Smoke and Mirrors: Fallacies in the NSW Government's Views on Local Government Financial Capacity

Presentation to Local Government Professionals Forum

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Preface

- This presentation is based on a paper with the same title jointly authored by Peter Abelson and Roselyne Joyeux.

- Peter Abelson is Mayor of Mosman and ex-Professor of Economics at Macquarie University. Roselyne Joyeux is an Associate Professor in Economics at Macquarie University.

- The Journal of *Public Money and Management* (an international refereed journal) has accepted the paper for publication.

- A copy of the paper can be downloaded from mosman.nsw.gov.au/news/2014/09/24/local-government-reform/

Amalgamation and ‘Fit for the Future’

- NSW Government proposes amalgamations across NSW.
- Aim in metropolitan Sydney to reduce the 41 local councils with average population just over 100,000 down to about 14 councils with an average population of 270,000 (and growing).
- New council structures were proposed by the Independent Local Government Review Panel (ILGRP, 2013).
- Under it’s “Fit for the Future” program, NSW Government requires all local councils to demonstrate by 30 June 2015 that they are adopting the structures proposed by ILGPR or some alternative that meets its critical criteria: scale, strategic capacity and financial sustainability.

The “Three” Criteria?

- It is not clear that scale defined as population has any significance separately from strategic capacity (or financial sustainability).

- In OLG advice to councils (Council Improvement Proposal, Completing Template 2), the concepts of scale and capacity are used interchangeably

- Capacity is defined in terms of 10 amorphous criteria such as “Knowledge, creativity and innovation”, “Advanced skills in strategic planning and policy development” and “Credibility for more effective advocacy”. These criteria cannot be quantified.

- Thus they appear to allow the Government to reach any conclusion that it sees fit.

- But focus of this paper is on relationship, if any, between size of local councils and financial sustainability.

Financial Sustainability

- In “Fit for the Future”, the NSW Government defines a financially sustainable council as “one that, over the long term, is able to generate sufficient funds to provide the level and scope of service agreed with its community through the Integrated Planning and Reporting process”.

- But it adopts various **current** financial ratios as indicators of financial strength. I will return to financial ratios later.

Three main points in our paper

1 The NSW Government has changed a key financial benchmark which was the basis for government rate setting since 1977 and it has exploited this change to allege that many local councils lack financial capacity without taking responsibility for rate pegging.

2 Lack of financial capacity is fundamentally a function of low income not of the size (population) of a local council area.

3 Differences in expenditure per capita are explained by differences in income and service levels not by the size of the local community or the unit cost of services.

Changing the financial benchmark

- For many decades up to 2012, councils and the OLG reported revenues inclusive of capital contributions and grants.
- Council surpluses were estimated primarily as the difference between total revenue (including capital contributions and grants) and total expenses.
- Typically an extra row in council accounts would show council operating results with capital contributions and grants excluded.

Changing the Financial Benchmark

- Following NSW TCorp report on *The Financial Sustainability of the Local Government Sector* in April 2013, the OLG excluded capital contributions and grants from operating revenue and published retrospective changes to the 2009/10 and 2010/11 figures.

- As shown in our paper, these changes made a dramatic difference to the outcomes. Comfortable council surpluses with capital contributions and grants became operating deficits without them.

Some Observations

- First, I support this change in accounting definition of a budget surplus. Combining opex and capex creates muddled thinking. Ideally current expenses (services) should be met from current revenues and capital grants spent on capital expenditure and included in the capital budget. This maximises the net public worth (the net assets) of the community.

- Having said that, a council with a surplus inclusive of capital contributions and grants **is** increasing the net assets of the local community, even if it is running an operating deficit exclusive of capital grants. These communities are becoming better off, not worse off as some of the rhetoric implies.

- But, third and most important, the State Government has pegged rates annually since 1977 and has done so on the basis of the traditional financial benchmark. It should accept responsibility for the outcomes, not blame councils.

Rate Pegging and Other Variables

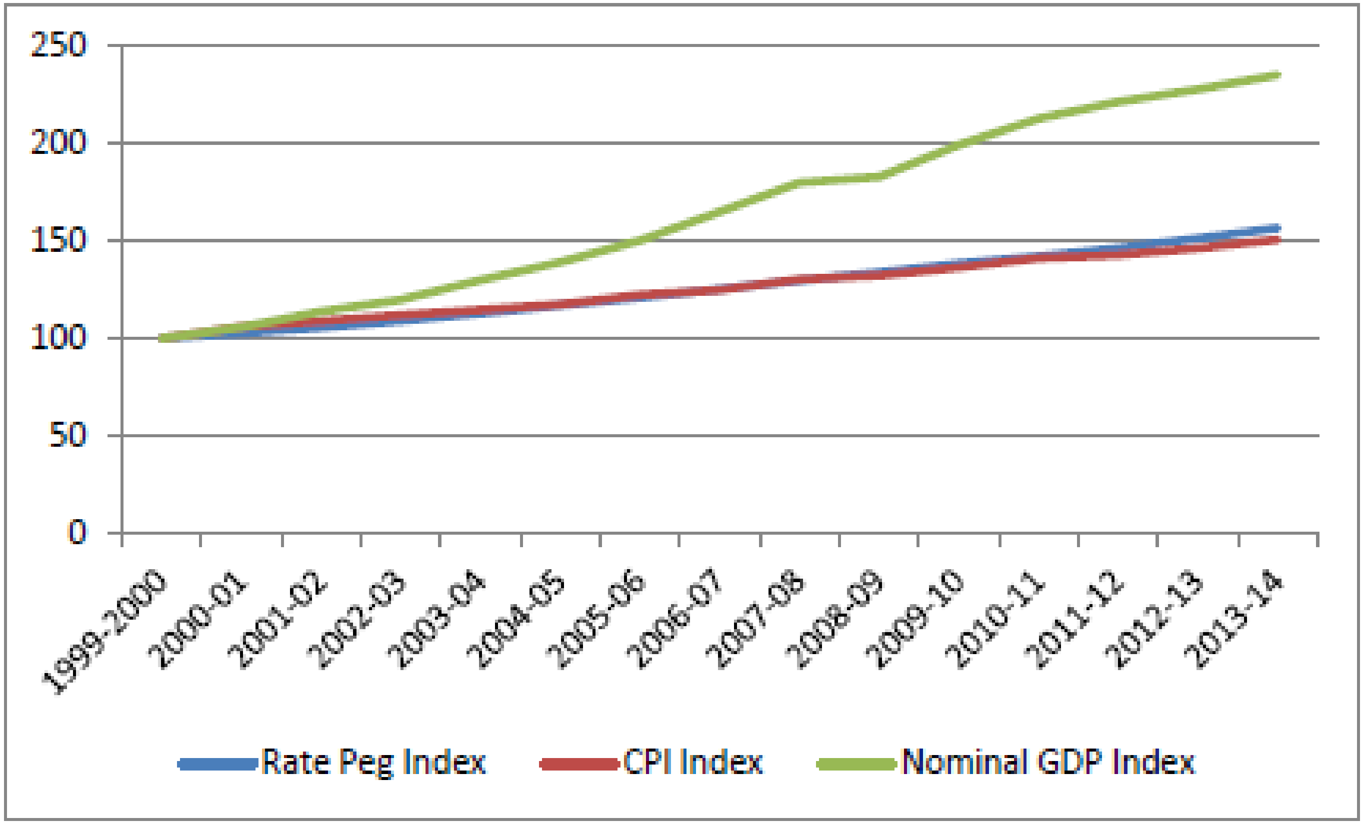
- Between 1999-2000 and 2013-14, regulated rates rose by 56.5% compared with the rise in the CPI of 50.5%, the rise in the wage price index of 63.9% and the rise in GDP of 134.8%.

- In other words, despite large rises in population, community incomes and demands, the state government did not allow for **any** increase in local council services in over 10 years.

- In effect the government was viewing operating deficits without concern. If these deficits had been a concern, the government could surely have allowed rate increases at least up to the increase in GDP.

- Certainly local councils could apply for rate variations. But evidently the OLG was content with the financial results that it was overseeing and regulating.

Figure 1 Rate pegging, gross domestic product and the CPI



Rate Pegging Under IPART

- In December 2013 IPART regulated a miserly 2.3% rate rise for 2014-15.
- This was the **lowest** rate increase since 1998-99.
- Yet, a few months later IPART (September, 2014) wrote "We consider that operating performance ratio is a key measure of financial sustainability and is fundamental for councils to be "fit for the future".
- If IPART was so concerned about councils' operating deficits, why did it not provide for a higher rate increase?

Conclusion on Point One

- In this regulatory environment it is wrong to infer that councils running operating deficits are unable to run balanced budgets, if they have the authority to do so.
- The NSW Government made the rules, the benchmarks and the rate pegs.
- It has now changed the benchmark for a balanced operating budget (which is appropriate) but not the rate pegs.
- The state government should accept responsibility for this and not use the rule change to denigrate the financial capacity of local councils.

Financial Capacity and Income

- Fiscal capacity is essentially a function of per capita income levels.

- In a major review of the revenue raising capacities of local councils around Australia, the Productivity Commission (2008) found that “the fiscal capacity of a council is best measured as the aggregate after-tax income of the community ... The higher is the fiscal capacity of a local government, the higher is its potential to raise revenue.”

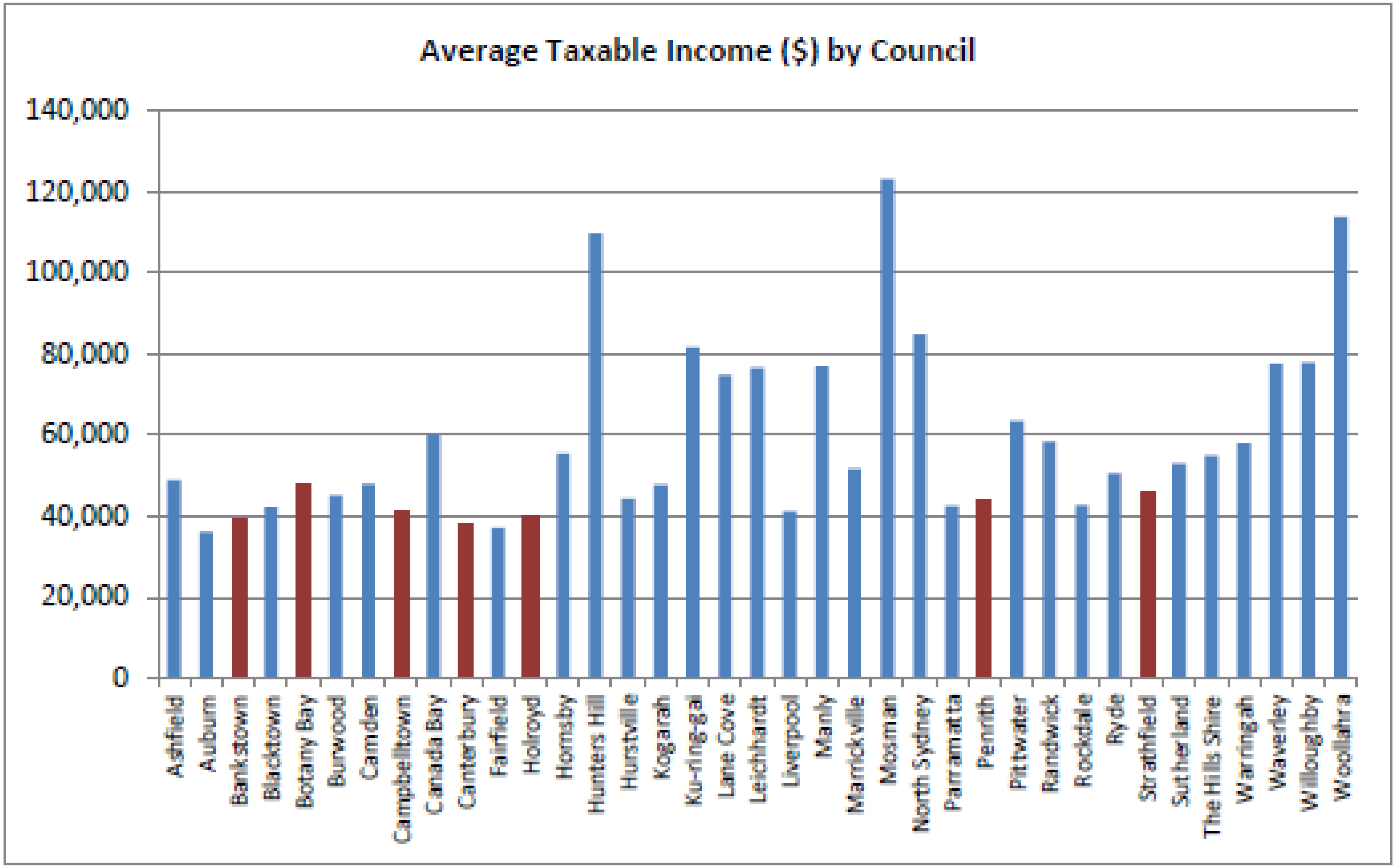
- This fundamental finding is confirmed from analysis of the local councils that NSW TCorp (2013) deemed likely to be financially weak.

- Drawing on 2011 Census data, the average taxable income of the 7 council areas in metropolitan Sydney deemed to have a weak financial outlook was $42,366.

- On the other hand, the average taxable income of the other 30 council areas deemed to have a moderate or strong financial outlook was $61,237.

- It is stunningly clear that income is the key source of financial weakness.

Figure 2 Average Taxable Income (weak areas in red)



Other Factors in Financial Weakness

- While TCorp (2013) deemed less than 20% of the Sydney metropolitan council areas to have a weak financial outlook, two-thirds of all other councils in NSW were found to have a weak financial outlook.

- TCorp highlights the financial weakness of councils in the north coast and western regions of NSW. Nineteen councils in these two regions are among the 24 least financially sustainable regions in NSW.

- TCorp also recognises that most of the urban councils that are financially weak or very weak are "in regional areas outside Sydney".

- Financial weakness is due to low population density as well as low incomes and is principally (though not solely) a non-metropolitan problem.

Expenditure per Capita and Income

- Larger organisations have the capacity to achieve greater internal economies of scale than small ones.
- However small organisations can achieve economies by shared services or by out-sourcing to large private firms.
- Importantly, organisational and behavioural inefficiency tends to rise in larger organisations (with which I do have some experience).
- So what is the evidence for cost efficiency and population size?

Authoritative Reviews

- Dollery et al. (2012) provide detailed and extensive evidence in Australia and internationally that forced amalgamations have not produced financial sustainability or any cost savings.

- In a further major review in an international peer reviewed journal, Dollery et al. (2013) cite 15 international studies from the United States, Canada and Europe all of which throw doubt on the claimed economies of consolidated local councils.

- They then examine 8 Australian national and state-based inquiries into the financial sustainability of local councils over the past decade. They found (p.215) that "with one exception, these inquiries are sceptical of the ability of forced amalgamation to improve local authority financial viability".

IPART's Misleading Contention

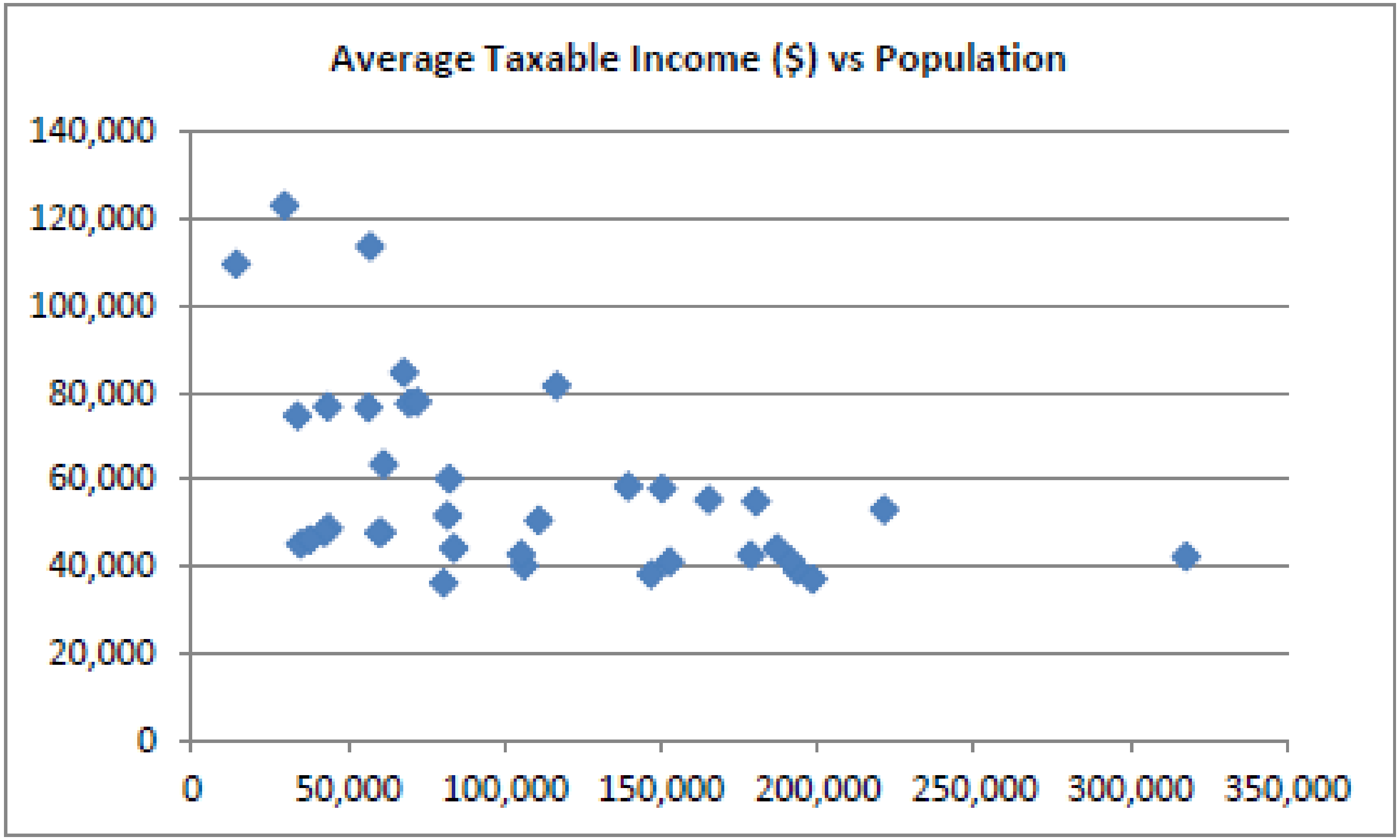
- On the other hand, IPART (2014) endorsed the ILGRP view that larger councils are more efficient than small ones.

- According to IPART, the data showed that "around 30% of the variation in opex per head amongst the councils of Greater Sydney is inversely associated with their population and that opex per head is lower the larger the population of the LGA".

- This finding is misleading because it fails to account for the substantial inverse correlation (of –0.49) between local council size and income levels per capita (see Figure 3).

- As it happens, in Sydney, smaller councils generally have higher income per capita and hence the residents expect, and are willing to pay for, more services. Larger councils in Sydney tend to spend less per capita than small ones because of lower income, not greater efficiency (see below). The lower expenditure would indicate efficiency only if the larger councils were producing equivalent services to small ones.

Figure 3 Average Taxable Income and Population of Local Council



Explaining Differences in Expenditure

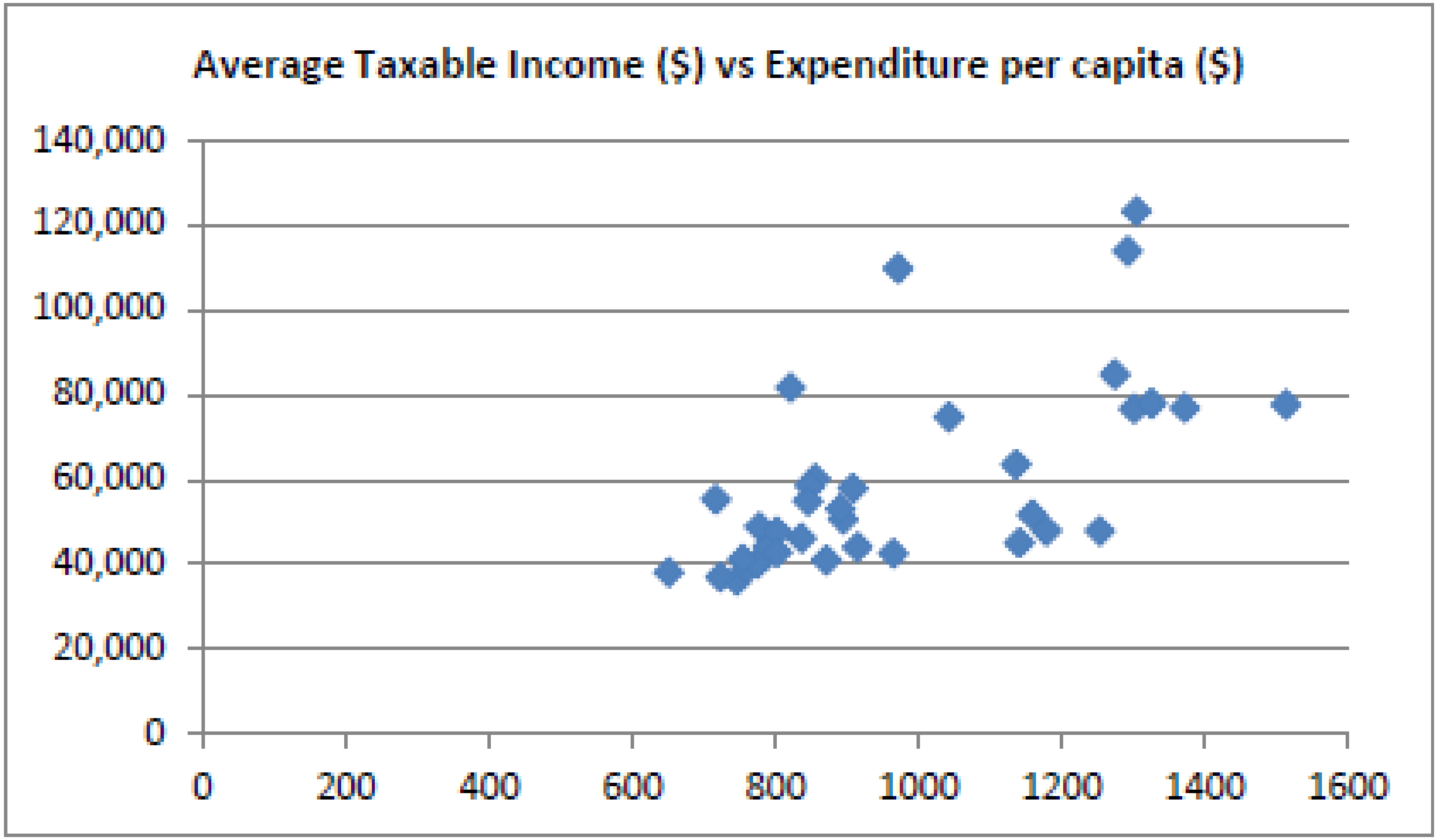
- In our paper we test the hypothesis that differences in operating expenditure per head are due primarily to differences in income and find that this hypothesis is strongly validated.

- Figure 4 (next slide) depicts the bivariate relationship between expenditure and income.

- Once differences in income are allowed for, the relationship between expenditure per head and population size is not statistically significant.

- To explain differences in local government expenditure, we collected the latest public data on expenditure per capita, population and average taxable income for the 37 local councils in metropolitan Sydney (excluding the City of Sydney and outlying councils)

Figure 4 Average Taxable Income and Expenditure per Capita



Statistical Results

- We then ran a regression with expenditure per capita as the dependent variable and population, average taxable income per capita and a dummy variable for major business centres (North Sydney, Willoughby and Parramatta) as explanatory variables.

- This equation is in log-log form. This means that the coefficients represent percentage changes in both the dependent and the explanatory variables. The results are shown in next slide.

- Taxable income and business centre are highly significant at the 1% level of significance. A 10% increase in average taxable income raises expenditure per head significantly by actually quite modestly 3.2% per capita. A business centre raises expenditure per head by nearly 19%.

- Differences in taxable income and business centres account for about 50% of the variation in expenditure per head.

- On the other hand, population is NOT statistically significant at the 10% level of significance (the p-value is greater than 0.10). This means that the coefficient does not satisfy the statistical test that it is clearly different from zero.

Table 3 Explaining Differences in Expenditure per Capita

Variable	Coefficient	Std. Error	t-ratio	P-value	Significance
Constant	4.367	1.570	2.78	0.009	***
Log Pop'n	-0.093	0.556	-1.68	0.102	
Log Tax income	0.323	0.105	3.07	0.004	***
Business centre	0.186	0.040	4.68	0.000	***
R squared	0.532				

Financial Ratios: Brief Comments

- The OLG has mandated that councils must show "fitness" under 7 financial ratios. I comment here on 5 of the ratios.

- The first ratio is a balanced operating budget. This is fine if it means **capacity** to achieve a balanced operating budget rather than actually doing so.

- A household with assets of $5m and income of $200,000 p.a. that spends $220,000 p.a. is not balancing a budget but it is clearly sustainable (unless someone has a gambling addiction!).

- But showing capacity is not always a simple matter.

Financial Ratios: Brief Comments

- More contentious are the three asset related ratios:
  - the Building and Asset Renewal Ratio,
  - the Infrastructure Backlog Ratio and
  - the Asset Maintenance Ratio.

- However there is NO consistent audit standard or verifiable data for key components of each ratio respectively:
  - Depreciation
  - “satisfactory condition” or
  - “required asset maintenance”.

- This means that all three ratios are non-comparable across councils and highly questionable.

Financial Ratios: Brief Comments

- Criteria 7: Councils must show “a decrease in real operating expenditure per capita over time”.
- Operating expenditure = $\sum C_i Q_i$
  - Where *C* is cost per unit of service, *Q* is quantity (units) of each service and there are *i* services
- Of course cost per unit of service (*C*) is important.
- But criteria 7 takes no account of service levels (either *i* or *Q*).
- This is totally unacceptable. It is inconsistent with the Government’s own definition of financial sustainability cited above. Indeed it appears to display a failure to understand basic economics.

Conclusions

- Our paper shows that financial capacity is fundamentally a function of local community income. It is not a function of council size.
- Neither the ILGRP nor OLG has produced any evidence to show that financial capacity or efficiency is a function of the size of a council or that mega councils of 250,000 or more persons are more efficient than small councils.
- Most councils in the Sydney Metropolitan area can run balanced operating budgets if they are not subject to unreasonable rate pegging. It is irresponsible to decry operating deficits and then in 2014-15 to allow the lowest rate increase in 15 years.
- However, less well-off and lower density council areas, especially outside Sydney, will likely need some financial assistance to provide acceptable services with, or without, amalgamation.

Final Comments

- Of course, there are other important issues, including the quality of local services and care for the local environment on the one hand and metropolitan and state wide planning of transport, housing and other infrastructure on the other hand.

- Arguably, small and medium sized councils are the more appropriate vehicles for provision of local services and protection of the local environment. In the famous words of Montesquieu (1748), “In a small republic, the public good is more strongly felt, better known and closer to the citizen”.

- Other vehicles, such as regional organisations in Sydney and outside, may facilitate the provision of metropolitan or regional infrastructure or, in the language of Fit for the Future, provide “strategic capacity”.

- Regrettably discussion of strategic capacity to date, including the ILGRP report and the Fit for Future template, is characterised more by slogans and rhetoric than by careful, evidence-based, discussion of the real issues.