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

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As many readers of *Public Money and Management* will be aware, the NSW Government plans to amalgamate local councils across the state of NSW. Within metropolitan Sydney the Government proposes to reduce the 38 local councils with an average population size of just over 100,000 down to about 14 councils with an average population of 270,000 and growing. The new council structures were proposed by the Independent Local Government Review Panel (ILGRP, 2013). Under its "Fit for the Future" program, the NSW Office of Local Government (OLG, 2014) requires all local councils to demonstrate by 30 June 2015 that they are adopting the proposed council structures or some alternative structure that meets its three critical criteria of scale, strategic capacity and financial sustainability.

It is not clear that scale defined as population has any significance separately from strategic and financial capacity. And strategic capacity is defined in the "Fit for the Future" document 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 would appear to allow the Government to reach any conclusion that it sees fit. But the focus of this paper is on the relationship, if any, between size of jurisdiction and financial sustainability.

In "Fit for the Future", the NSW Government defines a financially sustainable council as "one that is able to generate sufficient funds to provide the level and scope of service agreed with its community". However the Government has pre-empted rational 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 council.

It should perhaps be noted that the Chair of the ILGRP, Graham Sansom, has argued strongly in this very journal that the ILGRP recommended amalgamated councils solely on strategic, and not on financial, grounds (Sansom, January 2015). This assertion may surprise readers of the ILGRP report which appears at many points to link the case for larger councils with concerns about financial sustainability (see, for example, pages 3, 7, 18, 26, 72-3 and 98). Whether or not the ILGRP did allege a causal relationship between population size and financial sustainability, the NSW Government has certainly done so in its "Fit for the Future" program.

We should also recognise the recent valuable contribution by Drew and Donnelly (July, 2014) in this journal. Drew and Donnelly make three main points. Commercially based financial ratios and their associated benchmarks should be used with extreme caution as a basis for structural reform; there is little evidence of any relationship between the financial sustainability ratio benchmarks and population size in Sydney; and it is very doubtful whether amalgamations would improve the financial ratios.

This paper complements the Drew and Donnelly analysis. In this paper we show that the NSW Government's equation of population size with financial capacity is both baseless and incorrect at least in Sydney.

In particular, we make the following three main points.

1. The NSW Government has changed a key financial benchmark which was the basis for government rate setting since 1977 and 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 of a local council.

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.

These points show that the local council population and financial capacity are not equivalent. Financial capacity is fundamentally a function of income, not of "scale" however defined. This has fundamental implications for the structure of local government and amalgamation policies.

Financial benchmarks and NSW government rate setting

For many decades, both local 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.

Table 1 shows how OLG reported total revenue and expenses in its annual reports up to 2010-11. These reports showed total revenue inclusive of capital grants and expenses and total expenses, and we 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 NSW Treasury Corporation (TCorp, 2013) report on *The Financial Sustainability of the Local Government Sector*, 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.

These changes substantially change the outcomes. Comfortable council surpluses with the inclusion of capital contributions and grants become operating deficits without them.

It should be noted that we support this change in definition of a surplus. Ideally current 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 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 has an operating deficit exclusive of capital grants. These communities are becoming better off, not worse off as some of the rhetoric implies.

More important is the NSW Government's responsibility for rate pegging and its consequences. The NSW Government has pegged council rates annually since 1977. The Independent Pricing and Regulatory Tribunal (IPART) took over in 2011/12.

As shown in Table A.1 in the Annex, 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 real income as well as price increases) of 134.8%.

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 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.

Further, **following** the TCorp report in April 2013, IPART in December 2013 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?

In this regulatory environment it is wrong to infer that councils are unable to run balanced budgets. 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 a major review of the revenue raising capacities of local councils around Australia, the Productivity Commission (2008) concluded 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 strongly confirmed from analysis of the local councils that NSW TCorp (2013) deemed likely to be financially weak. In the Annex we provide a map of weak, moderate and strong councils based on TCorp views of their financial outlook and a table of income and other statistics for local councils in the Sydney Metropolitan area.

As shown in 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. The average taxable income of the other 30 council areas deemed to have a moderate or strong financial outlook was $61,237. No area with an average taxable income of over $48,000 has a weak financial outlook. It is clear that income is the key source of financial weakness.

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). Nineteen councils in the north coast and western regions of NSW 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

Certainly larger councils have the potential to achieve more 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 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 for cost efficiency and population size? The ILGRP report (2013) did not produce any evidence.

Dollery et al. (2012) provide detailed evidence in Australia and internationally that forced amalgamations have not produced cost savings. They conclude that anyone who still believes that compulsory council amalgamation leads to lower costs or scale economies is not acquainted with the vast empirical literature on amalgamation.

In another major review, Dollery et al. (2013) cite 15 international studies from the United States, Canada and Europe all of which throw doubt on claimed economies of consolidated local councils. They also examine 8 Australian inquiries into the financial sustainability of local councils over the past decade and 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, the NSW Independent Pricing and Regulatory Tribunal (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".

However, this finding failed to account for the substantial inverse correlation (of –0.49) between local council size and income levels per capita (see Figure 1). In Sydney, 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 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 this hypothesis is strongly validated. Figure 2 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 1 Average Taxable Income and Population of Local Council

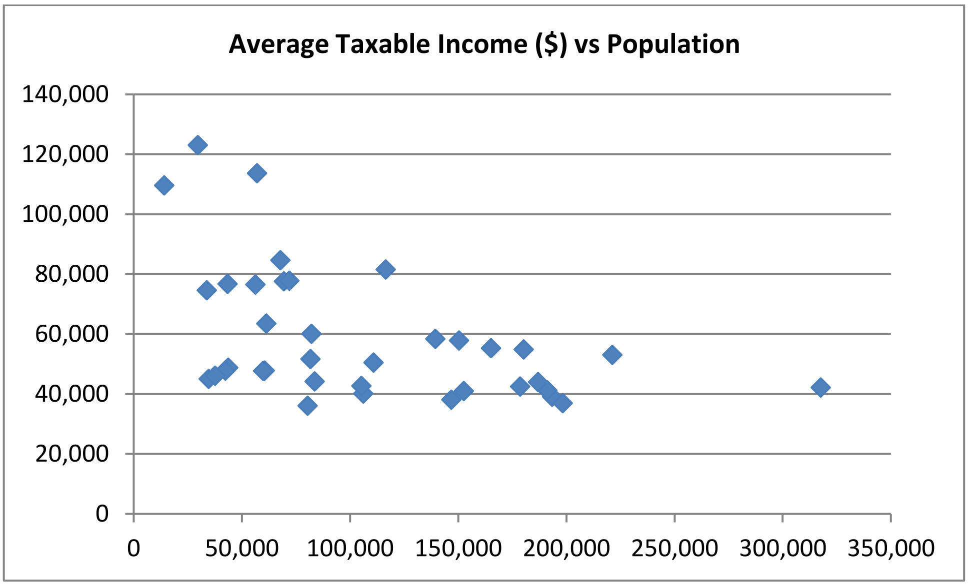
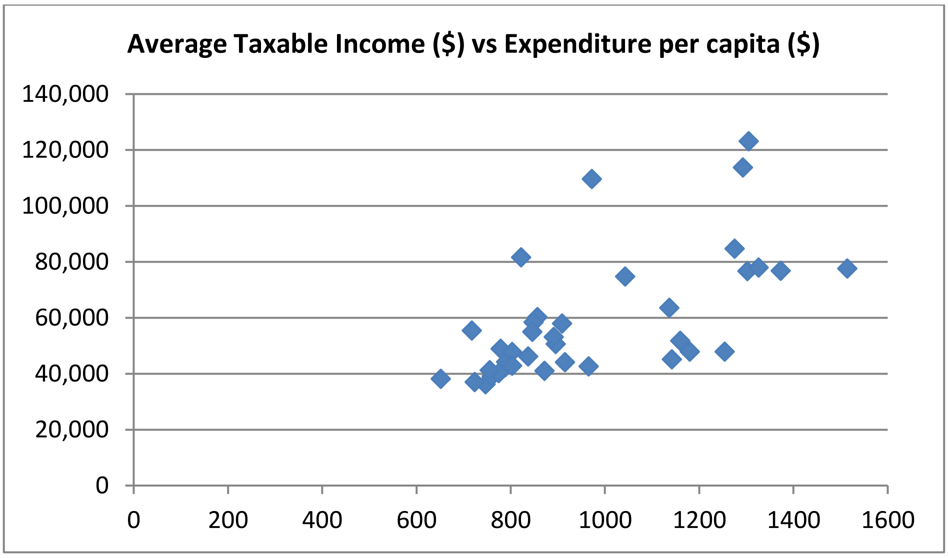


Figure 2 Average Taxable Income and Expenditure per Capita



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 explained as a function of population, average taxable income per capita and a dummy variable for major business centres (North Sydney, Willoughby and Parramatta). 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.

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. As there is significant heteroscedasticity, robust standard errors are used. 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).

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				

Conclusions

Financial sustainability or capacity is fundamentally a function of local community income, not of council size. The ILGRP produced **no** evidence to show that large councils are more financially efficient than small councils. Nor has the NSW Office of local Government explained why population scale and financial capacity are synonymous.

Most councils in the Sydney metropolitan area could run sustainable, balanced, operating budgets if they 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 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 NSW Government “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 the best 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 Joint Regional Organisations may facilitate the provision of metropolitan and state infrastructure or, in the language of Fit for the Future, 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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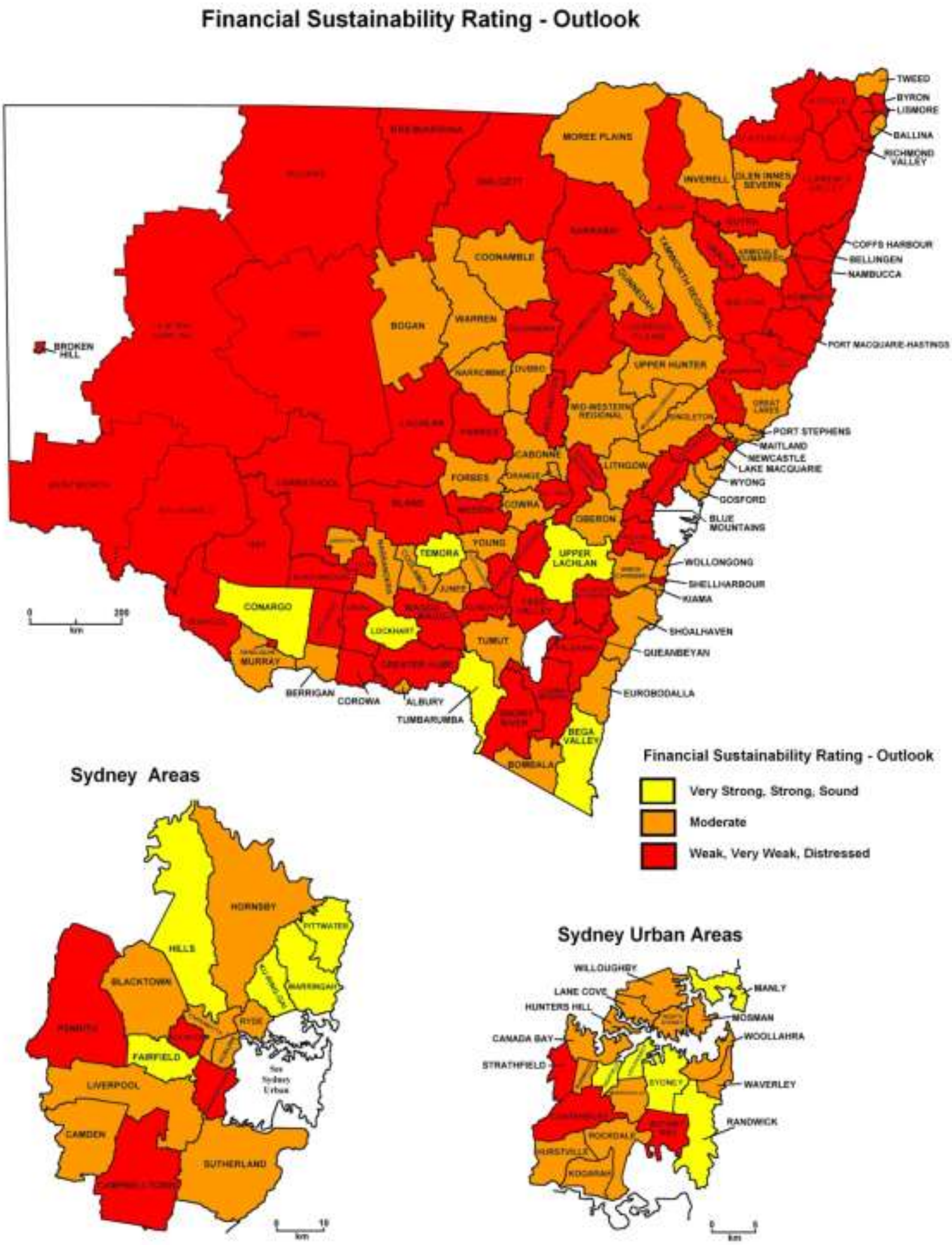
Figure A.1



Source: Office of Local Government based on TCorp maps.

Table A.1 Analysis of Rate Pegging and Comparable Data

Financial year	Rate peg % increase	Rate peg index	CPI % change over year	CPI index June	Wage price index % change over year	Wage price index June	Nominal GDP % change over year	Nominal GDP index June
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.