

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

Peter Abelson and Roselyne Joyeux¹

Introduction

Under its "Fit for the Future" program, the NSW Office of Local Government (OLG, 2014) requires local councils to demonstrate that they are adopting a local council structure that has scale, strategic capacity and is financially sustainable. This paper addresses the relationship between scale (population) and financial sustainability.²

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". However the Government has pre-empted rational and informed analysis of the efficient financial scale of local councils with its arguments that councils are currently running financial deficits of \$1 million a day and that this can be rectified only by councils adopting a scale of organisation in the order of 250,000 persons per mega council as recommended by the Independent Local Government Review Panel (ILGRP, 2013).

The ILGRP provided **no** evidence or reference in its report to support their view that larger councils are more financially sustainable than small ones. And, as this paper shows, the NSW Government's equation of scale with financial capacity is both baseless and incorrect. There is no basis for the belief that larger councils are necessary for financial sustainability.

This paper makes three main points. Points 2 and 3 are related.

- 1 The State 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 the 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.

¹ Dr. Peter Abelson is Mayor of Mosman Council and has held a Chair in Economics at Macquarie University. Dr. Roselyne Joyeux is an Associate Professor at Macquarie University.

² "Fit for the Future" defines "strategic capacity" in term of 10 amorphous criteria such as "Credibility for more effective advocacy", which cannot be quantified. These criteria would appear to allow the Government to reach any conclusion that it sees fit.

Taken singly, and more especially together, these points show that the local council scale and financial capacity are not equivalent. Financial capacity is fundamentally a function of income, not of “scale” however that may be defined. This has important and fundamental implications for the structure of local government and amalgamation policies.

In this paper we demonstrate each of these three main points and draw some important conclusions.

Financial benchmarks and NSW government rate setting

For many decades, both local councils and the OLG have reported revenues inclusive of capital contributions and grants. Consistent with this, council surpluses have been estimated primarily as the difference between total revenue (including capital contributions and grants) and total expenses. Typically an additional row in council accounts has shown council operating results with capital contributions and grants excluded.

Table 1 shows how OLG reported total revenue and expenses in its annual reports up to 2012 (when the results for 2010-11 were published). These reports showed total revenue inclusive of capital grants and expenses and total expenses, and we have added the total surpluses into the table. They also showed operating revenue and expense per capita, but not the total operating deficit or operating deficit per capita, which we have estimated and included.

Following the publication of the TCorp report on Financial Sustainability in April 2013, with its strong emphasis on the operating deficit, the OLG radically changed the format of its annual report, dropped total revenue inclusive of capital contributions and grants, and published only the operating revenue as in Table 2, including retrospective changes to the 2009/10 and 2010/11 figures.

Table 1 Summary of Financial Results for NSW Councils

		Mean	High	Low	Median
2009/10					
Total revenue ^a	\$'000	61,592	457,841	5,947	37,991
Total expenses ^a	\$'000	54,832	378,870	4,610	32,474
Total surplus ^a	\$'000	6,760	78,971	1,337	5,517
Operating deficit per capita ^b	\$	-13	-358	-3	-62
2010/11					
Total revenue ^a	\$'000	(c)	496,989	7,034	38,736
Total expenses ^a	\$'000	(c)	390,797	6,656	37,794
Total surplus ^a	\$'000	(c)	106,192	468	942
Operating deficit per capita ^b	\$	-75	-179	-6	-143

(a) Revenue including capital grants and contributions.

(b) Excluding capital grants and contributions.

(c) Figures given were wildly different and clearly inaccurate and so not reproduced here.

Source: Office of Local Government, *Comparative Information of NSW Local Government Councils 2009/10 and 2010/11*.

Table 2 NSW Key Financial Aggregates for Local Councils (\$ million)

	2009/10	2010/11	2011/12
Total revenue ^a	8,284	8,811	9,340
Total expenses	8,510	9,485	9,606
Operating surplus (deficit) ^a	-93	-532	-267

(a) Excluding capital grants and contributions

Source: Source: Division of Local Government, *Comparative Information of NSW Local Government Councils 2011/12*, October 2013.

As can be seen from Tables 1 and 2, these changes make a dramatic difference to the outcomes. Comfortable council surpluses with the inclusion of capital contributions and grants become (operating) deficits without them.

Here three main points should be made. First, we support this change in the accounting definition of a surplus. Ideally current expenses (services) should be met from current revenues and capital grants should be spent on capital expenditure and included in the capital budget. This maximises the net public worth (the net assets) of the community.

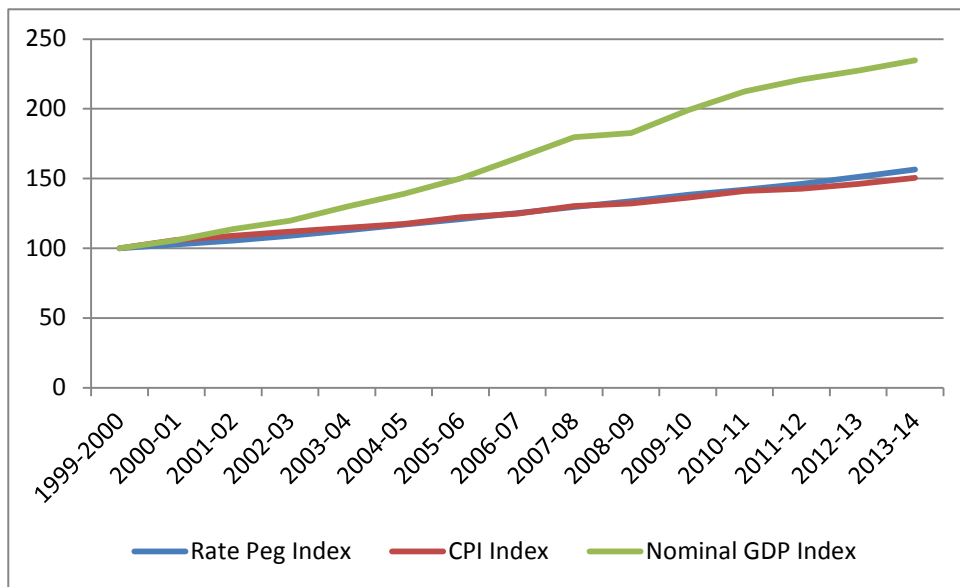
However, having said that, a council that runs a net surplus inclusive of capital contributions and grants **is** increasing the net assets of the local community, even if it is running an operating deficit exclusive of capital grants. These communities are becoming better off, not worse off as some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

The third and most important point relates to the government responsibility for rate pegging and its consequences. The NSW Government has been pegging council rates annually since 1977. The Independent Pricing and Regulatory Tribunal (IPART) took over in 2011/12. The figures since 1989-90 are shown in Table A.1 in the annex.

As shown in Table A.1 and in Figure 1 (next page), 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 nominal GDP (which includes increases in real income as well as price increase) of 134.8.5%.

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. Moreover, 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



Further, in the rate pegging that followed the TCorp report in April 2013, IPART in December 2013 regulated a miserly 2.3% rate rise for 2014-15.³ 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?⁴

In this regulatory environment it does not follow that councils running operating deficits could not run balanced budgets if they were given the authority to do so. The NSW Government made the rules, the benchmarks and the rate pegs. It has now changed the benchmark but not the rate pegs. That is fine. But 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

In its major review of the revenue raising capacities of local councils around Australia, the Productivity Commission (2008, p. xviii, p. xxiii) found conclusively 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.” Fiscal capacity is essentially a function of per capita income levels, not the nature of the rate base.

³ Arguably the real rate increase was 2.6% as IPART allowed an extra 0.3% two years earlier to compensate councils for the carbon tax. This would still be the lowest rate increase since 1999-2000.

⁴ Given the rate ruling was made only in December 2013, it was impossible for a council to respond to the extensive reporting and consultation requirements involved in seeking a rate rise by mid-February 2014 unless it had started this process several months earlier.

This fundamental finding is strongly confirmed from analysis of the local councils that NSW TCorp (2013) deemed likely to be financially weak either based on past performance or more importantly in their forward financial outlook. In the annex to this paper we provide a map of weak, moderate and strong councils based on TCorp views of their financial outlook and a table of relevant income and other statistics for local councils in the Sydney Metropolitan area.

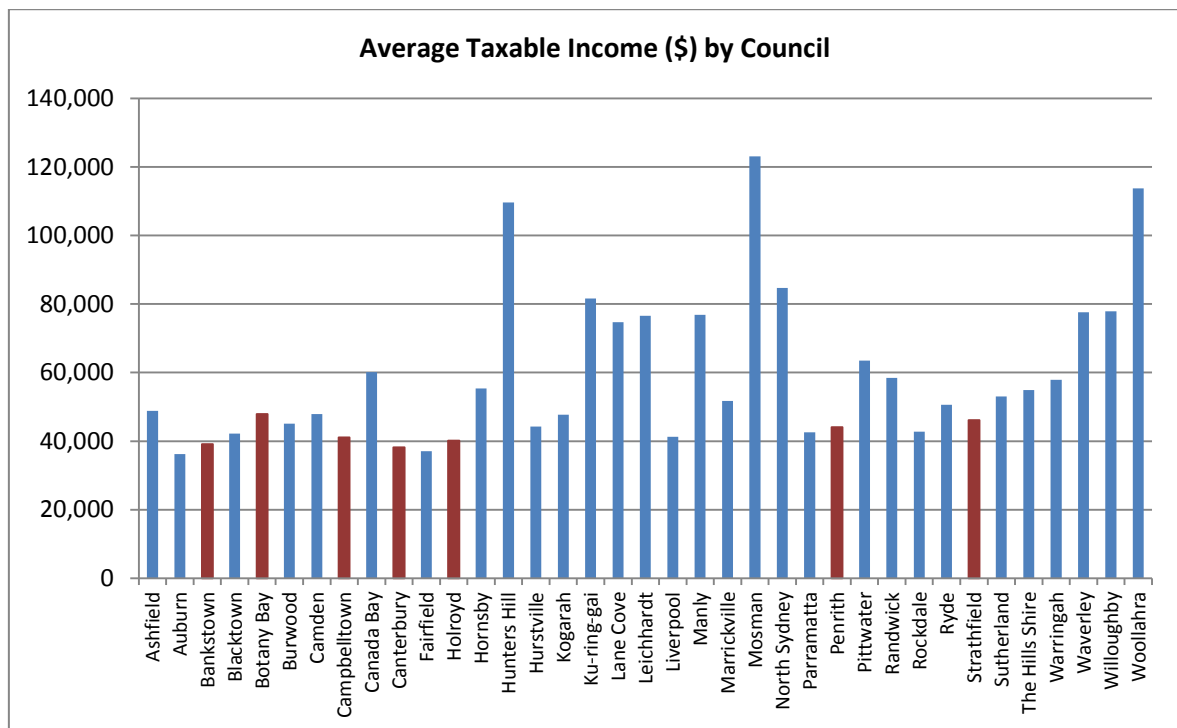
As shown in the Annex Table A.2, drawing on 2011 Census data, the average taxable income of the seven council areas in metropolitan Sydney deemed by TCorp to have a financially weak outlook was \$42,366. On the other hand, the average taxable income of the other 30 council areas deemed to have a moderate or strong financial outlook was \$61,237. It is stunningly clear that income is the key source of financial weakness.

Figure 2 provides a graphical depiction of the same point. No area with an average taxable income of over \$48,000 has a weak financial outlook.

It may also be observed that 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 (see Annex Figure A.1). TCorp (p. 14) highlights the financial weakness of councils in the north coast and western regions. 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.

Figure 2 Average Taxable Income (weak areas in red)



Expenditure per Capita and Income

As noted at the start of this note, the ILGRP (2013) provided no evidence that larger organisations are more efficient than smaller ones. Certainly larger councils have the potential to achieve more internal economies of scale than smaller councils. However, small councils can generally achieve similar economies of scale by shared services with other councils or by outsourcing some services to large private providers.

Moreover, there is little doubt that organisational and behavioural inefficiency rises with the size of the bureaucracy. Truly it may be said that all bureaucracies waste money and the larger the bureaucracy the more is wasted.

What is the evidence? 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. They conclude that anyone who still believes that compulsory council amalgamation leads to financial sustainability in local government, lower costs or scale economies, has not acquainted themselves with the vast empirical literature on amalgamation.

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”.

On the other hand, in a recent report IPART (September 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). Smaller councils generally have higher income per capita and hence the local 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. The lower expenditure would indicate efficiency only if the larger councils were producing equivalent services to small ones.

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

Figure 3 Average Taxable Income and Population of Local Council

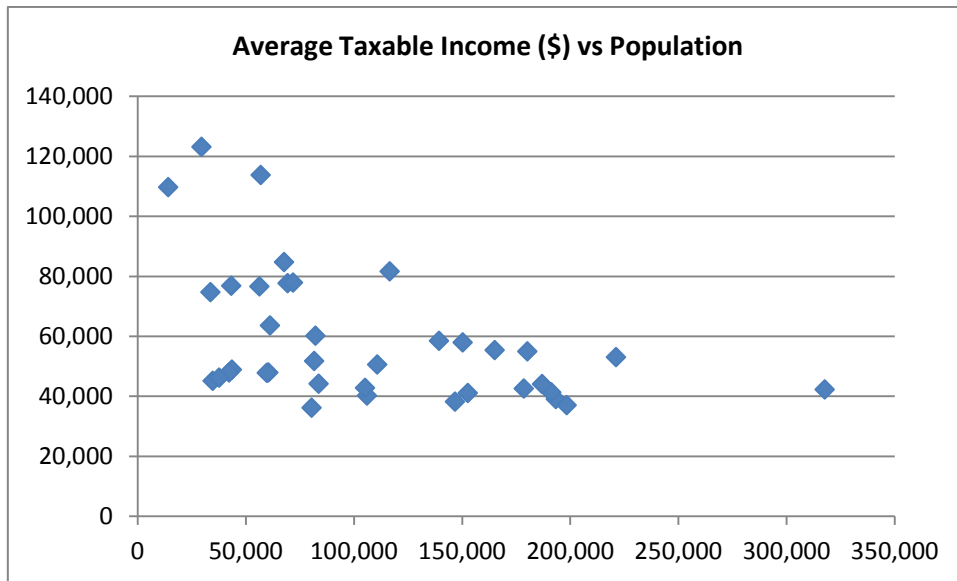
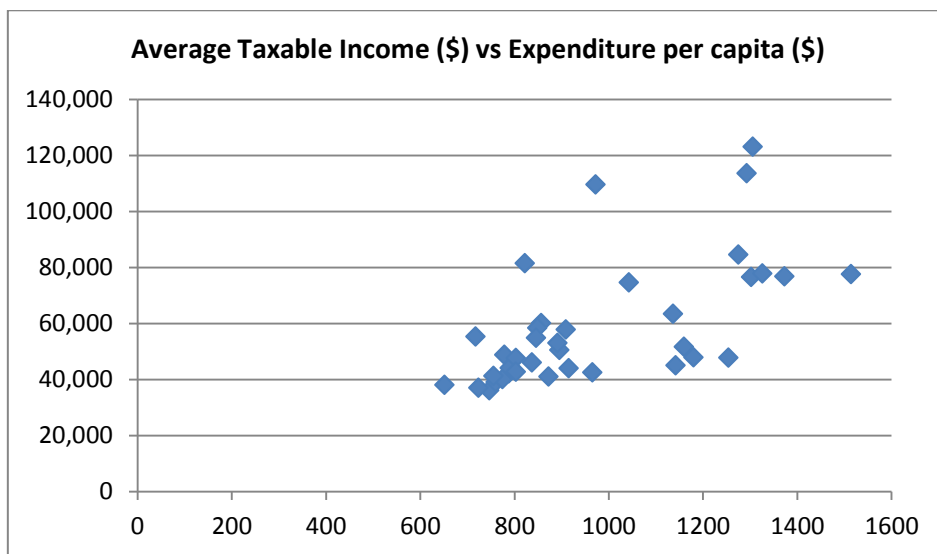


Figure 4 Average Taxable Income and Expenditure per Capita



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) as shown in Annex Table A.2.

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 Table 3.

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				

As shown 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 cent 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. It should also be noted that there is significant heteroscedasticity and, for this reason, robust standard errors were used.⁵

On the other hand, after allowing for differences in income per capita, 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.

Finally it may be remarked that even if population size were marginally significant (which it is not), this could be due to the greater inclusiveness of small population areas which, other things such as income being equal, tend to want a greater supply of local services. For example, research that we have done shows that volunteering is substantially greater per head of population in small councils than in large one.

Conclusions

As the Productivity Commission (2008) showed and as we have shown in this paper, financial sustainability or capacity is fundamentally a function of local community income. It is not a function of council size. The ILGRP produced **no** evidence to show that financial capacity is a function of the size or scale of a council area and **no** evidence to show that mega councils of 250,000 people or more are efficient or produce the services that local community want. Nor has the OLG been able to explain why population scale and financial capacity are synonymous.

As this paper has shown most councils in the Sydney Metropolitan area would be able to run financially sustainable, balanced, operating budgets if they were able to determine their own rates and were not subject to rate pegging. It is irresponsible to decry operating deficits and then in 2014-15 to allow the lowest rate increase in 15 years. On the other hand, less well-off

⁵ Heteroscedasticity means that there is a systematic variation in the error terms with increases in expenditure per capita.

and lower density council areas, especially outside the Sydney Metropolitan area, would need financial assistance with, or without, amalgamation.

Finally it should be noted that this paper has been concerned with financial capacity as this is a core focus of the “Fit for the Future” requirements. We recognise that there are other important issues, including the provision 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.

It is strongly our view that small and medium sized local councils are by far the best vehicles for provision of local services and for 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 Joint (Regional) Organisations may be needed to facilitate the provision of metropolitan and state infrastructure or, in the language of Fit for the Future, to provide “strategic capacity”. Regrettably discussion of strategic capacity to date, including in the ILGRP report, has been characterised more by slogans and rhetoric than by careful, evidence-based, discussion of the real issues.

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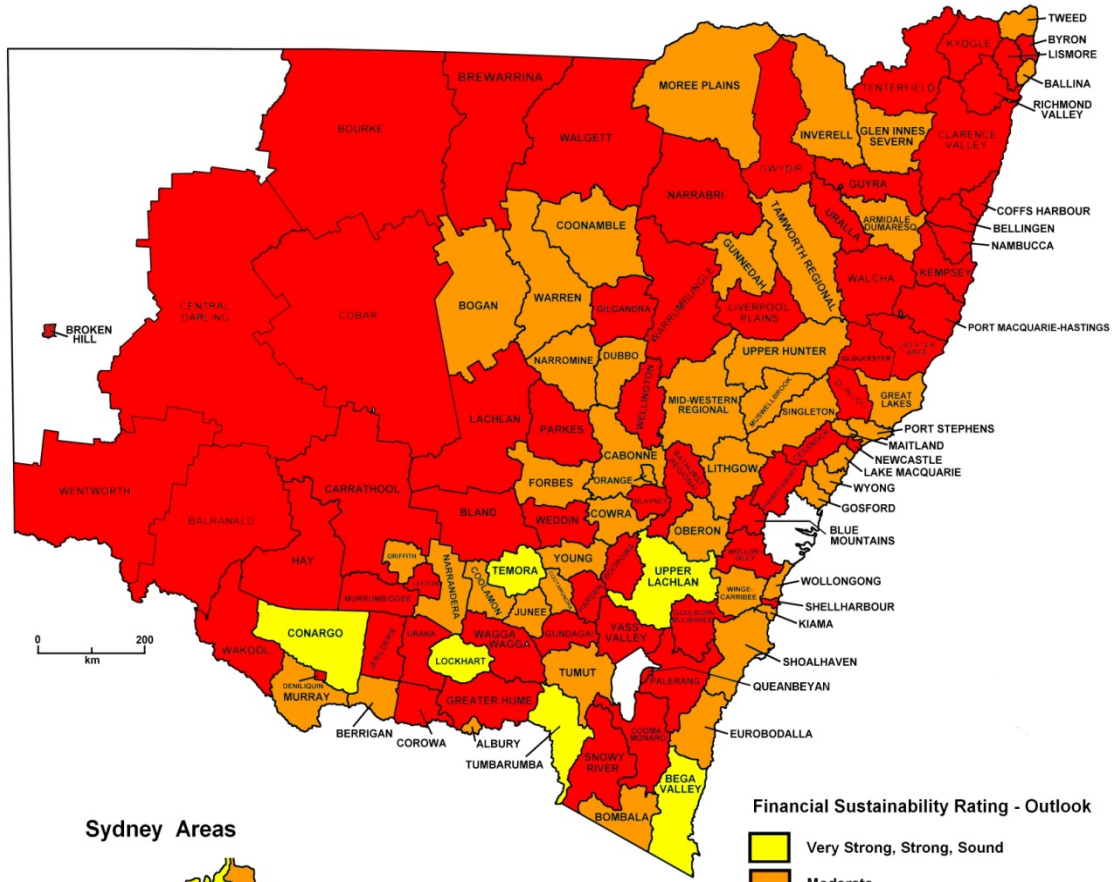
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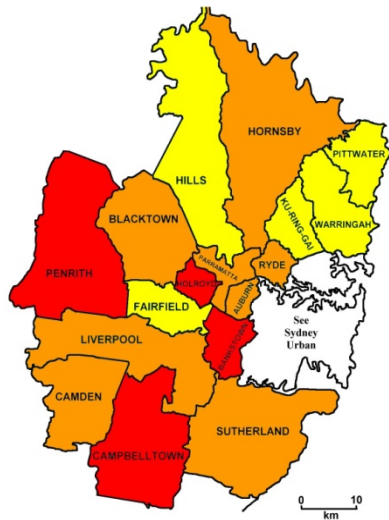
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Figure A.1

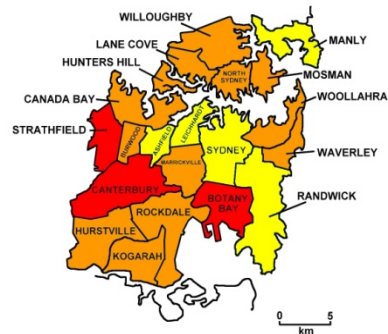
Financial Sustainability Rating - Outlook



Sydney Areas



Sydney Urban Areas



Financial Sustainability Rating - Outlook

- Very Strong, Strong, Sound
- Moderate
- Weak, Very Weak, Distressed

Source: Office of Local Government based on TCorp maps.

Table A.1 Analysis of Rate Pegging and Comparable Data

	Rate peg	Rate peg	CPI	CPI	Wage	Wage	Nominal	Nominal
	%	index	% change	index	price	price	GDP	GDP
	increase		over year	June	index	index	% change	index
Financial year					% change	June	over year	June
					over year			
1989-90	7.3	74.9	7.7	81.3			7.4	
1990-91	4.9	80.4	3.3	84.0			-0.5	65.0
1991-92	1.5	84.3	1.2	85.0			3.4	64.7
1992-93	2.6	85.6	1.8	86.6			6	66.8
1993-94	3.5	87.8	1.8	88.2			5.5	70.9
1994-95	0.0	90.9	4.5	92.2			5.8	74.8
1995-96	2.2	90.9	3.1	95.0			8.6	79.1
1997-98	2.7	92.9	0.3	95.3			5.9	85.9
1998-99	3.1	95.4	0.7	96.0			4.5	91.0
1998-99	1.7	98.3	1.0	97.0	3.1	97.0	5.2	95.1
1999-2000	2.4	100.0	3.1	100.0	3.0	100.0	8.4	100.0
2000-01	2.7	102.7	6.1	106.1	3.7	103.7	5.7	105.7
2001-02	2.8	105.6	2.8	109.1	3.1	106.9	7.6	113.7
2002-03	3.3	109.1	2.6	111.9	3.6	110.8	5.3	119.8
2003-04	3.6	113.0	2.5	114.7	3.5	114.6	8.5	129.9
2004-05	3.5	116.9	2.5	117.6	4.1	119.3	7.1	139.2
2005-06	3.5	121.0	4.0	122.3	4.2	124.4	7.8	150.0
2006-07	3.6	125.4	2.1	124.8	4.0	129.3	9.8	164.7
2007-08	3.4	129.7	4.4	130.3	4.3	134.9	9.1	179.7
2008-09	3.2	133.8	1.4	132.2	3.8	140.0	1.7	182.8
2009-10	3.5	138.5	3.1	136.3	3.0	144.2	8.8	198.9
2010-11	2.6	142.1	3.5	141.0	3.8	149.7	6.8	212.4
2011-12	2.8	146.1	1.2	142.7	3.8	155.4	4.0	220.9
2012-13	3.6	151.3	2.4	146.1	2.8	159.7	3.0	227.5
2013-14	3.4	156.5	3.0	150.5	2.6	163.9	3.2	234.8
2014-15	2.3	160.1						

Sources: Office of Local Government and Reserve Bank of Australia

Table A.2 2011/12 Data for 37 Local Councils in Metropolitan Sydney excluding City of Sydney

LGA's	Operating costs (\$'000)	Opex per capita (\$)	Population	Avg taxable income (\$)	Business centre	Financial outlook (a)
Ashfield	33,969	778	43,661	48,859		M
Auburn	60,026	746	80,422	36,178		M
Bankstown	146,897	760	193,398	39,083		W
Blacktown	250,170	788	317,598	42,241		M
Botany Bay	53,059	1254	42,317	47,875		W
Burwood	39,570	1141	34,668	45,117		M
Camden	71,414	1179	60,546	47,896		M
Campbelltown	133,029	872	152,612	41,044		W
Canada Bay	70,378	856	82,201	60,161		M
Canterbury	95,556	651	146,729	38,145		W
Fairfield	143,437	723	198,335	37,051		S
Holroyd	82,112	774	106,038	40,166		W
Hornsby	118,395	717	165,090	55,348		M
Hunters Hill	13,740	972	14,139	109,660		M
Hurstville	66,095	790	83,671	44,208		M
Kogarah	47,987	803	59,782	47,745		M
Ku-ring-gai	95,744	822	116,527	81,612		S
Lane Cove	35,167	1043	33,726	74,698		M
Leichhardt	73,301	1302	56,307	76,617		M
Liverpool	144,365	755	191,244	41,261		M
Manly	59,525	1372	43,371	76,827		M
Marrickville	94,718	1159	81,689	51,700		M
Mosman	38,635	1305	29,605	123,143		M
North Sydney	86,324	1275	67,722	84,686	X	M
Parramatta	172,349	965	178,549	42,571	X	M
Penrith	171,051	915	186,938	44,083		W
Pittwater	69,551	1136	61,201	63,529		S
Randwick	118,254	849	139,365	58,428		M
Rockdale	84,476	803	105,227	42,783		M
Ryde	99,149	895	110,791	50,595		M
Strathfield	31,516	837	37,665	46,166		W
Sutherland	197,036	891	221,147	53,063		M
The Hills Shire	152,414	846	180,214	54,921		S
Warringah	136,563	909	150,275	57,939		S
Waverley	105,122	1514	69,431	77,618		M
Willoughby	95,379	1326	71,933	77,896	X	M
Woollahra	73,661	1293	56,986	113,742		M
Average		973	107,328	58,774		
	Av. tax. Income	Av. Population				
Weak areas	42,366	123,671				
Moderate areas	61,683	95,955				
Stong areas	59,010	141,310				
Mod/strong areas	61,237	103,514				

(a) Source: Treasury Corp view of council financial outlook: S = strong, M= moderate W = weak.

Source: Office of Local Government: *Comparative Information on NSW Local Government, 2012/13.*