, the greenbelt diminished and it fell into disuse by the 1950s. Subsequent plans have followed with increasing rapidity in 1968, 1988, 1995 and 1998. Some of Sydney's strategic plans have

contributed positively to shape the Sydney region whilst others have remained on the drawing board or been abandoned by an in-coming State Government.

Population projections, which are the key driver of metropolitan planning, have generally not been accurate and are either exceeded or not reached. To date, all Sydney regional or metropolitan plans have been abandoned before being implemented, some after only a few years of their publication. The main reasons have been pressure from developers and politicians for more greenfield land to be released, financial constraints limiting the building of planned infrastructure and in-coming Ministers who have wanted to issue 'their own' planning policies.

The current metropolitan strategy started off well with the involvement of planning experts and extensive consultation with Local Government, businesses and individuals. However, the strategy became politically sensitive late in 2004, its release date was delayed, state politicians changed following the resignation of Premier Carr, the Department of Planning, Infrastructure and Natural Resources was split up and the political mood became more risk averse. Early in 2006 the nine person expert panel overseeing the strategy was disbanded, leading to criticisms from high profile academics such as the NSW Sustainability Commissioner Professor Newman and former Panel Chairman Professor Blakely. The panel's recommendation for a permanent independent advisory committee, which could provide continuity in times of political change over the 25-year timescale of the Sydney Metropolitan Strategy, has been ignored by the state.

Although the Minister for Planning has indicated that the metropolitan strategy is still important, the general consensus amongst experts is that the strategy may not be given as high a priority as was originally intended. With this uncertainty, Local Government will have difficulty in preparing future budgets and assessing how much impact the strategy will have on them.

Prior to the current metropolitan strategy, many local authorities had already voluntarily formed regional organisations of councils (ROCs) to seek mutual benefits from working together. This idea was furthered in the 2005 strategy by introducing a new planning tier in the form of the nine sub-regions in the Sydney region, which each contain as many as six councils. Sub-regional planning aims to prevent duplication of service provision, manage situations where activities cross council borders, and to encourage closer collaboration. It is at the sub-regional level that the metropolitan strategy will be implemented and councils within these groupings are expected to voluntarily coordinate planning, prioritise objectives and set targets for housing mix. However, no regional sub-bodies such as the ROCs will be established.

Centralisation

In NSW, as with all Australian states, planning powers rest with the state legislature. Local Government is given decision-making responsibilities through instruments of delegation. The principal responsibility conferred on councils is the administration and implementation of the *Planning Act*. The Planning Minister reserves the power to call in and approve DAs that do not comply with the State Government policies as set out in strategic strategies and plans. The State Government controls land supply, is the main infrastructure provider and has primary responsibility for natural resources, safety and the environment.

Many approval decisions affecting land use and natural resource allocation are made by the state (via the SEPP process and others) rather than the local council being the consent authority. Recent contentious examples of the removal of consent powers from Local Government include plantation development approval in agricultural areas, where the state Department of Planning assesses proposals under the *Plantations and Re-forestation Act (NSW) 1999* and the SEPP for State Significant development.

The Sydney Metropolitan Strategy positions the State and Local Government working in partnership. However in reality, many projects transfer a degree of strategic decision-making, and to some extent implementation, to the state. The Minister for Planning now has greater control over schemes that are classed by him as being ‘major’, reducing the influence of councils over medium and large-scale property development schemes within their boundaries.

Recent changes give the Planning Minister the ability to ignore, without giving reasons for doing so, many statutory controls that should apply to a development, including important heritage and environmental aspects (Gilmour 2005, p5). From February 2006 the Department of Planning started reviewing draft LEPs before they are placed on public exhibition to ensure that they conformed to the state’s regional planning objectives. The Minister now has the power to take planning powers from councils considered too slow at processing DAs, and can amend or repeal a council’s development contribution plan, which controls how much developers must pay towards the provision of local services and infrastructure. The latter change is thought necessary to channel more funds to the state to pay for infrastructure in the south-west and north-west growth areas.

The centralisation of planning decision making in NSW has not just been about the state wanting more power. There has been pressure from developers and architects who complain about the problems they face in dealing with inconsistencies within and among local plans, and councils such as Gosford which have adopted a strong environmental policy stance. As a NSW architect (RAIA 2005, p10) noted:

The NSW planning system has become gridlocked as a result of poor consistency of planning regulations between different local Council areas, the inability of elected government representatives to make decisions based on long term strategic issues rather than local vested interest group pressures and the inability of the State Government Planning agencies to show some leadership and make some hard decisions about stripping planning powers from various anti-development local Councils ... NSW is still plagued by a plethora of inconsistent and sometimes contradictory planning regulations.

Remedies

The drift towards more planning controls being set and implemented at state level could be halted or reversed if the NSW Department of Planning took a more strategic role when approving LEPs. To improve transparency at state level, the Planning Minister’s role in making decisions on individual DAs and spot re-zonings could be given to an independent planning commission at arm’s length from government.

Option 6: Establish an independent state planning commission to make recommendations to the Minister on DAs for major projects with the Cabinet deciding the outcome if the Minister rejects the commission’s advice.

Pros

- Giving councils somewhat more control over purely local issues would reinforce the principle of subsidiarity and free state planning resources for more strategic thinking. With the introduction of independent local planning panels, state planners should have more confidence in the integrity of councils' planning decisions;
- If options 3 or 4 in this chapter were implemented there would be a balanced and parallel system of panels/commissions at state and local level; and
- Elected politicians would still be able to make the final decision on state significant planning matters.

Cons

- It would be a large cultural change for the Planning Minister to cede some of his considerable planning powers; and
- Selecting members of the commission would be difficult and controversial. To be effective, the members of the commission would need to be independent of the Ministry of Planning, yet they may still be seen as political appointees.

8.5 FUTURE REGULATORY REQUIREMENTS

Requirements

Local Government plans should be based on a clear understanding of the economic, social and environmental needs of the area. Decision makers should analyse relevant data, and where necessary collect more information such as an attitude survey of residents. There should be a clear vision of what changes will take place in the area over the next couple of decades and councils should make long term plans to accommodate trends such as population growth, changes in household composition and the growth of new employment opportunities.

State, regional and local plans should cover the same time horizon. Population forecasts, which are the main driver of demand for council services, should be consistent between all three levels of administration. Longer-term strategic plans should be broken down into typically five year and one year plans, which are action orientated, fully costed and publicised to residents. The success of plans should be measured, and when local circumstances change there should be a mechanism for modifying the long-term plan.

Reality

Strategic thinking

The pressure on councils, faced by a large volume of DAs to process, is to concentrate on day-to-day operational issues. This tends to limit their opportunity to consider the broader land use and development strategies, which are needed for their locality.

From this perspective, reducing the role of councillors in the DA process is not just a way of reducing conflicts of interest, but gives them more chance to see and to address 'the big picture'. The Inquiry's interviews with state agencies found that one criticism of Local Government was that it was not sufficiently strategic, spending too much council meeting

time on individual DAs to the exclusion of bigger planning and other issues of more concern to the community. The Bird Inquiry (DIPNR 2005, p8.) reiterated this point:

Councils must shift their focus away from daily operations and move towards a more strategic role in managing their plan making and development processes.

The 1993 council reforms and the new *Local Government Act (NSW) 1993* was a move by the state to position councillors as members of a board of directors of a company. Some followed this direction, others did not.

To achieve a more strategic role for councils, the reduction of councillor involvement in DA approvals detailed above in section 8.4 would assist. In addition, compulsory training for new or re-elected councillors would emphasise the need to be proactive in achieving land use outcomes rather than reacting to DAs when they are received. This was recommended by the Local Development Taskforce in 2003, but not implemented. The Minister for Local Government recently announced mandatory training for new councillors, but this was about explaining their roles and responsibilities particularly in relation to necessary economic and financial skills. He made no mention of training in land use planning. (Hickey 2006)

Without qualified planners, Local Government will not be able to develop strategic land use plans. There is an acute shortage of urban planners, particularly those with more experience, and many have moved from Local Government to state bodies or the private sector (DLG, 2005f). Improvements are needed in training, scholarships and workplace conditions, which are seen as stressful. The Planning Institute of Australia (PIA) in their submission to the Inquiry estimates that there are 1,890 planners in NSW with 302 unfilled vacancies and that in the next decade an additional 529 planners are needed. Half of all planners are employed in Local Government. The PIA is:

... particularly concerned with the shortage of planners and the impact this has upon the effectiveness and efficiency of Local Government ... Recent reforms to the planning system are going to require additional Local Government resources, particularly in terms of preparing strategic land use plans, new LEPS and DCPs. Those Councils that are currently under resource stress will be impacted greatly by these reforms (PIA 2005, p3)

The shortage of skills, observed state wide, is particularly apparent in rural areas.

Planning documents

The current range of plans produced by councils is complex and over-lapping. They are required to prepare a management plan covering at least three years, but this does not need to be submitted to the state. The main mechanism of community accountability is the annual report, which is sent to the department, but it is not in any standard format. A social and community plan is required every five years and a state of the environment report after each election. Whilst both these documents are submitted to the Minister for Local Government it has been made clear that this is to make sure that the task has been completed; the Minister does not review them in detail.

This again raises issues, discussed elsewhere in this report, about the need for more time and focus on long term planning by councils based on such indicators as community needs and demographic projections (consistent with state projections). A similar point was made by the DLG (2005d, p16):

...a surprising number of Councils spending too little time developing and working under a clear, comprehensive and longer term strategic plan. This leaves Councils ill prepared to meet the challenges of the future such as an ageing population, skill shortages and environmental challenges...

Furthermore, the discussion document noted that there are often few linkages between the various plans that are produced by councils. Nor is there a requirement for councils to have a long-term plan that integrates all social, economic, environmental and financial strategies in a single document. No decision has yet been made on how to remedy the strategic planning problem, but the indication is that the state will *encourage* strategic planning rather than *enforce* an integrated structure of plans that need to be signed off centrally. If councils do not have a robust strategic position, their re-written LEPs will be produced without proper consideration of long-term land use issues. Those councils that do plan strategically still face a mismatch in that their budget is limited to one year, their management plan covers three years whilst land use planning under the metropolitan strategy is over 25 years.

In New Zealand, the government granted Local Government full autonomy, but only on the condition that it introduce integrated long term strategic planning involving extensive community consultation (McKinlay 2006).

Remedies

Councils need to improve their strategic planning in general, as noted in Chapter 10 of this report. More resources will need to be allocated, and staff and councillors trained. Plans will need to be for the medium to longer term, say 10 years, but must be reconciled with the 25-year goals of the Sydney Metropolitan Strategy for councils in this area.

A robust corporate planning framework that incorporates social, economic, environmental, financial and other future strategies must be in place before councils complete their new LEPs so that they do not just have an operational focus. Land use should be just one component of a council's broader social, economic and environmental vision and cannot properly be developed in isolation. The Inquiry has become aware that measures have been taken in Liverpool Council (currently under administration) to combine economic development and other strategic planning functions with land use-planning functions – this would appear to offer advantages.

Longer term planning will require strategic, economic and financial skills in addition to the land use control skills traditionally associated with council planning. This combination of skills will be difficult to find, so would need to be developed over several years.

Each council will be preparing a new LEP over the next five years and the process would benefit from active community engagement in determining the broader vision for local land use and development. Stakeholder involvement was a feature of preparing the new Sydney Metropolitan Strategy. In 2004 leaders from government, business and the community gathered at the Sydney Futures Forum to discuss options for housing, the economy, the environment, transport and infrastructure funding. By virtue of the *Local Government Act*, councils have an obligation to consult with their communities but the extent to which they do varies considerably.

Option 7: Each council should develop a 10-year strategic plan that incorporates its vision, values, mission, objectives, strategies and implementation initiatives with particular attention to social, economic, environmental and financial considerations.

Land-use would be an important, though not the only, component of such a plan. Service and infrastructure delivery would also figure prominently.

Pros

- Strategic planning would help place councils' shorter-term decision making within a more coherent longer-term framework;
- Community involvement should lead to decisions being taken by councillors, which would better reflect the wishes of the electorate. Local people would have more ownership of land use plans if they were personally involved in their formulation; and
- A more strategic approach by councils would improve the confidence of the State Government in Local Government's ability shape and control its own destiny.

Cons

- Improvements to strategic planning would be costly, more staff would be required and it would add an additional task to already hard-pressed councils;
- Conflicts may develop between, for example, the state's strategy of wishing to increase residential densities and the local population's wish for low or zero population growth; and
- Long term strategic planning might be difficult for councils to implement given their short term electoral mandates, though the New Zealand experience would suggest otherwise.

9. LOCAL GOVERNMENT REVENUE

9.1 INTRODUCTION

In this chapter, the Inquiry reviews the main ways in which Local Government in NSW raises or receives revenue, namely by taxes (mainly rates); charges, fees, fines and contributions (such as from developers); and grants (from the Commonwealth and state governments).

It examines a fundamental issue before this Inquiry — the financial sustainability of Local Government from a revenue perspective. Is a council's revenue base adequate to meet its statutory obligations, current and expected functions, and new challenges?

It also assesses the major revenue sources (rates, charges and grants) against the four basic requirements (criteria) of a good public levy, namely equity, efficiency, administrative simplicity and transparency/accountability. In each case, it explores evident weaknesses and possible remedies.

9.2 LOCAL GOVERNMENT REVENUE

In 2003/04, the total ordinary revenue of all local governments in NSW was \$6.6 billion. As shown in Table 9.1, rates and annual charges²⁵ provided \$3.1 billion, which was nearly half of all revenue. Of this amount, rates accounted for \$2.4 billion. Domestic waste management charges account for most of the revenue collected in annual charges. User charges (including fees)²⁶ and grants each account for just over \$1.0 billion, or about one-sixth of all council revenue. Contributions and donations, mainly payments towards regional roads by the Roads and Traffic Authority and developer contributions pursuant to section 94 of the *Environmental Planning and Assessment Act (NSW) 1979* (EPA Act), account for one-eighth of revenue. Note that RTA road payments to councils are classified statistically as 'contributions and donations' rather than 'grants'.

Table 9.1: Major sources of ordinary revenue of NSW councils, 2003/04

Sources	2002/03	2003/04	2002/03	2003/04
	\$M	\$M	%	%
Rates and annual charges	\$3,034m	\$3,132m	47.3%	47.6%
User charges and fees	\$1,070m	\$1,108m	16.7%	16.8%
Interest	\$216m	\$252m	3.4%	3.8%
Grants	\$1,041m	\$1,053m	16.2%	16.0%
Contributions and donations	\$815m	\$758m	12.7%	11.5%
Other revenues	\$241m	\$279m	3.8%	4.2%
Total ordinary revenue	\$6,147m	\$6,582m	100.0%	100.0%

Source: DLG (2005b).

²⁵ Annual charges mainly refer to annual domestic waste management charges. Rates and annual charges form one revenue category because they are both subject to the Minister for Local Government's power to limit annual revenue from these components. In practice, the Minister currently only imposes limitations on the revenue from rates (rate pegging).

²⁶ User charges are commonly levied on water and sewerage (outside the Sydney and Hunter regions), trade waste and extra waste management collection. Fees are generally charged for commodities and services, admissions, providing information and in connection with councils' regulatory functions, such as building and health inspections and development applications (DLG 2005a, p71).

The system of rating and charges is based on the *Local Government Act (NSW) 1993* (LG Act). Section 492 of the LG Act provides for ordinary and special rates. Councils are required to make and levy an ordinary rate each year on all rateable land in its area. This rate may vary for four types of land: residential, farm, mining and business land. Under the LG Act, a substantial amount of land is exempt from ordinary rates, including land held by the Crown (Commonwealth and State Government holdings) and by religious and charitable bodies. Councils can raise special rates on properties that benefit from specific works or services.

The ordinary rate may consist of a base amount and an ad valorem amount. The base amount is a common flat dollar levy on all properties within a rating category. It is intended to reflect the cost of common overhead services, such as property maintenance and rate administration, and the revenue raised must not exceed 50 per cent of the revenue from that rate category. Councils have a fair amount of discretion within this constraint.

The ad valorem amount of a rate is a fixed percentage levy on the assessed land value of properties. This land value is the assessed improved land value, inclusive of capital applications to the land. However, it does not include the value of structures, which are included in the local property tax in some other Australian jurisdictions and most of the United States of America.

Under the LG Act, the Minister for Local Government can limit that component of a council's annual general income that comes from ordinary and special rates and annual domestic waste management charges – the so-called rate peg. In practice, however, the Minister pegs only annual general income from rates. Each year the Minister informs councils of the maximum percentage by which this amount may increase. The limit may vary for councils which apply for and are granted a variation on the rate peg.

The Act also enables councils to levy charges or fees for services that it provides. The Act generally encourages a flexible approach to setting charges and the use of modern pricing approaches subject to charges not exceeding reasonable costs.

Regional differences

Table 9.2 shows how the composition of revenue varies with councils in different classes according to the Australian Classification of Local Government (LGI 2005, Appendix B). Councils in metropolitan Sydney (Sydney City Council and councils of the class urban, metropolitan developed) raise nearly 60 per cent of their revenue from council rates and annual charges (mainly domestic waste services) and obtain less than 10 per cent of their revenue from either grants or contributions and donations. On the other hand, rural councils raise only about a third of their revenue from rates and annual charges and obtain nearly as much revenue in government grants. The main common feature is that most areas receive about 15-17 per cent of their revenue in user charges and fees (as distinct from annual charges for waste services) and 3-4 per cent in interest income.

Table 9.2: Composition of Local Government revenue by council category, 2003/04 (%)

Area	Rates and annual charges	User charges and fees	Interest revenue	Grants	Contrib'ns and donations	Other revenue
Sydney City	53.7	17.7	4.6	1.8	4.8	17.5
Metropolitan developed	57.6	14.1	3.7	9.8	8.0	6.7
Regional town/city	43.4	19.4	4.0	16.3	14.6	2.3
Fringe	51.9	14.6	3.9	13.2	13.6	2.7
Rural	32.3	18.9	3.4	31.9	11.6	1.9
NSW total	47.6	16.8	3.8	16.0	11.5	4.2

Source: Brooks, J. 2006.

In 2003/04, Local Government in NSW raised 66 per cent of its rate revenue (\$1.5 billion) in residential rates, with the balance from business, mining and farmland rates.²⁷ The state average residential rate was \$605. Urban councils levied an average residential rate of \$624; rural councils levied an average residential rate of \$400.

Within Sydney, average residential rates per council varied from about \$500 to \$1000 per property per annum. In country areas, average residential rates per council varied from about \$200 to \$600 per property per annum, with rates generally lower further from the coast. The average rate in a municipality or shire for freestanding houses is much higher than for individual apartments and units.

Average rates may also vary greatly between particular wards within a council area. For instance in the Leichhardt municipality in 1999/00, average rates in the Balmain/Rozelle ward (\$1,287) were 66 per cent higher than in the rest of the municipality (\$774), reflecting the higher land values of an area constituting a peninsula on Sydney's harbour. Council data showed that, while the ward had 36 per cent of ratepayers, it contributed 48 per cent of council rate revenues (Allan 2001, p76). Such a disparity within a council area is not uncommon. Indeed the disparity between rates in the Pittwater area and the other areas in Warringah Council was a factor in the Pittwater area breaking off and setting up a new municipal council.

In 2003/04, councils received 26 per cent of their rate revenue (\$573 million) from business rates. The average rate per business assessment was \$3,499. Councils received eight per cent of their rate revenue (\$179 million) from farmland rates. The average rate per farmland assessment was \$1,471.

Trends in Local Government revenue

Table 9.3 shows the changes in the major components of NSW Local Government revenue and other relevant data over the eight years from 1995/96 to 2003/04. Over this period, the ordinary revenue of Local Government rose by 47.1 per cent compared with a 58.8 per cent increase in gross state product (GSP), and 20.9 per cent increase in the consumer price index (CPI) for Sydney

Rate revenue and annual charges combined rose more or less in line with total ordinary revenue. However, the rate revenue component rose by only 29.2 per cent. User charges and fees rose by 39.4 per cent and total grant income by 30.5 per cent.

²⁷ The data in this sub-section are sourced from Department of Local Government (2005a).

Table 9.3: Changes in composition of Local Government revenue, 1995/96 to 2003/04

Variable	% Change Nominal	% Change Real	% Change p.a. Nominal	% Change p.a. Real
Ordinary revenue (total)	47.1	21.6	4.9	2.5
Rate revenue and annual charges	45.7	20.5	4.8	2.4
-Rate revenue component	29.2	6.9	3.2	0.8
User charges and fees	39.4	15.3	4.2	1.8
Grant income	30.5	7.9	3.4	1.0
Contributions and donations	87.1	54.7	8.2	5.6
Consumer Price Index (CPI) Sydney	20.9	0.0	2.4	0.0
Gross state product (GSP)	58.8	31.3	6.0	3.5
Gross domestic product (GDP)	61.8	33.6	6.2	3.7
NSW State Govt. revenue	57.5	30.3	5.8	3.3
Commonwealth Govt. revenue (a)	58.1	30.7	5.9	3.4

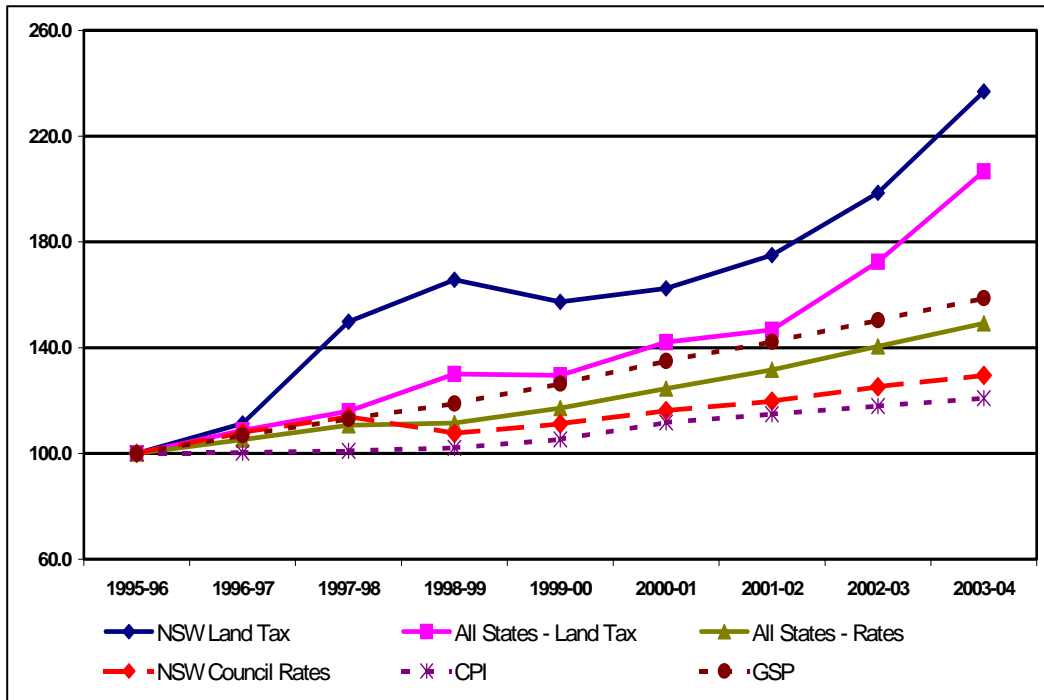
Source: Brooks, J. 2006 for figures in first column, except NSW State and Commonwealth Government revenue estimates, which were calculated by the Inquiry. Figures in other columns also calculated by the Inquiry (a) Commonwealth Government revenue excludes indirect taxes (e.g. wholesale and sales taxes and thereafter GST) in order to obtain a consistent historical time series.

In terms of real changes per annum (i.e. changes after discounting for inflation as measured by the consumer price index (CPI) Sydney), gross state product (GSP) rose by 3.5 per cent per annum between 1995/96 and 2003/04²⁸. On the other hand, in real terms, the ordinary revenue of Local Government rose by only 2.5 per cent per annum. Significantly, again in real terms, rates rose by only 0.8 per cent per annum and grant income rose by 1.0 per cent per annum.

Figure 9.1 compares the movement in NSW council rates compared with those of all states, NSW GSP, Sydney CPI, NSW land taxes and all states' land taxes. As can be seen the only index that NSW council rates has surpassed is the Sydney CPI. In all other cases, especially state land tax, NSW council rates have lagged significantly behind.

²⁸ Gross state product (GSP) is a measure of the value of a state's total economy. It is the equivalent of gross domestic product (GDP) at the state level.

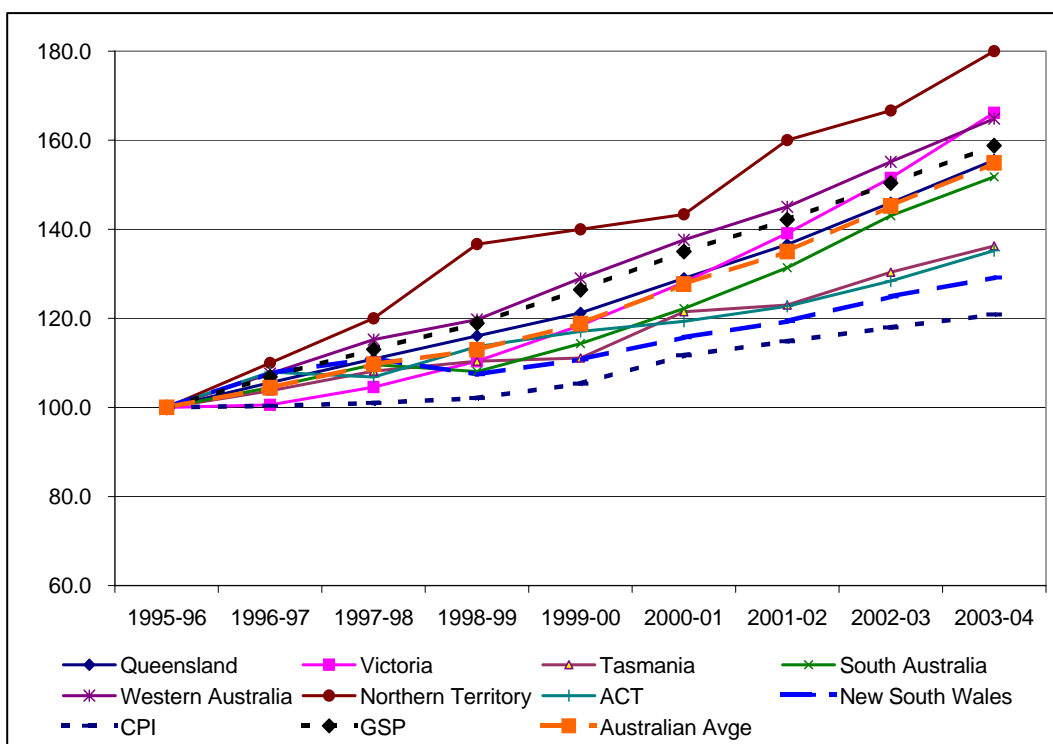
Figure 9.1: Growth in NSW council rates compared with increases in other indices, 1995/96 to 2003/04



Source: Brooks, J. 2006.

The next figure shows that the growth in NSW Local Government rates revenue has lagged behind every other state in Australia over the period reviewed.

Figure 9.2: Growth in NSW council rates compared with those of other states, 1995/96 to 2003/04



Source: Brooks, J. 2006.

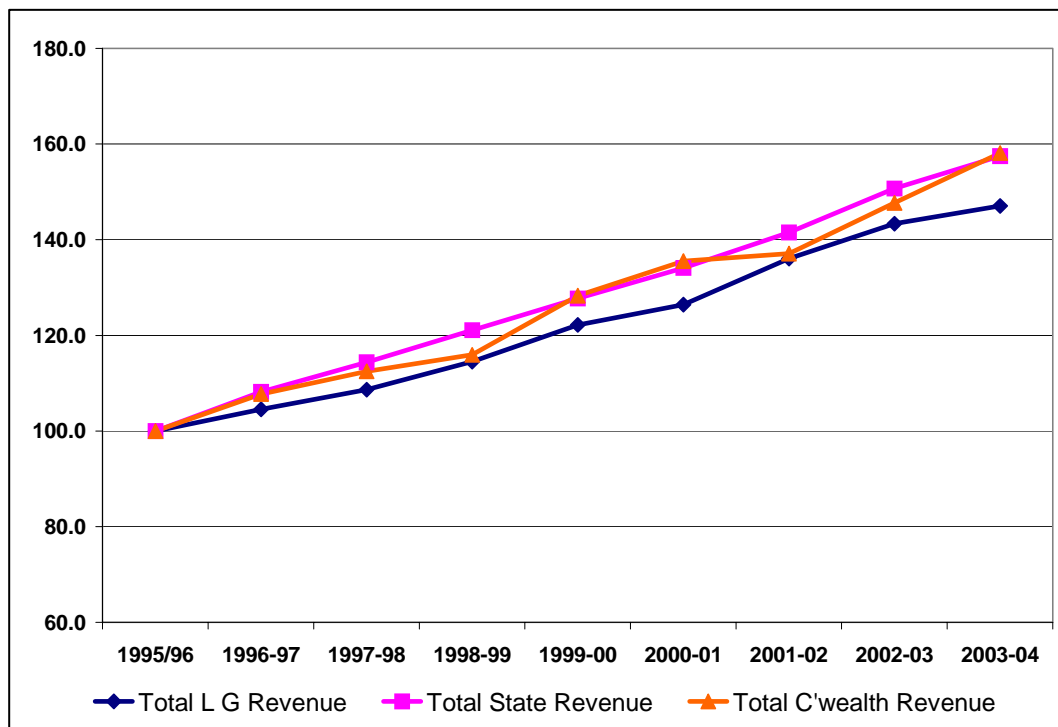
While specific periodic comparisons must be regarded with caution, it is evident from Table 9.3 and Figures 9.3 and 9.4 that the increase in Local Government revenue and each of its components (other than contributions and donations) has fallen significantly short of general economic growth whether measured on a state (GSP) or national (GDP) basis. By contrast state and Commonwealth revenue growth has broadly kept pace with GSP/GDP growth. Nevertheless, total NSW Local Government revenue (and even the slower-growing rate component) has more than kept pace with inflation over the observed period.

Had Local Government revenue grown as fast as state and Commonwealth revenue over the period examined, councils would have been \$400 million better off by 2003/04. If this lag persisted in 2004/05 and 2005/06, then Local Government would now be over \$550 million worse off than if its revenue growth had kept up with that of the state and Commonwealth since 1995/96.

Local councils say that their inability to raise revenue to the same extent as the state and Commonwealth governments is not a manifestation of taxpayer resistance, but a direct result of state administered rate pegging and regulated fees and charges. The IRIS opinion survey lends credence to this claim because only a minority of respondents (24 per cent) supported a cut in services to keep rate rises to a minimum. The vast majority (66 per cent) were prepared to pay more in council rates if this meant better services (IRIS 2006, p8).

With Local Government revenue expansion lagging state economic growth by almost 12 per cent over the eight-year period examined (1995/96 to 2003/04), unless councils can obtain greater flexibility to set their own rates and fees they may have to accept a diminished role vis-à-vis other tiers of government. The Minister for Planning's legislation to curb councils' capacity to impose developer contributions could stem the one source of council revenue that has grown faster than GSP. Annual charges may still offer some scope for increases, but legislation prohibits them from being raised above their cost-recovery levels.

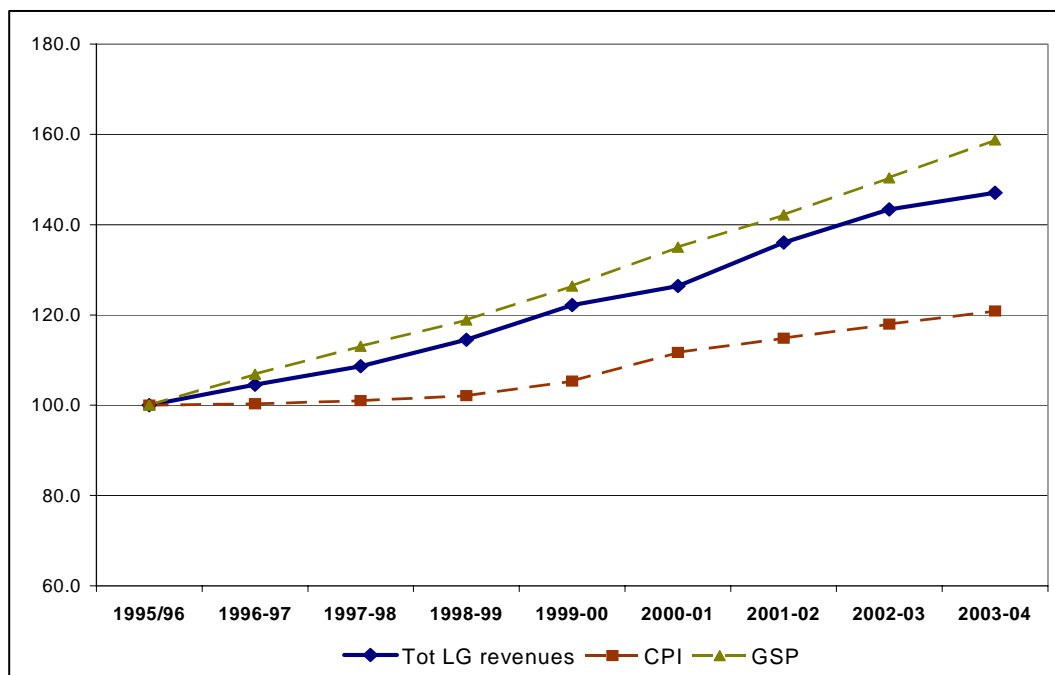
Figure 9.3 Growth in NSW council total revenue compared with Commonwealth and NSW State Governments' total revenues, 1995/96 to 2003/04



Source: Inquiry's own estimates based on Commonwealth and State Budget Papers.

Note: Commonwealth revenue excludes indirect taxes (e.g. wholesale and sales taxes and thereafter GST) in order to obtain a consistent historical statistical time series.

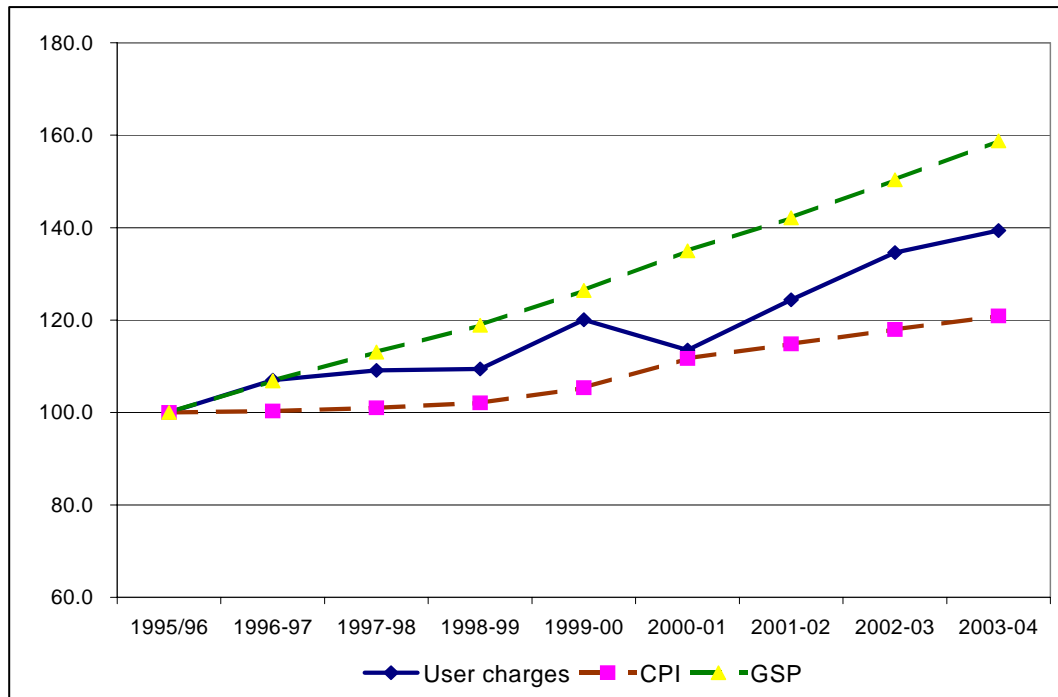
Figure 9.4: Growth in NSW council total revenue compared with increases in other indices, 1995/96 to 2003/04.



Source: Brooks, J.2006.

The next figure shows the growth in NSW Local Government's user charges revenue has exceeded price inflation, but lagged the growth of the state economy.

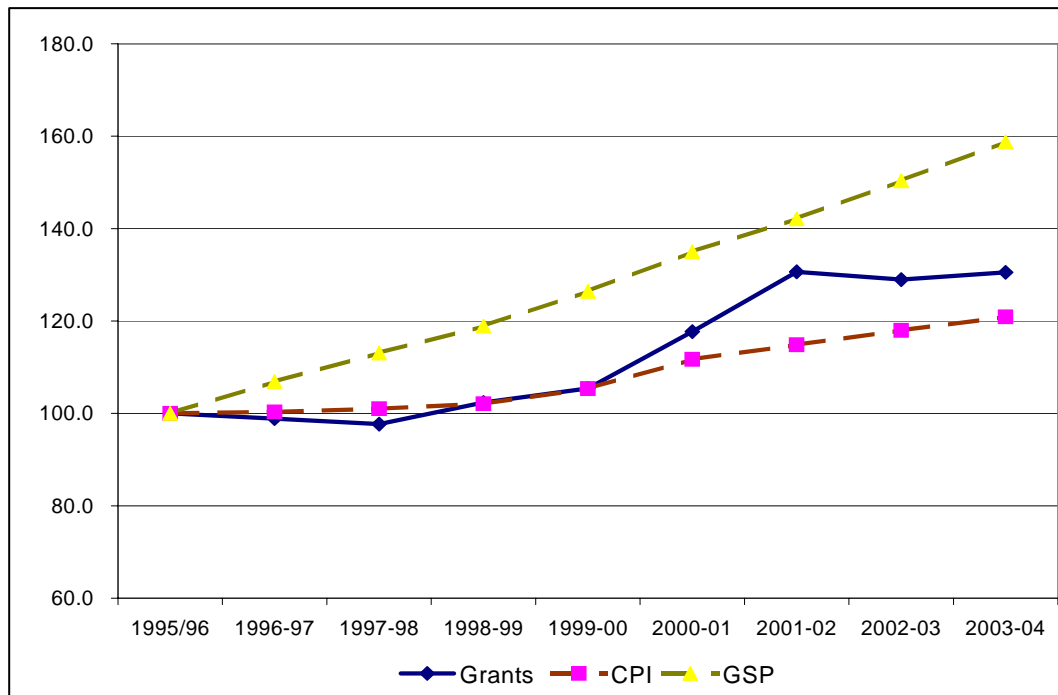
Figure 9.5: Growth in NSW council user charges compared with increases in other indices, 1995/96 to 2003/04.



Source: Brooks, J. 2006.

The chart below shows that total Commonwealth and state grants to NSW Local Government have exceeded inflation, but fallen short of state economic growth.

Figure 9.6: Growth in total grants to NSW Local Government compared with increases in other indices, 1995/96 to 2003/04.



Source: Brooks, J. 2006.

9.3 LOCAL GOVERNMENT RATES

Requirements

A sound Local Government rating system should ideally exhibit four traits; it should be financially adequate, administratively simple, vertically and horizontally equitable and economically efficient.

Financial adequacy means that a local council authority must have the means to fund all services that may reasonably be demanded. Ideally the revenue base should ensure autonomy and flexibility, and predictability and stability (so that councils can budget with confidence).

Administrative simplicity means that raising revenue should have low administration or transaction costs for the revenue-raising agency. It may also be interpreted as a system that imposes low compliance costs. It may therefore be regarded as a form of cost-effective (technical efficiency) criterion.

Equity requires that taxes should be fair to taxpayers. However, equity (or fairness) has two possible and distinct interpretations. The benefit principle of equity is that people should participate in the costs of services in proportion to the benefit that they receive. User charges that reflect costs are an application of this principle

On the other hand, the ability to pay principle of equity is that people should participate in the costs of services in accordance with their means to afford them. The ad valorem component of the ordinary rate is sometimes viewed as an application of this principle.

Which of the two equity principles should apply to Local Government, or the extent to which each principle should apply, depends on the role that Local Government is expected to play in the community. It is generally accepted that the prime purpose of Local Government is to provide local public goods that are better provided at the local level than at more centralised levels where the Commonwealth Government has prime responsibility for providing welfare in the community via its control of the income tax/welfare transfer system (Abelson 2003, Chapter 27). However, most local communities also wish to provide some equity for their local households.

Thus the appropriate outcome for Local Government is likely to be a balance between the benefit principle (whereby households pay for the services they receive) and the ability to pay principle (whereby taxes are related to income).

In the public finance literature, an efficient tax requires not only that collection costs are low (administrative simplicity), but also that the tax does not distort economic activity. The classic example of a distortionary tax was the 17th Century British tax on the number of windows in a house. Not surprisingly households boarded up their windows. The cost of the tax was the sum of the tax paid and the loss of light. A more contemporary example would be the effect of income tax on labour supply. High taxes on housing may reduce the production and consumption of housing. Local Government taxes may also distort the location of households or businesses.

Reality

The following section considers the extent to which the NSW Local Government rating system meets the criteria described above.

Adequacy of revenue base

Rates are only one part of the revenue base. However, as the major single source of revenue (around 40 per cent of all ordinary revenue on average, although a smaller proportion in rural areas), rates should be the basis of revenue adequacy. Here three main points may be made about rate income.

First, as National Economics (2005) points out, rates are not a large impost for most households. Rates are typically around \$600 per household in average income areas. These charges are in line with (or less than) typical utility bills such as annual electricity and telephone charges.

Second, the revenue that can be raised from the rate base is actually constrained by disposable household income, not by land values. Whether or not an average household can pay \$600 a year (or a low income household can typically pay \$400 to \$500 a year) depends on their income after Commonwealth taxes and transfers. Changing the revenue base will not change this fundamental fact.

Thirdly, as reported by IRIS Research (2005, p8), the community at large does not oppose rate increases when necessary: 'About 70 per cent of surveyed residents provided a medium to high support rating for the statement "I would rather see council rates rise than see cuts in local services".' However, support for a rate rise rather than service cuts was stronger in wealthier households with incomes \$100,000 and above.

Overall, rate income is predictable and stable and allows for a fairly high level of local financial autonomy. The homeowner land value tax base is not shared with other levels of government since state land tax applies only to investment property, not the primary residence.

It may be concluded that the rate base is adequate as a tax base for most metropolitan and large regional councils (allowing also for grants). The ability of councils to raise revenue depends on local political will, local household income, and any constraints that the State Government may impose. Generally the rate base is not itself a constraint in local council revenue and most local councils do not need new forms of taxes to survive.

However it should be noted that in many rural areas where the rate base is already small and continues to decline, neither a rate rise nor new forms of taxes would produce financial viability. Even with efficiency reviews and improved management processes these councils will remain largely dependent on grants to ensure that essential services can be provided and community needs met.

Administrative simplicity

The present rating system is administratively cost-efficient. The main reason for this is that the tax base (land) is not mobile and stays broadly the same in physical and usage terms from one year to the next. Changes in ownership are notified to councils. By contrast the introduction of the poll tax in the United Kingdom in the late 1980s proved an administrative nightmare, as councils had no reliable information database on their taxpayers (many of whom were itinerant tenants).

The main exceptional administrative cost associated with the land value tax is the cost of regular valuations to a reasonable level of accuracy. Because the tax base is not related to an ongoing market transaction such as payment of a wage or a consumer purchase, there is a special transaction cost with estimating the tax base, which is passed on to local councils.

Equity

Ideally the overall revenue system as a whole should be fair in both a vertical and horizontal sense. Vertical equity means that those with a greater capacity to pay should bear a bigger share of the tax burden. Horizontal equity means that households with a similar capacity to pay should pay approximately the same rates.

Overall the rate base can be viewed as an equitable base for taxation. As we have seen, equity implies an appropriate balance between benefit and ability to pay principles. For rates, this means balancing appropriately the ordinary rate base component and ad valorem component. These instruments provide councils overall with a reasonable capacity to produce fair outcomes, where rates are related partly to services (the base property component) and partly to capacity to pay (the ad valorem component based on land values). Moreover a tax on land may be viewed as fair because the community rather than the landowner creates most of the pure value of the land. In addition, because the tax base (land) is immobile and easily identified, tax cannot be evaded.

Nevertheless, there are four ways in which the rating system is not fully equitable.

First, land values are correlated only weakly with income or with ability to pay. Land is only one component of wealth. Also, wealth is not necessarily correlated with income. Owner-occupied land does not produce income. Some unit owners have a high income and live in expensive million dollar units, but pay relatively low rates even though they may use council services more than house owners (e.g. a home with a garden may compost a lot of its waste). Property values or income are better indicators of ability to pay than are land values.

For example, the Lake Macquarie Ratepayers Action Group (2006, p3) claims that the current rating system based on the 'notional' vacant land value fails to adequately represent the ratepayer's ability to pay; for example, it does not protect:

...long term residents from unrealistic increases in property values for which they have no control.

Also, the Group claims (2006, p12) that under the current system properties with multiple occupancies (e.g. strata titles) do not contribute anywhere near to the extent to which they add pressure on Local Government services.

North Sydney City Council (2006, p10) points out that:

The current system provides for huge distortions...For example expensive apartments on the Harbour pay the minimum rate whereas a small house will pay many times more than that. The rating system should be based on capital improved value.

The pros and cons of a rate tax based on the capital improved value of a property are considered under Option 8 in this section below.

For some time the State Government has attempted to assist low-income pensioners by requiring local councils to provide rate rebates to pensioners on the total of their ordinary rates assessment and their domestic waste management service charges. This is costly to Local Government and not necessarily fair where a pensioner is residing on expensive land. Furthermore, the Local Government and Shires Associations NSW (LGSA, 2006, pp26-27) point out that:

...that pensioner rate rebates should be fully funded by the Commonwealth and/or State Government... It should be noted that every state provides pensioner rate concessions, but the NSW Government is the only state government that does not fully fund the mandatory concessions.

There appears to be merit in the New Zealand system whereby rates are not forfeited, but deferred until death when they are charged against the estate.

Second, rates paid may bear little relationship to the level of council services used by a household. For instance farm households complain that for their rates they don't get a garbage collection service like towns' people, but on the other hand maintaining local rural roads takes up a large proportion of country councils' resources.

Third, many rate exemptions are inequitable.²⁹ For example, Crown Lands, National Parks and State Forests do not pay rates on land holdings other than those occupied by their commercial premises (a voluntary arrangement) even though such bodies receive significant Local Government services. Rail, road, electricity and water corridors are exempt from rates and charges pursuant to section 611 of the LG Act, which is an alternative mechanism to rating (although there is an historical anachronism in relation to AGL gas pipes) Many State Government trading enterprises pay tax equivalent payments to the Office of State Revenue, but these are not passed onto councils. For a detailed discussion of the pros and cons of existing tax exemptions between councils and State Government see NSW Treasury, 2003b and 2001.

Rate exemptions also apply to major non-government landholders including private hospitals, private schools, churches, charities and benevolent institutions (which may extend to retirement type villages and other aged care facilities). The proportion of land subject to rate exemptions can be very large in many municipalities and shires denying their councils vital revenue for servicing property and people related to such premises.

Fourth, visitors generally contribute less than their fair share to the provision of local services. This can be alleviated partly by user charges, especially for parking. However, this may not compensate fully for the burden carried by ratepayers.

²⁹ See sections 555 and 556 of the *Local Government Act (NSW) 1993*.

On the other hand, the claim sometimes made that local rates create horizontal inequality between areas should be dismissed.

It is true that similar households living in similar quality houses pay higher rates (or receive poorer services) when they live in a poor area. This occurs because the rate per dollar of land value is higher in areas with low land values. However, the higher rate in the dollar is compensated by lower house prices. There is substantial evidence in the United States that differential property rates (or service levels) are capitalised in property prices including in land values (Mieszkowski and Zodrow 1989).

A final important matter relates to landlords who own, but do not occupy, about 30 per cent of dwellings. Although landlords pay the rates, the rates are mainly passed on to tenants in the long run. The return on property must equal that on other assets. If costs rise, either rents must rise or landlords vacate the sector in which case market rents rise in due course with falling unit supply. This places renters in a similar position to homeowners with regard to the bearing of local costs. However, as most renters occupy units, they usually pay a low share of the ordinary rates. Also, because renters do not directly pay rates, they may not appreciate the nexus between the level of services they obtain from their council, the amount of rates paid on their behalf, and the consequent impact on their rents. This may make tenants less sensitive to council rating policies than owners.

The above discussion relates to residential rates only. Horizontal equity may be limited in rural shires, where farmers receive very little in the way of services (other than use of local roads), but pay a much higher rate because it is levied on the total value of their farm, rather than just on their house-site. The ability to pay should also be questioned – there are some rural shires where a very high proportion of farm rates remain unpaid. The council is left with vastly reduced income, but a constant demand for service – and has no means of redress other than property foreclosure or adding unpaid interest to outstanding balances.

Finally, equity also requires a judicious balance between what is collected from properties through rates (which being taxes are unrelated to service provision) and charges/fees (which are meant to reflect service usage).

Efficiency

Taxation of land values is generally considered non-distortionary and therefore efficient because the supply of land is fixed. Taxation of land does not affect the total supply of land. This is true up to a point, but it ignores the true economic nature of land.

First, land values include capital improvements to the land, including provision of local roads, water and sewerage services, power supply and so on. Therefore taxation of land value is in substantial part a tax on capital. However, because the demand for these components of a house is highly price inelastic (i.e. people require public utilities regardless of their cost), a land value tax has little (distortionary) effect on the provision of these services.

Second, land uses vary. Insofar as taxes on certain land uses are higher than on others, for example higher on urban housing than on farmland, one might expect land use to be diverted from housing towards other uses such as farmland. This could occur if housing consumption was sensitive to the level of rates. However, at around \$600 per household per annum

residential rates are only a small part of the user cost of housing, which includes actual and imputed interest payments.

By contrast rates may be several thousand dollars for a farm that occupies a larger land area, even though the rate per hectare is less than in an urban area. However, higher returns from using land for non-agricultural purposes means that farms are being lost to housing and commercial development in population growth areas such as coastal regions.

In practice, a tax on land value has little effect on the amount of housing consumed or produced. It follows that taxes on land value have only minor efficiency (distortionary) effects.

Rate pegging

As shown in Table 9.4, between 1995/96 and 2003/04, rate increases in NSW were lower than in any other State. NSW has the lowest council rates per capita of any jurisdiction in Australia other than the Northern Territory.

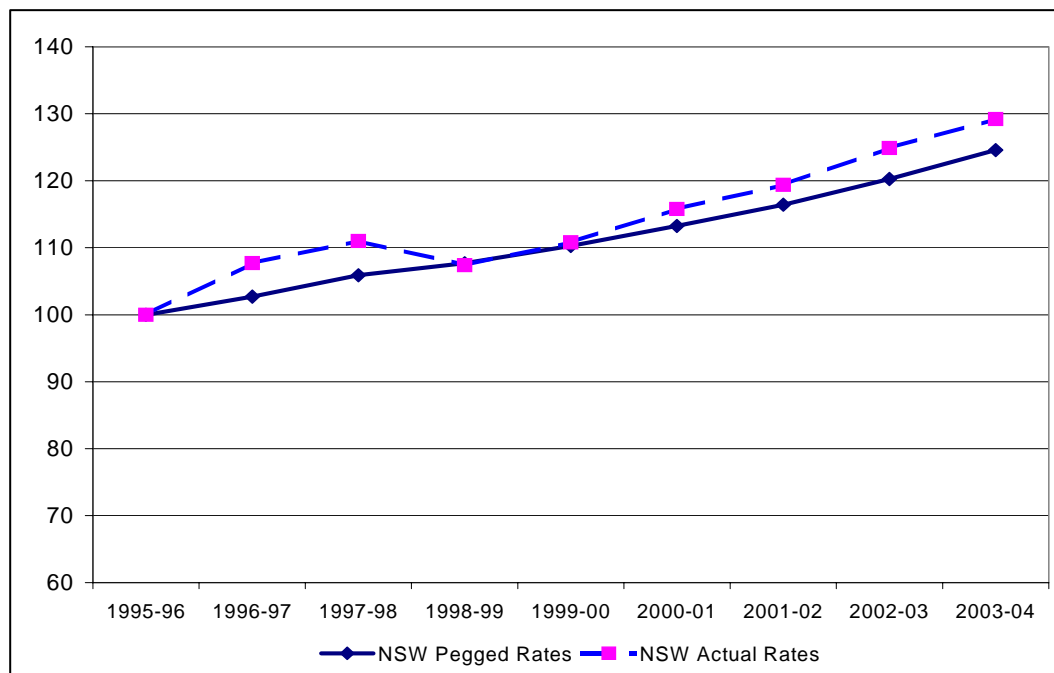
Table 9.4: Rate increases by jurisdiction, 1995/96 to 2003/04

State or territory	Per cent increase
NSW	29.2%
ACT	35.2%
Tasmania	36.3%
South Australia	55.1%
Queensland	55.6%
Western Australia	64.8%
Victoria	66.1%
Gross domestic product	61.8%

Source: Brooks, J. 2006.

The chart below shows the extent to which actual rate income has exceeded that allowed by rate pegging as a result of special rate variations granted to some councils by the Minister for Local Government. As can be seen the additional revenue allowed has not been large as a proportion of the total increase in the rate peg limit. This would suggest that rate pegging has been a major constraint on councils' revenue raising capacity causing it to fall behind other states, notwithstanding NSW's relatively strong property market over this period compared with Australia as a whole (see figure 9.1 for comparative expansions in land tax revenue).

Figure 9.7: Growth in actual council rates compared with pegged rates, 1995/96 to 2003/04.



Source: Brooks, J 2006

However, this does not itself present an argument for or against rate pegging. Rate pegging may have limited the supply of local services below what residents would have wanted or alternatively provide local citizens with some protection against local council monopoly power.

It may be argued that, because local councils are exclusive suppliers of various basic services, the maximum price of their services (in this case local rates) should be regulated just the same as a private monopoly to prevent abuse of market power. Also, such power may not be checked adequately by four yearly elections (for example, tenant-residents may be unaware of a council's rating policy as the link with their rents is not clear and landlords may not exercise their vote). However, as Graham Sansom (2006, p5) points out:

Local Government in other states, notably in Queensland, operates without any such restriction and there is no evidence of massive, unwarranted rate increases.

Also, if Local Government is regarded as an independent level of government, the mere fact that it is a monopoly provider of some services cannot justify restrictions on its rate income imposed by other levels of government (Sansom 2006, p4). Rates are taxes and as such a levy demanded by a level of government for the benefit of providing services to all constituents regardless of individual user-pays considerations. .

Furthermore, the existing rate pegging system seems to lack fairness insofar as different rating levels in different but comparable councils could not be adjusted since rate pegging was introduced.

Wakool Shire Council (2006, p2) notes that:

Another significant influence over current circumstances under rate pegging is the state of each Shire's finances at the commencement of rate pegging. Those shires that were already under-rating when this period of artificial funding constraint commenced will have suffered far worse effects than those who had a healthy rate-take and sound asset condition at that time.

At that time rate pegging commenced, the rate level of comparable councils might have been very different for reason of policy choice (see the example in Wakool Shire Council 2006, p3). With the introduction of rate pegging these relativities and the policies behind them were frozen with only limited means for councils to change them through special variations requests to the Minister.

The relevance of the issue of 'compounding' is also mentioned by Ballina Shire Council (2006, p1) which notes that:

...if a council had a higher average rate at the time it [rate pegging] was introduced in the 1970s then that high rate has simply been compounded over many years. Conversely, a council with low average rates has been left further behind as the compounding would have been far less than that for the higher rated shires.

Consequently, Wingecarribee Shire Council (2006, p2) strongly argues for:

...lower rated Councils to be permitted a one off dispensation to bring their rates in line with similar Councils who have historically rated at much higher levels.

Irrespective of the discussion above, evidence from IRIS Research (2005, p8) suggests that on balance households in NSW would prefer more local services to less. Also, in their submissions to the Inquiry, several councils expressed concerns that the criteria used by the State Government to determine the maximum rate increase and exceptions to this maximum lack both an adequate economic basis and transparency. It seems that the State Government often sets the peg below generally accepted cost indices and makes determinations for individual councils without providing adequate explanations.

IRIS Research (2005, p9) shows about equal numbers of residents supporting and opposing rate pegging, with a significant balance sitting on the fence. This could be interpreted as either a significant majority would not object to a removal of rate pegging or that the community is ambivalent about whether it should stay or go.

In 2001, the Local Government and Shires Associations NSW (LGSA) established a Rate Pegging Task Force in order to improve the operation of the rate pegging system. The task force suggested a two-tier approach to rate determination. Tier 1 would be based on an annually determined index reflecting costs to Local Government, which are beyond their control, and which would more accurately reflect the actual cost to Local Government than do the CPI or AWOTE³⁰ (e.g. includes heavier weightings for roads and building materials and other goods and services acquired by Local Government).

According to a report prepared for the task force by Centennial Consultancy (2004), Tier 2 would be based on individual council needs such as infrastructure renewal. Tier 2 would replace the current special variations request requiring Ministerial approval with a provision

³⁰ AWOTE; Average Weekly Ordinary Time Earnings.

permitting councils to make their own variations up to a maximum dollar amount or percentage of their general income. Variations in excess of this would still require Ministerial approval. If this was not acceptable, Centennial suggested that at least the application process for small variations be simplified to involve less paperwork than the large variation requests.

If rate-pegging remains, the view of this Inquiry is that the peg should be made less discretionary (i.e. not subject to Ministerial fiat), be based on explicit criteria (e.g. Local Government unit costs), and be made more transparent (i.e. be published in full). Any variations to the peg with respect to a particular council should be fully disclosed and explained in terms of rational criteria that are applied consistently across councils and not subject to capricious change.

Measures to improve consultation with stakeholders as to the desired balance between rate increases and service provision would also assist in this area, as a pre-requisite for council submissions. Transferring rate pegging to the electorate that appoints a council is canvassed in Chapter 5 as an alternative option to Ministerial control.

Overall, the NSW rating system provides an efficient and administratively simple tax base, which can provide adequate tax revenues if not constrained by rate pegging. However, it would be more effective and in some ways fairer if there were fewer exemptions.

Remedies

Possible options for reforming the Local Government rating system in NSW were canvassed in Chapter 5. They are repeated here in a slightly different form:

Option 1: Complete deregulation of rates.

Free councils to set their own rates as they do in other states.

Pros

- Would provide local autonomy and responsibility;
- Would allow councils to renew infrastructure (see Chapter 6), improve services (see Chapter 7) and eliminate their operating deficits (see Chapter 11); and
- Would bring NSW into line with rating regimes in every other state in Australia.

Cons

- Would give councils monopoly powers over rates and certain charges; and
- Could result in high and unaffordable rate increases.

Option 2: Partially deregulate rate pegging.

Deregulate rates for infrastructure maintenance, renewal and enhancement.

Pros

- Would ensure councils could address their infrastructure renewal backlog, the ongoing annual renewal gap as well as current and future needs for infrastructure enhancements; and
- Would remove need for councils to raid capital funds to balance their books.

Cons

- Would be difficult to set firm walls between areas of council expenditures; and
- Could result in over-expenditure on some services at the expense of others.

Option 3: Keep rate pegging, but make it more transparent.

Rate pegging, if kept, would be made less prescriptive and based on both clearer principles and also on evidence of council cost movements.

Pros

- Would allow state to retain control over possible excess rate increases; and
- Would be politically popular with some stakeholders, though only a minority judging by the Inquiry's public opinion poll (IRIS 2006, p9)

Cons

- Would not provide councils with genuine autonomy and responsibility; and
- Would most likely aggravate the existing infrastructure backlog and result in future infrastructure and other community service needs being under-proved.

Option 4: Permit a rate catch-up.

If deregulating rates was not acceptable, the State Government instead could permit councils whose rates were relatively low when rate pegging started or whose rates did not match peg rises to bring them into line with those councils whose rates are in the top quartile.

Pros

- This would assist the financial viability of those councils that got trapped with relatively low rate levels when rate pegging was introduced in 1977 or which forfeited rate increases in certain years (e.g. periods of drought or economic recession) when their residents' capacity to pay was constrained.

Cons

- Could result in sharp rate increases over a very short time period.

Option 5: Permit fewer rate exemptions.

Fewer bodies should be exempt from local council rates or charges, including State Government trading enterprises and other entities that receive significant Local Government services and have the ability to pay for commercial use of public space under s611 of the LG Act.

Pros

- All stakeholders should pay for services they receive;
- Local ratepayers should not have to subsidise services to outside groups; and
- Since councils, including their commercial activities, pay payroll tax, all state enterprises (e.g. State Forests used for commercial harvesting, electricity authorities with street poles and wires, water authorities with underground pipes, Crown lands leased to farmers) should pay rates or land use charges.

Cons

- Could reduce capacity of some subsidised bodies to provide services;
- Government trading enterprises such as electricity distributors and water authorities already pay council rates on their commercial premises (e.g. offices and shops); and
- Council commercial activities do not pay all state taxes (e.g. land tax, stamp duties).

Option 6: The NSW Government, like all other state governments, fully rebate councils for pensioner rate concessions.

Pros

- Pensioner rate rebates are a community service obligation imposed on councils by the state so should be funded by the state;
- Pensioner rebates would be more equitable funded from the broader revenue base of the State or Commonwealth Government (considering that such rebates should be funded and distributed in a horizontally equal way);
- NSW councils would be put on the same footing as councils in the other states;
- As the population ages the cost to Local Government of meeting the net shortfall in state rebates will escalate sharply; and
- Would reduce inequities as pensioners who qualify for rebates are disproportionately represented in low income areas; areas that already have a high demand for council services, but a limited revenue raising capacity.

Cons

- Ratepayers who are financially self-sufficient should be prepared to cross-subsidise pensioners for the 50 per cent of rates not rebated by the state.

Option 7: Rate deferments rather than concessions.

Rate deferments, with deferred rates and interest a charge against the estate, should replace pensioner rate rebates.

Pros

- Would ensure that all local households pay for fair share of services; and
- Would allow a low-income household to retain its residences during its lifetime.

Cons

- Would result in a loss to councils of state rebates which at present are 50 per cent of the value of pensioner concessions;
- Would reduce the effective subsidy to pensioners;
- Would have some administrative costs;
- Would mean that councils had to wait many years to recover outstanding rates and that council would bear the risk of the amount of outstanding rates exceeding the value of the rated property; and
- Considering the increase in pensioner and aged populations such a policy might be financially unsustainable.

Option 8: Change rating base.

Change the base for calculating rates from the land content of a property to its capital improved value.

Pros

- Income is related more closely to property values than to land values. Accordingly, rates based on property values would be more equitable than rates based on land values; and
- It may be perceived as a fairer system as ratepayers would be better able to relate the value of their property to the rates they are levied.

Cons

- If rate pegging was not abolished concurrently changing the rate base would not provide councils with any additional rate income;
- Would be a tax on capital and as such might discourage development (the current system of unimproved capital value operates as an economic incentive to develop the land to be productive in order to meet the level of rates);
- Would significantly increase difficulties with valuations and their administration; and
- Would be difficult in rural areas where land values and property values tend to be much closer.

9.4 USER CHARGES, FEES, FINES AND CONTRIBUTIONS

Requirements

Efficient pricing of services, in the public sector as in the private, ensures efficient use of resources and an efficient output of services. Efficiency here means producing the services where individuals are willing to pay for at least cost of supply. As shown in Abelson (2003, Chapter 15), efficient pricing of public services varies with market circumstances. The following are three important general principles for efficient use of resources:

- If a single public supplier produces a service, and output can be increased, the efficient price of the service is the short-run marginal cost, which is the cost of providing an extra unit of service;
- If a single public supplier produces a service, and output is fixed, the efficient price is the market-clearing price; and
- If a service is or can be supplied by more than one supplier, including by private firms, the efficient price is the long-run marginal cost, which coincides with the average future cost of providing the service (past costs are ignored, but all future costs are relevant).

Of course, equity considerations may suggest that prices be subsidised for some users with the subsidy funded either by higher prices for other users or from consolidated revenue.

Reality

User charges (including annual charges)

Byrnes (2005a) reports that the most common commercial businesses run by Local Government in NSW are water and sewerage services (38 per cent), waste collection and related services (8.8 per cent), childcare facilities (5.8 per cent), caravan parks (4.5 per cent) and leisure centres and pools (3.9 per cent). Collectively, they account for about 61 per cent of the turnover of all Local Government businesses. Of course for many rural councils, businesses such as airports, saleyards, abattoirs, and even truck-stops/fuel outlets may (proportionally) be much more important.

Businesses with a turnover greater than \$2 million are known as category 1 businesses. They are expected to meet the requirements of National Competition Policy (NCP). This means that they are required to:

- Adopt a corporate model;
- Include debt guarantee fees;
- Factor into prices an appropriate return on capital invested;
- Quantify and make explicit community service obligations;
- Operate in the same regulatory environment as other businesses; and
- Include in costs the same taxes as faced by private businesses.

Most category 1 businesses are water and sewerage authorities.

Other requirements imposed by the National Competition Policy and National Water Initiative specifically for council water and sewerage services include:

- Pay-for-use water supply pricing;
- Full cost recovery;
- Removal of cross subsidies;
- Trade waste pricing;
- Performance reporting and benchmarking; and
- Payment of tax equivalents and the ability to pay dividends from water and sewerage businesses to councils' general funds.

Councils which satisfy the above requirements will have met all the business costs required for sustainably delivering their services and will have achieved at least ‘lower bound’ pricing. Councils which meet the above requirements and are either repaying loans for major capital works or are paying a dividend will have earned a significant return on the capital invested and would be moving towards ‘upper bound’ pricing. A council’s pricing should not consistently exceed ‘upper bound’ pricing since that would mean an abuse of the council’s monopoly pricing powers.

Businesses with less than \$2 million turnover are category 2 businesses. Councils have discretion over the adoption of a corporate model for these businesses. However, such businesses are expected to cover their costs.

In addition, councils levy user charges for a large number of services. In total, user charges contribute a significant amount of revenue mainly from water and sewerage services in regional and rural areas (though many farming enterprises pay private companies for their irrigation water) and from a variety of user charges in urban areas (including parking).

Besides NCP requirements, there are various state guidelines for council businesses.

DEUS has prepared the following guidelines for use by councils:

- Best practice management of water supply and sewerage;
- Water supply, sewerage and trade waste pricing guidelines;
- Developer charges guidelines for water supply, sewerage and stormwater;
- Reference rates manual for valuation of water supply, sewerage and stormwater assets; and
- Liquid trade waste management guidelines

Section 539(1) of the LG Act sets guidelines for charges and fees. These guidelines are not especially restrictive. While user charges are expected in general to reflect costs, they may exceed the cost of providing a service, providing that the charge is “reasonable”. However the LG Act does not provide guidelines as to what is reasonable.

The LG Act uses similar language with respect to charges for domestic waste management services. Under Section 504(3), the LG Act provides that charges for these services should not exceed “reasonable cost”. The Minister has the power under Section 507 of the LG Act to regulate domestic waste management charges, but has elected not to do so.

In a similar vein, Department of Local Government (DLG 2005b, p42) advice on charging for services says: “The system of charges in the Act seeks to confer the maximum possible degree of flexibility, in recognition of the need to allow and encourage councils to implement modern pricing structures and policies for the basic services and utilities concerned”.

The Inquiry supports the spirit and intention of these comments. Commercial services in particular should fully recover their economic costs, including the cost of capital, but not exploit any monopoly powers. However, the department’s recommendations, as well as those in the LG Act, are vague. They do not define or discuss the nature of costs, the treatment of sunk costs, pricing according to marginal cost principles where appropriate, the treatment of accrued versus cash costs, the allocation of joint overhead costs, the treatment of depreciation, or the appropriate real return on capital. In the view of the Inquiry, more work needs to be

done on pricing guidelines to improve pricing practices. This applies to both commercial businesses and to user charges.

Turning to actual practices, there are three areas with important implications for user charges, namely water and sewerage, waste management and the use of roads.

Under Sections 496 and 501 of the LG Act, a council may levy an annual charge for the provision of water, sewerage, drainage, waste management and any other services prescribed by legislation. A charge may be set at a level that enables part or full cost recovery or, in some case, which exceeds costs.

Water and sewerage services are provided by council businesses outside the Sydney and Hunter regions of NSW. In 2003/04, the 126 local water utilities (LWUs) providing these services had a total turnover of \$806 million and total assets under management of \$10.6 billion. Of these LWUs, 51 were category 1 businesses and required to apply corporate principles to their operations.

The average real rate of return for water supply and sewerage businesses was only 2.7 per cent (Byrnes 2005a). This rate of return has been relatively constant over the last decade. The typical residential water bill in 2004-05 was \$705 per assessment (DEUS 2005).

LWUs are expected to carry out best management practices as defined in guidelines issued by the Department of Energy, Utilities and Sustainability (DEUS, 2004). These practices include: strategic business and financial planning, cost recovery pricing, demand management, performance reporting, drought management, and integrated water cycle management. If an LWU meets various conditions, including an audit that it has met all required practices, it may pay a dividend to its owner (i.e. local council). However, besides covering its accounting costs, an LWU is not obliged to earn an economic rate of return on its equity so that its dividend payout can be truly commercial (see Reality - Commercial discipline in section 7.4 of Chapter 7).

Two further concerns can be expressed about LWU practices from an economic viewpoint. First, few if any councils charge for the water resource itself. In this, they are following common practice in NSW where the Independent Pricing and Regulatory Tribunal regularly sets water prices to reflect expenditures and makes no allowance for the scarcity value of water. However, the failure to charge for the resource itself is a major cause of the water crisis that currently grips Sydney and many other parts of the state.

Where water is limited, economic theory advocates setting a market clearing price to ensure efficient use of the water. Often water is under-priced with the result that inefficient rationing of water has to be introduced. However, it should be noted that agreement has been reached with the LGSA to amend the existing legislation to provide councils with the option to implement integrated water pricing of the water and sewerage services.

Second, the rate of return on assets employed is low even by utility standards and does not reflect the rate of return available from alternative uses of scarce capital resources. This indicates that not only is there no scarcity charge for water itself, but that the charges for the use of capital and other resources are also too low.

Waste management services are normally funded by flat annual charges, but may also be funded by user charges. They are a contestable service in that private firms are usually able to compete (via a tender) for provision of the service if they are allowed to do so. Accordingly, if the service is provided in-house, councils should charge long-run marginal cost prices to ensure that their price signals are correct and that they conform to national competition policy. However, the structure of charges for waste collection is important. Efficient management of waste is encouraged by charges that reflect the weight or volume of materials collected rather than by fixed annual charges that do not influence use of the service. This encourages households to minimise waste disposal.

Where there is a shortage of parking facilities (on or off street), the principle of efficient allocation suggests charging at the market-clearing price. This ensures that scarce parking space is utilised most efficiently. Parking charges are also an effective way of ensuring that visitors pay for local services. Importantly, parking systems are now visually relatively neutral. While groups who lose free parking rights may resist the new charges and the fines that go with overstaying parking meters, councils have powers to exempt local residents from parking fees and often do so for short stays (e.g. Leichhardt Council offers free parking for the first quarter hour at selected street meters in strip shopping centres) or in residential streets and popular local amenity areas.

Roads and open spaces are high value assets of local councils. They are also a source of long-run financial viability. It is important that use of roads and open spaces be appropriately rationed and used in the public interest and this is likely to involve charging commercial returns for the use of scarce resources.

In general this Inquiry supports the principle that residents and visitors who can afford to do so should pay for the services they use. This enhances financial viability and provides important signals for efficient resource use. However, councils are, and should be, mindful of the importance of community facilities and of the provision of services to children, pensioners and others in need.

Thus there is also a case for providing a substantial amount of subsidised services.

Fees and fines

Similar principles apply to fees for Local Government administrative services, such as development applications, building certificates, clean up notices, s603 rate certificates, inter-library loans, admissions to exhibitions, *Freedom of Information Act (NSW) 1989* disclosures, health inspections, registrations of dogs, and so on (Section 608 LG Act). In principle, many fees are restricted to cost recovery (e.g. development application fees) but others are not (e.g. parking fees). In practice, there is no official guideline to how cost recovery should be determined. Nor is there any agreed approach to deciding what should be a 'merit' good or service whose price warrants a subsidy.

When a local council is sole supplier of development and building approvals (which was traditionally the case), efficient pricing suggests that approvals be charged for at marginal cost. Charging a higher price may deter households from proceeding with minor developments or, possibly, encourage significant non-compliance. However, if the service is provided competitively, long-run marginal cost pricing is appropriate.

Recently there has been concern about rising fines for parking. Parking fines rose from \$60 million in 2002-03 to \$95 million in 2004-05 (Abelson 2005a). However, this concern is largely misplaced. The key issue is not whether fines are charged, but whether parking fees are reasonable. As has been discussed, parking fees are an inevitable and necessary method for fairly and efficiently dealing with limited road space subject to excessive demand.

A contrary view is that given the absence of a convenient mass public transit system as exists in many other large cities (e.g. the underground railway networks common in many overseas metropolises), residents of the Sydney metropolitan area are forced to use their cars so the imposition of parking fees and fines exploits their inability to choose alternative modes of transport. This may be true in some areas, but the strongest backlash to councils charging for private use of public space has been in inner city suburbs (e.g. Balmain) where public transport is excellent, but residents prefer the convenience of a motor vehicle for traversing short distances.

Contributions

For many councils the major contribution received in their capital accounts are developer contributions, which are discussed below. However, for councils operating LWUs water head-works contributions are also significant. RTA contributions, largely block grants for regional and local road maintenance, dominate contributions to councils' operating accounts. It is not clear why the Local Government Accounting Code (Note 4 to the Accounts) requires these moneys to be treated as contributions rather than grants.

Section 94 of the *Environmental Planning and Assessment Act (NSW) 1979* (EPA Act) and section 64 of the LG Act give councils the power to levy developers for contributions towards local infrastructure even if it is not directly related to serving the property being developed. Infrastructure includes local roads and drainage, augmentation of water and sewerage, active and passive open space, and community facilities. The basic principle is that developers may be required to contribute to the costs of any such infrastructure that is required as a consequence of the planned development, but in practice there is no legal nexus between the two. As at 30 June 2002, NSW councils held \$720 million in unspent developer contributions (Department of Infrastructure, Planning and Natural Resources 2004).

The principle of developer contributions is a sound one. Developer contributions are efficient and equitable. They are efficient because they set charges that should reflect the real costs of local public infrastructure needed to support a private development and so ensure that such a development does not occur when its total costs exceed its total benefits in both a private and public sense. Also, they provide a mechanism for financing development.

They are equitable because the contributions are borne by the beneficiary of the works. The major beneficiary is the owner of the land on which the development is made. As shown in Abelson (1999 2005b), when the supply of land for urban housing is fixed and the price of housing land exceeds its value in alternative uses, as is usually the case in NSW, developer contributions reduce the price of land. When the supply of housing land is fixed, the number of new houses supplied is independent of developer contributions. The price of new houses is determined by the relative attractiveness of the new housing compared with the existing stock of housing. This relative attractiveness is not affected by contributions that the developer has paid.

However, developer contributions have to be paid from somewhere and, in general, development is a competitive business so the contributions cannot come out of developer profits. Faced with developer contributions, developers bid less for land. Of course, if developers already hold land, they pay the extra contribution as the landowner. In the absence of developer contributions, the land price would be substantially higher since the owner would capture the value of adjoining public infrastructure investments.³¹ This would be inequitable because the landowner has contributed nothing to this higher price.

In practice, there can be problems in the application of developer contributions. There needs to be a nexus between the contributions and the development and it can be hard to determine in advance exactly what costs will be involved. Special problems arise when development incurs 'lumpy' infrastructure. It can also be difficult to identify marginal incremental costs when development occurs in established areas. Many councils simplify administration of developer contributions by estimating an average rather than marginal or project specific cost for a new development. Dollery (2005a) argues that this is inappropriate because it sends the wrong price signals to developers and may encourage the wrong form of development.

In a working paper on developer contributions for the Inquiry, Dollery (2005a) concludes that developer contributions have worked well and that there is a strong case for expanding them. There is merit to this view. However, there needs to be greater clarity in the calculation of developer contributions (including a clear nexus to the development project), more certainty in their application (by minimising changes to their basis), and improved accountability for moneys raised (as to where they are spent). This latter point is particularly important when there may be a long time interval between the developer contribution being received by council, and the expenditure being made – as for example where plantation developers pay for road infrastructure that the local council is not required to construct for 30 years. On the other hand, the LGSA (2006, pp30-31) points out that:

...the recent reforms to the development contributions system [*Environmental Planning and Assessment Amendment (Development Contributions) Act (NSW) 2005*] have moved away from the principle of a strict nexus between the development and the object of expenditure in respect of both planning agreements and development consent levies...*In the case of such developments it may be necessary and reasonable for the developer to contribute to a range of non-capital added costs, including costs of ongoing monitoring of development impacts and the costs of environmental management, in order for the development to proceed* [quoted from NSW Legislative Assembly Hansard, dated 18 February 2005 specifically in relation to planning agreements];

and:

...development impacts do not respect council boundaries, but have a wider impact. Consequently, there needs to be a mechanism by which a development contribution may be levied or imposed for the benefit of an adjoining council or councils, and having a strict nexus requirement may be limiting in this regard. Not having a strict nexus arrangement is also viewed as beneficial to developers as it provides an opportunity for local government to negotiate improved and innovative planning outcomes.

³¹ In a few cases, when developer charges reduce the supply of new housing, part of the developer charges may be passed forward in higher house prices because of the scarcity of new houses.

and finally:

...a fixed levy may be best for small rural councils to use where the rate of development can be sporadic in comparison to established urban areas, and to have a clear nexus between the charges and development in all circumstances could potentially mean that vital public amenities or services are not provided.

The Minister for Planning recently introduced legislation to curb the use by councils of developer charges so that there would be greater scope for state infrastructure such as rail lines, roads and schools in new release areas in north-west and south-west Sydney to be funded from this source, too (Davies 2006).

Remedies

Possible options for upgrading the existing system of user charging are:

Option 9: Better pricing guidelines.

The Department of Local Government should provide more precise guidance on the pricing principles and key cost concepts necessary for pricing local services.

Pros

- Would improve the use of all resources and goods with public use, for example it would help to minimise waste and ration scarce public resources; and
- Would make councils provide a more transparent explanation of their user charges and fees.

Cons

- Councils might ignore the guidelines so they would not be a useful exercise; and
- Councils may consider them not necessary where they are already pricing services efficiently.

Option 10: Better cost recovery.

Fully charge for the use of water as a scarce resource (including the true cost of capital invested), fully charge for the volume of waste collected, and charge for the temporary 'lease' of public road space used for private parking.

Pros

- Cost recovery ensures funds are available for asset maintenance; and
- Cost recovery is equitable because users pay for the services they receive.

Cons

- Sometimes councils load their costs and overcharge in the name of cost recovery;

- Cost recovery can lead to inefficient use of resources if it is not combined with efficient short run user charges, for example with two-part tariffs for infrastructure and usage; and
- Opportunities to raise revenue in this way vary significantly among councils. For example, parking meters are an option restricted to high density commercial and tourist areas.

Option 11: More transparent developer contributions.

Local councils should be more accountable to property owners for the use of developer contributions derived from the development of their properties.

Pros

- Would reinforce that developer contributions are user charges that should benefit the payee, not taxes that may be spent on anything;
- Councils have failed to spend large amounts of developer contributions. This would be less likely to occur with stronger accountability; and
- Good government is based on trust between the governing and the governed.

Cons

- The reforms to the development contribution system, which commenced in 2005, already provide for in-built accountability and transparency measures (authorisation is required for the borrowing or pooling between contribution accounts, public exhibition required for development contribution plans, voluntary planning agreements and contribution plans regarding joint contribution for cross boundary levying, fixed development consent levies) (see LGSA 2006, p30);
- There could be an increase in administration costs; and
- Some contributions may be based on commercial-in-confidence conditions.

9.5 COMMONWEALTH AND STATE GRANTS

Requirements

It is generally accepted that local councils should receive external financial assistance to meet basic responsibilities that cannot be fully funded from other ordinary revenue raising means (e.g. because of lower than average household incomes in an area), that support facilities and services that have positive externalities (i.e. also benefit non-residents such as a regional convention centre or road network) and which are compensation for activities undertaken for other tiers of government (e.g. aged and child care). Of course this implies that basic responsibilities of Local Government and the responsibilities of other tiers of government can be defined.

It is sometimes argued, further to this, that the higher levels of government should ensure horizontal equity between local councils. This is generally taken to mean that all councils have the opportunity to provide a minimum acceptable standard of service. In particular this requires that councils would be compensated for residents with higher needs (e.g. an aged population or a large influx of non-English speaking immigrants), lower incomes (e.g.

suburbs on the outskirts of Sydney), and higher local costs (remote towns with high transport costs or areas experiencing a high influx of visitors who make demands on local services and infrastructure).

While the Inquiry supports the objective of reducing inequality between councils, complete horizontal equity is not viewed as a practical objective. It is not desirable or possible at reasonable cost to provide similar services, or similar levels of given services, in all areas.

Reality

Types of grants and grant allocation methods

There are three main sources of grant funds to Local Government:

- Commonwealth financial assistance grants (FAGs), which consist of an untied general-purpose component and an untied local road component;
- Commonwealth specific purpose payments (SPPs) that include the Roads to Recovery program and payments for child care, aged care, disability services and so on; and
- State Government grants for specific purposes and services that mainly comprise grants for regional roads, water, sanitation and environment, recreation, culture, etc (DOTARS 2005, table 1.16, p25).

Of these sources of grants, Commonwealth FAGs are the largest part. In 2003/04, the Commonwealth provided \$1,501 million nationally in FAGs, of which the general-purpose component comprised \$1,040 million and the local roads component \$461 million. However, between 1995/96 and 2003/04, the total rose by only 29 per cent from \$1,018 to \$1,501 million, which was far below the increase in GDP of 62 per cent over that period.

FAGs are provided by the Commonwealth Government and distributed by the Commonwealth Grants Commission to each state, the Northern Territory and the Australian Capital Territory.³² Currently, the real amount per capita is held constant each year, with increases accounting for changes in the consumer price index and population, but not for changes in real income. The general-purpose component is allocated to states on a per capita basis. The local roads component is allocated on the basis of a complex formula described in a Commonwealth publication (DOTARS 2005). Oddly it is untied, thus not earmarked exclusively for road spending.

The NSW State Government then allocates FAGs to local councils on the basis of advice from the NSW Local Government Grants Commission (LGGC 2005). Pursuant to the *Local Government (Financial Assistance) Act (Cth) 1995* the LGGC is required to distribute the funds according to certain principles, which include the allocation of a minimum amount to each council with the remainder (most of the funds) to be allocated using the principles of horizontal equity noted above.

In 2003, a House of Representatives Standing Committee (the Hawker Inquiry) recommended that Commonwealth FAGs be distributed directly to councils using horizontal equalisation principles. However, the Australian Government has not adopted this recommendation. This

³² Although the Australian Capital Territory does not have a Local Government system it receives an equivalent payment.

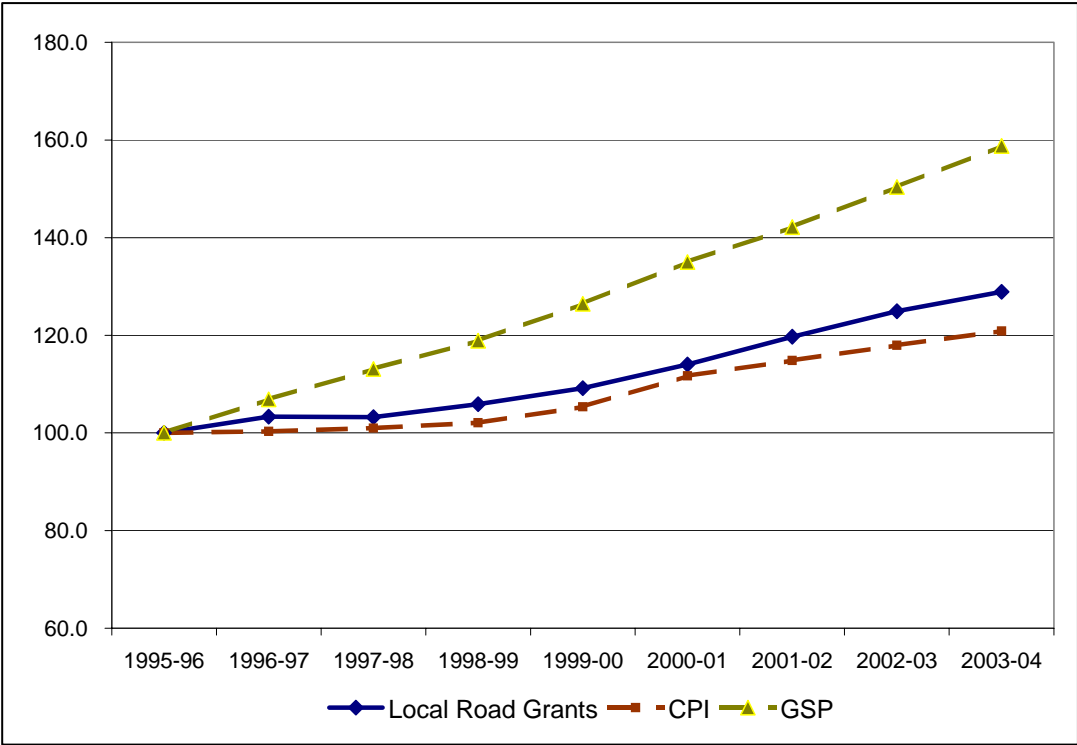
Inquiry also considers that this recommendation should be rejected. The Inquiry believes that allocation of FAGs on a per capita basis to states is fairer and more transparent than the Committee’s recommendation. GST revenues are allocated on horizontal equalisation principles, but the methods of allocation are far from transparent and arguably the outcomes are not fair (see Garnaut and Fitzgerald 2002)

Commonwealth SPPs are paid directly to local councils. Byrnes (2005b) reports that in 2003/04 these grants nationally totalled \$300 million for the ‘Roads to Recovery’ program and \$55 million for childcare.

The NSW Roads and Traffic Authority (RTA 2005) describes how the state road grants of \$140 million in 2005/06 are allocated to local councils. However, Byrnes (2005b) notes that data on other state grant funding to local councils are not readily available.

Figure 9.8 shows that total grants for local roads from the Commonwealth Government (FAGs local roads component and SPP Roads to Recovery program) have slightly exceeded price inflation, but not matched the growth of the state economy. Figure 9.8 does not include NSW State Government payments via the RTA to councils for regional roads, which are known as ‘block grants.’³³ These payments are classified in accounting terms as ‘contributions and donations’ not as ‘grants. Figure 9.8 is significant because local roads dominate Local Government infrastructure, which, as explained elsewhere (Chapters 6 and 11), is in urgent need of renewal after decades of neglect.

Figure 9.8: Growth in Commonwealth road grants to NSW councils compared with increases in other indices, 1995/06 to 2003/04.

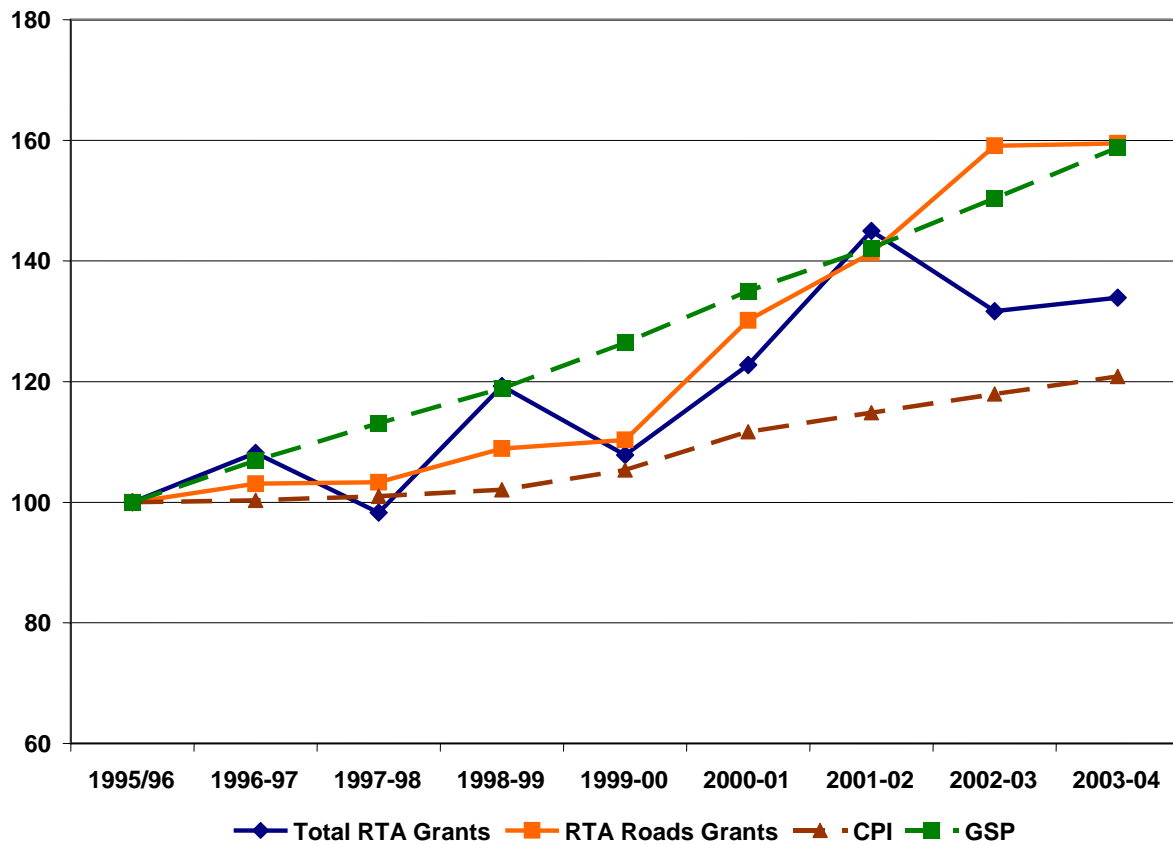


Source: Brooks, J. 2006.

³³ Regional roads are generally regarded as local roads by councils and are only classified as regional roads for RTA purposes.

State road grants to Local Government are distributed by the NSW Roads and Traffic Authority (RTA). They totalled \$193.3 million in 2003/04 and were earmarked for regional and local roads (\$151.9 million), natural disasters (\$9.5 million), traffic route lighting (\$13.4 million) and other road safety and facilities purposes (\$18.5 million). Total RTA grants to councils doubled between 1993/94 and 2003/04, though half of the growth occurred over the two years to 1995/96. Figure 9.9 shows the movement in total RTA grants compared with other indices since 1995/96 (the standard period used for all revenue charts).

Figure 9.9: Growth in State (RTA) grants to NSW councils compared with increases in other indices, 1995/96 to 2003/04.



Source: RTA private correspondence, 19 April 2006.

As shown earlier (table 9.2), rural councils are dependent on grant funding for almost a third of their total revenues. These councils own vast road networks which they are failing to maintain and renew because their resident rating base is too small to do so. Hence removing rate pegging would not solve their funding shortfall. To quote Professor Graham Sansom of the Centre for Local Government, UTS (2006, p5):

To bring about necessary improvements in infrastructure management, many smaller councils will need increased grants, meaning significant changes to the system of federal financial assistance grants (FAGs), but in some cases responsibility for roads and other infrastructure may have to be resumed by the State...

Wakool Shire Council (2006, p5) rejects the popular notion that because rural councils have many unsealed roads they involve little ongoing cost:

A heavily trafficked dirt road is cheaper to construct and maintain in the short term, but requires more frequent structural maintenance in the longer term.

Wakool Council has 620km of sealed and 960km of unsealed regional and local roads plus 84 local and regional bridges. It estimates that keeping these assets in perpetuity would require an annual investment of three per cent of their replacement value of \$260 million. It says (p5):

This would indicate that our road maintenance budget should be about \$7,500,000 per annum...It does not take into account the need to restore any capital deficit accumulated through past under-expenditure.

Wakool Shire's accumulated capital deficit from deferred maintenance of roads and bridges is more than \$50,000,000. Some roads and bridges have deteriorated to the point where replacement of worn out components of the network is now critical.

The council does not disclose what it spends on roads, but with a rate income of under \$2.4 million a year to support all its functions its capacity to fix its roads and bridges is negligible without direct government intervention.

Assessment of grant allocations

The Inquiry has four main concerns about the current allocations of grants to local councils.

The first and most important one is the ongoing decline in the allocation of grants from all sources (Commonwealth FAGs and SPPs and state grants) to Australian Local Government. These have declined from nearly 0.6 per cent of GDP in the mid-1980s to less than 0.4 per cent today (Access Economics 2004, p13, chart 4.1). In 2003/04 total FAGs to Australian Local Government (general purpose and local roads component) represented 0.18% of GDP.

The second concern is the complexity and related lack of transparency of the allocations of FAGs to local councils recommended by the NSW Local Government Grants Commission. Unlike its Commonwealth counterpart, the NSW Commission does not disclose its calculations of disability of each funding recipient (i.e. council), except to that recipient, when determining the FAGs' general-purpose component. As a result there is not a public document showing the LGGC's disability measures for all councils. That prevents a public assessment of whether the criteria and weighting of disability factors are adequate to address the pressing needs of infrastructure renewal and enhancements, particularly in areas with either strong population growth or an inadequate rate base (see Chapter 6).

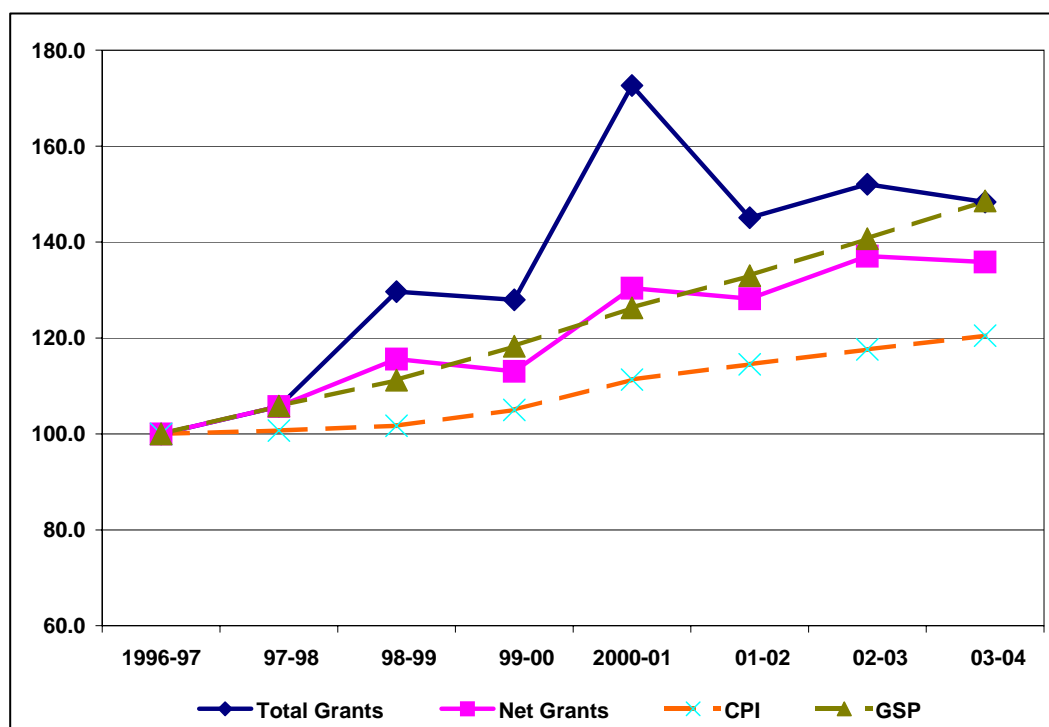
The third concern is the lack of detail about the quantum and amount of NSW Government assistance to local councils. The size, composition and trends for state grants are not published as they are in all but one other state (DOTARS 2005, p22). Fortunately the Inquiry was able to obtain data about state grants to councils from the NSW Treasury, which specially extracted it from its financial database (see figure 9.9). This shows that between 1996/97 and 2003/04, total grants increased from \$557.2 million to \$826.6 million, a compound growth rate of 5.0 per cent per annum. However, if pensioner rate rebates, non-cash capital grants (i.e. physical asset transfers), council rate payments, interest subsidies, assumption of liability associated with the collapse of HIH Insurance Ltd, national disaster capital grants and disaster welfare relief are excluded, net grants rose from \$544.4 million to \$739.6 million, an average annual rate of increase of 4.6 per cent. Data on state grants to Local Government was not available for years before 1996/97.

The fourth concern is the administrative complexity required of council when applying for and reporting back on grants for specific purposes, namely Commonwealth SPPs and state grants. As reported in many submissions and responses as well as in regional workshops the application cost generated by excessive documentation requirements and the cost of administrative and reporting processes cause an excessive proportion of grant funding being spent on grant administration rather than the grant's intended purpose.

In his response, John Rayner, General Manager of Sutherland Shire Council (2006, p2) describes in relation to additional state funding for public libraries offered on a competitive basis³⁴ that:

...the level of detail required in submissions as well as the reporting requirements if successful are onerous. As the maximum amount which can be applied for is limited to \$200,000 and some grants can be as little as a few thousand dollars, the resources required to put together a submission seem to be completely unrealistic.

Figure 9.10: Growth in NSW state grants to NSW Local Government compared with increases in other indices, 1996/97 to 2003/04.



Source: LGI based on data provided by NSW Treasury.

Remedies

Possible options for improving the present system of Commonwealth and state grants are:

Option 12: Increase FAGs in proportion to GDP.

Total Commonwealth FAGs to Local Government should be expressed as fixed percentage of GDP and raised from 0.18 per cent (2003/04) to 0.22 per cent, and thereby tied to the growth of the Australian economy as most Commonwealth taxes are.

Pros

- Would restore to local councils in Australia part of the relative loss of income from Commonwealth FAGs over the past 20 years; and
- Would provide local councils with greater certainty of income going forward.

³⁴ Public libraries are partially subsidised and receive state funding under the *Library Act (NSW) 1939*. Additional state funding is offered on a competitive basis and council can apply for such funds.

Cons

- Councils should be less reliant on other levels of government; and
- The figure of 0.22 per cent of GDP is an arbitrary one.

Option 13: Set FAGs as a fixed percentage of Commonwealth Government income.

Either increase FAGs from 0.72 per cent (2003/04) to 0.86% of total taxes (including GST) collected by the Commonwealth or from 1.06 per cent (2003/04) to 1.27 per cent of total income taxes. These ratios would be equivalent to 0.22 per cent of GDP.

Pros

- Would restore to local councils in Australia part of the relative loss of income from Commonwealth FAGs over the past 20 years; and
- Would be based more clearly on the Commonwealth's capacity to fund the intergovernmental grant.

Cons

- Councils should develop and use their own tax bases; and
- Any figure adopted would be an arbitrary one.

Option 14: Reform the distribution of FAGs

If FAGs were not increased as envisaged in Options 12 and 13, then the method of allocating them should be changed to increase the relative assistance given to the most infrastructure-disadvantaged local councils given that these are the least financially sustainable units of Local Government.

This would involve the Commonwealth Government changing its allocation guidelines to reduce the guaranteed minimum amounts distributed to each council and the NSW Local Government Grants Commission changing its allocation formula for the general component of FAGs to recognise not just operating, but also capital (i.e. infrastructure) disabilities of councils and to base the road component of FAGs on an asset preservation model as used in Victoria and Western Australia. An asset preservation approach estimates a council's cost of maintaining and renewing its road network instead of simply using factors such as the length of road and number of residents within a council area.

This option would need to be implemented in conjunction with the abolition of rate pegging so that urban, particularly metropolitan, councils could recover their lost FAG income through introducing higher rates. The existing grant pool could then be applied to support councils with infrastructure problems beyond their ability to fund with normal rate income.

This option would see the end of FAGs as a means to compensating for vertical fiscal imbalance to using them as a means of helping those councils with huge infrastructure renewal cost burdens to remain financially viable.

Pros

- Taking a council's capital needs into account when measuring its relative disability is vital given that failing road infrastructure is the biggest problem facing councils, especially rural ones with vast road networks;
- The poorest areas are most in need of assistance since they lack an adequate rate base;
- The more affluent areas do not need the minimum amounts that they receive; and
- Redistributing FAGs is necessary for the survival of many rural councils if the total level of these grants is not raised significantly.

Cons

- The LGCC (2006, p3) says:

There are significant difficulties, both practically and philosophically, in the assessment of capital needs. This is particularly the case given the untied nature and the limited level of grant funds. For this reason the Commission does not consider capital works in its grant formula';

- Measures of disadvantage are based on subjective weightings (for example, how much disadvantage is there is living in a small unit compared with living on a five or hundred hectare property);
- Higher income households have contributed most of the revenue. Equal per capita distribution of expenditure is therefore fairer; and
- High growth areas that are facing infrastructure strains would get increased FAGs, even though their rate base is expanding

Option 15: More transparent NSW Local Government Grants Commission.

The NSW Local Government Grants Commission should publicly disclose its calculations of disability of each council.

Pros

- Would parallel what is done by the Commonwealth Grants Commission;
- Would accord with the principles of transparency and accountability for use of public funds;
- Would help councils better understand how to apply for funds and the funds to which they are entitled; and
- May provide real benefits for rural councils.

Cons

- The LGGC provides each council with the disability measures used to determine its grant and visits each council about once every four years to explain its methodology and allow the council to discuss and make submissions about its particular circumstances;
- Wider disclosure might embarrass the recipients of the largest amounts of funds; and
- The calculations of disability might be challenged, creating disharmony between councils.

Option 16: State disclosure of its total grants

The NSW Government should publicly document its total assistance to NSW Local Government and show its breakdown as is done in the budget papers for Victoria, Queensland, South Australia and Tasmania.

Pros

- This accords with the principles of transparency and accountability for use of public funds;
- It is already standard practice in most other states; and
- It would encourage full documentation of assistance to local areas in all spheres of government.

Cons

- This might set a precedent whereby other funding recipients would also demand time series data on the total funds their sectors get on a state wide basis; and
- There may be administrative costs in providing such data.

Option 17: LGSA disclose state grants data

If the State Government refuses to implement Option 5, the LGSA should obtain and publish state grants data on an annual basis from either the NSW Treasury or all councils.

Pros

- This accords with the principles of transparency and accountability for use of public funds; and
- Many councils and public interest groups would find this valuable information.

Cons

- Not practical as some councils might not provide timely data on a voluntary basis;
- Surveying councils would be an expensive exercise that would double up on data the NSW Treasury already collects;
- The costs of the exercise might not be justified, especially if some councils refused to vouch for the accuracy of their data returns.

Option 18: Reduce ‘red tape’ for grant funding

Streamline and reduce the complexity of application, allocation, and administrative and reporting processes of Commonwealth SPPs and state grant funding for Local Government so as to reduce the cost burden to both grantors and grantees.

The level of detail required to applying for and report on specific purpose grant funding (Commonwealth SPPs and state grants) is often unnecessary and duplicated. This is causing councils to spend an excessive proportion of grant funding on application and administration rather than its intended purposes. The NSW Government’s present reviews into red tape could be extended to include that associated with grants funding to councils.

Pros

- Would reduce administrative cost to both Local Government and grant provider; and
- Would therefore allow for more grant funding to be spent on its intended purpose.

Cons

- Application and reporting requirement are necessary to ensure that grant funding is allocated to appropriate projects, particularly when there is competition for grants; and
- Red tape is an unavoidable part of grants funding given the legal and political demands on the grantor to justify the purpose, allocation and achievements of the moneys disbursed.

10. COUNCIL GOVERNANCE AND MANAGEMENT

10.1 INTRODUCTION

Good governance frameworks and management arrangements are the cornerstone of effective Local Government. This chapter starts with a discussion of current governance arrangements and questions how well councils are governed and how democratic their franchise is. It then continues the governance theme by examining councillor-management relations and analyses how appropriate, effective and productive the current roles and relationships are.

Thereafter the chapter moves onto the administrative performance of Local Government, examining how it compares to other public institutions, how lean its corporate overheads are, and the appropriateness of its key performance indicators. It concludes by focusing on council size and cooperation, examining possible measures to improve economies of scale including the contentious issue of forced amalgamations and alternative approaches such as resource sharing.

10.2 GOVERNANCE ARRANGEMENTS

Requirements

Governance is the process by which decisions are taken and implemented, the process by which organisations go about achieving their goals and producing their outputs and the process by which organisations are directed, controlled and held to account. It encompasses authority, accountability, stewardship, leadership, values and culture within the organisation.

Excellence in governance occurs when it is underpinned by accountability, integrity and openness. It involves a focus on clarity of roles and responsibilities, robust systems that support both internal and external accountability and public access to decision-making and information. (CPA Australia 2005, p4)

Excellence in governance within Local Government should ideally produce the following effects: promote confidence within the community regarding councils; result in better council outputs and outcomes; enhance the value (and standing) of the organisation; ensure that councils meet their legislative responsibilities; and focus councils on the requirements of their communities.

The principles of good governance demand that the roles and responsibilities of councillors, mayors and general managers are clearly defined, with a separation between legislative, executive and judicial positions and powers. Codes of good conduct must insist that councillors behave in good faith, don't improperly use their positions for private gain, don't misuse confidential information, and act with due care and diligence. Councillors should declare conflicts of interest when they arise and absent themselves from council decisions which might benefit them personally or their families or employers. Cooperation between councillors and staff needs to be based on an understanding and acceptance of the difference between each of the roles.

However, there must also be a sophisticated understanding that each party has a legitimate interest in the other parts of council and their input should be sought, wherever possible, in relation to important decisions.

Reality

A democratic franchise?

It is impossible to examine the governance arrangements of Local Government without questioning its democratic basis. If councils are a type of statutory corporation with a governing 'board' then who are the primary shareholders? Who do councils represent and serve? Are they an elected tier of government in line with the Commonwealth and state governments and therefore primarily responsible to their constituencies? If so, who are these constituents? Are they residents or property owners?

Given that Local Government in Australia has no constitutional basis and is established by and functions under the direction of state government legislation, and given the power of the NSW Minister for Local Government and his or her department to oversight, investigate and dissolve councils, is the NSW Government their ultimate master or is it merely a regulator?

Chapter 3, Section 8 of the *Local Government Act (NSW) 1993* (LG Act) provides a charter for each council. This charter contains numerous references to councils' obligations to their 'community'. Councils are required under this legislation to consult heavily with their communities and promote effective community participation in council affairs. Councils must also carry out activities appropriate to the current and future needs of local communities and the wider public.

It has been argued that tying Local Government to this concept of 'community' has weakened its legitimacy. The concept of community has no clear definition. It is rather vague and problematic and has reduced the need for councils to stake their claims for legitimacy by being the democratic representatives of their local area and its residents. (Kiss 2003, p104).

Kiss uses the examples of forced council restructuring and amalgamation in Tasmania and Victoria in the 1990s to argue that community of interest was not a meaningful concept in decision-making. Instead decisions were made on the basis of economic development, rate reduction and related operational matters. Amalgamations also reduced the number of elected representatives per constituent and increased their physical remoteness.

Under the present system of municipal voting in New South Wales it is also unclear who local governments actually represent given that both residents and non-resident property owners are entitled to vote in a council area in which they own property.

Pursuant to the LG Act a person is entitled to vote if he or she is a resident of the council area, or he or she is not a resident, but is an owner of rateable land, or he or she is an occupier, or rate paying lessee, of rateable land in a council area.³⁵ The 'one vote - one council' principle excludes a person from having more than one vote in one council area in an election. Therefore, a person who resides in a council area and also owns or occupies a property somewhere else in the same council area is not entitled to two votes.

³⁵ Section 266 of the LG Act.

However, nothing excludes a person from voting as a resident in one municipality or shire and voting as a property owner, occupier, or lessee in another or several other municipalities and shires.³⁶ Corporations and trustees are entitled to vote as property owners, occupiers or lessees through a person nominated as elector. Only residency voting is compulsory whereas voting as a property owner, occupier or lessee is voluntary.

The option of postal voting is available, but absentee voting is not provided for. Introducing absentee voting (i.e. voting at a different place than the council ward where a person is enrolled as an elector) would add to the administrative complexity and cost of a Local Government election under current paper based-voting systems. Each polling place would need to have resident and non-resident electoral rolls for each of the 152 council areas. However, absentee voting would be more practical with electronic voting.

It can be argued that Local Government voting rules should follow those of Commonwealth and state elections and allow only local citizens the right to vote. This would give Local Government a stronger local representative democratic basis. However, property owners, particularly investors and businesses, also have a legitimate interest in the local environment surrounding their properties as it impacts financially upon them. It is also property owners who are being taxed by Local Government in the form of rates.

Are councils well governed?

Part 2, Division 1 of the LG Act establishes councils as bodies corporate. Councillors are given the role of governing the council. The model is therefore generally seen as analogous with that of a statutory corporation and a corporate board.

Australian Standard 8000 sets out principles for good corporate governance. The standard is based upon the principles formulated for shareholder companies and for statutory corporations and is generally seen as the most relevant standard for councils in this area. However, while there are many similarities between a meeting of councillors and a meeting of a governing board, there are also fundamental differences. These differences create some basic tensions, which are difficult to resolve.

CPA Australia, through its Public Sector Centre of Excellence, has produced a comprehensive manual on council corporate governance (CPA 2005) covering vision, roles and responsibilities, working relationships, decision-making, financial management, risk management, accountability, performance measurement, independent review and consultation.

Chapter 4 of the LG Act provides for the conduct of councillors, council officers and delegates and it could be said that these legislative integrity control mechanisms have brought about positive changes within council administration. However, a corresponding reduction in the integrity risks for councillors has not been experienced. The recent Report of the NSW Independent Commission Against Corruption (ICAC) into Strathfield Council (ICAC 2005) continued to highlight corruption risks associated with the planning system. Seventeen per cent of all complaints received by ICAC annually are about planning decisions.

³⁶ See section 268 of the LG Act.

The major potential conflicts of interest occur in the following areas. Firstly, councillors are elected, not appointed, and the constituents who elect them are not shareholders, they are in some respects more similar to customers of council services such as waste collection and disposal. Secondly, each councillor is elected by only part of the council electorate and owes an allegiance to that ward as its representative. Thirdly, councils tend to be split into factions causing majority and minority groupings on the 'board'. Fourthly, council meetings follow parliamentary rules of debate and are required to generally be held in public. (Mant 2005b)

It must also be noted that in NSW most councillors are part-time representatives, with no formal 'board' training or educational requirements. They are generally only paid a small weekly fee, which goes nowhere near adequately remunerating them for the time it takes to effectively perform the job. For both elected and appointed officers achieving integrity in Local Government is complicated by the challenges in separating public duties and private interests. Many of the staff that work at local councils live in that area. Likewise the elected councillors live and often work within their Local Government area.

Under the planning legislation, councillors have been given a range of different roles which include: preparing Local Environment Plans (LEPs) for Ministerial approval and making Development Control Plans (DCPs); deciding whether to consent to a development application (DA), and if so, subject to what conditions; hearing appeals against development decisions, and being a constituent representative. At the same time some councillors claim an election mandate to be advocates for particular causes such as pro-business or anti-development, expanded services or lower taxes, pro-mergers or anti-amalgamations, etc.

These different legislative, executive, arbitral and advocacy roles are not always clearly distinguishable or separable from each other. This creates conflicts of interest for councillors.

The lack of a 'separation of powers' between policy and operations (i.e. between legislative and executive functions) has been a frequent criticism of the Local Government system. It has been argued that councillor involvement in the determination of development applications creates the risk of an emphasis on individual applications over the provision of clear policy direction. (ICAC 2005, p11)

Further, it can be argued that the systems within which councils make these regulatory decisions are flawed, as councils have an arbitrary power over re-zonings and development applications and there is no requirement for transparent decision-making. The structure of council meetings follows a parliamentary, not an arbitral, model. Councillors are representatives, not members of an independent hearing panel. As a consequence, hearings before councillors seldom comply with the principles of a fair hearing. (Mant 2005b, p5).

Conflicts of interest can also occur in relation to the service role of councils. The current system allows for the determination of budgets to be done on party factional grounds rather than on the basis of need, or effective management of assets, let alone any real assessment of future needs.

The ICAC discussion paper (ICAC 2005, p7) has identified several other key areas within local councils, which are at risk for corruption:

- Council officers' recurring dealings with professional developers and architects;
- Council acting as consent authorities over land that they own;

- Development proposals which include the purchase of council owned land;
- Potential conflicts of interest amongst consultants engaged by councils;
- Departures from development standards;
- Possible misuse, or perception of misuse, of planning discretions; and
- Political donations from parties with an interest in a development outcome.

The NSW Department of Local Government (DLG 2004c) has produced a model code of conduct for councils that covers key principles, general conduct obligations, conflicts of interest, personal benefit, relationship between councillors and staff, access to information and council resources, reporting breaches, complaints handling procedures and sanctions and councillor misbehaviour.

The LG Act requires every council to adopt a code of conduct that incorporates the provisions of the model code produced by the department. All council officials (councillors, management and staff) must comply with the code; failure by a councillor to comply constitutes misbehaviour, which can entail suspension³⁷, and failure by a member of staff may be subject to disciplinary action.

Another observation (Mant 2005b, p8) is that councils tend to report on outputs rather than outcomes, as there is not a comprehensive and simple corporate planning framework for councils in NSW. The primary planning document used by councils is the ‘management plan’. The management plan reports on proposed ‘activities’ (outputs) and provides the basis for the council’s budget. Although quarterly reporting on the achievement of activities is required in the management plan, and these reports are useful to see how budgets are being met, they do not really assist in measuring the effectiveness of activities in achieving outcomes. To date, only a few councils such as Fairfield Council have prepared longer-term strategic plans that provide an outcomes framework for the detailed annual management plan.

Who should councils be answerable to?

Unlike the board of a statutory corporation, a council is not directly responsible to the Minister for Local Government, although in NSW both the Minister and Department of Local Government play an active role in monitoring councils and dealing with complaints about their performance. The Minister also has tight control over the resources available to councils through the rate pegging arrangements.

The NSW Government retains reserve powers to dismiss councils. In NSW this power is used reasonably frequently, particularly in relation to councils that have demonstrated integrity failure. In the last three years the NSW Government has sacked three councils for integrity failure: Warringah, Liverpool and Rylstone.

If Local Government is a permanent elected sphere of government, the question remains as to how much intervention there should be from other tiers of government regarding its performance. Should it be up to the electors to decide the fate of a council’s governance as it is for the other spheres of government?

In some other states, such as South Australia, the relevant minister has a more hands off approach. Apart from facing elections every four years, the main sanction against

³⁷ Section 440I of the LG Act.

unacceptable performance by a council is the holding of a ministerial inquiry, and subject to the outcome, the subsequent dismissal of the council and the appointment of administrators as the governing body. While the Queensland Government retains the same reserve powers as NSW they have never been used since the introduction of the *Local Government Act (Qld) 1993*.

In New Zealand, the government has adopted a completely hands-off policy towards Local Government in return for local councils being guided by long-term strategic plans based on genuine community consultation and engagement (McKinlay 2006). McKinlay argues that while New Zealand has a different model of government to NSW, it offers an important lesson in that if Local Government is treated as a genuine third tier of government and as such is allowed to make its own mistakes and be held to account by its own constituency, then citizens cease looking to the state to provide solutions to local problems.

The 'autonomy for strategy' trade-off adopted in New Zealand would not need to start from scratch in NSW. Several councils, including North Sydney, Blue Mountains and Sutherland, already have long-term strategic plans (LGMA 2006, section 8.5). Another council (Maitland 2006, p4) has used long-term planning not just to identify, but also to draw councillor and public attention to its infrastructure crisis:

(We) have developed a 10-year financial plan in conjunction with an asset strategy for 10 years. This mix identifies the shortfall in revenue and maintenance of infrastructure, (and) although not palatable politically, shows the elected representatives of Council the additional revenue needed within the organisation. This is the real starting point (to) show categorically that the need is urgent and the community will need to shift its thinking to acknowledge the need to contribute more...

More recently the NSW Department of Local Government has instituted 'focused reviews'. These are short reviews on specific areas of council activities that have been identified as a result of a desktop analysis. The reviews are normally done for several councils in a region at the one time. The focused review has a greater legislative compliance focus than a full review.

Along with publishing best practice guides (e.g. model code of conduct) and Local Government key performance indicators (notwithstanding their imperfections), reviews show the important role that DLG would still play as a 'mentor' and 'monitor' if it was stripped of its task of also being a 'nanny' or 'governess' (e.g. helping the state dismiss a council and appoint an administrator rather than letting voters vent their wrath at the ballot box for wrongdoings or deficiencies exposed by DLG).

A DLG review of a council involves evaluating the effectiveness and efficiency of its operations and reporting the results to the council, the director general of the DLG and the Minister for Local Government. The review checks a council's legislative compliance, operating practices and performance monitoring frameworks. Both a council self-assessment checklist and an on-site inspection are used for undertaking the analysis (DLG, Review Report – Morree Plains Shire Council, Nov 2005, page 4).

Council activities and decisions are not only open to review by the DLG, but also by the ICAC and the NSW Ombudsman. Following recent ICAC reports, the LG Act has been amended to enable the suspension of individual councillors following an adverse report from the ICAC, the NSW Ombudsman or a departmental investigation. Mant (2005b, p8) believes that improved processes for the conduct of hearings on development applications and more transparent process for re-zonings would considerably reduce the number of complaints about

the performance of councils, councillors and staff and therefore lead to less need for sanctions.

However, doubts have been raised regarding the adequacy of resources to investigate Local Government. (Warburton & Baker 2005, p64). While the DLG, ICAC and the NSW Ombudsman all receive a significant number of complaints each year about councils, these agencies have limited investigation resources to deal with them. The DLG and the Ombudsman, for example, each receive over 800 complaints annually about council integrity issues. The vast majority of complaints received by these three agencies are referred back to the relevant councils for investigation.

Sutherland Shire Council, Warringah Council and Ku-ring-gai Council have each appointed quasi-independent Ombudsmen to deal with integrity issues to forestall the need for state government intervention. Queensland is also strengthening the obligations on councils to take responsibility in dealing with complaints about administrative decisions.

Remedies

As observed in the recent ICAC Discussion Paper (ICAC 2005, p17), the determination of development applications by councillors sits uncomfortably inside a model which attempts to separate the council's role in determining objectives and priorities and the general manager's responsibility for implementing council's decisions, day-to-day management and staff matters. Councillors are placed in a difficult conflict situation due to their requirement to set uniform development policies (e.g. maximum number of storeys, minimum building setback from a street, and share of any site dedicated to open space) that reflect the will of their electors, but also be impartial arbitrators on whether non-complying development applications should be exempted from such policies or not.

A viable option may be the establishment of independent hearing and assessment panels. These are canvassed in Chapter 8 of this report, which covers development planning and controls.

A variety of other options for reform are now advanced to address other issues raised in this section:

Option 1: Legislatively clarify the structure of governing bodies of councils.

The *Local Government Act (NSW) 1993* would be amended to clarify whether governing bodies of councils are a corporate type board or a quasi-parliament.

Pros

- Would provide greater certainty about the roles and responsibilities of councillors vis-à-vis council management; and
- Would provide greater certainty about accountability for councils.

Cons

- Would be difficult to resolve the conflicting roles of a 'statutory board' versus a 'representative chamber' implied in existing council mandates; and

- A more defined structure might cause greater inflexibility.

Option 2: Amend the Local Government voting system.

The Local Government voting system would be changed to mirror the State Government voting system by only giving citizens who actually live in a Local Government area the right to vote in that area.

Pros

- The concept of ‘community’ under the *Local Government Act (NSW) 1993* would be more clearly defined;
- Local Government would be given a more definite constituency; and
- Local Government voting procedures would be brought into line with other tiers of government;

Cons

- Individual investors and businesses that may have a legitimate interest in a council’s affairs due to owning property in the area would be denied voting rights.

Option 3: Increase councillors’ accountability in planning decisions.

Councils could be required to record how councillors vote on planning policy matters and individual development applications. These decisions would be easily discoverable by the community and the media via the council minutes posted on its website.

Pros

- Would increase transparency and accountability of planning decisions to the community; and
- Such community scrutiny would serve as a deterrent for decisions resulting from conflicts of interest.

Cons

- Councillors may feel constrained in making legitimate planning decisions that served the whole municipality or shire, but which conflicted with the interests of certain constituents of their own ward.

Option 4: Require councils to develop long-term strategic and financial plans in close consultation with their communities that would be subject to external compliance audits.

All councils would be required to have a 10-year strategic and financial plan (akin to the New Zealand Community Plan) with measurable outcomes based on community consultations and subject to external compliance audits. In addition, there would be a management plan with an accompanying three-year budget that demonstrated how the objectives, strategies, outputs and targets in the strategic plan were being implemented to deliver real outcomes for the community.

Pros

- Would enable council priorities to better reflect existing community concerns and aspirations as well as known demographic, social, environmental and economic challenges;
- Would allow councils to concentrate and report on both outcomes and outputs against agreed targets;
- Would increase performance review and general accountability; and
- Under DEUS guidelines, 77 per cent of councils have already developed such long term plans for their water and sewerage services and a further 11 per cent have developed draft plans demonstrating that councils have the capacity to do this when required to.

Cons

- Would place greater financial and resourcing pressure on councils, particularly smaller and rural councils which already have limited resources; and
- Unless community consultation was genuine and well done, a strategic plan could amount to simply a management vision with little public allegiance or legitimacy, and little real attempt to plan for the future.

10.3 COUNCILLOR/ MANAGEMENT RELATIONSHIPS

Requirements

As outlined in the previous section, effective governance depends on power being dispersed within an organisation through appropriate checks and balances such as the separation of executive and non-executive functions and a clear definition and understanding of the respective roles and responsibilities of councillors, mayor and general manager within a council.

A council should either be a corporate style board where the mayor acts as non-executive chairman and the general manager is the CEO or a quasi-parliament that holds a political executive to account for executing policy.

Reality

Current roles

The LG Act was intended to clarify both the respective roles and responsibilities of elected members and appointed general managers, and the ways in which they should relate to each other. However, these definitions remain a contentious matter.

Prior to the introduction of the LG Act in 1993, councils were locked into a structure of three often distinct divisions of senior management: a town or shire clerk; a council engineer; and a chief of health and building surveyor. The previous *Local Government Act (NSW) 1919* also gave the mayor the role of chief executive officer for the council.

The LG Act was intended to provide councils with much more flexibility in determining their organisational and managerial structures. The only statutory executive officer it provides for

is a general manager. Each council appoints a general manager on contract lasting up to five years. The role is analogous with a chief executive officer of a company established under corporation legislation.

Councillors have been given three separate, but overlapping functions: representing the interests of constituents; leadership and strategic policy formulation; and monitoring and reviewing the performance of council. General managers run the day-to-day activities of council, ensuring the organisation operates efficiently and effectively.

Productive relations

Mant (2005a, pp4-5), the principal author of the *Local Government Act (NSW) 1993*, identifies a number of ongoing problems between councillors and administrative staff. These are: the political nature of the governing structure; the annual election of mayors; access of councillors to staff; and contractual employment of senior management.

Councillors behave more like a Parliamentary body than a corporate board. Councillors represent constituents. Some councillors can be elected on the basis of a narrow range of issues. There are also what is known as ‘pot hole councillors’ who are much more interested in focussing on service delivery than strategic issues. Councillors often have little or no corporate experience, and there is a high turnover of councillors at elections. They are required to understand detailed internal processes and interpret financial reports and performance information. These are roles and responsibilities that many councillors in Inquiry workshops acknowledged they are ill equipped to perform effectively.

A survey done by the NSW Department of Local Government in 2000 found that 64 per cent of metropolitan councillors listed their occupation as professional or managerial. Only 41 per cent in regional councils listed this background. (DLG 2001a, p26). While these skills can arguably be acquired over time, the same survey found that 43 per cent of councillors who had been successfully elected in the 1999 council elections had not stood at the 1995 election; in other words, were new to the role.

On 17 January 2006 the NSW Minister for Local Government the Hon Kerry Hickey MP issued a media release (Hickey 2006) announcing that following the 2008 council elections newly elected councillors would be required to undertake professional development courses to familiarise themselves with their designated roles and responsibilities within six months of being elected.

The need for professional development of councillors was identified following an inquiry into Brewarrina Shire Council, which found that some councillors did not fully understand their official role, or what ratepayers expected of them. Nor did they have the necessary economic and financial skills to perform their roles.

On the other hand, Marshall (2005, p140) suggests that Local Government, having embraced a comprehensive corporate framework, should offer similar inducements and support to their councillors as company directors receive. This would take the form of better remuneration, allowing them to either give up full time employment or at least reduce work commitments in order to concentrate on council responsibilities. Arguably a larger and more diverse field of candidates would then stand at elections.

Marshall proposes that the extra costs could be met by reducing the number of councillors in each area. He argues that community consultative strategies to compensate for diminished representation already exist.

A council that has a cohesive majority is a much easier prospect for a general manager than a politically unstable group of independents. However, general managers must also be careful not to be seen as partisan for supporting the majority party. Also, councils that rarely have a change of political control may grow arrogant and complacent.

The annual election of a mayor can also serve to weaken council leadership and make it difficult for a general manager and mayor to develop a steady working relationship. This is particularly true of those councils which have a 'take it in turn' approach. Elected mayors have a relationship with their general managers which is more akin to a minister and a director general of a government department. The potential exists to build a stable and constructive partnership.

While councillors are denied direct access to staff under the Local Government legislation and should only interface with the general manager, an ICAC survey of 156 councils in 2001 found that about 10 per cent of Local Government staff had felt pressured by councillors to do something they were not supposed to do or to provide confidential information. Generally, there was found to be a high level of ignorance regarding roles and relationships. (ICAC 2001, pp16-17)

While the strong administrative powers given to general managers regarding employment of staff arguably gives them power to shape organisational structure, this power is counterbalanced by the contractual nature of their employment. Employing general managers and other executives on a contractual rather than permanent basis should make them more performance conscious, but it could also discourage them from giving frank and fearless advice at all times for fear of falling out of favour.

In essence, the problem with the present system is that councils often have too many councillors to exhibit the esprit de corps of a small corporate board, yet don't have a political executive to hold to account if they want to behave as a parliament.

Executive mayors

Many major cities in the United States have a structure by which mayors are popularly elected. The mayor is the chief executive officer of the council, and senior council staff tend to be political, non-merit-based appointments who report directly to the mayor. The council itself is a legislative body that approves the mayor's budget, makes rules and supervises the performance of the executive.

The Greater London Authority (GLA) is a variant on this structure. It is a unique form of strategic citywide government for London. The authority is made up of a directly elected mayor and a separately elected assembly. There are around 600 staff to assist the mayor and assembly in their duties.

The Mayor is London's spokesman. He leads the preparation of statutory strategies on transport, spatial development, economic development and the environment. He sets budgets

for the GLA, Transport for London, the London Development Agency, the Metropolitan Police and London's fire services.

The assembly scrutinises the mayor's activities, questioning the mayor about his decisions. The assembly is also able to investigate other issues of importance to Londoners, publish its findings and recommendations, and make proposals to the mayor.

Within Australia the closest comparable system to the Mayor of London, New York or Chicago is the Lord Mayor of Brisbane who is a full-time politician who drives the strategy and policy agenda for the city. The *City of Brisbane Act (Qld) 1924* gives the lord mayor the power to: draft the council's budget; set rates and charges; submit the capital works program to full council; run council's everyday business as an organisation; formulate policies relating to city governance; and implement policies adopted by council.

The lord mayor receives a salary equivalent to that of a Queensland state minister. Full council has delegated some of its powers to the Establishment and Coordination Committee, which is also known as the Civic Cabinet. The chief executive officer of the council reports directly to the mayor, is the principal advisor to the Establishment and Coordination Committee and has accountability to the whole of Brisbane Council.

Mant (2005a, p10) argues that larger councils in NSW should be given the option of an executive mayor structure as such a structure would afford a greater separation of powers. Further, within this system the mayor could claim an election mandate to govern on the basis of his/her policy platforms, offering true representation. There would also be greater cohesion between the mayor and the council manager in this model.

Remedies

A number of options are offered here to improve relations between councillors and management in Local Government and to assist in providing a better governance structure within Local Government.

Option 5: Improve councillors' remuneration.

Councillors should be treated more like corporate board members and more adequately remunerated, perhaps in the form of a salary plus fixed expense allowance rather than a fee and a reimbursement of expenses. This could be funded by reducing the number of councillors.

Pros

- Would encourage councillors to reduce their external workloads to better concentrate on council business;
- Would promote a better choice of candidates at elections; and
- Would provide greater recognition of the increasingly sophisticated demands upon councillors.

Cons

- Would increase council costs;

- Would be difficult to formulate adequate amounts of remuneration for different councils in an equitable manner; and
- Would reduce community representation if the total number of councillors was decreased to fund pay rises.

Option 6: Permit a dual choice of governance structures for councils.

The LG Act would be amended to provide for a choice of governance structures as outlined below:

Corporate board structure

The standard structure would be similar to the current structures except that:

- The maximum number of councillors would be seven, so they could interact like a board rather than a parliament;
- The standard position would be for an electorate of the whole with a referendum being required for a division into wards; and
- The election for mayor would be biennial or triennial instead of annual, with the option of a direct election of mayor, subject to a referendum.

Corporate governance principles, with appropriate modifications, would apply to the performance of a council.

Parliamentary/executive structure

Large councils (say over 50,000 people) would have the option of a structure that applied the separation of powers doctrine as between the legislature and the executive:

- Up to 15 councillors may be elected on a ward basis;
- Popular election of the mayor at the same time as councillors are elected;
- The mayor may appoint an executive committee of three persons selected from the councillors with the option of secondments from outside the council; and
- The general manager, selected by the mayor and endorsed by council, would report to the mayor.

The role of council would be to:

- Approve the strategic plan, the management plan and the budget;
- Approve the policies and development controls of council; and
- Question the executive and hold inquiries into policy and performance issues.

Pros

- Would permit greater flexibility for councils to choose the optimal structure for their situation;
- The parliamentary/executive structure (by separating powers) would make it easier to comply with good governance principles; and

- Would result in clearer lines of authority, better accountability and thereby less corruption.

Cons

- Would introduce governance inconsistencies across Local Government due to the differing structures permitted;
- Would require a major reorganisation of Local Government that would be disruptive; and
- Would increase councillor secretariat support services and thereby costs.

In the first model the council would act as a governing board chaired by the mayor with a general manager as CEO, while in the second model the council would be a representative chamber that held the mayor and an executive committee (council ‘cabinet’) to account for the management of the council. This dual structure would resolve the present dilemma that councils often have too many councillors to act as a board, yet can’t act as a parliament because there is no political executive to hold to account.

10.4 ADMINISTRATIVE PERFORMANCE

Requirements

The general manager of a local council should ensure that it operates appropriately, effectively, efficiently, prudently and accountably. A council should operate appropriately by pursuing agreed objectives and strategies that meet community needs and priorities. It should operate effectively by meeting its goals and satisfying its residents. Efficiencies are pursued by keeping unit costs low. Councils should act prudently in relation to their financial management, risk management and statutory compliance.

Accountability is achieved through publicly communicating results against targets and regularly consulting with the community via representative opinion polls and public meetings to ascertain key concerns and priorities. Policy direction should also take account of future needs, so that budget development can also allow for future priorities rather than concentrating solely on current needs.

Reality

Comparison with other institutions

The Independent Inquiry contracted QMI Solutions Limited (QMI 2005) to assess the relative management capacity and performance of NSW Local Government against other public institutions and private entities. Specifically it wanted to know:

- How do NSW Local Government management practices stack up against those in both service organisations and other Local Governments internationally?
- How do Local Government management practices compare between metropolitan, regional city and rural councils?

QMI Solutions is a registered provider of the PROBE benchmarking methodology that was developed by the London Business School and is now owned by Comparison International Limited. PROBE has been applied to thousands of private and public organisations throughout the world, including Local Government, with the result that it now has a large database against which any organisation's performance can be benchmarked.

Multi-level and cross-functional teams of four to seven staff from nine NSW local councils participated in the PROBE benchmark. Each council used a self-assessment questionnaire and with the aid of an independent QMI facilitator each team reached consensus scores on council capacity in terms of management practices (leadership, service processes, people, and performance management) and overall performance. The scores for each practice area and overall performance were aggregated and averaged and then compared to a world-class business model and benchmarked against other PROBE surveyed organisations worldwide within the data set. In particular, the international database also contains results for 26 organisations in the local authorities/public administration sector, which are primarily located in the United Kingdom including Ireland.

The benchmarking process was voluntary and took a full day to complete. Three councils volunteered from each of the metropolitan, regional city and rural groupings of councils. As a condition of obtaining their cooperation the Inquiry undertook not to disclose the names of any of the nine councils that agreed to participate in this performance review.

The process was completed between 26 October and 14 December 2005 and is the first time local councils within Australia have undertaken this benchmarking exercise.

Results are based on a 'gap analysis' methodology looking at the difference between observed results, the performance of the international comparison sector and current international best practice for service organisations.

The benchmarking process was voluntary and so the local authorities assessed were a self-selecting sample and therefore not taken at random. It was felt that there was an unintentional bias in the sample of councils benchmarked. Due to the very tight timeframe in which this exercise was performed it is possible that the councils who volunteered first tended to be the more dynamic and progressive organisations. It is very likely that such councils would perform better than a randomly chosen group of councils. Nevertheless, the LGSA, which helped enlist volunteers for the exercise, insists that the councils surveyed are not atypical of the Local Government categories to which they belong.

The following conclusions were drawn by QMI on the basis of the councils sampled:

General observations

- If the sample is genuinely representative, Local Government in NSW is well placed in terms of management capacity and capability. The overall performance score of 76 per cent and the overall practice score of 68 per cent puts the nine councils (on average) in the 'contender' for world-class category within the PROBE business best-practices model. This compared with an average score for 17 comparable Local Government authorities in the PROBE international database of 62 per cent (performance) and 60 per cent (practice) and an average score for all PROBE surveyed organisations worldwide of 67 per cent (performance) and 62 per cent (practice). The relative position of the nine

councils against overseas LGAs and service organisations in general is shown in Figure 10.1;

- Within the NSW Local Government sample, metropolitan councils generally performed better than regional councils, which in turn did better than rural councils. QMI mainly puts this down to larger councils being better resourced than smaller ones;
- Nearly all participants viewed the benchmarking process as a worthwhile and valuable exercise. All participants were asked to complete an evaluation form and the average result over a range of questions was over 8 out of 10 points;
- It was apparent that most councils were not thinking or behaving like a customer focused organisation in a competitive environment. Aspects of the culture still centre on the concept of a captive (monopoly) customer base. This is evidenced by distinctions drawn between “customers” and “ratepayers” who were not one and the same;
- There was little formal measurement of customer satisfaction. Larger councils were performing some measurement of satisfaction with existing services, but no organisation was endeavouring to formally identify customers’ expectations of councils; and
- There was generally poor understanding of what constitutes ‘value’ in the eyes of the customers of councils.

Sector and database comparison

- Overall, the service performance and maturity of management practices were found to be above those of both the Local Government sector and service organisations generally in other parts of the world;
- Compared to the Local Government sector internationally the results are strong with processes, procedures and practices some eight points above the sector average and performances a solid 14 points above;
- Similarly, compared to all service organisations in the database, the councils sampled have rated well with practices some six points above the database average and performances nine points above;
- In all instances scores on existing practices lag those on performance. This indicates a degree of vulnerability in the performance results since these results are not fully underpinned by matching practices;
- The councils sampled demonstrated consistently high scores in the indices relating to their people practices. It was obvious that councils generally recognise the benefits in looking after staff to provide a basis for effective service delivery;
- On the other practice indices (leadership, service processes and performance management) all councils performed very well, though on performance management and leadership shire councils scored in the third quartile compared with others in the international database; and
- Though, as stated at the outset, the council sample may have been unintentionally skewed towards better performing councils, the results nevertheless suggest that such councils are capable of holding their own against other government and private organisations both in Australia and worldwide.

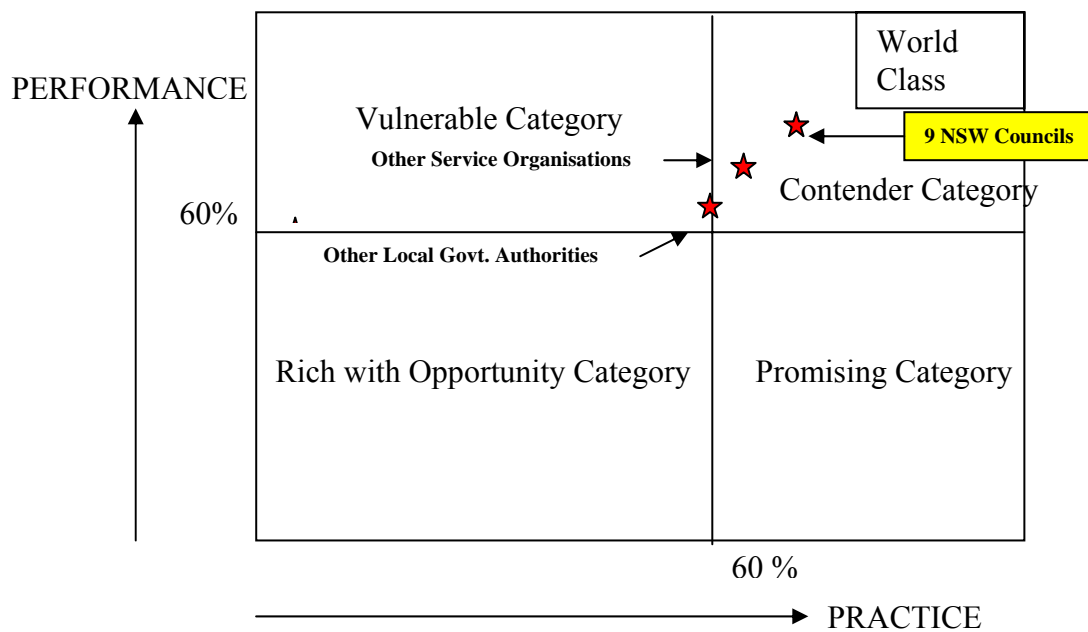
Comparison between council groups

- Understandably there was substantial variability in the benchmark outcomes between councils, with the metropolitan councils outperforming the regional councils, which in

turn did better than the rural councils. QMI put this down to greater resource availability on the part of the larger councils to implement modern management practices;

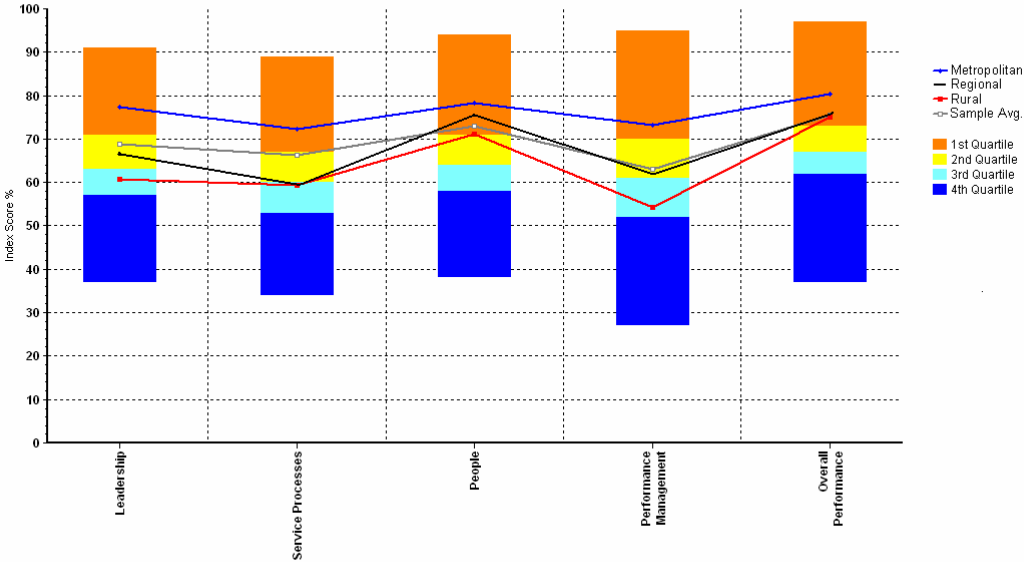
- The metropolitan group results were generally very strong relative to the sector average with all results falling within the top 25 per cent of all organisations in the database;
- Regional city results were generally above average and within the top 50 per cent of organisations;
- Rural council results were around sector average, falling below average in the performance management area, but returning top-25 per cent scores for people practices and also for the service performance delivered to customers;
- Generally, larger organisations require more structure and documentation in their practices to facilitate communication across the organisation. This was evident in the larger metropolitan councils, but it does not mean that smaller organisations, which do not score as well in these practice areas, must necessarily lag in performance or the service results they achieve for customers.

Figure 10.1: Average management practice and performance ratings of a sample of NSW councils compared with other local government authorities and service organisations worldwide.



Source: QMI Solutions 2005, pp4-5.

Figure 10.2: Average management and performance ratings of a sample of NSW metropolitan, regional and rural councils compared with other service organisations worldwide.



Source: QMI Solutions (2005, p14).

The following recommendations were made by QMI on the basis of these conclusions:

- The concept of customer value – what it means to ratepayers, how it is created and increased, and defining customer expectations versus satisfaction with existing services should be further explored and defined;
- From these customer expectations a comprehensive set of balanced performance measures can be developed unique to each organisation as a mechanism to provide clarity of goals and as a way to communicate desired standards;
- Although some service standards exist across most of the councils surveyed, they are largely structured around historical or internal data rather than providing a comprehensive understanding of customer value based on real customer survey data. Once customer expectations are understood, leverage can be achieved by exploiting the strong link that exists between high levels of employee satisfaction and high levels of customer satisfaction; and
- Most participants deemed the benchmarking process valuable. Worldwide this process has been used as a focus and driver of change and improvement. It is felt that a broader application of diagnostic benchmarking to all NSW councils would produce valuable results.

Corporate overheads

The Inquiry contracted D.B. & A.B. Maxwell, Consulting Accountants to assess and compare overhead costs of NSW local councils.

The NSW Council on the Cost and Quality of Government (CCQG) has developed a set of 'Corporate Overheads Percentage Benchmarks' for use in assessing and comparing the efficiency of corporate support services within State Government agencies. CCQG considers that corporate overheads as a share of agency staffing and expenses are an indication of the extent to which an agency minimises its back-office costs in favour of concentrating on front-line services. In general, agencies with low corporate overheads are more cost efficient. The corporate overheads percentage is normally separately calculated for staffing levels and for expenditure, and involves detailed assessment of staff activities, and (usually) reference to source financial information. (CCQG 2004)

The consultants were asked to prepare a modified version of the CCQG back-office analysis of a representative sample of 58 councils using available 2005 financial data. No staffing analysis was prepared as suitable staffing information was not available.

The purpose of the exercise was to enable the Inquiry to form an opinion of the general efficiency of councils' 'back-office' operations, and to assess the impact of the operations on the future sustainability of NSW councils generally.

Councils generally adopt activity-based costing (ABC) procedures, which means that by apportioning back-office costs to front-line services it makes it difficult to unravel corporate overheads. Furthermore, the extent to which ABC is applied varies considerably. Small councils have particular difficulty in attributing overhead costs to different functions where employees are involved in multiple functions.

All councils apply a direct labour on-cost recovery percentage (DLO per cent) in relation to outside staff directly involved on grant works. Almost all councils apply the same DLO per cent for all works undertaken by outside staff; a few also apply a DLO per cent to some, or all, other classifications of staff. The accuracy of the calculation of the on-cost percentage varies. A few councils apportion costs similar to fringe benefits tax in accordance with the relevant employee's activities - most do not.

Despite these variations, there is a general consistency in procedure for all councils with variations being in the level of detail to which the procedures are taken. Other important influences towards consistency include the transfer of staff between councils, and the swapping of ideas and experiences at regional meetings of the finance professionals' special interest group of the LGMA.

The CCQG analysis of corporate overheads of NSW government agencies (CCQG 2005b, p15) found the level of corporate overheads varies in NSW government agencies depending on size (as measured by staff numbers), with acceptable benchmarks for the proportion of total organisational staff or expenses engaged in corporate services activities being:

- Large agencies (1,000 FTEs³⁸) 8-10 per cent;
- Medium sized agencies (350 to 1,000 FTEs) 10-12 per cent;
- Small agencies (less than 350 FTEs) 12-14 per cent; and
- Very small agencies (less than 100 FTEs) 14-16 per cent.

Government overheads were examined on two bases: staffing (FTEs) and expenses. Based on staffing, the corporate overhead ratios of the agencies reviewed vary between six per cent and 27 per cent with the average score being 17 per cent. Corporate overheads will vary depending on the type of business and the degree to which technology is applied to its transaction processing. Based on an analysis of expenses, reviewed NSW government agencies used between seven per cent and 39 per cent of their expenses on corporate overheads. The average overhead expenses ratio was about 18 per cent. (CCQG 2005b, p16)

Contrary to the findings of the CCQG review, the Maxwell study found that the corporate efficiency of councils decreases as employee numbers increase. However, given that the calculation was based on limited and variable information, further detailed work on councils' overhead costs in accordance with the CCQG Corporate Overheads Costing Guide would be necessary to validate this finding. An alternative conclusion might be that smaller councils, which are largely rural, have a leaner back office because they are suffering a more acute shortage of skilled employees engaged in accounting, transactions processing, clerical duties, information gathering, systems improvement, policy analysis, planning and regulation.

The following is an expanded set of Corporate Overhead Percentage Benchmarks developed by CCQG since the 2004 Annual Report.

Table 10.1: Desirable corporate overhead percentage benchmarks for general government agencies

Number of FTEs	Size of Agency	Benchmark Minimum	Benchmark Maximum
< 25	Micro	20%	25%
26 – 100	Very Small	14%	16%
101 – 350	Small	12%	14%
351 – 1000	Medium	10%	12%
1001+	Large	8%	10%

Source: CCQC 2005b, with supplementary data on Micro provided by Premier's Department.

The calculation of the Corporate Overhead Percentage for the sample exhibited the following characteristics.

³⁸ FTE means Full Time Equivalent. Full-time staff are equivalent to 1.0 FTE, while staff who work fractionally equate to an FTE of less than 1.0.

Table 10.2: Corporate overhead cost ratios for a representative sample of 58 NSW councils, 2004/05 financial statements

	Very Small	Small	Medium	Large	All
No of Councils	22	22	12	2	58
Minimum	2%	5%	4%	Sample too small	3%
Maximum	17%	19%	19%		19%
Mean	9.09%	10.50%	11.67%		10.38%
Median	9.5%	10%	13.5%		10%
95% Confidence level for range	7.86% -	9.34% -	8.91% -	N/A	9.29% -
	10.32%	11.66%	14.42%		11.53%

Source: Maxwell 2006a.

The percentages shown suggest that corporate efficiency in the very small, small and medium councils outperforms the State Government benchmarks (and even more so most state agencies' results) in each category. The data demonstrates that significant variability exists between councils, and this reflects both variations in efficiency, and variations in the derivation of the source data. Given that the sample analysed represents 38 per cent of councils preparing 2004/05 annual financial statements, and given that the variability is consistent irrespective of the type of analysis (employee numbers, location, DLG groups and area/population), Maxwell Consultants conclude that the corporate efficiency of NSW councils of all sizes, populations and locations is at least comparable to, and possibly better than, equivalent sized State Government agencies.

Another way of interpreting these results is that councils' corporate support services are insufficient for meeting the normal clerical, supervisory, policy and strategic functions of a back to middle-office of a modern organisation. This may explain why, at the dozen Local Government workshops held by the Inquiry, the burden of state regulatory and reporting imposts was one of the most cited complaints.

Many councils may simply not have the depth of professional and clerical resources to cope with external demands that other public and private institutions accept as a burdensome, but normal cost of doing business. If this is correct, councils will have to look to increased resource sharing or to acquiring costly extra staff. Alternatively, state and Commonwealth governments should review the necessity for all the data, information returns, policies and plans that their agencies demand of Local Government.

Relevance of key performance indicators

The performance of Local Government has an important impact upon the overall performance of the economy in a number of ways. Local Government is an important provider of final outputs such as environmental management and community services. A number of intermediate outputs provided by Local Government such as waste management and recycling services, planning and development services and the provision of essential infrastructure are also relied upon by the private sector. This has created a longstanding interest in assessing the performance of Local Government, and in identifying the likely determinants and outcomes of variations in performance (Worthington 2003, p176).

Three methods of performance appraisal currently co-exist in Australian Local Government. Councils themselves evaluate the efficiency and effectiveness of their service delivery to

assist in monitoring, controlling and improving productivity and quality through the use of internal performance measurement. Economists have used data envelopment analysis (DEA) to evaluate performance in specific Local Government services in particular areas, such as libraries, waste management, the planning function, and regulatory services. These studies provide relative measures of performance allowing the ranking of individual councils in specific service areas.

However, by far the most important and the most commonly used method of evaluating Local Government performance in Australia is comparative performance indicators. These form the basis on which councils are assessed by their respective Departments of Local Government and the method by which policy decisions are made.

The NSW Department of Local Government (DLG 2004a) requires councils to submit annual reports on their performance covering 18 different areas. It then uses the information to compile tables on the comparative performance of councils based on 30 key performance indicators (KPIs) grouped into eleven categories (rating, financial, corporate, library services, domestic waste management and recycling services, water supply services, sewerage services, planning and development services, environmental management and health services, recreation and leisure services, and community services).

The KPIs include such things as average rate per assessment, council's debt service ratio, number of equivalent full-time council staff, library circulations per capita and kilograms of recyclables per capita. The data is presented under a scoring system for each indicator. Individual councils are further broken down into categories to allow for comparison with other similar councils. The Department of Local Government also produces an historical time series for these performance indicators (DLG 2004b).

The KPIs are mostly single, rather than multiple, input and output indicators. Often more than one indicator is applicable to a single service area. Therefore, each measure is only an incomplete appraisal of the overall performance of the service. (Dollery 2005e, p4)

The DLG also creates 'monitoring lists' of councils which appear to be experiencing financial difficulty. These councils are deemed by the department to be 'at risk' and they may have various sanctions imposed.

A recent academic study would suggest that the 'monitoring lists' bear little relationship to the actual financial risks of councils as measured by the six key financial performance indicators prescribed by the department (Murray, 2005).

Dollery argues that since its inception in 1995, NSW KPIs data collection has served to demonstrate that:

- (1) Significant differences occur between councils within the same DLG grouping with respect to the same KPI;
- (2) Different councils within a DLG grouping differ widely across the various indicators, with some councils 'doing well' in some indicators and disappointingly on other indicators;

- (3) If departmental groupings are ignored, significant differences exist between the total sample of councils in NSW, with councils in all clusters sometimes ‘doing badly’ in particular areas, regardless of cluster status; and
- (4) Broad trends may nevertheless be discerned between departmental cluster groupings taken as a whole.

Dollery believes that the DLG’s KPIs fail to effectively account for all the circumstances which impact upon council performance, including the sheer diversity between councils, especially between metropolitan, regional and rural councils. Other limitations are that there is an emphasis on collecting financial information at the expense of qualitative assessment, and that as a consequence, service effectiveness tends to be disregarded. He argues that these indicators should not be used as the basis for policy decisions nor to instigate punitive measures against all councils.

By contrast Young (2005) believes that the DLG’s KPIs contain a subset of useful ‘dashboard indicators’ that can alert the public to problems in key results areas for Local Government. However, Young argues that while the DLG’s KPIs reasonably distil general governance and financial information there is room for better measurement of other areas. Young believes that the DLG’s KPIs should be reviewed using logics analysis, a device for identifying key performance indicators by tracking critical community outcomes back to core services and their main underlying outputs and inputs.

Young has done such an exercise for every policy area of the NSW general government sector (CCQG 2005a). He was commissioned by the Inquiry to attempt a similar exercise for three councils (one metropolitan, one regional and one rural) that could form the basis for a generic performance management framework for all councils (Young 2005, p6).

His accountability matrix contends that councils have four generic goals; a sustainable environment, a sustainable economy, a sustainable society and sustainable governance. Under each of these goals he found between one and two outcomes (e.g. under environment one is protection of biodiversity), around half a dozen key results (e.g. under sustainable society one is care and management of companion and stray animals) and between two and six key services (e.g. under sustainable governance one is financial management).

He then proposed performance indicators for each key outcome (e.g. under sustainable governance one is the total tax burden per resident as a percent of income), for each key result (e.g. under adequate safety infrastructure on local roads he suggests per cent of schools with adequate pedestrian safety provisions) and for each key service (e.g. under sustainable economy the number of DAs determined).

He does not attempt to refine or reduce his results to a shorter list of dashboard indicators because while he drew on documents supplied by the three councils his assignment stopped short of brainstorming with the councils their input and his results. Hence his report should not be considered a definitive answer to what is the most appropriate set of performance indicators for councils. Rather, it is an illustration of how to use logics analysis to develop a council’s outcomes hierarchy and from this choose KPIs relevant to those outcomes and their underlying drivers.

Dollery (2005e, p7) is not convinced that the DLG's KPIs are helpful. He argues that any performance measurement system of this kind should allow for the spatial distribution of Local Government such as distance, climatic conditions, socioeconomic characteristics and regional price variations. Further, structural constraints imposed by the State Government such as rate pegging and accounting frameworks must be taken into account. Local electorate idiosyncrasies and other non-discretionary factors should also be encompassed.

Dollery (2005e, p7) argues that to develop appropriate performance measures for Local Government an exercise should be conducted with a sample of metropolitan, regional and rural councils to identify the outcomes, outputs, processes and inputs they generally have in common. Additionally, the primary causal links between each of these building blocks in their service delivery should be taken into account in order to devise the most appropriate performance indicator for each result.

One way forward, therefore, would be for NSW Local Government, through the DLG and/or LGSA, to develop a common reporting framework, which allows for different contexts, to measure the efficiency and effectiveness of council services based on:

- A sustainability framework which encompasses environmental, economic, social and governance considerations;
- Common outcomes and key result areas which reflect a unified vision and shared strategies, while highlighting areas of concern; and
- Common measurement indicators to promote benchmarking.

A separate set of indicators dealing with financial management and risk are proposed in Chapter 11.

Financial (and non-financial) indicators must have performance targets or ranges (i.e. floors/ceilings) to be meaningful. For instance, some years ago Sydney Water discovered that the incidence of cryptosporidium and giardia in its water supplies had risen alarmingly, yet no one inside or outside the authority knew what a safe tolerance level was, let alone whether the microscopic parasites were alive or dead. Other water authorities in Australia avoided this scandal, but not the risk, simply by not measuring these bacteria in their water. The lesson from this episode was not just about the importance of measuring the right thing, but knowing what benchmarks to use for 'ringing the bell' if indicator results changed.

In Chapter 11 the Inquiry suggests possible financial management indicators for councils to use as well as appropriate benchmark tolerance ranges for each indicator. Clearly a similar exercise should be done for non-financial indicators derived by logics analysis either at an individual council or whole of Local Government level.

Council performance targets or benchmark ranges can be derived by using previous performance as the baseline and/ or the results of a comparable group of councils as a benchmark. Setting quantifiable goals can be a powerful instrument for improving service outcomes as the British Government has demonstrated with its civil services (Allan 2005).

Remedies

While Young's study concluded that the existing Department of Local Government KPIs are reasonable 'dashboard indicators', the general consensus, outside the NSW Department of

Local Government at least, appears to be the current key performance indicators relating to Local Government are inadequate and misleading. Development of new, more relevant performance measurements is desirable. These indicators should be formulated following a process by which the commonality of outcomes, outputs, processes and inputs is identified through a sample of metropolitan, regional and rural councils.

Ideally, this should be done at a national level via relevant peak bodies as it is in other arenas such as medicine. Australia-wide acceptance and application would help give any new measures real legitimacy. If this is not feasible and NSW wishes to take the lead, the NSW Department of Local Government and the LGSA, with input from Premier's Department and the NSW Treasury - each of which have experts in logics analysis - should jointly undertake the exercise to ensure both State Government and councils' acceptance.

Option 7: The DLG in conjunction with the LGSA devise new key performance indicators (KPIs) for NSW Local Government using logics analysis to derive an outcomes hierarchy showing the causal link between core council goals, desired results, intermediate results and services.

Any such exercise should draw on the expertise of the NSW Premier's Department, the NSW Treasury and/or private consultants in using logics analysis for deriving KPIs in other parts of the public sector.

Pros

- Would provide more effective and realistic performance measurement of local councils that recognises the particular challenges facing Local Government (e.g. skills shortages in rural councils compared with metropolitan or regional councils) and allow for individual differences between councils (e.g. councils in growth areas versus ones with declining populations);
- Would provide a robust basis for benchmarking the performance of councils against other councils of a similar type (e.g. all rural councils);
- Would improve monitoring of areas such as social policy, which are not effectively covered under the existing KPIs;
- Would result in indicators that cater for multiple inputs and outputs and outcomes;
- Would give local councils greater 'ownership' of KPIs; and
- Would improve the accountability of councils for service delivery against targets or benchmarks.

Cons

- Could be difficult and expensive to design and implement since customised outcomes hierarchies and KPIs would be needed for different types of councils in order to suit their special circumstances;
- Would require each council to introduce a reliable management information system which many do not have the resources and skills to do;
- Could encounter resistance from councils that might perform poorly on such measures;
- Would need independent auditing of results in order to be credible to third parties (e.g. state and Commonwealth agencies and general public); and
- Would impose an additional cost on councils.

Option 8: Each council's administrative capacity and performance be benchmarked regularly (say every three years) with the results used to identify the most pressing organisational improvements for incorporation into the management plan.

Pros

- Would enable councils to undertake a meaningful SWOT (strengths, weaknesses, opportunities and threats) analysis of their operations;
- Would save money by directing organisational reforms towards the areas that would generate the most benefit;
- Would improve the operational performance of councils by strengthening management practices related to planning, policies, people and processes; and
- Would demonstrate to the general public and State Government that Local Government was serious about improving its administrative capacity and performance.

Cons

- Would be expensive and time consuming if a more sophisticated benchmarking methodology than PROBE was used. (Note that the QMI survey took less than two days to do in each council that participated);
- Being a self-assessment tool, a survey such as PROBE is open to manipulation by management and staff notwithstanding the involvement of an external facilitator and other safeguards for detecting and adjusting for fraudulent answers; and
- There would be public pressure to disclose the performance results, which could embarrass a council unless its management was proactive in addressing any problems uncovered.

10.5 COUNCIL SIZE AND COOPERATION

Requirements

Each council should have the structure, personnel, policies, processes and systems to:

- Understand its client and stakeholder needs;
- Meet its statutory obligations;
- Undertake strategic and operational planning;
- Foster an ethical and motivated work culture;
- Communicate internally and externally;
- Specify job tasks and accountabilities;
- Develop support and appraise staff;
- Manage assets, risks and finances; and
- Monitor and report council performance.

Reality

Economies and diseconomies of scale

Past Local Government amalgamations were based on the primary rationale that larger councils with larger populations could exhibit greater economic efficiencies. Larger Councils would enjoy lower administrative costs, smaller unit costs of representation, increased

purchasing power, improved utilisation of depots, plant and equipment and draw from a more diverse funding base.

However, there appears to be uncertainty about whether such a concept has a sound empirical basis, especially in a modern economy where speed rather than scale is becoming the key determinant of business success and thanks to technology the minimum scale needed for efficient output is becoming much smaller (Baldock 2000, ch.1-2; Allan 2001, pp75-76 and 78-79).

Byrnes and Dollery (2002a) examined the known studies on economies of scale in municipal service provision. In an assessment of the international research they discovered that 29 per cent of studies found evidence of a non-linear relationship between population size and costs (what economists call a U-shaped average cost curve), nine per cent found no statistical relationship between per capita expenditure and population size, eight per cent found evidence of economies of scale, and 24 per cent found actual diseconomies of scale. The authors concluded therefore that there was a great deal of uncertainty about whether economies of scale exist, or could exist, in Local Government service provision.

Byrnes and Dollery believe that the over-riding flaw in these international studies is that they do not correctly measure cost output. Population size cannot stand as a proxy for output unless the two are positively related. To make the assumption that the number of council residents is an accurate indicator of total need ignores the fact that population needs may be quite diverse across Local Government areas depending upon the demographics. Areas heavily frequented by non-residents such as shoppers, tourists and commuters also skew per capita expenditure as councils need to serve them, too. For instance, the people who use the Sydney CBD far outnumber its permanent residents.

Further, measuring the total cost of a particular service is not straightforward, especially if overheads and administration costs are taken into account. The authors also found that population size says little about the extent of various capital outputs being used to produce goods and services. For instance, a rural council with a small population but a large land area may have a huge road network that inflates its expenses because of high maintenance and depreciation.

As part of their worldwide literature review, Byrnes and Dollery considered nine Australian studies. Taking into account the problems with the methodology identified above and the assumptions used, the authors concluded that no satisfactory Australian study has yet been conducted into economies of scale in municipal service provision, largely because most studies focused on total per capita costs of councils rather than the average cost of delivering a specific council service under different volume scenarios.

This raises the question as to whether it is actually possible to investigate economies of scale in Local Government, given the huge obstacles to doing meaningful research in this area. Such problems include the fact that current accounting systems make it exceedingly difficult to compare operational costs between councils. Further, in Australia the relationship between economies of scale and the democratic structures of Local Government is complex and difficult to model in any satisfactory way. The massive differences in the geographic size of Local Government areas raises further impediments.

Bombala Shire Council (Rawlings 2005) recently reviewed the implications of reforming their boundaries with a view to creating an amalgamated council combining Bombala Shire, Cooma-Monaro Shire and Snowy River Shire Council.

While Bombala Shire Council identified some potential cost savings in the area of governance, as a result of an amalgamation through a reduction in elected representatives, the cost savings were calculated to be in the region of only \$50,000. It was considered that these savings would be offset by increased travel allowances for councillors and other support costs.

Similarly, modest savings could potentially be made through the reduction of management and administrative staff. However, smaller councils such as Bombala do not have excess capacity within each specialty and rely on other areas within the organisation to fill shortfalls. Dr Peter Chen in a report discussing the de-amalgamation of Delatite Shire Council in Victoria (Chen 2001) estimated that administration costs in an amalgamated Local Government system would range from 15 per cent upwards. As Bombala Shire Council currently has administrative costs of 20 per cent, a saving of 5 per cent may arguably be achieved. This amount would only equal around \$41,500 per annum.

It was also calculated that with amalgamation there would be a reduction in grant funding available to the area, primarily through a drop of 14 per cent in Financial Assistance Grants. This would leave the community with lower external resources and necessitate an increase in rates and other charges in order for the current level of services to be maintained.

Data provided by Rawlings (2005, pp5-10) indicates that households in Local Government areas with a population of 5,000 or less currently pay significantly less in residential rates than those in areas with populations of 30,000 (the projected size of the amalgamated council) so any amalgamation was unlikely to result in lower residential rates. This trend also applied in relation to business rates

The Bombala study could not find other savings in the areas generally identified as most likely to provide economies of scale – such as information technology, printing or road construction and maintenance. However, a marginal saving of around \$65,000 per annum (five per cent) in purchasing was identified as a possible outcome of merging with neighbouring councils.

Allan (2003 p77) compares actual financial savings arising from amalgamations in other states to the originally predicted amounts. He argues that Victorian amalgamations of councils in the 1990s realised only an 8.5 per cent reduction in expenditure, which was largely as a result of competitive tendering, not because of mergers. The Kennett Government had promised a savings ratio of 20 per cent. In South Australia a saving of 17.4 per cent was originally envisaged by a government taskforce, but the State's Local Government Reform Board identified savings of only 2.3 per cent.

It is interesting to note that since the mid 1990's rates in Victoria have been growing faster than in other states (Brooks 2006, p9), suggesting that the original rate cut may not have been sustainable.

The Inquiry investigated the extent to which a council's operating costs per capita were related to its population size (Byrnes 2006; Allan 2006). This was not just of academic

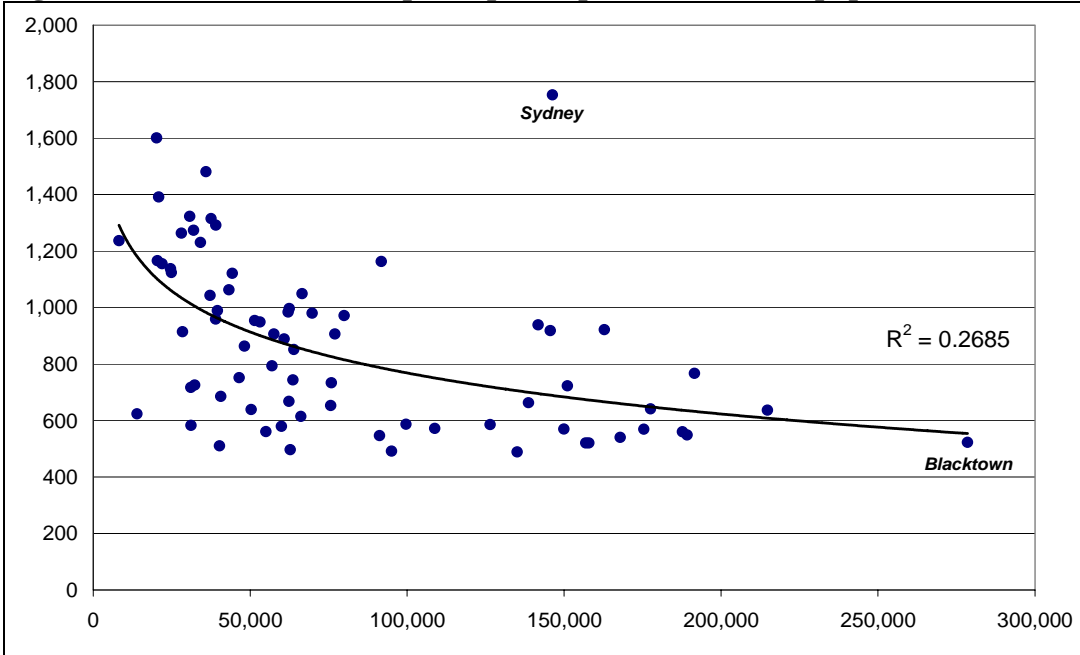
interest, since, as already mentioned, the case for forcible amalgamations is based on the notion that bigger councils have lower unit costs of producing services.

The investigation was broken into two parts, metropolitan and regional urban councils on the one hand and rural councils on the other. In each case the extent of correlation between council unit costs and population size was measured by both arithmetic (straight line) and logarithmic (curved line) correlation coefficients (R^2). A result of one (1.0) would mean a perfect correlation while that of zero (0) would mean no fit existed.

On a straight trend line (see figure 7.2 of Chapter 7), the R^2 was 0.22 for metropolitan and urban councils suggesting a very weak link between population size of councils and unit costs. Even if the two outlying councils (Sydney, which services a CBD with few residents, and Blacktown, which services a mega-population) were excluded, the result was still only 0.30.

Using a curvilinear trend line (figure 10.2 below) gave a better R^2 result for urban and metropolitan councils (0.26 for all councils and 0.36 excluding Sydney and Blacktown). However, the statistical correlation was still very weak, suggesting that factors other than population size are the major determinants of cost efficiency in NSW metropolitan and large regional centres.

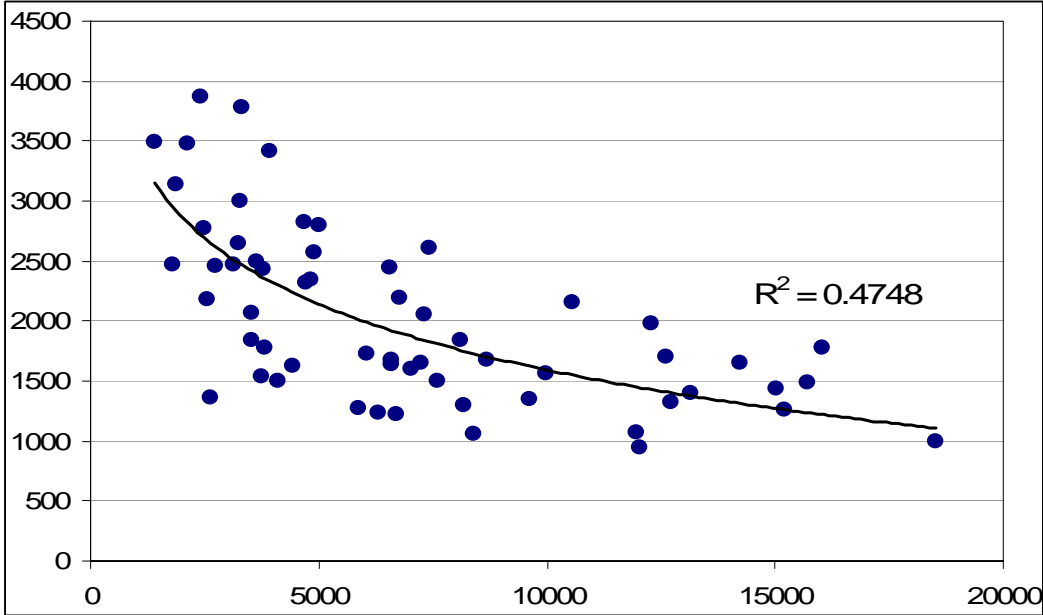
Figure 10.2: Urban councils' per capita expenditure versus population size, 2003/04



Source: Allan, P. 2006.

The research then addressed rural councils, that is, councils of under 20,000 inhabitants with population densities of 30 or fewer people per square kilometre whose urban centres account for no more than 90 per cent of their residents. The straight line trend (see figure 7.3 in Chapter 7) gave an R^2 score of 0.39, while the curvilinear one (figure 10.3 below) gave a score of 0.47, still weak by statistical standards, but better than for urban councils. This implied that rural councils have per capita costs more aligned to population size than urban areas, but with little direct causal relationship.

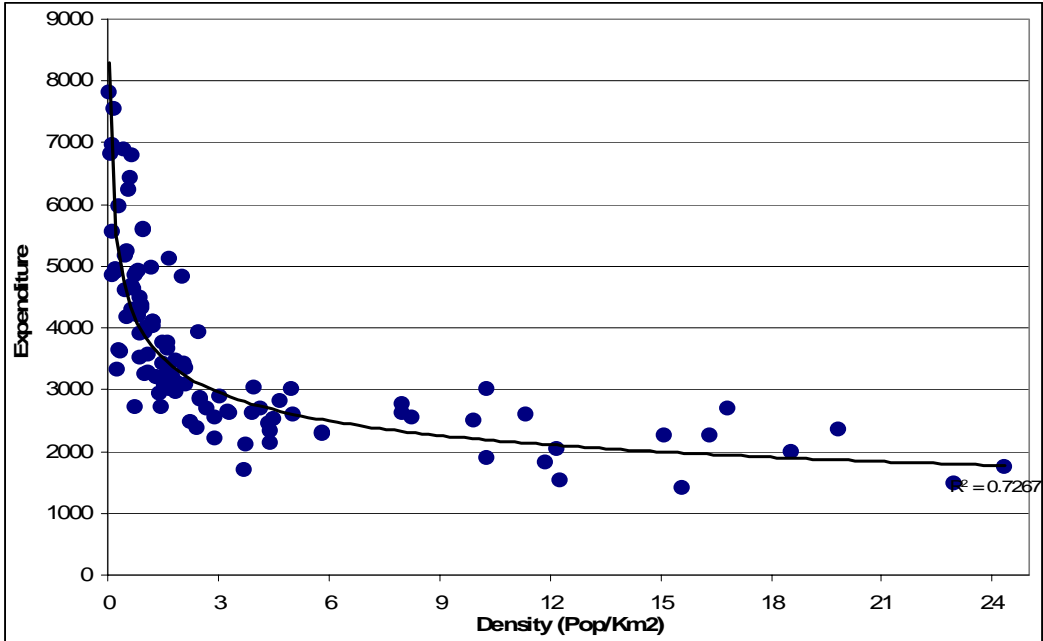
Figure 10.3: Rural councils' per capita expenditure versus population size, 2003/04



Source: Allan, P. 2006.

The research study then tested the extent to which low population density might explain the higher costs of councils (whether rural or urban) whose population was small compared to the areas they administered. The results were dramatic (figure 10.3). The R^2 was 0.73, a very high correlation by statistical standards. This would suggest that amalgamating country councils without also forcibly merging their populations into large urban centres so that residual rural areas would require fewer council services (something prohibited in a democracy and that in any event would undermine the councils' agrarian economic base) might not achieve significant cost savings.

Figure 10.4: Outlying rural and urban councils' per capita expenditure versus population density (per km), 2003/04



Source: Allan, P 2006.

The Inquiry's literature review and statistical analysis would suggest that amalgamating smaller councils may not be the panacea that many imagine it to be. However, this is not to say that resource sharing or private outsourcing does not offer possible efficiencies if applied to individual council inputs, intermediate outputs and final services.

With resource sharing between councils, account needs to be taken of the average costs of managing and performing a particular service in one locality (say a shared services centre) versus doing so in disparate offices and depots in many localities. Evidence from other public and private organisations would suggest that some back-office services (e.g. general accounting, financial transaction processing, general procurement, treasury management, legal work, etc) could be done more efficiently and effectively on a shared basis (Acumen 2006)

A recent survey of the views of 28 council general managers undertaken on behalf of the Inquiry (Byrnes 2005f, table 2) suggests possible front-line activities where rural and regional councils could either pool or share service provision on a regional basis (e.g. fire protection, emergency services, health administration and inspection, noxious plants, museums, water and wastewater, tourism and area promotion, saleyards and markets). By contrast, front-line services nominated as requiring very strong local place management and delivery (e.g. public cemeteries, public conveniences, public halls, swimming pools, sporting grounds, parks and gardens, and real estate development) would be less amenable to pooled or shared services.

Other research (Allan 2006) cites many activities in the back and front offices as well as in the field-work of councils that are possible candidates for joint resource sharing or third party outsourcing. However, in such exercises councils need to safeguard their middle offices where the 'steering' (strategy, policy making and acquisition) rather than the 'rowing' (task processing or service delivery) is done.

Areas that particularly lend themselves to outsourcing to shared service centres or independent specialist providers have the following characteristics (see Allan 2001, pp39-40, for a more detailed explanation of each facet):

- Low core capability (i.e. task involves 'rowing' rather than 'steering');
- High supplier availability;
- Low task complexity;
- High scale economies;
- Highly specialised technology; and
- Low asset specificity (i.e. limited term contract does not require supplier buying an expensive long life asset).

Structures for extracting greater operating efficiencies from councils are explored in more detail below.

Structures to optimise performance

Given that achieving increased economies of scale and greater efficiencies through forcible amalgamation seems questionable, and generally not desirable from a Local Government or community perspective, how might resource sharing and regionalised provision of particular services be used by Local Government to enhance the efficiency and effectiveness of municipal service delivery?

Dollery & Johnson (2005) have identified a number of models that could be used here:

- *Ad Hoc Resource Sharing Models* are voluntary arrangements between geographically adjacent councils to share resources on an ad hoc basis whenever and wherever the perceived need arises. Resources may be employees with specialist skills and knowledge, capital equipment, administrative services or entire operational services such as waste disposal and removal. This model is generally driven by economic imperatives.

The authors argue that ad hoc resource sharing enjoys several advantages over other methods of enhancing Local Government efficiency. In addition to its inherent flexibility, the arrangement may arise spontaneously and voluntarily between councils. It should combine detailed localised knowledge with genuine cost savings, as a council would not enter into an agreement if it were not in its best interests. The model also does not impinge on council independence and autonomy and arrangements can easily be terminated if they do not prove to be mutually productive. However, the lack of a solid institutional foundation means that arrangements can be easily changed or terminated at the whim of councillors or senior staff.

- *Regional organisations of councils (ROCs)*. ROCs are voluntary groupings of neighbouring councils. They generally consist of between five and 15 councils and are governed by a board consisting of two members from each constituent council.

Membership of a ROC confers several potential benefits on participating councils. Meetings encourage the free exchange of common concerns and potential solutions; joint forums foster the development of common policy decisions; ROCs facilitate the coordination and rationalisation of the activities of their members; and promote mutually beneficial schemes to achieve economies of scale and scope.

- *Strategic Alliances*. Several councils in the New England, Hunter and Central West regions of NSW are attempting resource sharing through what they call 'strategic alliances'.

The Hunter Integrated Local Area Council, which comprises 13 local councils, has established a shared service centre known as Hunter Councils Incorporated. The shared service centre provides centralised records storage, joint procurement, training and development, waste processing and regional environmental planning, design, management, database and mapping services. It has four divisions: Administrative Support; Regional Purchasing; Organisational Development; and Environment. It employs 32 staff.

The New England Councils' Strategic Alliance consists of four councils that share 14 functions covering community services, customer services, finance and budgets, HR, IT, land information and GIS, leases and investments, internal audit and risk management, plant and fleet operations, records, regulatory and planning functions, review, supply and procurement, and works operations. Each council general manager takes responsibility for a select portfolio of functions on behalf of all councils in the alliance. The arrangement works by using a common IT enabling system across all councils plus shared service teams drawn from each council that report directly to the general

manager responsible for the functions they perform on behalf of the alliance. (Uralla 2006, attachment A)

Another example of cooperation is the Councils of Wellington, Blayney and Cabonne in the Central West region that have established a joint records storage facility and joint purchasing and use of assets such as trucks and tractors.

- *A Joint Board Model* of governance has been developed by the Shires Association of NSW (SANSW 2004) in response to the forced amalgamation program adopted by the NSW Government in 2003. The joint board model aims to retain the autonomous existing councils and their current spatial boundaries, while merging their administrative staff and resources into a single organisation in an attempt to achieve greater economies of scale and scope. Assets remain the property of the individual council.
- *Virtual Government*. This is a model for Local Government service provision (Allan 2001 and 2003) that attempts to deliver the democratic benefits of smaller Local Government with the efficiency of delivering some services on a larger scale. It proposes that routine 'back office' type functions such as processing rate notices can be carried out by a joint service centre or outsourced to an external provider serving multiple clients, thus delivering savings from scale economies. More complex functions and those that require greater judgement and local place management should remain within the council.

Councils would be required to transfer those services that would benefit from being handled on a larger scale to a shared services centre, which would be jointly owned and governed by its member councils. The shared services centre would be run strictly as a business providing contracted services to participating councils on a fee-for-service basis. (Allan 2003, p79).

The above models partially or fully resemble a 'shamrock' organisation (Handy 1989), which has become a popular structure elsewhere in business, government and NGOs (Allan 2003, pp78-79). In its pure form a 'shamrock' organisation consists of three elements (Byrnes 2005d, p6):

1) the core workers (the central leaf of the shamrock) – professionals, technicians and managers versed in the mix of policies, processes and systems that is unique to the organisation; 2) the contractual fringe – contract workers and outside organisations who perform corporate support tasks that are generic to all industries, such as financial transaction processing, general accounting, general procurement, legal services and treasury functions; and 3) the flexible labour force consisting of temporary staff for peak workloads or specialist professional assignments.

The Queensland Local Government Association engaged consultants to suggest ways by which resource sharing could deliver reduced costs. The authors suggested the following criteria should be considered when identifying services to be delivered on a joint basis: (KM Management Consulting 2005):

- Retain processes that require unique ad hoc local knowledge and are strategic;
- Outsource non-strategic, low risk, rule based activities or high volume transaction processing;
- Share or outsource to gain access to latest technology without ongoing significant capital investment or a requirement for specialist expertise; and

- Share or outsource to gain expertise, which the council could not otherwise afford.

The general manager of Sutherland Shire Council is sceptical of the likelihood of resource sharing becoming widespread without external pressure (Sutherland 2006, p3):

Resource sharing is a more palatable option than amalgamation, however, it may need to be driven by government, or preferably the Local Government (LGSA) itself. The opportunity for resource sharing is considerable; what is required (is) for this option to be driven to get over the self preservation/ protection that currently exists with some Councils...

Local Government has had no such direction and in many cases Councils have not taken hard decisions to ensure that works and services are provided at best possible cost and value.

Local Government must ensure and be able to demonstrate that its house is totally in order in terms of providing residents with quality services at the best possible cost. It is only then that Councils should complain about lack of funding.

Enlargement of water and sewerage facilities

The Inquiry explored whether economies of scale could be achieved by merging water and sewerage utilities. Expert opinion was negative, due to the fact that water pumps and sewerage treatment works are locally based with short networks. However, if within a reasonable distance of a water-rich council there were councils that were water poor, it could be to their mutual advantage to establish a joint water reticulation authority.

The shared service approach could also be applied to a service that requires two types of expertise, such as water and wastewater management in rural and regional NSW. The problem of hiring suitably qualified staff in the regions is becoming increasingly acute. Skilled professionals tend to gravitate to the cities where they can easily receive higher salaries. As a result, two neighbouring councils may find it difficult to each employ an engineer and an economist.

Rather than struggling to recruit two experts each, the two councils could join forces, and recruiting budgets, in order to employ one engineer and one economist at attractive salaries to service the whole region. Provision of the service could still be the responsibility of each council, and the attendant revenue streams could still accrue to each council, but in a time of a national skills shortage, councils in rural and regional NSW would have a better chance of hiring skilled staff, and reap the benefits of scale economies.

There are other 'back-office' costs that may be cut by using a jointly owned shared services centre or outsourcing to a third party (e.g. using the local electricity authority to process water rate notices).

The alliance or shared service approach is strongly supported and encouraged by DEUS.

Remedies

Shared service centres offer a model whereby the overall cost of service delivery in Local Government may be reduced through an examination of each service and whether it can be delivered or dealt with externally to the council. The Inquiry's survey of selected NSW council general managers indicates that there are a significant number of services that may be

sustained and strengthened through shared service centres. Studies of other sectors and organisations show that back-offices are also well placed for pooling, sharing or outsourcing work (Allan 2003, p79).

Option 9: The DLG and the LGSA jointly undertake a functional analysis to determine which, if any, of the services that councils deliver would benefit from being provided by contractually-based resource sharing or outsourcing arrangements including jointly owned shared service centres and sizeable third party providers (e.g. regional electricity authorities).

Pros

- Would identify which precise activities offer economies of scale;
- Would enable separation of ‘purchasing’ from ‘provision’ that would encourage closer scrutiny of unit costs of the services contracted;
- Should result in greater efficiency and effectiveness of service delivery;
- Would promote more accountability and transparency of Local Government administrative processes; and
- Would provide a viable alternative to forced amalgamations

Cons

- Would require comprehensive service contracts and monitoring arrangements with external suppliers (be they a shared service centre or a third party provider) that councils may not have the expertise to negotiate and sustain;
- Would require a commercial board for the joint venture if it was not to be politicised;
- Would imply less autonomy by councils in service provision, though not service acquisition; and
- Would involve implementation costs before any savings were generated.

11. LOCAL GOVERNMENT FINANCES

11.1 INTRODUCTION

Whether NSW councils are financially sustainable is at the heart of this Inquiry. This chapter examines the financial performance and position of NSW councils, both at present and into the future, and the vital role of financial information, professional management and good governance in ensuring long-term sustainability.

It starts with a review of published financial data on councils, then looks at appropriate key financial performance measures and benchmarks for assessing them. Next it examines the financial situation and outlook of councils and finishes by examining the significance of financial management policies and practices as well as financial governance and guidance.

11.2 COUNCILS' FINANCIAL DATA

Requirements

Information about a council's finances, whether reported externally or internally, should be relevant in the sense that it has the capacity to make a difference in its informational or accountability role.

The key financial aggregates necessary for the analysis of a council's financial position and performance are set out in Table 11.1.

Table 11.1: Key financial aggregates

Income items	Expense items	Capital flows	Asset items	Liabilities items
Rates revenue	Operating costs (employee expenses, superannuation, other non-employee expenses, current grant expenses, subsidy expenses and capital grant expenses)	Capital expenditure, distinguishing between capital expenditure on: (i)The renewal or rehabilitation of existing assets; and (ii)New or enhanced assets	Cash and investment securities – externally restricted	Interest bearing liabilities
Fees and charges				
Grants from other governments for non-capital purposes				
Other operating revenues				
Interest				
Gain from the disposal of assets	Borrowing costs	Grants from other governments for capital purposes	Cash and investment securities – other	Other liabilities (provisions, other)
	Depreciation			
	Loss from the	Other grants & contributions	Other financial assets (receivables, investments accounted for using equity method, other)	Memo item: Infrastructure renewal backlog
			Non-financial	

Gain from interests in joint ventures/ associates	disposal of assets	provided for capital purposes	assets (property, plant and equipment, inventories)	
Gain on revaluation of non-financial assets	Loss from interests in joint ventures/ associates	Assets donated		
		Revenue from disposals of non-financial assets		

The information reported should be timely, and have the capacity to confirm or correct prior expectations about past events or to assist in forming, revising or confirming expectations about the future.

As recognised in the NSW Code of Accounting Practice and Financial Reporting (NSW Code) (DLG 2005a), financial information should also be:

- Consistent – where the information reported enables valid comparisons to be made for the council over periods of time;
- Comparable – where the information reported enables valid comparisons to be made between different councils; and
- Reliable – where the information reported corresponds with the actual underlying transactions and events, is capable of independent verification and is reasonably free from error and bias.

The financial information reported should distinguish between a council's general government activities (funded largely from taxes, statutory fees and fines) and its commercial activities (funded largely from user charges).

Relevant financial information should be provided in forecast form as well as in historical form.

Prospective information should be available in both narrative and quantitative form. The narrative form should provide an assessment of prospects focussing on anticipated changes in the economic environment. The quantitative form should provide of information about the council's future financial position and performance based on assumptions about future economic conditions and courses of action.

Reality

NSW councils are required to provide general-purpose financial reports prepared in accordance with the NSW Code (DLG 2005a), involving the accounting and financial reporting requirements embodied in the *NSW Local Government Act 1993 (LG Act)* as well as the applicable Australian Accounting Standard (AAS27).

The published financial statements report at a consolidated level (combining a council's general government activities and its commercial activities). While the NSW Department of Local Government (DLG) and the NSW Department of Energy, Utilities and Sustainability (DEUS) collect some disaggregated information, these data are not generally published.

That said, the information that is gathered by these State Government agencies for local water utilities via special purpose financial reports is more comprehensive than the general purpose financial reporting by councils for their general government activities.

The general purpose financial reports published by councils are entirely historical. Only some councils prepare medium- to long-term (10 year) financial plans, and these vary in quality.

Information on some key financial aggregates is not published as a matter of course, notably annual capital expenditure particularly its renewals and enhancement components. Related to this, there are no comprehensive council-by-council figures on the extent of any infrastructure renewal backlog.

Disappointingly, the introduction of AAS27 in 1993 has not given rise to comparability in financial reporting, as the information reported does not always enable valid comparisons to be made between different councils. Councils do not always apply standard accounting methods and practices, making comparisons between councils and over time problematic. Year-to-year consistency can also sometimes be an issue.

Financial information published by the Australian Bureau of Statistics (ABS) is prepared under a reporting system that differs in certain respects from the NSW code and is only available with lag. Although accrual accounting principles are applied under the ABS Government Finance Statistics (GFS) system, some of the definition, recognition, measurement, classification and presentation principles and rules differ from those applying under Australian Accounting Standards (AAS).

Unlike NSW State Government agencies, councils are not required to regularly update the value of their physical assets. As a result, all but a handful of councils report their asset values at cost. As pointed out in one submission (Maxwell 2005, p15):

In accounting terms, “at cost” means “beware – this figure is a historical accident”.

This is significant, as Access Economics (Access 2006, p16) has pointed out:

Annual depreciation based on historical cost will understate both the consumption of capital by that year’s ratepayers and the amount of capital expenditure necessary during the year in order to restore the council’s non-financial assets to the service potential apparent at the beginning of the year in question. Where asset values and so depreciation are based on historical cost, the calculated operating surplus (deficit) will be systematically overstated and of little value from an inter-generational equity point of view.

It may not be strictly correct to say that councils are valuing their assets at historical cost, but it is certainly true that all but a small number have not re-valued their assets since accrual accounting was introduced over 10 years ago. Nor do councils use consistent depreciation rates for identical assets operating under similar conditions, despite the provision by DEUS of the Reference Rates Manual which provides appropriate guidance for estimating the useful life of water and sewerage assets. This results in not only a miscalculation of a council’s true annual depreciation charge, but also an under-estimation of its infrastructure renewals gap (i.e. the gap between the rate at which infrastructure depreciates and the amount spent on restoring its service capacity).

In discussing this issue the Local Government Auditors Association of NSW (LGAA 2005, p1) pointed out that:

...there still exists a range of useful life estimates for (apparently) similar assets and this results in depreciation charges that also show wide variation and impact upon each council's operating result. This can make comparison between councils a difficult task.

Differences are also understood to exist between councils regarding the extent that capital-related expenditure is expensed or capitalised. This gives rise to the possibility that some recorded maintenance expense involves spending that extends the life of existing assets.

There are apparent differences too between councils in the accounting treatment of grants received from other spheres of government (Maxwell 2005, p3):

In 2004, thirteen Councils adopted this practice [allocating a portion of their Financial Assistance Grants (FAGs) as capital revenue], and in one instance this represented over 37% of total FAGs received.

Given the many inadequacies of external financial reports, it is not surprising that in-house financial briefing papers for councillors vary in quality with no agreed best-practice simple format.

There are several reasons for these deficiencies:

- While Local Government financial reporting was substantially upgraded with the introduction of AAS27, too much discretion is left with councils in applying accounting policies. Not only are there some grey areas in accounting standards requiring interpretation, audit processes can play only a limited role in promoting comparability and consistency in accounting approaches across the Local Government sector;
- There does not appear to be a general consensus within Local Government about the relationship between certain key financial aggregates and council performance;
- There seems to be a lack of will at the NSW State Government level to bring Local Government reporting requirements (especially in the area of asset valuation) into line with those for state agencies; and
- State wide or national monitoring of the financial performance of Local Government is at minimal levels, with the DLG and the National Office of Local Government seemingly reluctant to pursue uniform reporting agendas similar to that imposed on state governments by the Commonwealth in the early 1990s. However, this does not apply to water and sewerage services where an annual NSW Performance Monitoring Report has been published by DEUS since 1986.

Remedies

Option 1: Develop standard (internal and external) reporting practices and methods, via extension/modification of the NSW code.

The standardisation of key accounting policies, such as asset valuation, depreciation and maintenance, and adoption of common practices for classifying capital outlays as new, renewal or maintenance, could be targeted. In addition, a common high-level chart of accounts and a common workforce profile database, each with agreed definitions of terms as exists in the NSW general government sector, could be adopted.

Pros

- Would assist councils to better exercise the discretion they have under accounting standards;
- Consistency and comparability of council accounts would be improved; and
- Credible advocacy by any industry group is only possible with a consistent database.

Cons

- Standard practices erroneously assume there is a single correct way of addressing some accounting issues;
- Deciding who should take the lead (professional organisations or Local Government) may prove difficult; and
- Use of standard practices could see a tendency to adopt one-size-fits-all solutions.

Option 2: Adopt a fiscal transparency code.

Something akin to the ‘*Charter of Budget Honesty*’ at the Commonwealth level or the International Monetary Fund’s fiscal transparency code (IMF 2001) could be developed for application by NSW councils. The objective could be to ensure that all information used to calculate the key financial performance indicators was:

- Reliable and capable of audit;
- Comparable among councils; and
- Consistently measured over time.

Pros

- A fiscal transparency code for Local Government would be aimed at achieving a degree of transparency broadly equivalent to the uniform reporting framework implemented Australia-wide at the State Government level; and
- Transparency in external financial reporting is vital for ratepayers and the community generally to be satisfied about the sustainability of a council’s long-term financial performance and position.

Cons

- Extending the DLG’s comparative performance information may be more cost-effective, by including both forecasts of key variables and encouraging uniform reporting of the various (non-accounting standards) key analytical aggregates; and
- Such a code could double-up on AAS27.

11.3 COUNCILS’ FINANCIAL KPIs AND BENCHMARKS

Requirements

Each council’s financial reports should be accompanied by disclosure of relevant key financial performance indicators (financial KPIs). The financial KPIs should provide an indication of the state of both:

- A council's *financial position*, which involves the state of its balance sheet, and so the relative level – and composition – of its assets and liabilities; and
- A council's annual *financial performance*, which involves the state of its annual operating statement, and especially the size of relevant annual surpluses or deficits.

Comparative financial KPIs should be provided on an estimates basis for the current year, actuals for the three previous years, and projections for at least the coming three years based on continuation of current policies, allowing users to undertake meaningful analysis of the council's finances.

The financial KPIs used should have a strong predictive relationship with the degree to which a council's finances are likely to be sustainable in the long term, being based upon generally-accepted key analytical balances, with the principal choices indicated in Table 11.2.

Table 11.2: Key analytical balances

Analytical balances	Definition	Denominator for comparative ratio
Net debt	Interest-bearing financial liabilities less holdings of cash and securities other than externally restricted cash and securities	Total operating revenue
Net financial liabilities	Total liabilities less financial assets net of holdings of externally restricted cash and securities	Non-financial assets plus holdings of externally restricted cash and securities
Net interest expense	Annual interest expense less interest earnings on holdings of cash and securities other than externally restricted cash and securities	Total operating revenue
Operating surplus/(deficit)	Operating revenue before capital amounts less operating expenses less depreciation expense less net interest expense	Own-source revenue
Net borrowing/(lending)	Capital expenditure less capital revenues less depreciation expense less operating surplus/(deficit)	Annual capital expenditure on new or enhanced assets
Annual renewals deficiency	Annual depreciation expense less annual capital expenditure on existing assets	Annual capital expenditure on renewal or rehabilitation of existing assets
Renewals backlog	Cumulative past annual renewals deficiencies	Non-financial assets

A council should set target values, and where appropriate also minimum (floor) and maximum (ceiling) values, for each of these financial KPIs, based upon the following broad principles:

- A council's financial position is in a healthy state if its net financial liabilities (and associated debt) are at levels where the resultant net interest expense can be met comfortably from a council's annual income (i.e. by current ratepayers) at the existing rating effort;

- A council’s general government operating financial performance is appropriate if it is running a modest operating surplus before capital revenue³⁹ indicating that costs incurred in the year in question (including both routine maintenance and annual depreciation of physical assets) are at least being met by today’s ratepayers and not being transferred to tomorrow’s ratepayers, with rates revenues more than sufficient to finance current operations. Where an operating deficit persists, rates revenues are insufficient to finance current operations and liabilities must be incurred (or financial assets liquidated) in order to finance those operations;
- The operating financial performance of a council’s commercial entities is appropriate if its earnings before interest and taxes (EBIT = operating surplus before net interest expense and taxes and dividends paid) are around the weighted average cost of capital.
- A council’s capital performance is appropriate if its capital expenditure on the renewal or replacement of non-financial assets broadly matches the cash flows generated to cover annual depreciation expense; and
- A council’s overall (i.e. capital and operating) financial performance is satisfactory if its annual net borrowing as a proportion of capital expenditure on new (growth) non-financial assets does not put any long-term pressure on achievement of the council’s targeted net debt or net financial liabilities ratios.

Prudential parameters used by financial analysts to assess the credit worthiness of general government authorities and government trading enterprises provide a basis for establishing the extent to which councils and their commercial entities could take on debt and other liabilities without being fiscally imprudent.

The benchmark values for Local Government’s financial KPIs suggested on this basis are indicated in Table 11.3. The values shown apply to an ‘average’ NSW council. Accordingly, these values should be adjusted on account of each council’s individual circumstances (e.g., whether it is a developed or a developing council, or a growing or a declining council), within the upper and lower ‘safe’ limits also provided in the table.

Table 11.3: Indicative benchmarks values for council financial KPIs

Financial Key Performance Indicators	Average Council Actual	Proposed Council Target	Proposed Upper limit	Proposed Lower limit
Net debt as % of total revenue	10.5%	100%	150%	50%
Net financial liabilities as % of total capital employed	2.2%	10%	15%	5%
Net interest expense as % of total revenue	0.6%	15%	20%	7%
For general govt activities: Operating surplus as % of own-source revenue	-4.5%	5%	10%	0%

³⁹ To ensure the operating surplus analytical balance is useful for the key purpose of assessing whether a council’s annual operating revenues (rates, charges and grants) are sufficient to recover its annual costs of operations, the operating surplus must be calculated *before* account is taken of capital revenues. Capital revenues are intended to finance capital expenditures, being expenditures that are not included in the calculation of the operating surplus, and not the annual costs of operations. AAS27 requires a council to show two operating surpluses on its operating statement; one including and the other excluding capital revenues. By legitimising the inclusion of capital revenues in the operating account, AAS 27 permits a council to portray its financial performance as stronger than it really is.

For commercial activities only: EBIT as % of non-financial assets	0.9%	5%	7%	3%
Net borrowing as % of capex ⁴⁰ on new or enhanced assets	1.3%	50%	60%	30%
Annual renewals deficiency as % of renewals capex	40.2%	0%	10%	-10%
Infrastructure backlog (\$M) as % of total infrastructure assets (estimated at fair value)	8.1%	0	1%	0%

If used, each of these ratios should be adhered to, not just some of them.

Reality

While AAS27 does not require disclosure of performance indicators, the NSW code makes them mandatory. However, the financial indicators prescribed under the NSW code principally focus on balance sheet indicators (among them the unrestricted current ratio) which by themselves generally are uncertain predictors of the sustainability of a council's long-term finances.

Encouragingly, the NSW code does require that, where there has been a change in council policy, which affects the calculation of performance ratios, the change in policy must be stated, and ratios under the new policy provided for the current period and the three previous years.

The Local Government Managers Australia, NSW Division (LGMA)'s Financial Health Checklist (LGMA 2002) does include some operating statement indicators such as the operating result before capital revenues and asset maintenance as a percentage of maintenance required. It also provides some limited guidance on the 'safe' range for certain ratios:

- The unrestricted current ratio⁴¹: <1:1
- Renewals capital expenditure as % of depreciation: <100%
- Asset maintenance as % of maintenance required: <100%
- Gross debt service costs as % of total revenue: >20% for developing councils, and >15% developed councils.

Nevertheless, considerable confusion exists within Local Government about the interpretation of operating statement deficits and surpluses, in particular whether operating surpluses should be measured before or after capital revenues. AAS27 and the NSW code include both operating surplus measures in a council's operating statement, with no guidance provided at all as to the relevance of each concept.

The DLG does not disclose the financial tolerance limits it uses – if any – for monitoring council performance against the indicators required under the NSW code.

This range of deficiencies can be attributed to a number of factors:

⁴⁰ Capex means capital expenditure.

⁴¹ This ratio excludes restricted assets from the current assets numerator and specific purpose liabilities from the current liabilities denominator of the usual current ratio, where such restrictions or specific purposes are imposed by regulations or other externally imposed requirements.

- Scepticism about the funding (and interpretation) of depreciation, importantly but not entirely associated with uncertainties about the accuracy of current measurement of depreciation (Maxwell 2005, p13):

...the depreciation charges currently reported in NSW Council annual financial statements is an inadequate basis for assessing financial sustainability, even as a proxy for future renewal and replacement of assets. ...the Inquiry should make full allowance for the deficiencies inherent in the information.

...Further, we understand that a common characteristic of infrastructure assets is that it takes approximately 50% of the useful life before the first 10% of wear indicators become visible.;

- The absence of a consensus within Local Government about desired financial performance ‘outcomes’; and
- A lack of analysis of past financial position and performance data for NSW councils, due in part to limited availability of comparable and consistent data.

Remedies

Option 3: The *Local Government Act (NSW) 1993* could be amended to enshrine certain ‘golden rules’ for financial sustainability (financial governance) purposes.

Such ‘rules’ would include a requirement for councils to run an operating surplus without including capital revenues in operating income and after depreciating assets regularly re-valued at ‘fair value’. Other ‘rules’ would be guided by Table 11.3.

Pros

- A clear operating surplus target is enshrined in the New Zealand *Local Government Act 2002 (section 100)*. A similar requirement in NSW would force councils to be accountable for the sustainability of their long-term finances; and
- There is insufficient financial management (as opposed to accounting) expertise in councils to expect them to make these judgements on their own.

Cons

- This would involve the State Government taking initiative in areas where there should be Local Government leadership, especially by the LGSA or the LGMA; and
- Financial targets and rules should instead be left to Local Government to decide in consultation with the community.

Option 4: The LGMA’s Financial Health Check be re-issued with an expanded list of financial KPIs and an appropriate range of lower and upper benchmarks for each KPI. The expanded list should be determined collaboratively by the LGMA, LGSA, DLG, LGAA and other relevant bodies.

Pros

- This would put Local Government in control of devising necessary financial targets and rules; and
- Such a vehicle would provide the maximum degree of flexibility in choosing and explaining the suggested financial targets and rules.

Cons

- General agreement on the key indicators would be required first, and, even if agreement was reached, this may delay promulgation of expanded financial KPIs.

11.4 COUNCILS' FINANCIAL SITUATION

Requirements

For a council's financial position to be assessed as 'currently healthy', the council:

Should be a modest net debtor, with borrowings (debt) comprising a minority of the total capital invested in the council's infrastructure and other assets; and
The associated interest expense burden should not be a substantial proportion of the council's annual operating revenues.

For a council's financial performance to be assessed as 'currently healthy', and to involve a margin of comfort to cope with the usual assortment of financial risks and financial shocks, the council:

- Should generally be running an operating surplus rather than an operating deficit;
- Should not have a significant infrastructure renewal backlog, and its annual capital expenditure on the renewal or replacement of existing assets should on average over time be about the same level as the council's depreciation expenses; and
- Annual net borrowing should not be putting any pressure on the council's targeted net financial liabilities ratio.

A council should be able to easily compare its financial KPIs with those of other councils (both in NSW and interstate), in order to help it better establish benchmarks and to refine its own financial targets.

A council should have knowledge of and understand the main factors explaining recent trends evident in the values of its own financial KPIs.

Reality

Net financial liabilities

Indications are that the balance sheets of most councils are exceptionally strong, displaying very low levels of indebtedness to other sectors of the economy. On average, the net financial liabilities of councils are little more than two per cent of their total assets. Only a handful of councils exceed 10 per cent. This compares with 25 per cent for the NSW State Government and over 50 per cent for many large asset-intensive businesses in the private sector.

Table 11.4 provides an indication of the latest state of the level of net indebtedness of NSW councils.

Table 11.4: Net financial liabilities ratio ^(a), 30 June 2005

	Total ^(b)	General government activities	Commercial activities ^(c)
NSW Councils	2.2%	2.1%	2.7%
NSW State sector	25.1%	29.3%	20.9%

Source: Access 2006, p5.

(a) Total liabilities less financial assets net of (in the case of NSW councils) holdings of restricted cash and securities; expressed as a percentage of the sum of non-financial assets plus (in the case of NSW councils) holdings of restricted cash and securities. (Note that Access Economics included both internally and externally restricted assets in its analysis which may have resulted in a slight understatement of the net financial liabilities position.)

(b) For the state, excludes the State Government-owned financial corporations

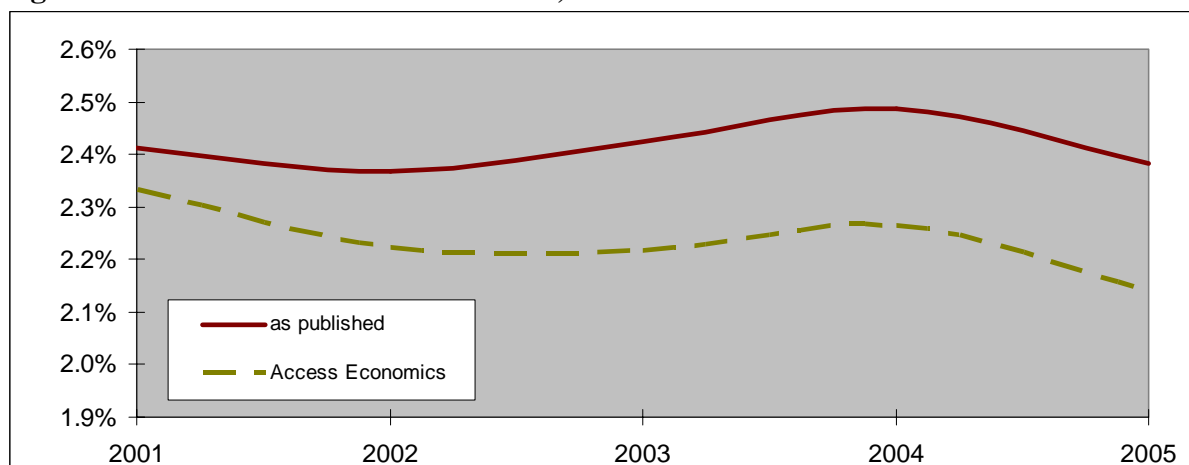
(c) For NSW councils, only covers their water businesses. It has not been possible to extract other commercial activities from the data included in general government activities.

Access Economics' advice is that, while the 25 per cent ratio for the state (non-financial) sector as a whole seems to sit comfortably with the NSW State Government (and earns it a triple-A credit rating), the ratios being targeted in its two sub-sectors are likely to be the reverse of the currently observed ratios, with the target ratio being in the order of 20 per cent for the state's general government activities and 30 per cent for the state's commercial activities (Access 2006, p5).

The smaller size of councils relative to the NSW State Government would imply the target ratio applicable to NSW councils being a little lower than these State Government targets. For example, Christchurch City Council has formally adopted a ratio of 12 per cent. There is little doubt, however, that the net financial liabilities ratios exhibited by NSW councils on average are substantially lower than appropriate benchmark levels.

Figure 11.1 indicates that, for councils' general government activities, the published average net financial liabilities ratio has been steady or declining in recent times. Also shown is the effect of adjusting the value of all council assets onto a current cost basis (as undertaken by Access Economics).

Figure 11.1: Net financial liabilities ratio, ^(a) at 30 June



Source: Access Economics.

(a) Net financial liabilities as a percentage of the sum of non-financial assets and holdings of restricted cash and securities.

Note: The "published" net financial liabilities ratio is based on published asset values. The "Access Economics" ratio is based on estimates of council assets valued at closer to current cost.

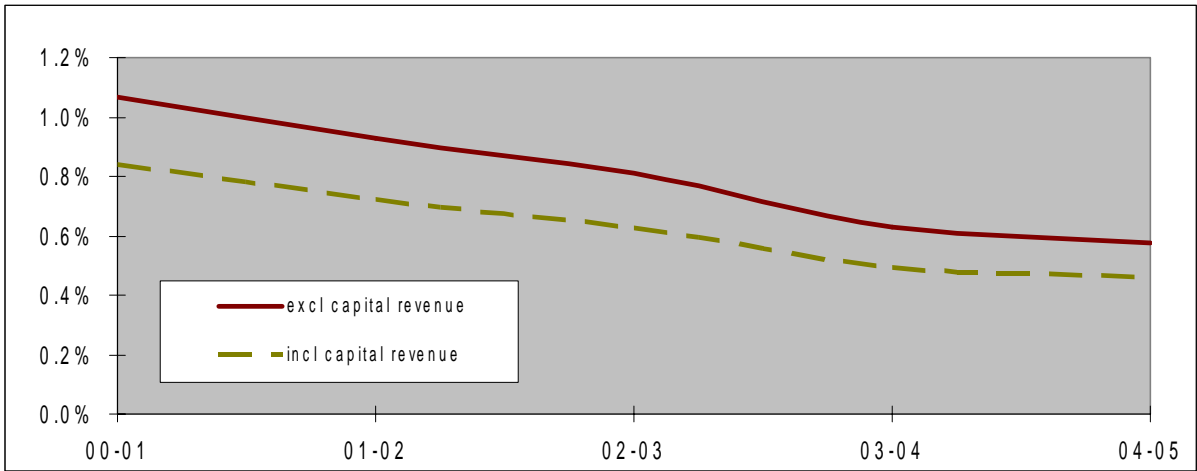
There is a range of ratios currently evident among NSW councils, with the maximum ratio being just over 10 per cent and with one in every 10 councils in fact being net creditors as indicated by them recording negative ratios (Access 2006, pp6-7).

Net interest expense

Accordingly, the interest burden on NSW councils is very low compared to that facing the NSW State Government and large asset-intensive businesses in the private sector.

Figure 11.2 shows recent trends in the net interest ratio, and the effect of including or excluding capital revenue from the total revenue denominator, for NSW council’s general government activities.

Figure 11.2: Net interest expense ratio ^(a)



Source: Access Economics.

(a) Net interest expense as a percentage of total revenue.

Note: The “excl capital revenue” and “incl capital revenue” ratios are based on excluding and including, respectively, capital revenue in the ratio’s revenue denominator.

Operating surplus

In contrast to their strong financial positions, the operating statements of most councils indicate that annual deficits are common. Excluding their commercial activities (water and sewerage businesses), the Inquiry has been advised that councils on average run an operating deficit of almost five per cent of their total own-source revenues (Access 2006, p17).

Table 11.5 provides an indication of the latest state of the operating financial performance of the general government activities of NSW councils.

Table 11.5: Operating surplus ratio, ^(a) 2004-05

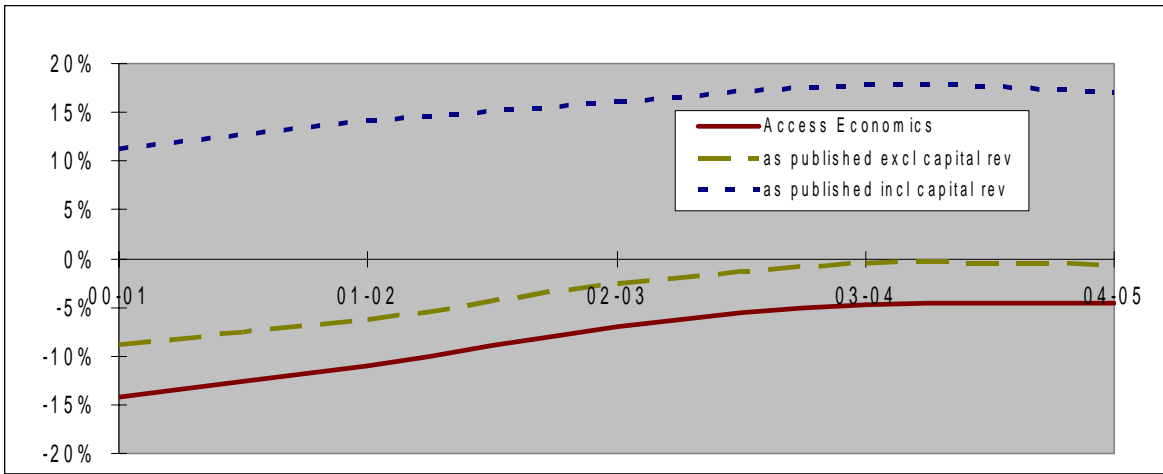
	Total ^(b)	General government activities	Commercial activities ^(c)
NSW Councils	-3.0%	-4.5%	6.5%
NSW State sector	1.5%	4.6%	-4.7%

Source: Access Economics.

- (a) Operating surplus before capital revenues as a percentage of total own-source operating revenues.
- (b) For NSW councils, the operating surplus ratio is based upon estimates of annual depreciation where council assets are valued at closer to current cost, similarly to the basis used for State Government agencies.
- (c) For the State, excludes the State Government-owned financial corporations.
- (d) For NSW councils, covers their general government sector, but for trading enterprises includes only their water businesses.

The above conclusions are dependent on the operating surplus measure used as well as the basis for measuring depreciation. Councils’ statutory accounts include operating surpluses both before and after capital revenue, and application of depreciation rates to physical assets based on values that for the vast majority of councils have not been updated at least since accrual accounting was introduced in the mid 1990s. Figure 11.3 compares recent trends for NSW councils’ general government activities in operating surpluses both before and after capital revenues and, in Access Economics’ case, both before capital revenues and after an adjustment to offset the under-estimation of council depreciation on account of council asset values being outdated.

Figure 11.3: Operating surplus ratio ^(a)



Source: Access Economics.

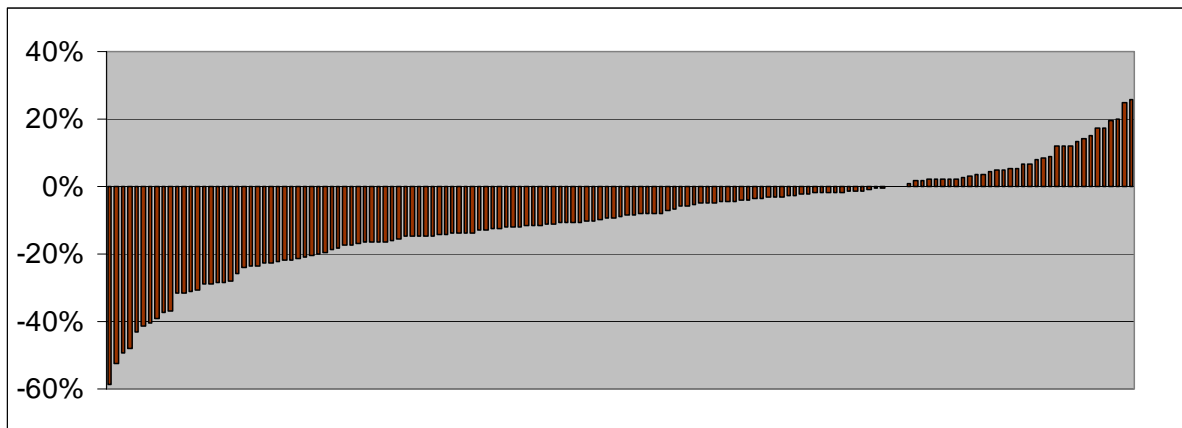
- (a) Operating surplus as a percentage of total own-source operating revenues.
- Note: Both “published” operating surplus ratios are based on published depreciation figures. The “Access Economics” ratio is based upon estimates of annual depreciation were council assets valued at closer to current cost.

Despite the element of estimation involved, the Inquiry considers the adjusted operating surplus ratios prepared by Access Economics to be closer to the mark than ratios relying solely upon published data. Even these adjusted ratios may be on the conservative side.

According to Access Economics, only one in every four NSW councils are currently running operating surpluses for their general government activities (Access 2006, p19). Fifty per cent of NSW councils currently run adjusted operating deficits in excess of 10 per cent of their own-source revenues.

Differences evident among NSW councils in their general government operating surplus ratio in 2004-05 are shown in Figure 11.4, which portrays the ratios of each council ranked in ascending order. This type of chart shows the extent of differences among councils without revealing the identity of particular councils.

Figure 11.4: Operating surplus ratio,^(a) by individual NSW councils



Source: Access 2006, p19.

(a) Operating surplus (adjusted onto a basis involving depreciation on council assets valued at closer to current cost) as a percentage of total own-source operating revenues.

The reasons for the prevalence of operating deficits are many (LGAA 2005, p2):

Our assessment of most NSW councils is that they have either reached or are near the point where the operating revenue within council's general fund is fully committed to recurrent expenditure and there is very little flexibility left in the budget. There are a plethora of reasons given for this including rate pegging, rising costs (insurance in particular), increasing community expectations, "unfunded mandates" and dollar-matching grants that entice councils to take on projects that both become recurrent and which, but for the grant funding, the council might not otherwise have prioritised...

Also playing a role may be reluctance on the part of councillors to fund renewal programs, based on scepticism (or ignorance) about the relevance of depreciation expenses (which unlike most operating costs are not visible cash transactions) to asset life cycles reported by councils, and of the need to fund depreciation (Access 2006, p.iv):

The prevalence of operating deficits among NSW councils is due mainly to policies – at the State and local government level – that both fail to ensure the full recovery from ratepayers of annual depreciation expenses and seemingly also encourage the under-reporting of these expenses.

Infrastructure spending

Currently, in aggregate, council spending on infrastructure – particularly on the renewal of existing assets – is very low. The annual deficiency in capital spending for all council purposes is in the order of \$400 million (Access 2006, p27) to \$500-600 million (Roorda 2006, p5) a year.

This has resulted in a present infrastructure backlog of over \$6.3 billion (Roorda 2006, p10).

It should be noted that Access Economics and Roorda and Associates each used different approaches to calculate the annual deficiency in capital spending. This deficiency is colloquially known as the 'renewal gap'. The renewal gap is simply total depreciation of

assets less actual renewal of existing assets (but excluding any enhancement of existing assets or addition of new assets to the existing portfolio).

The main difference between the two advisory groups was that each used a different approach to valuing council assets. Roorda used published council data for 2003/04, which is based on asset values, 80 per cent of which were valued at replacement cost between 1993-95 (when accrual accounting became mandatory) meaning that only 20 per cent were costed at 'fair value' since then. By contrast Access attempted to estimate what councils' assets might be worth if they had all been costed at fair value in 2004/05. As a result Access' asset values (and hence asset depreciation values) are much higher than Roorda's.

Another difference was that each used an alternative approach to estimating annual asset renewals. Roorda used data from councils' cash flow statements. Because this does not split renewals and maintenance, Roorda had to make a guesstimate of the renewal component. By contrast, Access derived annual capital spending estimates from annual balance sheet movements. Because this does not split asset renewals from enhancements, Access, like Roorda, had to make a guesstimate of the renewals component.

In any event the final estimates of the annual infrastructure renewal gap by each group were derived as follows:

Roorda: Asset Value \$48,500m (2003/04); based on mainly 1993-95 replacement costs.
Asset Depreciation (\$862m) minus Asset Renewal (\$410m) = Renewal Gap (\$452m)

Access: Asset Value \$77,700m (2004/05); based on estimate of current 'fair value' of assets.
Asset Depreciation (\$1,397m) minus Asset Renewal (\$997m) =
Renewal Gap (\$400m)

In the Inquiry's opinion:

- Roorda's depreciation figure (\$862m) is too low because it is based on an outdated asset value for councils;
- Roorda's asset renewal number (\$410m) looks low. Indeed, he acknowledges that it may range from \$410m to \$601m;
- Access' depreciation figure (\$1,397m) looks more or less correct if its asset valuation (\$77,700m) is right; and
- Access' asset renewal number (\$997m) may be soundly based, but may be a broader concept than that used by Roorda.

Using these conclusions, the renewal gap might be \$875 million using (a) Access' current asset value (\$77.7m) to calculate depreciation (\$1,381m) and (b) the midpoint of Roorda's range for estimating asset renewal (\$506m):

Asset Depreciation (\$1381m) minus Asset Renewal (\$506m) = Renewal Gap (\$875m)

A renewal gap of \$875 million is almost double Roorda's estimate. Nevertheless, what the above arithmetic exercise demonstrates is that a renewal gap of approximately \$500m as used by the Inquiry looks very conservative indeed. It also illustrates the need for councils to improve the quality of asset data in their annual reports.

The large annual infrastructure renewal gap explains why excessive borrowing is not evident in NSW councils. Low capital spending (both renewals and refurbishments) may be a common means of balancing budgets. In fact, compelling evidence has been presented to the Inquiry that councils' operating deficits are funded largely by running surpluses on their capital accounts rather than resorting to borrowing. This means capital contributions, capital grants and proceeds of asset sales are used mainly to prop up operating costs rather than to finance capital renewals and enhancements (Access 2006, p52):

In our view, the prevalence of operating deficits and their frequent co-existence with substantial infrastructure renewal backlogs are symptomatic as much of deficiencies in council spending and revenue policy frameworks as they are of shortfalls in the level and escalation of tax sharing grants from other governments and any past cost shifting.

Remedies

Option 5: Councils should increase their use of borrowing to fund necessary infrastructure spending.

Councils should consider making prudent use of additional borrowing to finance the acquisition of new infrastructure assets and the upgrading of existing infrastructure assets and, where considered appropriate, to fund the elimination of any major backlog in the renewal of existing assets (Access 2006, p12):

Borrowing to fund capital spending is not a common practice for most councils across Australia. It is time for the long-run decline in local government's reliance on borrowing to be reversed. External borrowing can be an appropriate financing source in the right circumstances, namely when it is used to fund the acquisition of new infrastructure assets or the upgrading of existing infrastructure assets (as distinct from funding routine maintenance and renewal of existing infrastructure assets which should be funded out of current revenues).

Any limits on borrowing for the purpose of acquiring new infrastructure assets within the local government sector should be set – based upon expert advice and generally-accepted standards of prudence – by reference to a council's long-term financial capacity to service debt rather than an anti-debt mindset.

Pros

- The level of indebtedness of NSW councils is well below levels considered appropriate to their circumstances, reflecting a widespread reluctance by councils to borrow even when it may be prudent to do so; and
- Borrowing spreads the cost of infrastructure over both current and future generations of ratepayers.

Cons

- Some doubt whether councils' have the financial capacity to undertake sufficient borrowing to deal with the current and emerging infrastructure challenge (LGAA 2005, p3):

...it is unlikely that many (if any) councils could feasibly fund the replacement of their infrastructure. One of the prime reasons for this is that typically they did not fund its original construction – it was either partially funded by Federal or State governments or the completed asset was handed over at a later date. When time comes to replace or renew these assets (as opposed to the ones constructed solely by council) there is a genuine need for funding from above.

Option 6: Councils should maximise their revenue-raising effort.

This option is discussed in the next section.

The main glimmer of hope in this area arises from the Commonwealth Government's response to the Hawker Committee recommendations (Commonwealth 2005, p8) indicating agreement:

...with the [Hawker] Committee on the importance of local government authorities having the capacity to raise revenue from their own sources and will ask the Productivity Commission to examine this issue.

At the very least, the Commonwealth can be expected to want an examination of state-imposed constraints and influences on Local Government's revenue raising capacity to be included in that study.

Option 7: Councils should review their current levels of operating expenditure.

This option is discussed in the next section (see option 10).

11.5 COUNCILS' FINANCIAL OUTLOOK

Requirements

Councils should develop and annually update 10-year financial plans.

Each council should prepare projections of its finances, first, on unchanged council revenue and expenditure policy ('no policy change') and given expected economic and demographic developments.

Each council should also develop projections of its:

- Likely additional financial *capacity* were the revenue and financing effort of high-effort councils elsewhere in the sector to be adopted; and
- Likely additional financial *requirements* if faced with additional functions and spending, and financial shocks.

A council's finances should be considered sustainable in the long term only if its financial capacity is sufficient – for the foreseeable future – to allow the council to meet its expected financial requirements over time without having to introduce substantial or disruptive revenue (and expenditure) adjustments (Access 2006, p43).

The meaning that should be given to 'financial sustainability' is a controversial issue. Box 11.1 explores this issue in a little more detail.

To ensure its long-term financial sustainability, a council should be able to provide answers to the following questions:

- Does the council have the long-term ability to finance its statutory and accountability obligations to the community and to fund its future activities?

- Can the community be convinced to accept a lower level of service if the council's future financing requirements look set to outstrip its future financial capacity?
- Does the council currently have the financial capacity to sustain its infrastructure?

Box 11.1 What does financial sustainability involve?

The NSW Government (NSW Government, *Fiscal Responsibility Act 2005*, section 3(1)) defines fiscal sustainability as follows (with 'fiscal' sustainability and 'financial' sustainability being inter-changeable in a public sector context):

“Fiscal sustainability requires that the Government be able to manage financial risks and financial shocks in future periods without having to introduce significant and economically or socially destabilising expenditure or revenue adjustments in those future periods. What is considered consistent with fiscal sustainability will vary depending on the strength and outlook for the economy, the structure of expenditure and revenue of the budget, the outlook for the State's credit rating, demographic and social trends that will affect the budget, and the nature of financial risks faced by the Government at any given time.”

Effectively, a financial sustainability assessment involves a comparison of a Council's long-term 'financial capacity' with its long-term 'financial requirements'.

A Council's *financial capacity* means the sum total of the financial resources (both operating and capital) that a Council can mobilise through its (present and prospective) revenue-raising and financing policies.

A Council's *financial requirements* means the sum total of the spending (both operating and capital) that is necessary by a Council to meet both its present statutory obligations and any expected additional functions, spending pressures and financial shocks.

If a Council's long-term finances are sustainable, then disruptive rates increases or spending cuts can be avoided, the rating burden will be fairly shared between current and future ratepayers and the stability or predictability of a Council's rates will not be at risk.

'Unsustainable' finances in the long term only refer to the unsustainability of *current* (revenue-raising and spending) *policies*. Council finances can almost always be corrected with substantial rating increases and/or expenditure cutbacks.

Reality

While many individual councils prepare medium- to long-term financial projections, these projections are not systematically pulled together and analysed at the sector-wide level.

The Inquiry's advisers have prepared some financial projections. These projections suggest that, on a 'no policy changes' basis, in aggregate:

- Council per capita revenues and expenses are expected to grow in real terms by eight per cent and nine per cent respectively over the next decade, if anything aggravating slightly existing operating deficits (Access 2006, pp32, 44); and
- The infrastructure backlog facing councils could grow by a further \$14.6 million over the next 15 years if the renewals gap is not closed (Roorda 2006, p4).

After account is taken of possible additional functions and pressures (and the additional financial capacity that could be accessed to finance such developments), in aggregate:

- Additional functions and pressures could result in council per capita expenditure growth being at least double that expected on a 'no policy change' basis (Access 2006, p46);

- Such expenditure growth could be matched by revenues if all water utilities achieved full cost recovery (so they could pay commercial rates of tax and dividends) and all councils lifted their rates, charges and fees to those of the top 25 per cent of councils (Access 2006, p48);
- Even these radical revenue measures would not be sufficient to eliminate most councils' operating deficits (Access 2006, pp47-48); and
- The infrastructure backlog facing councils could grow beyond that expected under no-policy-change conditions as a result of future infrastructure enhancements arising from increasing community expectations, rising social mobility and better building standards.

There are large differences among councils in their access to any available additional financial capacity. In particular, councils relying more on grants from Commonwealth and state governments, and less on their own-source revenues, only have access to relatively low levels of additional financial capacity.

The advice prepared for the Inquiry indicates that the long-term outlook seems particularly bleak for one in four councils. These are councils whose prospects are for double-digit operating deficit ratios after allowing for emerging pressures notwithstanding any elimination of relatively low revenue-raising efforts on their part. Without substantial grant and/or rate increases and/or disruptive expenditure cuts, these councils appear financially unsustainable (Access 2006, p51):

The councils whose current policies seem unsustainable over the long term are mainly, but by no means exclusively, country councils, councils experiencing above-average growth rates and the smallest councils. However, other types of councils seem sufficiently well represented among those we would classify as unsustainable to indicate that more factors are at work in explaining the sustainability of a council's long-term finances than just its structural characteristics.

The financial outlook for NSW councils prepared for the Inquiry has been developed at a relatively high level and without the benefit of consultation with individual councils. Of necessity, the view of the outlook prepared for the Inquiry is more reliant than we would prefer on various estimation procedures. Much more work needs to be done by councils themselves in developing consistent views regarding their financial prospects.

At the moment in NSW, there is no formal obligation on a council to prepare and publish a 10-year financial plan, like those that exist in New Zealand and South Australia for example.

To overcome Local Government's infrastructure renewal backlog and annual renewal gap as well as achieve budget surpluses the Inquiry has suggested a package of fiscal measures involving more grant funding, efficiency savings and higher revenues including a diversion of most real revenue growth in future towards capital spending until infrastructure is fixed (see section 6.4: Infrastructure Funding – Remedies – option 4 and section 5.4 Local Role of Councils – Remedies – option 7).

Remedies

Option 8: Increase the flexibility available to individual councils to vary their revenue-raising effort (by deregulating rate pegging and regulated fees and charges as raised in Chapter 9) to ensure they are able to match increases in their financial requirements with additional own-source revenues.

Pros

- Providing councils with the requisite revenue-raising flexibility would increase their accountability to the local community in general and ratepayers in particular;
- Would ensure a more careful balancing at the margin of additional spending and additional revenue raising; and
- Without revenue flexibility councils' infrastructure backlog is likely to escalate to a more unmanageable crisis than exists at present.

Cons

- Many of the identified own-source revenue increases that materialise will depend upon the policies adopted by the State Government, as well as councils themselves (Access 2006, p41):

The State Government's policies are important too, most particularly in the area of rate pegging. Additional flexibility is required for those Councils that currently display below-average rating effort. Similar flexibility is required when it comes to improving cost recovery in areas where the State government regulates the fees and charges levied by a council;

- Without rate and fee pegging councils could exploit their monopoly power to over-tax residents, especially in municipalities dominated by one political grouping;
- Providing councils with the necessary revenue-raising flexibility could encourage them to be less efficient and effective in spending the money and avoiding duplication with State responsibilities;
- The revenue-raising bases assigned to Local Government have relatively low growth prospects; and
- For councils heavily dependent on grant revenues because of a low revenue base, greater revenue raising flexibility won't be enough to arrest their growing deficits.

Option 9: Increase the pressure on the Commonwealth and the NSW State Government to provide a larger share of tax revenue to local government through increased FAGs, special purpose payments and other allocations.

Pros

- Financial Assistance Grants from the Commonwealth are below levels necessary to equalise the financial capacities of councils. Their annual growth falls short of that necessary to meet economic, social and environmental demands upon Local Government. Their amounts continue to decline as a proportion of total Commonwealth tax revenues. Higher FAGs would address this problem; and
- Tying FAGs to Commonwealth income tax or total tax revenue would ensure they grew in line with the general economy.

Cons

- The Commonwealth has traditionally seen Local Government funding as largely the preserve of State Governments. This view may have been reinforced with State Governments having benefited considerably in recent years as the result of the GST-related Commonwealth-State funding arrangements.

Option 10: If additional revenues are not in prospect (from whatever source), charge councils with the task of trimming their spending responsibility so that they can live within their means.

Pros

- This would see councils addressing that part of their financial problems that may be due to any past over-willingness to take on additional functions, especially in human as opposed to property services, in response to pressure from interest groups or other spheres of government.

Cons

- To the extent that the financial problems facing councils are due to revenue-raising inflexibilities imposed by other governments or an inadequate focus by other governments to ensure grants achieve fiscal equalisation among and within the different levels of government in Australia, this could put in jeopardy economically and socially desirable services and infrastructure;
- There are statutory, moral and political limitations to the extent that councils can withdraw from the provision of human and other non-property related services; and
- The most vulnerable councils are also likely to be those that already have least involvement in human services.

11.6 COUNCILS' FINANCIAL POLICY AND MANAGEMENT

Requirements

Each council should develop and publish a 'revenue and financing policy' statement (similar to the statement required of councils by law in New Zealand), which ensures the adoption of a comprehensive and 'economic' approach to funding decisions.

Each council should develop and publish a 'services policy' statement clearly stating the roles and functions that it is prepared to adopt based upon its philosophical viewpoint and specifying its policies regarding the number and nature of services to be delivered and the methods for delivery, as a basis for:

- All significant new policy proposals being subject to rigorous cost/benefit analysis;
- Its range of services, relevant service levels and quality standards being clearly specified;
- A regular cycle of program reviews being in place; and
- Sufficient transparency in decision-making and among the service options being created to enable service policy decisions to be validated by the community.

Each council should have in place an asset management framework that meets accepted industry standards, which includes:

- A clear definition of the services to be provided by each of its classes of infrastructure;
- A detailed knowledge of the assets held (thereby allowing predictions to be made about performance);

- The risks associated with managing the infrastructure being well understood;
- Capital spending distinguishing between spending on maintenance, capital renewal of existing assets and construction of new assets; and
- The cost of long-lived assets over their useful lives being accurately recognised.

On the liabilities management side, councils should avoid undertaking separate or specific borrowings to finance particular projects or assets, and rely instead on taking a coordinated approach to managing a council's borrowings and financial investments. Associated with this, councils should be managing their interest rate exposures in an up-to-date and deliberate fashion.

Spending and revenue decisions should be taken in a multi-year framework, and against the background of long-term financial rules. Otherwise, the natural short-term focus of political decision-makers may cause councils to lose sight of future costs of decisions, the best allocation mix and the appropriate timing of spending. A council's budgetary forward estimates framework should be the first three to five years of its long-term (10 year) financial plan.

As per the CPA Australia (CPA) and the Municipal Association of Victoria (MAV) good governance guides (CPA 2005 and MAV 2004), councillors should:

- Recognise that, collectively, they are accountable for the financial sustainability of their council;
- Ask enough questions to enable them to understand the council's financial position and performance, and have access to all appropriate financial information;
- Be in the forefront of setting quantitative target values for the council's financial KPIs;
- Ensure that the longer-term financial plan is reviewed regularly;
- Understand and be comfortable with the assumptions and strategies underpinning the long-term financial plan;
- Respect and adhere to the plan once it has been developed; and
- Adopt best practice ethical behaviour to avoid conflicts of interest, and to focus at all times on overall community benefit rather than on particular sectoral interests.

The council's general manager/CEO and senior managers should be offering up-to-date advice on all matters pertaining to financial governance and accountability, and ensuring that the necessary information systems are in place. The financial reports provided to councillors should be sufficient to ensure good financial governance. Being internal reports, they should present a council's finances in a way that is intelligible to non-financial people.

Independent review of processes and decision-making should be undertaken regularly to assist the council to meet its accountability to ratepayers and the community. There should be an audit committee to oversee and advise the council on matters of statutory compliance, public accountability and internal control.

Reality

Few councils appear to have developed or implemented a rigorous policy framework for funding their services and infrastructure, stating (for example) the role to be played by 'user pays' and how any grants shortfalls are to be covered for services provided through grants

funding. The current funding approach relies heavily on the use of rates to fund the difference between estimated operating expenses and non-rates revenues each year. Limited consideration is given to the linkage of service beneficiaries to the funding source for each council service through greater application of user charges.

Regular reviews of existing programs and of the consistency of new policy proposals with the council's accepted roles and functions seem to be the exception rather than the rule. As a result, councils are generally too prepared to accommodate operating spending pressures. This seems to be associated with an inadequate understanding of the ongoing fiscal impact of those decisions and insufficient scepticism about expanding the role of councils – at least without commensurate increased access to the necessary financial resources.

Inadequacies in asset management practices and associated depreciation and asset valuation policies are all too evident, especially with under-spending on the renewal of existing infrastructure. Too little consideration is given to the extent to which future generations are expected to pick up the tab for renewing council-provided infrastructure.

On the liabilities management side, credit foncier and fixed interest borrowings still predominate.

Despite implementation of AAS27 in 1993, much internal reporting still has a cash accounting focus, without much emphasis upon the operating surplus in the annual Statement of Financial Performance. Traditional cash accounting can easily lead to a misleading picture of commitments undertaken when payments can be accelerated or deferred. For instance, in cash accounting, no provision is made for funding depreciation of physical assets with the result that when such assets need to be renewed there may be no funds set aside for doing so, the very situation that most councils now find themselves in.

This makes cash accounting an unsatisfactory basis, at least by itself, for monitoring recent developments or for the assessment of long-term sustainability of council finances. Only accrual accounting recognises the financial implications of transactions when they occur, irrespective of when cash is paid or received.

Where financial governance is not well developed in councils, it is not surprising that there is a lack of understanding on the community's part of the true costs of current infrastructure and service commitments.

Access Economics (Access 2006, p52) has advised the Inquiry that:

Existing shortcomings in the financial governance policies and practices of NSW councils that contribute to chronic operating deficits and mounting infrastructure renewal backlogs deserve to be addressed. These policies and practices include those relating to the under-funding of depreciation, the outdated measurement of asset values and depreciation, poor asset management systems, and the inadequate monitoring and reporting of a council's financial position and performance.

Improving such policies and practices would not only prompt councils to do more to ensure their financial sustainability, but that might also convince other governments that increasing grant funding to local government could after all be a prudent use of taxpayer funds.

Inadequate expertise and understanding among councillors and senior officers regarding financial governance also seems to be playing a role. There is limited training available to help councillors without accounting skills to understand accounts, let alone frame fiscal

strategies, set budget priorities and monitor results. This may also explain why some councils are reluctant to develop effective internal audit committee arrangements, including an unwillingness to invite external participation or restricting internal membership.

Remedies

Option 11: Make it mandatory for each council to:

1. **Develop and publish a ‘revenue and financing policy statement’ regarding the funding of both operating expenses and capital expenditures, along the lines of the statement legally required of councils in New Zealand;**
2. **Develop and publish a services policy statement clearly specifying the number and nature of services to be delivered and the methods for delivery;**
3. **Introduce outcomes, not just output budgeting, together with performance indicators to show progress against key results areas; and**
4. **Develop and annually update a 10-year financial plan.**

Pros

- Increasing transparency and accountability would provide a clearer basis for increasing councils’ revenue-raising flexibility; and
- A focus on long-term priorities would discourage short-term reactive spending decisions.

Cons

- Developing such policies and plans at the individual council level would be resource intensive, and particularly difficult for less well resourced councils; and
- Unless councils have revenue-raising flexibility, such statements and plans might not serve any particular purpose.

Option 12: Local Government should adopt a clear statement of the principal role and accountabilities of councillors for financial governance in general and the financial sustainability of their councils in particular.

Pros

- The separation of these roles and accountabilities from those of general manager and senior managers would be acknowledged (financial governance is primarily the responsibility of councillors, and cannot be delegated to the administration);
- Obligations required of councillors would be made more explicit (and strengthened), including the importance of councillors adopting a whole-of-council approach and being more strategic; and
- The part to be played by further training of councillors in support of these financial governance responsibilities would be reinforced.

Cons

- The political role of councillors is not easily codified;

- The general manager and senior management also have an integral role in financial governance so trying to delineate the respective roles of councillors and council staff may prove difficult; and
- It could be hard to reach agreement on the term ‘financial governance’ in a political context.

Option 13: Require more specific training for councillors, to give them the tools they need to undertake this expanded financial governance role.

Pros

- Without formal training it is doubtful that most councillors would fully appreciate and understand their fiscal fiduciary duties; and
- By providing an extensive education and training program, councillors and senior staff could be kept up-to-date with key changes to best practice financial governance in Local Government.

Cons

- Such training could be expensive;
- Some training courses might not be Local Government-specific enough; and
- Training may improve the skill, but not necessarily the will to be financially responsible.

Option 14: External monitoring/ranking of council finances.

Another option involves the establishment of some sort of external monitoring of the long-term financial performance and position of councils, which would rank individual councils and thereby promote ‘yardstick’ competition to achieve better outcomes.

In Local Government, there is no sector-wide assessment (or ranking) of the sustainability of councils’ financial performance and position equivalent to that published annually with regard to (a) the Commonwealth Government by the International Monetary Fund, the OECD, the international rating agencies and major financial institutions, and (b) the state governments in Australia by the Australian Loan Council, the international rating agencies and major financial institutions.

Pros

- A league table or something similar could see councillors and council administrations taking an increased interest in the sustainability of their council’s long-term financial performance and position; and
- This approach might enhance interest in specifying appropriate financial KPIs and benchmarks values.

Cons

- A monitoring system would require development of (a) the categories of financial sustainability to apply to councils, and (b) the financial criteria to assign to the different financial sustainability categories for purposes of rating councils; and

- This could involve a relatively drastic – and expensive – process, which unless undertaken by the State Government could be resisted by councils that expected poor ratings or did not have the resources to support such a monitoring system; and
- There would be a need to appropriately categorise councils to make comparisons meaningful.

Option 15: Changes to the structure of council governance.

Some have suggested that fundamental changes in the nature of councils are necessary if councils are to become more effective in ensuring their financial (and policy) sustainability.

In some councils, the number of councillors may exceed the number best suited to ensure that councillors are accountable for the financial sustainability of their council. It might be preferable too if some council members were appointed on account of their specific skills to complement the role to be played by councillors. And, given the additional accountabilities involved, improvements in remuneration of councillors might also see a change in the calibre of councillors.

Pros

- Such change should drive necessary changes from within the councils affected.

Cons

- Changes along these lines may take place over time, but they are not practical mechanisms to initiate the changes urgently required within Local Government; and
- An effective audit committee may be the best way for a council to access external expertise.

11.7 COUNCILS' FINANCIAL GOVERNANCE AND GUIDANCE

Requirements

Councils should have a choice of available sources of advice on best-practice financial governance.

External sources of guidance should provide advice entirely relevant to the Local Government context.

The development of policies, practices and software that improve financial governance should be coordinated among the different parties involved, and reinventing of wheels should be avoided.

The special circumstances of smaller or remote councils should be recognised in the way financial governance improvement programs are both developed and delivered.

Reality

Groups that in recent times have made noteworthy contributions to the understanding of best practice in financial governance are:

- The Municipal Association of Victoria, which has published a good governance guide with a specific section on financial governance (MAV 2004);
- CPA Australia, which has recently published a good governance guide specifically for Local Government, sponsored by Local Government Managers Australia (CPA 2005);
- LGMA NSW, which in collaboration with the LGSA, DLG, ICAC and other relevant parties has produced the a financial health check manual (LGMA 2002) and a governance health check self audit guide (LGMA 2004);
- DEUS has issued best-practice guidelines for managing councils' water utilities (DEUS 2004) as well as a comprehensive annual financial performance monitoring report covering each utility (DEUS 2005); and
- DLG has issued a code of accounting practice and financial reporting (DLG 2005a), an asset accounting manual, an internal audit discussion paper and provides annual comparative indicators including financial ones, on NSW Local Government (DLG 2005b).

A limited role has been played so far by the:

- Local Government Auditors Association (LGAA);
- Australian Accounting Standards Board (AASB);
- Australian Bureau of Statistics (ABS), as a result of an apparent lessening in the priority now being given to the preparation of government finance statistics for the Local Government sector; and
- Commonwealth's National Office of Local Government (NOLG) and the Australian Local Government Association (ALGA) at the national level.

Research undertaken by the two university centres of Local Government studies in NSW (UNE and UTS) has been making a modest, but increasing, contribution in this area. LGSA runs regular training courses for councillors that include a module on financial management, governance, roles and responsibilities.

The LGMA's *Sustainable Financial Health Check Manual* (LGMA 2002) made some important advances when it was first introduced, notably by:

- Recognising the important role of the operating surplus before capital amounts (and effectively relegating the surplus after capital amounts to the scrap heap);
- Providing a basis upon which councillors and managers could assess the state of their council's financial health – whether or not they had a financial background – by referencing actual ratios relative to target levels, via a colour coding 'traffic light' system of "green", "amber" and "red";
- Stressing the importance of a trend (i.e. multi-year) analysis rather than a static, one year perspective;
- Recognising that some key ratios, or the information required to calculate them, may not be available directly from the AAS27 external financial reports;

- Recognising the importance of separate “financial health checks” for a council’s non-commercial and commercial (e.g., water and sewerage) activities;
- Covering a range of operating and capital indicators;
- Recognising that the “target” value for the key ratios, and the upper and lower limits for such ratios, may need to be fine-tuned to the particular circumstances of each council; and
- Pointing to the importance also of tracking variances in forecasts/estimates over time.

These important strengths deserve to be built on, and extended.

Based upon the research reports prepared for the Inquiry, and the Inquiry’s own analysis, the LGMA’s *Sustainable Finances Health Check Manual* could be made even more useful for financial governance purposes by:

- Extending the checklist of key ratios to include all financial KPIs nominated in Table 11.3 above, and thereby providing a balance of financial performance and financial position indicators, as well as including capital as well as operating financial performance indicators; and
- Ensuring that, for each of the financial KPIs, targets as well as upper and lower limits are nominated, and thereby recognising that – for most of the key financial KPIs – the “red” zone is evident when the ratio is too low as well as too high.

At the same time:

- Some of the indicators currently included could be modified (e.g. replacing the debt service ratio with the net interest ratio – reflecting the fact that under modern debt management practice principal repayments are only financed from revenue when debt levels are high relative to the council’s asset base; and replacing the asset condition management indicators with ratios suggested by the work undertaken for the Inquiry by Roorda);
- A clear distinction should be made between (balance sheet) indicators of a council’s financial position and (operating statement) indicators of the council’s financial performance; and
- Some of the ratios currently included could be relegated to a secondary grouping (e.g. the liquidity and debtor management ratios which, while they may be important for small councils, are unlikely to distinguish between the financial position and performance of medium and larger-sized councils where adequate cash and debtor management practices may coexist with inadequate financial governance policies and practices).

The Inquiry has prepared a one-page Financial Governance Statement that councils could use to check their financial health (see Appendix B). It takes account of the above suggested changes to the LGMA financial checklist.

Another important contribution to financial governance is FINMOD (DEUS 2000), a financial planning software package created specifically to help councils to develop a strategic financial plan. Its ability to consolidate all facets of a council’s operations and compare the consequences of different policy options makes it a powerful tool for gauging a council’s long-term financial sustainability under various scenarios. Its graphical displays and use of

key performance indicators also makes it a useful device for communicating alternative policy choices to non-financial managers and councillors.

Priced at only \$700 to \$6000 (depending on council size), the FINMOD General Fund Module has been bought by most councils. The FINMOD Water Supply and Sewerage Module was already widely used by non-metropolitan councils before the General Fund Module became available.

Remedies

Option 16: Local Government putting its own house in order (via LGSA leadership).

Roles that could be played by the LGSA include a facilitation role (either as the service provider or by identifying/accrediting external consultants with required expertise), documenting case study examples or giving specific technical advice on matters such as community engagement, financial analysis or business unit options.

In addition, the LGSA could undertake a coordination role (Maxwell 2005, p17):

...it would be unfortunate if this Inquiry were to spawn a number of parallel – rather than co-operative – research projects in NSW [at the same time as similar projects are being progressed following the SA Inquiry]. ...We submit that the Inquiry should positively encourage mechanisms for interstate co-operation, including provision for funding to enable Councils to allocate staff to such projects, and for the preparation of reports.

Pros

- By taking a leadership role wherever possible, the LGSA would reinforce the willingness of Local Government to initiate and drive a coherent and ambitious reform agenda without the need for intervention by State Government.

Cons

- While LGSA leadership and facilitation could kick start the process, there may also be a need to offer financial incentives to councils that achieve process and performance improvements as a result of structural reform. This could require Commonwealth and state involvement since the LGSA would not have the mandate or resources to provide such rewards.

Option 17: State Government support ('carrots').

It is unlikely that significant efforts will be made by councils to undertake structural reform unless there are some incentives available. The State Government may need to indicate that it is prepared to provide financial support to facilitate key structural reforms. Possible support could include:

- Grandfathering for a period the Financial Assistance Grants paid to councils after any structural reform has occurred;
- Increased capital subsidies for investment in facilities required to support any structural change process;
- Priority access to funding programs by councils that vigorously pursue reforms; and

- Professional advice and training in public policy, management and finance.

Pros

- Support from the State Government for this facilitation role may be important to achieving momentum in the structural reform process; and
- Setting a time limit of, say, two to three years on such support could encourage early initiatives.

Cons

- Introducing incentives for new starters would penalise those councils that have already embarked upon efficiency and effectiveness improvement programs.

Option 18: Legislative mandating of key changes to councils' financial governance, planning and management ('sticks').

The necessary policy framework and financial governance reforms could be mandated, via legislation, as opposed to being implemented voluntarily by the development and rollout of sector-wide standards and codes.

For example, the obligation to target an annual operating surplus could be along the lines of section 100 of the NZ *Local Government Act 2002*, namely that a council's annual income (excluding capital grants) in any financial year must be set at a level that covers all expenses. Such a balanced-budget 'golden rule' would put at the top of councils' agenda the fostering of intergenerational equity, and so:

1. Ensure that each year's ratepayers meet the full cost (including depreciation) of that year's use of services and infrastructure; and
2. Provide for the maintenance and replacement of infrastructure assets.

Pros

- Setting such a clear performance goal may be the most effective means of increasing efficiencies and accountability without the need for costly, prescriptive, additional layers of bureaucratic processes; and
- This option would represent a sort of trigger mechanism designed to force the issue or make many of the necessary changes self-fulfilling.

Cons

- With the legislative route may come inflexibilities and a possible one-size-fits-all approach, as well as a possible lack of buy-in on the part of some councils;
- The risk is that the focus could be on prescription rather than clarifying objectives and guiding principles;
- Transitional time frames (over several years) are needed to enable councils to have an adequate opportunity to prepare budgetary adjustments. Inevitably, this will require community consultation;

- If legislative change is not carefully formulated, the requirement for improved financial governance could turn into a compliance nightmare, absorbing significant amounts of councillor and officer time;
- It is important to set appropriate time frames for Local Government to meet any new standards, and the proposed operating surplus obligation. It is one thing to develop new frameworks and systems, and another to actually achieve the required outcome; and
- Given the diversity at present in council finances, sufficient time is required to achieve any mandated targets. This transition may not be achieved quickly.

Option 19: Each council include in its annual report a financial governance statement as outlined in Appendix B plus a comparison of the results for its key financial ratios against the targets and upper/lower limits shown in Table 11.3. In addition, the DLG or LGSA prepare and publish a consolidated version of this statement for each of the metropolitan, regional and rural categories of councils as well as one for Local Government as a whole.

Pros

- Would assist council management, councillors and residents to better understand the real financial performance, position and sustainability of their council, which statutory accounts may obscure;
- Would provide a one-page management tool for councils to monitor their financial situation, both against absolute targets as well as relative to other councils within their own category; and
- Would encourage councils to ensure that depreciating infrastructure was adequately replaced by highlighting any renewal gap.

Cons

- Would give too much importance to one document relative to all other financial statements;
- Would not stop councils from acting irresponsibly on financial matters; and
- Could be subject to manipulation unless audited.

12. RECOMMENDATIONS

12.1 INTRODUCTION

The Inquiry's Panel after carefully considering all research findings and the public's response to the *Interim Report* makes forty eight specific recommendations for improving both the financial and administrative capacity of councils. The key recommendations are prefaced with a hash (#).

They address the critical challenges for Local Government, namely to:

- Define its role relative to other tiers of government;
- Renew infrastructure to overcome a growing backlog;
- Prioritise services to better reflect public preferences;
- Reform development controls at both state and council levels;
- Improve strategic planning and operational efficiency;
- Boost revenues from rates, fees and grants;
- Strengthen governance structures and procedures; and
- Achieve long-term financial sustainability.

It is important that both financial and administrative reform tasks be done in tandem to ensure that any extra resources obtained are spent appropriately (to meet community priorities), effectively (to achieve stated goals), efficiently (so that ratepayers get value for money) and prudently (to avoid needless risks).

Because the previous chapters are largely self-contained, many options are repeated throughout the *Final Report*. The preferred options, recast as recommendations, have been ascribed below to the chapter topic to which they most logically belong. For each recommendation there are cross references to all options from which it stems. For instance where a recommendation refers to 5.2.1 it means that it is based on Chapter 5, section 2, option 1, though its actual wording may have been altered to clarify its meaning or address issues raised by stakeholders.

Rather than restate the case for each recommendation, the reader is asked to refer to the relevant option or options in the text. It goes without saying that the Inquiry Panel, after considering all the pros and cons, has chosen those options (amended in the light of new information and respondents' comments) which it believes on balance would produce a net gain. In a few cases it has added new options (in previous chapters) and recommendations (below) where obvious policy gaps in the *Interim Report* were brought to its attention.

It should be stressed that this is only the panel's judgement. Local Government will need to draw up its own agenda for change, which may or may not reflect the views of the independent Inquiry. However, in making these recommendations the Inquiry was mindful of three considerations other than the popularity or otherwise of the options canvassed in the previous chapters:

- **Empowerment:** What can Local Government do to fix its own problems without waiting on state or Commonwealth permission or funding, which may not be forthcoming until public opinion is convinced that a change to intergovernmental relations and funding is critical to fixing local infrastructure and providing for future services?
- **Credibility:** What can Local Government do to win the trust and confidence of other tiers of government, the public, the media and key stakeholders that it is genuine about reforming its modus operandi so that it can be more responsive, effective, efficient and prudent in its governance and management? and
- **Catalyst:** What policy or procedural mechanisms might act as a circuit breaker to spur remedial action on the part of both councils and other tiers of government?

Jack Welch, the former CEO of General Electrics and perhaps the most successful corporate leader of all time, has a favourite saying: ‘Control your own destiny or someone else will’.

Many of the actions required to revive Local Government finances and infrastructure will need State and Federal Government assistance. Nevertheless, many of the Panel’s recommendations could be implemented by Local Government itself if it musters the will and the skill to embark on this ambitious reform agenda. To control its own destiny, Local Government should forge ahead as soon as possible without ‘waiting for Godot’ to make the first move.

12.2 ROLE OF LOCAL GOVERNMENT

Recommendation 1: Constitutional Recognition

The LGSA seek recognition of Local Government as a separate independent tier of government in the Australian constitution through a national campaign by ALGA and the state members aimed at obtaining the signed pledge of a majority of ratepayers in a majority of states to supporting such a course of action if a constitutional referendum were held. See 5.3.6

The purpose of such a campaign would be to persuade ratepayers to sign a pledge on their rate notices that they support the proposal that councils are democratically elected governments of local areas and though subject to State laws are not subsidiaries of State Government. If such a campaign was to result in constitutional change it would accord Local Government the official recognition and legitimacy that it enjoys in most other developed countries.

In the interim the Commonwealth Government should move a motion in both houses of the Commonwealth Parliament that they formally recognise Local Government as the third self-governing tier of the Australian federation.

Recommendation 2: Intergovernmental Agreement

The State Government and the NSW Local Government and Shires Associations enter into an intergovernmental agreement (IGA) that draws on both the Memorandum of Understanding in South Australian and the Local Government Policy of the New Zealand Government. See 5.6.11

The final IGA should be based on the allocative model. However, the parties should initially enter into a Partnership IGA with the goal to implement an allocative IGA. The Partnership IGA should assist in building a meaningful relationship between State Government and Local Government and introduce proper communication and consultation processes. An IGA should also include an integrated system for long term strategic and financial planning as well as performance measurement.

Such an agreement should recognise that Local Government is not just a state statutory corporation, but also a legitimate and democratically elected third tier of government with wide discretionary powers.

The IGA should establish a mechanism for determining the respective roles, service responsibilities and financial obligations of each level of government, the limits of State intervention in Local Government and future consultative processes. It would also give greater operational autonomy to councils in return for councils introducing more effective community consultation, longer-term strategic and financial planning and more meaningful performance accountability.

An IGA could be the catalyst for achieving many of the other measures that require State government consent. The new high-level IGA signed by the Local Government and Planning Ministers and ALGA in April 2006 provides for further bilateral agreements such as that envisaged by the Inquiry between the NSW State Government and NSW Local Government.

Recommendation 3: Cost Shifting

The LGSA build on the work of the Inquiry and undertake an annual survey of all councils to establish the total cost to Local Government of the main regulatory and policy responsibilities imposed by other tiers of government and any changes thereto over the previous year. See 4.2.1

The LGSA must develop a better understanding of the magnitude of and trends in cost shifting before it can seek any changes or compensation under an IGA.

Recommendation 4: Red Tape

The State Government undertake a review of the Commonwealth and state red tape applying to Local Government with a view to eliminating unnecessary requirements. See 9.5.18

The NSW Government's present reviews into red tape should be extended to include that associated with statutory planning and reporting requirements on councils. In

recommendation 33 the Inquiry proposes that all council planning be subsumed within a single comprehensive long-term Strategic and Financial Plan.

Recommendation 5: Revised Role

All councils with an infrastructure renewal gap and backlog voluntarily agree to restrain operating expenditure by adopting an ‘optimalist’ approach to new recurrent services until their physical assets are restored to a satisfactory condition. See 5.4.8 and 11.5.10

This would involve devoting the bulk of future real growth in council total revenues to renewing and enhancing local infrastructure, especially roads, kerbing, pavements, street lighting, bus shelters, bridges, storm water, seawalls, parks and gardens, public amenities (like public places, libraries, swimming pools and camping grounds), waste management, water and sewerage until the renewal gap and backlog was overcome.

At the same time each council would continue to strive for better social, environmental and economic outcomes for its community provided any additional resources required for expanding recurrent operating services were largely provided by external public, private or not-for-profit sources as envisaged in an ‘Optimalist’ approach. This would provide a useful stopgap solution, but would need to be combined with actions to deal with the lack of grant funding, rating flexibility, professional capacity, asset management and long term planning.

12.3 LOCAL GOVERNMENT INFRASTRUCTURE

Recommendation 6: Infrastructure Management

The State Government provide financial incentives and technical assistance to enable all councils within three years to adopt a total asset management (TAM) system with consistent asset accounting practices. See 6.3.2

TAM covers the registration, valuation, depreciation, condition assessment, planning, design, acquisition, funding, maintenance, operation, replacement and disposal of all council physical assets. It includes a long-term plan of infrastructure spending and funding, which gets incorporated within a council’s long-term strategic and financial plan (see recommendation 34). It is recognised that three years is a short timeframe, yet the adoption of a TAM system is a prerequisite for ensuring that any moneys a council sets aside for infrastructure are spent in a relevant, effective, efficient and prudent manner.

Recommendation 7: Infrastructure Funding

To overcome the infrastructure crisis, increase council funding by the order of \$900 million per annum through a combination of increased Commonwealth and state grants (\$200 million), council expenditure savings (\$200 million) and higher rates, fees and charges (\$500 million). See 6.4.4

The size of the infrastructure problem is so large that it will require a combination of revenue, debt and savings measures to overcome it. No single measure will be adequate on its own.

To minimise the impact on council rates, fees and charges of overcoming the \$6.3 billion infrastructure backlog and closing the \$0.5 billion annual infrastructure renewals gap, the Inquiry would suggest the following course of action:

- Borrow \$5.3 billion to fund renewals to overcome the infrastructure backlog (other than in LWUs). This would generate about \$400 million in debt charges (interest and principal repayments) annually;
- Raise an extra \$900 million per annum in revenue to both close the renewals gap (\$500 million) and meet the new debt charges (\$400 million); and
- Derive the extra \$900 million in revenue by seeking \$200 million in extra grants (say \$100 million from the Commonwealth and \$100 million from the State), \$200 million in council expenditure savings and \$500 million in extra income from rates, fees and charges.

If neither increased grants nor savings were forthcoming and the entire \$900 million had to be sourced from additional rates, fees and charges, these levies would have to rise by around 23 per cent in aggregate. Naturally some councils would require a higher rise while others would have the capacity to keep increases below this figure

To the extent that Local Government used the bulk of any real increase in its revenues over and above inflation for exclusively infrastructure purposes this would help, though not be sufficient in itself to solve the funding problem⁴². Also the longer the solution is deferred the higher the ultimate cost will be to the community.

Recommendation 8: Depreciation Funding

Each council aim to fully cash-fund its asset depreciation within three to five years and dedicate such funds exclusively for asset renewals. See 6.3.5

This measure is necessary to fund the closing of the present huge (roundly \$500 million) shortfall between the annual renewal (i.e. replacement) of existing infrastructure assets and their annual depreciation (i.e. consumption). This measure will require each council to find sufficient additional revenue or cost savings to close any gap in its infrastructure renewal.

It may be difficult to distinguish what component of an asset's replacement is renewal versus expansion, but that should not prevent cash funding of depreciation. This does not necessarily mean spending all such funds in the year they are raised. But it does mean sequestering such money for exclusively capital outlays.

To help achieve this goal *most* councils from hereon will need to devote the bulk of any real increase in their revenues to fixing their infrastructure (see recommendation

⁴² Between 1995/96 and 2003/04 the total ordinary revenue of councils grew by 2.5 per cent per annum in real terms. This was equivalent to \$165 million in 2003/04. Assuming 60 per cent of any future increases could be devoted to infrastructure renewal this would provide an additional \$100 million a year (at 2003/04 values) for this purpose.

5). Between 1995/96 and 2003/04 the average annual growth in Local Government ordinary revenue after excluding price inflation was 2.5 per cent.. This equated to \$165 million in 2003/04. If 60 per cent of this annual growth was in future devoted to infrastructure renewal then the annual renewal gap (which is conservatively estimated at \$500 million) might be closed in as little as five years.

However, because the renewal gap varies greatly between councils the time involved would be much longer than this. Also such a strategy would not solve the \$6.3 billion infrastructure renewal backlog. For this reason it needs to be combined with the other measures mentioned in recommendation 7.

Recommendation 9: Regional Roads

The NSW Government assume responsibility for all regional roads in rural shires since such councils do not have the financial capacity and asset management systems to maintain and renew them. See 6.4.6

Most council infrastructure is comprised of roads and a high proportion of roads are in under-populated rural shires which do not have the rate base to support the upkeep let alone renewal of such roads, especially regional roads. Neither improved FAGs nor rate deregulation will be sufficient to solve the rural regional road problem

12.4 LOCAL GOVERNMENT SERVICES

Recommendation 10: Opinion Survey

Each council periodically (at least at the start of its four year term) conduct an opinion survey of its residents to find out how they rate the importance of each of its major services and how they rate their satisfaction with each service. See 7.3.2

The survey results should be used to shape the priorities of the council's annual management planning and long-term strategic and financial planning from the outset of its term.

Recommendation 11: Future Needs

All councils should develop and adopt a long-term services plan that takes into account demographic, political, economic, environmental, social and technological trends as well as existing community's priorities based on opinion surveys and community consultations that disclose the costs and benefits of alternative scenarios. See 7.5.7 and 10.2.4

This plan should be a subcomponent of its long-term strategic and financial plan (see recommendation 34).

Recommendation 12: Procurement Practices

The DLG permit the LGSA to undertake joint purchasing arrangements on behalf of Local Government, perhaps using a council network of commodity

action teams, to identify where savings could best be made. In addition, the LGSA should develop best practice procurement guidelines to assist councils to better align and integrate their service plans and policies with their procurement processes and practices. See 7.4.3

Procurement is an area where councils could make significant cost savings that would help their finances. The LGSA has already established Local Government Procurement Pty Ltd to become a bulk purchaser on behalf of councils, but it requires permission under Section 55(3) of the LG Act for this company to operate.

Recommendation 13: Innovative Solutions

Local Government pursue innovative solutions to expenditure saving and revenue enhancement to help boost its infrastructure funding capacity under Recommendation 7. See 7.4.4

To overcome the infrastructure crisis councils will need to find a lot more financial resources. Raising rates, fees, charges and grants and reordering expenditure priorities are not the only ways that councils can make ends meet.

Possible other measures submitted to the Inquiry include standard financial capacity and solvency assessments of tenderers, improved treasury or investment management, alternative dispute resolution (e.g. mediation) at various stages of the land use planning process, replacing pay by space parking meters with pay and display ones, and sales of surplus land (e.g. narrow lanes at the back of houses traditionally used for collecting toilet bins).

Recommendation 14: Commercialise Businesses

Councils further commercialise their business operations (especially category 2 business) so that they set their prices to fully recover economic costs, including the cost of capital, and pay dividends like a normal business. Any community service obligations imposed on such a business activity by a council or another tier of government should be fully subsidised from taxpayer funds rather than commercial income. See 7.4.5

Additional dividends from commercial activities (such as water and sewerage services) would strengthen councils' finances. By externally subsidising CSOs their true cost to taxpayers is made transparent and the commercial activity's motivation to perform is not undermined. Local Water Utilities, which dominate councils' business assets, are already well advanced in achieving full commercial, status.

12.5 DEVELOPMENT PLANNING AND CONTROL

Recommendation 15: Planning Documentation

The State Government introduce a single planning document to apply to whatever land-use control format is adopted (e.g. land zones, land parcels or localities). See 8.2.1

This would replace SEPPs, REPs, and LEPs with a single planning document that prescribes all state and council controls to a particular site.

Recommendation 16: Future Needs

All councils develop and adopt a long-term land usage plan that takes into account demographic, political, economic, environmental, social and technological trends as well as existing community's priorities based on opinion surveys and community consultations that disclose the costs and benefits of alternative scenarios. See 8.5.7

This plan should be subcomponent of its long-term strategic and financial plan (see recommendations 34).

Recommendation 17: Council Delegations

Increase the number of development decisions that can be delegated by councils to certified planners or architects so as to enable faster processing times of the remaining DAs. See 8.3.5

This would greatly reduce the volume of DAs handled by councils, thereby allowing planning staff, who are in short supply, to concentrate on the more important applications and also freeing up council meetings to spend more time on those matters which the community considers more important (e.g. roads, public places, environmental management, etc).

Recommendation 18: Advisory Panels

Establish independent advisory panels to consider and *advise* councils on disputed DAs and to consider appeals from third parties. See 8.3.4

This would address community concerns, still leave councillors with the final say and pre-empt moves by the State Government to impose its own panels. It would also free up council meetings to deal with other council services that the Inquiry's opinion poll found were of greater importance to residents.

Recommendation 19: Voting Record

All councils introduce a system for recording how individual councillors vote on planning policy matters and individual development applications as well as any explanations they offer for their actions. Where a council departs from a recommendation by an independent advisory panel its collective reasons for doing so should also be recorded. See 10.2.3

These decisions would be easily discoverable by the community and the media via the council minutes posted on its website.

Recommendation 20: Planning Commission

The State Government establish an independent State Planning Commission to make recommendations on major projects removed from council control by the Minister for Planning with the State Cabinet deciding the outcome of such DAs if the Minister rejects the commission's advice. See 8.4.6

Just as councils should ensure a degree of separation between development control policy-making (a political exercise) and individual development control approvals (an executive and arbitral function) so too should the State Government.

12.6 LOCAL GOVERNMENT REVENUE

Recommendation 21: Rate Pegging (1)

The State Government free councils to determine their own income by removing statutory limitations on their rates (i.e. rate pegging) and certain fees (e.g. development application processing fees) in return for councils adopting longer-term strategic and financial planning with outcome targets. See section 5.2.1, 9.3.1 and 11.5.8.

Rate deregulation would bring NSW into line with all other states and territories. A council would then be answerable to its local constituency rather than the State for its taxation policy.

As mentioned in recommendation 5, such a policy should initially apply within the context of an 'optimalist' approach to spending (in place of the traditional 'maximalist' approach) so that the bulk of any real growth in rate revenue was used for fixing worn out infrastructure.

Recommendation 22: Rate Pegging (2)

If recommendation 21 is not acceptable, the State Government instead (a) permit councils whose rates were relatively low when rate pegging started or whose past rate rises have not kept pace with peg rises to bring them into line with those councils whose rates are in the top quartile; and (b) tie rate pegging to a published price or cost index such as the Sydney CPI, NSW GDP deflator index or a specifically designed Local Government cost index. See 5.2.2, 9.3.3, 9.3.4 and 11.5.8.

This would assist the financial viability of those councils that got trapped with relatively low rate levels when rate pegging was introduced in 1977 or which forfeited rate increases in certain years (e.g. periods of drought or economic recession) when their residents' capacity to pay was constrained. It would also make rate pegging more transparent and less capricious by relating it to a recognised objective measure of cost inflation.

Recommendation 23: Rate Exemptions

The State Government should review and remove rate exemptions for all land use for commercial or residential purposes regardless of ownership. See 9.3.5

This includes State Government trading enterprises (e.g. NSW Forests landholdings used for commercial forestry) and benevolent organisations' commercial activities (e.g. retirement homes and business premises). Councils should also be allowed to apply Section 611 charges for all commercial use of public spaces (e.g. underground pipes and cables, street poles, overhead wires).

Recommendation 24: Pensioner Concessions

The NSW Government, like all other state governments, fully rebate councils for its policy of pensioner rate concessions, otherwise councils be given permission to introduce rate deferments for the unfunded component of such concessions. Deferred rates and accrued interest thereon would be charged against a pensioner's estate. See 9.3.6

Rate deferments would not generate significant revenue in the short term, but would do so in the long-term. With the population quickly ageing the proportion of ratepayers who are pensioners is escalating dramatically. New Zealand already applies this system which gives asset rich but income poor pensioners the financial relief they need.

The fairest solution would be for the State Government to lift its rebate to councils from 50 to 100 percent of the cost of pensioner rate concessions so that councils were put on the same footing as they are in other states.

Recommendation 25: Pricing Guidelines

The Department of Local Government issue best-practice guidelines on the pricing principles and key cost concepts necessary for pricing council services, especially of a commercial nature. See 9.4.9

Such guidelines would help councils to adopt more efficient, equitable and common pricing policies that would raise more revenue, help manage demand for limited council services and provide a rational basis for full or partial cost recovery. They should be developed in consultation with the LGSA, LGMA and other relevant stakeholders.

Recommendation 26: Developer Contributions

Local councils be more accountable to property owners for the use of developer contributions derived from the development of their properties.
See 9.4.11

Developer contributions are effectively held in trust for expenditure on public amenities and services generated by the demands of additional residents arising from a development. This recommendation would help ensure that residents of the property

making the contribution are made fully aware of how the contributions have been spent on community infrastructure and services to their benefit.

Recommendation 27: Financial Assistance Grants (1)

The Commonwealth Government set its financial assistance grant (FAG) to Local Government at a fixed percentage of gross domestic product (GDP) so that it is tied to the growth of the Australian economy as most Commonwealth taxes are. In addition the level of such assistance be lifted from 0.18 per cent (2003/04) to 0.22 per cent of GDP. See 9.5.12 and 11.5.9

This would restore part of the reduction in Local Government general purpose grant funding as a proportion of GDP in the last two decades. It would also partially address the *vertical fiscal underutilisation* (VFU) between the Commonwealth and the lower tiers of government, particularly in relation to Local Government (see Access 2004).

Recommendation 28: Financial Assistance Grants (2)

Alternatively, Local Government FAGs be set at 0.86 per cent of all taxes (including GST) collected by the Commonwealth or 1.27 per cent of total income taxes, which would be equivalent to 0.22 per cent of GDP initially. See 9.5.13

This would be a more precise mechanism for adjusting future grant funding since Commonwealth taxes are easier to audit than GDP and not subject to extensive and frequent revision like national accounts data.

The rise in FAGs, whichever ratio was used, would be 20 per cent (\$300.8 million in 2003/04 of which NSW would get 33.7 per cent).

The Commonwealth Government is unlikely to break its agreement with the states and divert a fixed percentage of GST revenue to Local Government. Hence any increase in Local Government FAGs will need to come from revenues intended for Commonwealth purposes.

Recommendation 29: Financial Assistance Grants (3)

If FAGs were not increased as envisaged in recommendations 27 and 28, then the method of allocating them be changed to increase the relative assistance given to the most infrastructure-disadvantaged councils given that these are the least financially sustainable units of Local Government. See 9.5.4

This would involve the Commonwealth Government changing its allocation guidelines to reduce the guaranteed minimum amounts distributed to each council and the NSW Local Government Grants Commission changing its allocation formula for the general component of FAGs to recognise not just operating but also capital (i.e. infrastructure) disabilities of councils and to base the road component of FAGs on an asset preservation model as used in Victoria and Western Australia. An asset preservation approach estimates a council's cost of maintaining and renewing its road network instead of simply using factors such as the length of road and number of residents within a council area.

This scenario assumes that neither the Commonwealth nor State Governments come to the rescue of asset rich but income poor rural councils, forcing them either to go excessively into debt or allow their roads to become unusable or unsafe. In such circumstance a redistribution of FAGs between councils might be a partial solution. This would disadvantage other (mainly urban) councils that would be forced to raise rates (assuming rate pegging was relaxed) and other levies to compensate for lower FAGs income.

Recommendation 30: Disability Data

The NSW Local Government Grants Commission publicly disclose its calculations of disability of each council. See 9.5.15

This would put the LGGC on par with its federal counterpart which publishes its disability calculations for all states and territories. The NSW LGGC discloses its disability calculations to the council affected, but does not share it with Local Government as a whole, let alone the wider public.

Recommendation 31: State Grants

The NSW Government publicly document its total assistance to NSW Local Government and show its breakdown by major categories of assistance. See 9.5.16

Most other State Governments publish this data as part of their annual budget papers. The NSW Treasury is able to extract this information from its financial database. Should this vital data not be published in future State Budget Papers, the LGSA should request it directly from the Treasury, which cooperated with the Independent Inquiry without the need for a Freedom of Information request.

Any breakdown of grants should distinguish between payments for services provided on behalf of the state and payments to Local Government for its own purposes. It would be impossible for the LGSA to negotiate an IGA with the state if it was not aware of what its constituents got in grant funding from NSW Government agencies.

12.7 COUNCIL GOVERNANCE AND MANAGEMENT

Recommendation 32: Governance Structure

The State Government amend the LG Act to provide for a choice of governance structures as outlined below. See 10.3.6

(a) Corporate Board structure

The standard structure would be similar to the current structures except that:

- The maximum number of councillors would be seven, so they could interact like a board rather than a parliament;

- The standard position would be for an electorate of the whole with a referendum being required for a division into wards; and
- The election for mayor would be for the full term of the council (four years) instead of annual, with the option of a direct election of mayor, subject to a referendum.

Corporate governance principles, with appropriate modifications, would apply to the performance of a council. The mayor would be like a non-executive chair of a board without the power to direct the general manager between meetings of the council, which is the present situation.

(b) Parliamentary/Executive structure

Large councils (say over 50,000 people) would have the option of a structure that applied the separation of powers doctrine as between the legislature and the executive:

- Up to 15 councillors may be elected on a ward basis;
- Popular election of the mayor at the same time as councillors are elected;
- The mayor may appoint an executive committee of three persons selected from the councillors with the option of secondments from outside the council; and
- The general manager, selected by the mayor and endorsed by council, would report to the mayor.

The role of council under this structure would be to:

- Approve the strategic plan, the management plan and the budget;
- Approve the policies and development controls of council; and
- Question the executive and hold inquiries into policy and performance issues.

In the first model the council would act as a governing board chaired by the mayor with a general manager as CEO, while in the second model the council would be a representative chamber that held the mayor and an executive committee (council ‘cabinet’) to account for the management of the council. This dual structure would resolve the present dilemma that councils often have too many councillors to act as a board, yet can’t act as a parliament because there is no political executive to hold to account.

Recommendation 33: Councillor Remuneration

The State Government raise the maximum permissible remuneration level for councillors. See 10.3.5

Under the existing council governance structure (a state statutory corporation) councillors should be treated more like statutory body board members and more adequately remunerated, perhaps in the form of a fixed salary plus expense allowance rather than a fee and reimbursement of expenses. This increased payment would be expected to be associated with increased levels of capacity and commitment amongst councillors.

Recommendation 34: Long-term plan

All councils develop and adopt a long-term strategic and financial plan in close consultation with their communities that would be subject to annual external compliance audits and updated in the first year of each council's term. See 10.2.4

This would be akin to the New Zealand Community Plan, a 10-year strategic and financial plan with measurable outcomes based on community wishes and a council's financial capacity and subject to external compliance audits. It would include a 'revenue and financing policy statement' regarding the funding of both operating expenses and capital expenditures as well as a 'services policy statement' specifying the number and nature of services to be delivered and the methods for delivery.

The DLG's integrated planning and reporting initiative should ensure that disparate social, cultural, environmental, land use, stormwater, economic and other plans were consolidated into the long-term strategic and financial plan so as to avoid unnecessary duplication and waste of scarce professional resources.

There would still be an operational plan – the existing annual management plan with a detailed three-year operating and capital budget, showing outcomes and outputs as well as performance indicators to show progress against key results areas. See also recommendations 10 and 15.

Recommendation 35: Performance measures

The DLG in conjunction with the LGSA and a representative cross section of councils devise new key performance indicators (KPIs) for NSW Local Government using logics analysis to derive an outcomes hierarchy showing the causal link between core council goals, desired results, intermediate results and services. See 10.4.7

Any such exercise should draw on personnel in the NSW Premier's Department, the NSW Treasury and/or private consultants with expertise in using logics analysis to derive KPIs in other parts of the public sector.

Recommendation 36: Performance benchmarking

Each council on a regular basis (at least once every three years) benchmark its administrative capacity and performance with the results used to identify the most pressing organisational improvements for incorporation into the management plan. See 10.4.8

Such a benchmarking exercise could start with a PROBE style analysis as used by the Inquiry for nine councils, but should also include a more detailed performance review thereafter.

Recommendation 37: Resource sharing

The DLG and the LGSA jointly undertake a functional analysis to determine which, if any, of the services that councils deliver would benefit from being provided by contractually-based resource sharing or outsourcing arrangements including jointly owned shared service centres and sizeable third party providers (e.g. regional electricity authorities). See 10.5.9

Initial survey work by the Inquiry (in conjunction with the University of New England) has demonstrated that this line of research could deliver tangible results that might encourage further resource sharing and outsourcing either to tap economies of scale or access scarce professional skills.

12.8 LOCAL GOVERNMENT FINANCES

Recommendation 38: Financial data

The DLG amend its Code of Accounting Practice and Financial Reporting for councils to standardise key accounting and reporting policies, especially in relation to asset condition assessment, asset valuation, depreciation rates, capital expenditure (including the distinction between asset maintenance, renewal and expansion), a high-level chart of accounts, a workforce profile database (each with agreed definitions of terms as exists in the NSW general government sector) and key financial indicators. See 11.2.1

Any such changes should be done in close consultation with the DLG's Accounting Advisory Group which includes members of the LGFP and LGAA.

Recommendation 39: Financial Benchmarks

The LGMA reissue its Sustainable Financial Health Check Manual with an expanded list of financial KPIs and an appropriate range of lower and upper benchmarks for each KPI along the lines shown in the table below. See 11.3.4

The expanded list should be determined collaboratively by the LGMA, LGSA, DLG, LGPP, LGAA and other relevant bodies.

Financial Key Performance Indicators	Average Council Actual	Proposed Council Target	Proposed Upper limit	Proposed Lower limit
Net debt as % of total revenue	10.5%	100%	150%	50%
Net financial liabilities as % of total capital employed	2.2%	10%	15%	5%
Net interest expense as % of total revenue	0.6%	15%	20%	7%
For general govt activities: Operating surplus as % of own-	-4.5%	5%	10%	0%

source revenue				
For commercial activities only: EBIT as % of non-financial assets	0.9%	5%	7%	3%
Net borrowing as % of capital expenditure on new or enhanced assets	1.3%	50%	60%	30%
Annual renewals deficiency as % of renewals capital expenditure	40.2%	0%	10%	-10%
Infrastructure backlog (\$M) as % of total infrastructure assets (estimated at fair value)	8.1%	0	1%	-1%

Recommendation 40: Infrastructure Borrowings

Councils increase their use of borrowing to fund necessary infrastructure spending. See 11.4. 5

Councils should consider making prudent use of additional borrowing to finance the enhancement of existing infrastructure assets and the acquisition of assets for a completely new purpose. Where alternative revenue funding is not readily available for the elimination of any major backlog in the renewal of existing assets, borrowings should also be considered for this purpose. Care should be taken with any increase in borrowings not to exceed the upper limits of the parameters in the above table (see recommendation 39).

Recommendation 41: Financial Responsibility

The State Government amend Section 232 of the LG Act to clarify that councillors are responsible and accountable for a council's financial governance in general and its financial sustainability in particular. See 11.6.12

Recommendation 42: Councillor Training

The DLG in conjunction with the LGSA and relevant professional bodies provide all councillors with specific training in the tools they need to undertake the expanded financial governance role envisaged in recommendation 41. See 11.6.13

Such training should also include information about strategic planning, town planning and development controls. The Inquiry's regional workshops repeatedly heard that land use planning and control was the area councillors felt least knowledgeable about.

Recommendation 43: Sustainability Ratings

The LGSA obtain the agreement of its members to appoint an independent expert organisation to regularly 'rate' the long-term financial situation and outlook of each council using an appropriate assessment methodology agreed in advance with the LGSA. See 11.6.14

This would put Local Government on par with State and Commonwealth Governments, whose finances are subject to regular review by credit rating agencies,

auditors' general, major financial institutions, the OECD and the International Monetary Fund.

Publishing such data would make communities aware of the financial capacity and sustainability of their individual council vis-à-vis other councils and any remedial measures needed. Unless electors become aware of the gravity of the infrastructure and financial problems of their own municipality or shire, they may not be agreeable to the cost savings and revenue hikes necessary to achieve sustainable Local Government.

Recommendation 44: Industry Database

The LGSA undertake a facilitation and coordination role in improving the financial governance and management of Local Government by providing a dedicated resource library, up-to-date statistical data base, best practice manuals, case studies and registry of recognised experts working within councils and accredited external consultants with the requisite expertise. See 11.7.16

Also, greater interstate cooperation between LGAs (perhaps assisted by ALGA) in exchanging staff and reform ideas would assist in this process given that other Local Government financial sustainability studies are under way (nationally and in Western Australia) or already completed (South Australia).

Recommendation 45: Reform Assistance

The State Government provide financial incentives and professional assistance to councils to facilitate key structural, financial and administrative reforms.
See 11.7.17

Possible support could include:

- Grandfathering for a period the financial assistance grants paid to a councils after any structural reform has occurred;
- Capital subsidies for investment in facilities required to support any major change process;
- Priority access to funding programs for councils that have made significant progress in undertaking reforms; and
- Professional advice and training to help councils upgrade their strategic planning, financial management and public policy and administration skills.

Recommendation 46: Surplus Budget

All councils make a concerted effort to achieve within three to five years a surplus on their operating budgets (excluding capital grants as income).
See 11.7.18

Section 100 of the NZ *Local Government Act 2002* stipulates that a council's annual income (excluding capital grants) in any financial year must be set at a level that covers all expenses.

The Inquiry is not recommending that such a requirement be included in the LG Act until rate pegging was scrapped or significantly relaxed and there was a significant improvement in FAGs. However, by adopting such a balanced-budget ‘golden rule’ each council would give public notice of the size of the revenue boost and/or expenditure saving necessary for it to become financially sustainable.

It would also commit a council to fostering intergenerational equity since a surplus operating budget would:

- Ensure that each year’s ratepayers met the full cost (including depreciation) of that year’s use of services and infrastructure; and
- Provide for the maintenance and renewal of existing infrastructure assets plus generate surplus revenue, which with borrowings could be used for funding future infrastructure.

Recommendation 47: Financial Governance

Each council include in its annual report a financial governance statement as outlined in Appendix B plus a comparison of the results for its key financial ratios against the targets and upper/lower limits shown in the table in recommendation 39 above. In addition, each year the DLG or LGSA prepare and publish a consolidated version of this statement for each of the metropolitan, regional and rural categories of councils as well as for Local Government as a whole. See 11.7.19

This short statement encapsulates in one table all the key financial variables, results and indicators necessary for councillors, managers and the public to adequately assess the financial health and progress of a council. It would enable councillors and other interested parties with a non-financial background to master the essence of good financial governance and understand how to monitor results against prudent benchmarks.

Besides publishing it in its annual report, a council could use this statement to monitor variations in its financial situation on a monthly, quarterly and annual basis. It is an example of ‘management’ accounting (designed to help run a particular organisation such as a council) as distinct from ‘statutory’ accounting (such as a council’s formal accounts) which are necessary for meeting statutory reporting requirements, but less well suited for helping councillors understand whether their council is financially sustainable or not.

12. 9 NEXT STEPS

Recommendation 48: Summit Conference

Stage a Local Government summit to which all interested parties would be invited. The purpose of this conference would be to consider, debate and hopefully endorse all or most of the recommendations of the Inquiry. See 1.13 – Recommendations.

A leadership team under the guidance of the LGSA plus a firm timetable for achieving tangible outcomes should also be an outcome of this event

Recommendation 49: Independent Commission

The summit consider proposing to the State Government an independent commission consisting of equal representative from the LGSA and the state to assess the gravity of the problems facing Local Government, to recommend urgent action to be undertaken, to help implement such changes in cooperation with Local Government and to monitor progress in achieving agreed outcomes. See 1.13 – Recommendations.

Such a vehicle is necessary for the State Government to coordinate its own response and actions to the Inquiry's Final Report. An important task of such a commission would be to prepare a draft intergovernmental agreement (IGA) for both the state and Local Government to consider.

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APPENDIX A

VOLUME 2 OF FINAL REPORT

(Visit 'Research Reports' under – www.lgi.org.au – to access all Research Reports and Papers in Volume 2 of the *Final Report*.)

1. Research Reports

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14. Kasper, W. (2005), *Local Autonomy – Healthy Local Democracy*, December 2005, Tura Beach.
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APPENDIX B

COUNCIL FINANCIAL GOVERNANCE STATEMENT

Introduction

This *pro forma* proposes a uniform presentation of a council's financial performance and position for internal and external 'financial governance' reporting purposes. As such, the treatment of some items in this *pro forma* departs from the standard treatment required for external accounting reporting purposes. These departures are necessary for the purposes of assisting councillors to make assessments related to the appropriate levels of council operating revenues and expenses, capital income and outlays, and borrowings and debt based on consideration for financial sustainability/inter-generational equity.

Reflecting best practice reporting, this *pro forma* includes not only financial data for the current (budget) year, but also (a) a recent financial history for comparative purposes (suggested to be a minimum of three years), and (b) financial projections over the medium term (suggested to be a minimum of five years) based on appropriate 'unchanged policy' assumptions.

Also, this *pro forma*, besides providing the key ratios identified by the Independent Inquiry, shows (a) annual year-on-year percentage changes for certain key aggregates, and (b) for the same key aggregates, the percentage variation from the previous estimates/projections tabled by council management for the years in question.

Definitions of the key terms used in this *pro forma* are provided in the **Table 1: Framework and Definitions**, in terms appropriate for a council's tax-supported activities. The numbers for the council as a whole are shown in **Table 2: Consolidated Summary** and are the sum total of the equivalent numbers for the council's tax-supported activities in **Table 3** and for the council's commercial activities, such as local water utilities (LWU) where applicable, in **Table 4**.

With two exceptions, all the financial data used in this *pro forma* are available from the notes or schedules to a council's annual financial statements. The exceptions are (a) the 'Capital expenditure on renewal/replacement of existing assets' item, and (b) the 'Capital expenditure on new and upgraded assets' item, neither of which are currently required by AAS27 or for the DLG's annual financial returns. The sum total of these two items, total capital expenditure, is also not currently required by AAS27 or the DLG's annual financial returns for Council activities other than LWUs.

Differences from AAS27 treatment

The sole *operating surplus* measure used in this *pro forma* is based on the surplus before capital amounts, with the following two further modifications:

- Realised gains/losses from the sale of assets are treated in this *pro forma* as below-the-line 'capital' receipts, and not as income/expenses; and

- The portion of a council's financial assistance grants from the Commonwealth Government designated as being for 'capital' purposes is treated in this *pro forma* as operating grants, and so no differently than the portion designated as being for 'operating' purposes.

Contentious issues

This *pro forma* defines 'working capital' as simply the difference between receivables on the one hand and payables on the other.

This *pro forma* proposes a differential treatment of 'restricted' versus 'unrestricted' cash and securities. Specifically, only the unrestricted portion of cash and securities is offset against debt when calculating the net debt measure; with the restricted portion being included in the total capital employed measure. Accordingly, in this *pro forma*, only interest earned on the unrestricted portion of cash and securities is offset against interest expense when calculating 'net interest expense'; with interest earned on the restricted portion of cash and securities being included in the 'investment income' item.

Qualifications

The definitions of key ratios in table 4 may need to be standardised where appropriate with definitions of the equivalent ratio mandated by DEUS.

Table 1: Council Financial Governance Statement – Framework and Definitions

ITEM ⁴³	KEY INDICATORS	DEFINITIONS
FINANCIAL PERFORMANCE		
Operating grants from the Commonwealth		Financial assistance grants (untied; both operating and "capital")
<i>plus</i> Operating grants from the State government		Pensioners' rates subsidies; Specific purpose operating grants (from State)
Operating grants from other governments		
Rates revenue (ordinary and special)		Ordinary rates (revenue); Special rates (revenue)
<i>plus</i> Fees and charges		Annual charges (revenue); User charges (revenue); Fees (revenue)
<i>plus</i> Investment income (not including interest income)		Interest (revenue) from holdings of restricted cash & securities; Gain from interests in joint ventures/associates <i>less</i> any loss from interests in joint ventures/associates; Tax equivalents payable from LWUs; Dividends payable from LWUs
<i>plus</i> Other revenue (not including realised gains on asset sales)		Other revenue from ordinary activities; Operating contribution and donations
Own-source revenues (before interest and realised gains on asset sales)		
Total revenue before capital amounts (and before interest and realised gains on asset sales)	<i>annual % increase % variation on previous estimates/projections</i>	Operating grants from other governments <i>plus</i> Own-source revenues
Interest expense		Interest charges (Borrowing costs)
<i>less</i> Interest income		Interest (revenue) from holdings of cash & securities other than externally restricted cash & securities
Net interest expense	<i>% of total revenue before capital amounts</i>	
Employee-related operating expenses		Employee costs
<i>plus</i> Depreciation expense		Total depreciation -- to be revised onto an approximate 'fair value' basis
<i>plus</i> Other operating expenses (before any realised losses on asset sales)		Materials & contracts; Other expenses from ordinary activities
Other expenses (before any realised losses on asset sales)		
Total expenses (before any realised losses from asset sales)	<i>annual % increase % variation on previous estimates/projections</i>	Net interest expense <i>plus</i> Other expenses
Operating surplus/(deficit) before capital amounts (and before realised gains/losses on asset sales)	<i>% of own-source revenue</i>	Total revenue before capital amounts <i>less</i> Total expenses
Capital expenditure on renewal/replacement of existing		<i>special-purpose estimate required</i>

⁴³ Item defined in terms used in Annual Financial Statements as well as aggregates appearing elsewhere in this *pro forma*

ITEM⁴³	KEY INDICATORS	DEFINITIONS
assets		
<i>less</i> Depreciation expense		Total depreciation -- to be revised onto an approximate 'fair value' valuation basis for the associated assets
Net acquisition of existing non-financial assets	<i>annual % increase % variation on previous estimates/projections % of capex on renewal/ replacement of existing assets</i>	
Capital expenditure on new and upgraded assets		<i>special-purpose estimate required</i>
<i>less</i> Capital receipts		Carrying amount of assets sold (property, plant & equipment, other assets) <i>plus</i> Gain from the disposal of assets <i>less</i> any loss from the disposal of assets <i>plus</i> Specific purpose capital grants (from other governments) <i>plus</i> Capital contribution and donations (general purpose and specific purpose)
Net acquisition of new and upgraded non-financial assets	<i>annual % increase % variation on previous estimates/projections % of capex on new/ upgraded assets</i>	
Net borrowing/(lending)	<i>% of total capital employed</i>	Net acquisition of existing non-financial assets <i>plus</i> Net acquisition of new and upgraded non-financial assets <i>less</i> Operating surplus/(deficit) before capital amounts
FINANCIAL POSITION		
Plant, property & equipment		Plant & equipment; Office equipment; Furniture & fittings; PPE leased; Land; Buildings; Other structures; Infrastructure, Other assets) -- to be revised onto an approximate 'fair value' basis
<i>plus</i> Inventories		Inventories
<i>plus</i> Cash & securities restricted		Cash assets; Investment securities {both restricted only}
<i>plus</i> Working capital		Total receivables {restricted and unrestricted} <i>less</i> Total payables {specific purpose and general purpose}
Total capital employed		
Interest bearing liabilities		Total interest bearing liabilities {specific purpose and general purpose}
<i>less</i> Cash & securities unrestricted		Cash assets; Investment securities {both unrestricted only}
Net debt	<i>% of total revenue before capital amounts</i>	
Provisions		Total provisions {specific purpose and general purpose}
<i>less</i> Interests in joint ventures & associates		Interests in joint ventures & associates
<i>less</i> Other assets		Prepayments; Other {both restricted and unrestricted}
Other net liabilities		
Net financial liabilities/(worth)	<i>% of total capital employed</i>	Net debt <i>plus</i> Other net liabilities
Net worth		Total capital employed <i>less</i> Net financial liabilities

Table 2: Council Financial Governance Statement - Consolidated Summary

		2002-03	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11
FINANCIAL PERFORMANCE		actual	actual	actual	estimate	projection	projection	projection	projection	projection
Local water utilities (LWUs) plus Other (tax-supported) activities	\$ 000s									
Total revenue before capital amounts	\$ 000s									
<i>annual % increase</i>	%									
<i>% variation on previous estimates/projections</i>	%	n.a.	n.a.	n.a.						
Local water utilities (LWUs) plus Other (tax-supported) activities	\$ 000s									
Total expenses	\$ 000s									
<i>annual % increase</i>	%									
<i>% variation on previous estimates/projections</i>	%	n.a.	n.a.	n.a.						
Operating surplus/(deficit) before capital amounts	\$ 000s									
<i>% of own-source revenue</i>	%									
Local water utilities (LWUs) plus Other (tax-supported) activities	\$ 000s									
Net acquisition of existing non-financial assets	\$ 000s									
<i>annual % increase</i>	%									
<i>% variation on previous estimates/projections</i>	%	n.a.	n.a.	n.a.						
<i>% of capex on renewal/replacement of existing assets</i>	%									
Local water utilities (LWUs) plus Other (tax-supported) activities	\$ 000s									
Net acquisition of new and upgraded non-financial assets	\$ 000s									
<i>annual % increase</i>	%									
<i>% variation on previous estimates/projections</i>	%	n.a.	n.a.	n.a.						
<i>% of capex on new/upgraded assets</i>	%									
Net borrowing/(lending)	\$ 000s									
<i>% of capital employed</i>	%									

FINANCIAL POSITION

		30 June 2003	30 June 2004	30 June 2005	30 June 2006	30 June 2007	30 June 2008	30 June 2009	30 June 2010	30 June 2011
		actual	actual	actual	estimate	projection	projection	projection	projection	projection
Local water utilities (LWUs) plus Other (tax-supported) activities	\$ 000s									
Net debt	\$ 000s									
<i>% of total revenue before capital amounts</i>	%									
Local water utilities (LWUs) plus Other (tax-supported) activities	\$ 000s									
Net financial liabilities/(worth)	\$ 000s									
<i>% of capital employed</i>	%									

Table 3: Council Financial Governance Statement – Tax Supported Activities

		2002-03	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11
FINANCIAL PERFORMANCE		actual	actual	actual	estimate	projection	projection	projection	projection	projection
Operating grants from the Commonwealth	\$ 000s									
<i>plus</i> Operating grants from the State government	\$ 000s									
Operating grants from other governments	\$ 000s									
Rates revenue (ordinary and special)	\$ 000s									
<i>plus</i> Fees and charges	\$ 000s									
<i>plus</i> Investment income (not including interest income)	\$ 000s									
<i>plus</i> Other revenue	\$ 000s									
Own-source revenues (before interest and realised gains on asset sales)	\$ 000s									
Total revenue before capital amounts (and before interest and realised gains on asset sales)	\$ 000s									
<i>annual % increase</i>	%									
<i>% variation on previous estimates/projections</i>	%	n.a.	n.a.	n.a.						
Interest expense	\$ 000s									
<i>less</i> Interest income	\$ 000s									
Net interest expense	\$ 000s									
<i>% of total revenue</i>	%									
Employee-related operating expenses	\$ 000s									
<i>plus</i> Depreciation expense	\$ 000s									
<i>plus</i> Other operating expenses (before realised losses on asset sales)	\$ 000s									
Other expenses (before any realised losses on asset sales)	\$ 000s									
Total expenses (net of interest income)	\$ 000s									
<i>annual % increase</i>	%									
<i>% variation on previous estimates/projections</i>	%	n.a.	n.a.	n.a.						
Operating surplus/(deficit) before capital amounts (and before realised gains/losses on asset sales)	\$ 000s									
<i>% of own-source revenue</i>	%									
Capital expenditure on renewal/replacement of existing assets	\$ 000s									
<i>less</i> Depreciation expense	\$									

FINANCIAL PERFORMANCE		2002-03	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11
		actual	actual	actual	estimate	projection	projection	projection	projection	projection
	000s									
Net acquisition of existing non-financial assets	\$ 000s									
<i>annual % increase</i>	%									
<i>% variation on previous estimates/projections</i>	%	n.a.	n.a.	n.a.						
<i>% of capex on renewal/replacement of existing assets</i>	%									
Capital expenditure on new and upgraded assets less Capital receipts	\$ 000s \$ 000s									
Net acquisition of new and upgraded non-financial assets	\$ 000s									
<i>annual % increase</i>	%									
<i>% variation on previous estimates/projections</i>	%	n.a.	n.a.	n.a.						
<i>% of capex on new/upgraded assets</i>	%									
Net borrowing/(lending)	\$ 000s									
<i>% of total capital employed</i>	%									

FINANCIAL POSITION		30 June 2003	30 June 2004	30 June 2005	30 June 2006	30 June 2007	30 June 2008	30 June 2009	30 June 2010	30 June 2011
		actual	actual	actual	estimate	projection	projection	projection	projection	projection
Plant, property & equipment plus Inventories	\$ 000s \$ 000s									
plus Cash & securities restricted plus Working capital	\$ 000s \$ 000s									
Total capital employed	\$ 000s									
Interest bearing liabilities less Cash & securities unrestricted	\$ 000s \$ 000s									
Net debt	\$ 000s									
<i>% of total revenue before capital amounts</i>	%									
Provisions less Interests in joint ventures & associates less Other assets	\$ 000s \$ 000s \$ 000s									
Other net liabilities	\$ 000s									

Net financial liabilities/(worth)	\$ 000s								
<i>% of total capital employed</i>	%								
Net worth	\$ 000s								

Table 4: Council Financial Governance Statement – Commercial Activities (e.g. Local Water Utilities)

		2002-03	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11
FINANCIAL PERFORMANCE		actual	actual	actual	estimate	projection	projection	projection	projection	projection
User charges	\$ 000s									
<i>plus</i> Other charges	\$ 000s									
<i>plus</i> Operating contributions/donations	\$ 000s									
<i>plus</i> Other revenue (not including interest income)	\$ 000s									
Total revenue before capital amounts (and before interest)	\$ 000s									
<i>annual % increase % variation on previous estimates/projections</i>	%	n.a.	n.a.	n.a.						
Employee-related operating expenses	\$ 000s									
<i>plus</i> Other operating expenses	\$ 000s									
<i>plus</i> Depreciation expense	\$ 000s									
Expenses before interest and taxes	\$ 000s									
<i>annual % increase % variation on previous estimates/projections</i>	%	n.a.	n.a.	n.a.						
Earnings before interest and taxes (EBIT)	\$ 000s									
<i>% of total capital employed</i>										
Interest expense	\$ 000s									
<i>less</i> Interest income	\$ 000s									
Net interest expense	\$ 000s									
<i>% of total revenue before capital amounts</i>	%									
Tax equivalents paid	\$ 000s									
<i>plus</i> Dividends paid	\$ 000s									
Tax and dividend expenses	\$000s									
Interest, tax and dividend expenses	\$ 000s									
<i>% of earnings before interest and taxes</i>	%									
Operating surplus/(deficit) before capital amounts	\$ 000s									

FINANCIAL PERFORMANCE

		2002-03	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11
		actual	actual	actual	estimate	projection	projection	projection	projection	projection
Capital expenditure on renewal/replacement of existing assets <i>less</i> Depreciation expense	\$ 000s \$ 000s									
Net acquisition of existing non-financial assets	\$ 000s									
<i>annual % increase % variation on previous estimates/projections % of capex on renewal/replacement of existing assets</i>	% % %	n.a.	n.a.	n.a.						
Capital expenditure on new and upgraded assets <i>less</i> Capital receipts	\$ 000s \$ 000s									
Net acquisition of new and upgraded non-financial assets	\$ 000s									
<i>annual % increase % variation on previous estimates/projections % of capex on new/upgraded assets</i>	% % %	n.a.	n.a.	n.a.						
Net borrowing/(lending)	\$ 000s									
<i>% of total capital employed</i>	%									

FINANCIAL POSITION

		30 June 2003	30 June 2004	30 June 2005	30 June 2006	30 June 2007	30 June 2008	30 June 2009	30 June 2010	30 June 2011
		actual	actual	actual	estimate	projection	projection	projection	projection	projection
Plant, property & equipment <i>plus</i> Inventories	\$ 000s \$ 000s									
<i>plus</i> Cash & securities restricted <i>plus</i> Working capital	\$ 000s \$ 000s									
Total capital employed	\$ 000s									
Interest bearing liabilities <i>less</i> Cash & securities unrestricted	\$ 000s \$ 000s									
Net debt	\$ 000s									
<i>% of total revenue before capital amounts</i>	%									
Provisions	\$									

<i>less</i> Interests in joint ventures & associates	000s \$								
<i>less</i> Other assets	000s \$								
Other net liabilities	000s \$								
Net financial liabilities/(worth)	\$ 000s								
<i>% of total capital employed</i>	%								
Net worth	\$ 000s								