Careful What You Wish For: Rate-Capping in Victorian Local Government

Joseph Drew* and Brian Dollery#

The new Victorian Government won the 2014 election on a platform to inter alia introduce a cap on council rates in all Victorian councils. This means that a rate-cap will be introduced beginning with the 2016/17 financial year, with future rises in rates pegged at the Consumer Price Index (CPI) after this date. This paper provides a comparative empirical analysis of New South Wales local government - the only Australian local government system to operate a rate-pegging regime - and Victorian local government with respect to rate-capping. We find evidence to support the proposition that rate-capping has deleterious effects on municipal revenue effort, equity, debt and infrastructure maintenance. Moreover, our findings do not provide empirical evidence in support of the claim that rate-capping increases municipal efficiency. The paper concludes by considering various alternative public policy instruments to rate-capping.

1. INTRODUCTION

Local government systems worldwide are subject to a myriad of regulatory regimes, ranging from highly prescriptive to more *laisse faire*, with Australian state and territory local government

* Post-Doctoral Fellow, Institute of Public Policy and Governance, University of Technology Sydney.
# Professor of Economics and Director of the University of New England Centre for Local Government.

jurisdictions typically at the former end of the spectrum.[1] While the nature of municipal regulation varies widely, state-imposed limitations on council expenditure and revenue-raising represent one of its more draconian manifestations. In particular, state-wide limits on property tax increases, commonly known as 'rate-capping' or 'rate-pegging' in Australian local government, are an especially powerful policy instrument. In general, the rationale for rate-capping is to restrict the spatial monopoly power of local government to raise property taxes as it sees fit.[2]

In the Australian local government milieu, at present only New South Wales (NSW) has a comprehensive rate-pegging regime, although the Northern Territory (NT) caps mining and pastoral rates. In NSW, rate-pegging remains contentious. For instance, the recent Independent Local Government Review Panel[3] observed that 'changes to the rating system and rate-pegging are essential to generate the revenues needed to fund infrastructure and services, and – equally as important – to make the system more equitable.' The NSW Government promised to conduct a review of the rating system in response to the ILGRP recommendations. However, rate-capping has considerable populist appeal in Australia, as evidenced in the recent South Australian and Victorian state elections. It is thus important to empirically investigate the effects of rate-capping. Accordingly,

---

[1] Brian Dollery, Suzanne O'Keefe and Lin Crase, 'State Oversight Models for Australian Local Government' (2010) 28 *Economic Papers* 279, 290.

[2] Judy Temple, 'Community Composition and Voter Support for Tax Limitations: Evidence from Home-rule Elections' (1996) 62 *Southern Economic Journal* 1002, 1016; Robert Hay and Steve Martin, 'Controlling Local Government Spending: The Implementation and Impact of Capping Council Taxes' (2014) 40 *Local Government Studies* 224, 239.

[3] Independent Local Government Review Panel (ILGRP), Revitalising Local Government (2013).

in this paper we analyse the likely impact of rate-pegging on Victorian local government.

Following the electoral victory of the Australian Labor Party (ALP) in Victoria in late 2014, the new Minister for Local Government Natalie Hutchins announced that rate-capping - linked to the Consumer Price Index (CPI) - will be introduced into Victorian local government from the 2016/17 fiscal year onwards. Victorian Premier Daniel Andrews (2014) justified the introduction of rate-pegging on grounds that 'councils will be forced to limit rate rises and detail where every dollar will be spent, because ratepayers deserve a fair go', adding that 'this policy also sends a clear message that we expect councils to keep their rates in line with CPI'.[4]

The timing of the Victorian Government's foray into rate-capping is not propitious. Not only has the Commonwealth Government announced a three-year freeze on Financial Assistance Grants (which represent a significant proportion of Victorian municipal income), but Victorian councils have also been subjected to defined benefit superannuation imposts in the order of half a billion dollars over the past few years[5]. Accordingly, if the Victorian Government proceeds with its plan to cap rates – starting from the 2016/17 financial year – one (or more) of three responses must occur (in the absence of an increase in funding from higher tiers of government): (a) additional debt must be incurred; (b) local services must diminish; or (c) operational efficiency must increase. Against this background, in this paper we examine empirically the likely impact of rate-capping on Victorian local government in terms of equity considerations, financial sustainability and municipal efficiency.

[4] John Masanauskas and Christopher Gillett, 'Labor's Plan to Curb Council Rates' *Herald Sun* (Melbourne) 3 May 2014.
[5] Municipal Association of Victoria (MAV), Defined Benefits Taskforce – Final Report (2012).

The paper is divided into nine main parts. Section 2 provides a synoptic review of rate-capping and the debate on its merits in NSW. Section 3 outlines theoretical approaches to the analysis of rate-pegging whilst Section 4 provides a brief summary of the extant literature. Section 5 assesses the equity claims underlying property tax limitations, Section 6 examines sustainability claims for rate-pegging with respect to debt and infrastructure, and Section 7 evaluates the efficiency claims for rate-capping. Section 8 considers various alternative methods of addressing problems in local government identified by the application of personal finance theory and agency theory. The paper concludes in section 9 with a brief discussion of the policy implications of the empirical analysis.

2. RATE-CAPPING

Rate-pegging represents a sub-set of a larger category of public sector regulation dealing with state-imposed limitations on expenditure and taxation by local authorities, including property taxes.[6] Regulation of this kind has spawned a theoretical and empirical literature with an overwhelming American institutional focus[7], largely since state-wide limitations on local taxes, fees and charges, including property taxes, are relatively common in the United States, often deriving from referenda.[8] In addition to this

[6] Temple, above n 2; Nathan Anderson, 'Property Tax Limitations: An Interpretive Review' (2006) 59 *National Tax Journal* 685, 694.
[7] See, for example, Mathew McCubbins and Ellen Moule, 'Making Mountains of Debt Out of Molehills: The Pro-Cyclical Implications of Tax and Expenditure Limitations' (2010) 63 *National Tax Journal* 603, 622; Daniel Mullins and Bruce Wallin, 'Tax and Expenditure Limitation: Introduction and Overview' (2004) 24 *Public Budgeting & Finance* 1, 14.
[8] See, for example, David Figlio and Arthur O'Sullivan 'The Local Response to Tax Limitation Measures: Do Local Government Manipulate Voters to Increase Revenues?' (2001) 44 *Journal of Law and Economics* 233, 257.

American literature, some scholarly work has been undertaken on tax limitations in local government in other parts of the world, including Europe[9] and Australia.[10]

The economic rationale for rate-pegging is straightforward: local government typically holds a monopoly in providing local services. As a result, local councils can deliver these services at excessive prices and/or inefficiently, thereby justifying regulation by higher levels of government aimed at the efficient and equitable provision of local services.[11] Regulation of this kind generally has two main objectives. Firstly, in terms of economic efficiency, optimal regulation should strive to achieve (a) allocative efficiency, where local community preferences should be reflected in the range of local services, and (b) productive efficiency, where local services should be delivered at least-cost. Secondly, policy intervention regulation also should aim at equity objectives, such as ensuring essential local services are provided to all households at reasonable prices.

Effective regulation is notoriously difficult to implement, including in local government.[12] In the municipal realm, intervention is further complicated since councils possess taxation powers, absent in the private sector and most public utilities. Finally, rate-pegging poses particular problems since regulatory intervention does not target particular local services

---

[9] Robin Boadway and Anwar Shah, *Fiscal Federalism: Principles and Practice of Multi-order Governance* (Cambridge University Press, 2009); Jens Blom-Hansen, Martin Bækgaard and Soren Serritzlew, 'Tax Limitations and Revenue Shifting Strategies in Local Government' (2014) 34 *Public Budgeting & Finance* 64, 84.

[10] Brian Dollery and Albert Wijeweera, 'Time for Change? An Assessment of Rate-Pegging in New South Wales Local Government' (2010) 6 *Commonwealth Journal of Local Governance* 56, 76.

[11] Stephen Bailey, *Public Sector Economics* (Macmillan, 1995).

[12] Ayre Hillman, *Public Finance and Public Policy* (Cambridge University Press, 2005).

but instead the 'tax-price' of a basket of local public services (which are mostly unpriced).

In NSW local government, the Independent Pricing and Regulation Tribunal[13] has identified four arguments in favour of rate-pegging. In the first place, rate-pegging 'prevents the abuse of monopoly power' in the provision of basic local services. In addition, proponents contend it limits the 'provision of non-core services and infrastructure that might prove unsustainable to ratepayers'. Furthermore, rate-capping may reduce 'the risk of poor governance in the local government sector'. Finally, it is argued rate-pegging 'limits the ability of councils to divert funds from essential infrastructure to other projects', especially outlays on 'marginal services' better provided by private firms.

Two additional arguments for rate-pegging were advanced in the Independent Inquiry into the Financial Sustainability of NSW Local Government.[14] Firstly, compared with other Australian local government systems, NSW rate-pegging had been effective in its primary aim of restraining increases in rates. Secondly, rate-pegging had obliged NSW councils to become more efficient, especially in limiting overheads and administrative costs.

Dollery, Crase and Byrnes[15] proposed a public choice case for rate-capping in Australian local government. Drawing on Wittman[16], they argued that the ubiquity of 'local government failure' in Australia had simulated a demand by ratepayers for strict regulatory oversight of councils by state regulatory

[13] Independent Pricing and Regulatory Authority (IPART), Revenue Framework for Local Government (2009) 55.
[14] Local Government and Shires Association (LGSA), Are Councils Sustainable?, Final Report: Findings and Recommendations (2006).
[15] Brian Dollery, Lin Crase and Joel Byrnes, 'Local Government Failure: Why Does Australian Local Government Experience Permanent Financial Austerity?' (2006) 41 *Australian Journal of Political Science* 339, 353.
[16] Donald Witman, *The Myth of Democratic Failure: Why Political Institutions are Efficient* (University of Chicago Press, 1995).

agencies, especially in financial matters. Accordingly, in NSW rate-capping, '"watchdog" institutions will form an agency relationship with local government voters to demystify fiscal illusion by monitoring council revenue and expenditure decisions on behalf of voters'.[17]

However, rate-pegging in NSW has also come under sharp criticism. For example, IPART[18] has pinpointed four lines of attack: it 'limits councils' capacity to provide local services, it prevents 'infrastructure backlogs from being addressed', it has caused municipalities to impose 'higher user pays charges which could result in pricing inequities, and it runs counter to 'local democracy'.

The NSW Local Government and Shires Association[19] – now known as Local Government NSW – proposed a more general argument against rate-pegging. In particular, rate-capping has created 'public expectations about maximum rate increases, placing political pressure on councils to stay within the limit and not seek special variations'. Similarly, rate-pegging enables NSW local councils to engage in politically expedient 'blame shifting' onto the NSW Government. In particular, rate-capping offers political 'default option' since all rate increases can be attributed to the NSW Government agencies, community consultation is avoided, and local authorities can 'blame the state government for their financial deficiencies'. It is claimed that these factors have given rise to the 'under-provision of community infrastructure and services' and a substantial local infrastructure backlog.

3. THEORETICAL PERSPECTIVES

---

[17] Dollery, Crase and Byrnes, above n 15.

[18] Independent Pricing and Regulatory Authority, above n 13.

[19] Local Government and Shires Association of NSW, Submission to the Independent Pricing and Regulatory Tribunal of NSW's Review of Revenue Framework for Local Government (2008) 14.

Two conceptual approaches have been developed to explain property tax limitations through rate-capping. In the first place, agency theory[20] holds that residents (as principals) are wary of 'agency failure' by local authorities (as agents), which could result in excess expenditure above socially optimal levels. In most Australian local government systems, councillors are typically elected every four years, thereby providing residents with an opportunity to remove elected officials if they believe these persons are not representing their interests, although it might be noted that the limited number of prospective candidates are generally drawn from a small group of special interest parties. In fact, in the last Victorian local government elections 26 councillors were returned unopposed.[21]

However, this political mechanism offers only limited recourse given that (a) lengthy periods occur between elections (b) high information costs may mean that residents are unaware of excessive/unwarranted outlays and (c) 'candidates come as bundles, so that incumbents might be able to spend more and maintain their position if they satisfy people's views along other dimensions'.[22] Following agency theory, residents may seek state government intervention through rate-caps to limit agency failure by local councils.[23]

Secondly, 'personal finance theory'[24] holds that local residents judge the value of local services received from

---

[20] Michael Jensen and William Meckling, 'Theory of the Firm: Managerial Behaviour, Agency Costs and Ownership Structure' (1976) 3 *Journal of Financial Economics* 305, 360.
[21] Joseph Drew and Brian Dollery, 'The Price of democracy? Political Representation Structure and Per Capita Expenditure in Victorian Local Government' (2016) In Print *Urban Affairs Review*, DOI: 10.1332/030557316x14539914690045.
[22] David Cutler, Douglas Elmendorf and Richard Zeckhauser, 'Restraining the Leviathan: Property Tax Limitation in Massachusetts' (1999) 71 *Journal of Public Economics* 313, 334.
[23] Dollery, Crase and Byrnes, above n 15.
[24] Cutler, Elmendorf and Zeckhauser, above n 22.

municipalities according to their local government tax burden. Following this approach, the higher the perceived rate of property tax, the more likely it is that a resident will support rate-capping. In addition, significant increases to property taxes predispose individuals to support rate-pegs. This line of reasoning is particularly relevant to Australian local government given that municipal rates are highly visible through quarterly rate bills sent to residents by councils. An embryonic empirical literature offers some support for this approach in the American municipal milieu.[25]

Both of these perceptions are problematic since both presume rate-pegging inevitably limits rate increases. However, this is not necessarily the case: individual tax liabilities may still rise significantly as a result of a rezoning of land use, new property valuations in excess of the average valuation for the municipality, or (as in NSW) as a result of a Special Rate Variation (SRV) enabling rate increases in excess of the cap.

Unfortunately, to date there has been no attempt to empirically analyse these questions in the Australian local government context. Accordingly, we seek to address this gap in the literature. In addition, a second aim of our paper is to address the common misconception that rate-caps are the only reliable method of addressing the potential abuse of monopoly power in the local government. We show that viable alternative policy approaches exist.

The empirical comparison of the only fully-fledged rate-cap regime in NSW with existing Victorian municipal data undertaken in this paper can provide an insight into the likely response to the Victorian state government proposal.

[25] Ibid.

4. EMPIRICAL EVIDENCE ON TAX LIMITATIONS

While comparatively little is known about the effects of expenditure and tax constraints on local government, the empirical literature has shown that these measures can have substantial unanticipated effects.[26] Thus Temple[27] found evidence which suggested that state-wide limits on property taxes induced a relatively larger reduction in local services than local administration. Similarly, Vigdor[28] held that tax limitations succeed because they allowed voters to lower tax rates in local communities other than their own where they hold property, invest or work, but have no vote.

Two findings in the empirical literature have significance for Australian debates over rate-pegging. In the first place, property tax limitations often induce local authorities to increase income from other revenue sources. For instance, in a study of 29 American states, Shadbegian[29] found many local councils shifted income away from property taxes toward 'miscellaneous revenue'. Skidmore[30] found similar results in his analysis of 49 American states. In their US study, Kouser, McCubbins, and

---

[26] Mark Skidmore, 'Tax and Expenditure Limitations and the Fiscal Relationships between State and Local Governments' (1999) 99 *Public Choice* 77, 102; Thad Kousser, Mathew McCubbins and Ellen Moule, 'For Whom the TEL Tolls: Can State Tax and Expenditure Limits Effectively Reduce Spending?' (2008) 8 *State Politics and Policy Quarterly* 331, 361; Suho Bae, Seong-gin Moon and Changhoon Jung, 'Economic Effects of State-Level Tax and Expenditure Limitations' (2012) 72 *Public Administration Review* 649, 658.

[27] Temple, above n 2.

[28] Jacob Vigdor, 'Other People's Taxes: Non-resident Voters and State-wide Limitation of Local Government' (2004) 47 *Journal of Law and Economics* 453, 476.

[29] Ronald Shadbegian, 'The Effect of Tax and Expenditure Limitation on the Revenue Structure of Local Government, 1962–87' (1999) 55 *National Tax Journal* 221, 237.

[30] Skidmore, above n 26.

Moule[31] established that most states increased charges and fees following the introduction of tax limitations. In an analogous vein, Mullins and Joyce[32] examined 48 American states from 1970 to 1990 concluding that while tax limitations reduced local taxes, these reductions were offset by increases in fees and charges. In an analysis based on 1,400 American municipalities, Preston and Ichniowski[33] demonstrated that revenue limits decreased property tax revenue but increase 'other revenue'.

Secondly, available empirical evidence suggests that the impact of tax limitations is not uniform across local authorities and depends instead on the characteristics of local councils. For instance, Brown[34] found that in Colorado local government the effects of limitations depended on council size and were more potent in small councils. Similarly, Mullins[35] established that limitations were most effective in poor municipalities.

5. INTER-MUNICIPAL REVENUE EFFORT EQUITY

Residential tax effort measures the proportion of residential rates paid as a percentage of the total annual incomes accruing to residents in a given local government area. This is the most relevant measure of inter-municipal equity given that 'all taxes

---

[31] Kousser, McCubbins and Moule, above n 26.
[32] Daniel Mullins and Philip Joyce, 'Tax and Expenditure Limitations and State and Local Fiscal Structure: An Empirical Assessment' (1996) Spring *Public Budgeting & Finance* 75, 102.
[33] Anne Preston and Casey Ichniowski, 'A National Perspective on the Nature and Effects of the Local Property Tax Revolt, 1976–1966' (1991) 44 *National Tax Journal* 123, 145.
[34] Tom Brown, 'Constitutional Tax and Expenditure Limitation in Colorado: The Impact on Municipal Governments' (2000) 20 *Public Budgeting & Finance* 29, 50.
[35] Daniel Mullins, 'Tax and Expenditure Limitations and the Fiscal Response of Local Government: Asymmetric Intra-Local Fiscal Effects' (2004) 24 *Public Budgeting & Finance* 111, 147.

levied by the city would ultimately be paid from the income of the city residents regardless of the mix of taxes actually used'.[36] The data for residential tax impost was obtained directly from the notes to the Income Statement of individual NSW and Victorian councils and includes general rates as well as fees and charges for council services. It is important to include fees and charges in tax impost data given that the empirical evidence from abroad suggests that municipalities 'game' rate-caps by increasing the fees and charges not subject to regulation.[37] Total annual income accruing to people residing in a given local government area was obtained from the latest data i.e. the 2012 National Regional Profile[38]: alterations were made to the data by including a synthetic estimate of Commonwealth welfare payments and excluding unincorporated business income.[39] Residential tax effort was calculated by dividing the total residential tax impost for each council by the total income accruing to individuals residing in the respective council.

Table 1 contains measures of the range and central tendency of local council residential revenue effort for NSW and Victoria as well as a comparison stratified according to urban and rural categorisation (informed by the Australian Classification of Local Government (ACLG) scheme). A number of noteworthy points arise from the data. Firstly, the tax impost placed on residential

---

[36] See Helen Ladd and John Yinger, *America's Ailing Cities – Fiscal Health and the Design of Urban Policy* (John Hopkins University Press, 1989); Joseph Drew and Brian Dollery, 'A Fair Go? A Response to the Independent Local Government Review Panel's Assessment of Municipal Taxation in New South Wales' (2015) 30 *Australian Tax Forum* 471.

[37] Blom-Hansen, Baekgaard, and Serritzlew, above n 9.

[38] Australian Bureau of Statistics (ABS), National Regional Profile (2014).

[39] Quantum of welfare payments is not available on the ABS National Regional Profile. An estimate of the quantum was made by multiplying the number of recipients in each welfare payment category by the appropriate rate of welfare payment.

ratepayers is remarkably modest even when one considers the limited remit of Australian local government. In most cases, rates are a fraction of the personal income tax paid by individuals.[40] It is thus surprising that rate-pegging enjoys so much popular support. However, as noted earlier, the 'visibility' of rates compared with other forms of taxation, such as salary deductions, may be part of the reason (see also, Section 8 below).

Secondly, Table 1 provides evidence which suggests that the almost four decade-long rate cap regime in NSW may have been successful in limiting the tax burden on ratepayers. Finally, the evidence seems to support the ILGRP's[41] claim that rate-capping has reduced inter-municipal equity, as demonstrated by the fact that the range of rate effort in NSW is considerably larger than Victoria, which is particularly evident in the stratified summary. Moreover, the standard deviation – which measures the average 'scatter' of individual councils with respect to the mean – is relatively high and suggests quite a lot of variation within each strata.

Inter-municipal inequity seems to be an unavoidable consequence of any long-term rate-cap regime. This is because rate-caps are applied in a *compound* fashion to rate levels existing in the base year. If inequity exists in the base year, then the equity gap will be exacerbated through time. Moreover, if demographic patterns change as a result of urban sprawl or changes to local economies, then inter-municipal inequity must follow in the absence of SRV. The ILGRP[42] cited the incongruity of average rates of $484 in affluent North Sydney when compared with the average residential rates of $957 in the more modest Penrith as a

---

[40] In fact, local government rates represent only 3.4% of total tax revenue collected by the various tiers of Australian government; Australian Bureau of Statistics 'Government Finance Statistics 2013-14'.

[41] Independent Local Government Review Panel, above n 3.

[42] Ibid.

specific example of the inequity which can result from almost forty years of rate-pegging.

Table 1: Revenue Effort Equity NSW and Victoria, 2012 (%)

	Smallest	Largest	Median	Mean	Standard Deviation
NSW (State)	0.61	3.30	1.39	1.39	0.51
Victoria (State)	0.91	2.62	1.75	1.74	0.39
NSW Urban	0.61	3.30	1.521	1.58	0.48
Victoria Urban	0.91	2.62	1.69	1.69	0.38
NSW Rural	0.33	2.37	1.12	1.17	0.44
Victoria Rural	1.1	2.57	1.84	1.88	0.38

6. Municipal Sustainability

We examined two claims regarding the deleterious effects of rate-capping on financial sustainability: (a) that rate-pegging increases debt and (b) that rate-pegging reduces investment in infrastructure. Both claims follow from the proposition that - in the absence of increases in revenue from higher tiers of government - rate-capping will probably result in lower levels and/or quality of local services or higher debt loads. In the latter case this also raises problems of intergenerational inequity.

Table 2 presents data for local government liabilities per household for each council jurisdiction over the period 2009-2013 inclusive (inflated by CPI to 2013 dollars). Total liability data was extracted from the balance sheets of each council in the relevant jurisdiction, while household data was extracted from the

Australian Bureau of Statistics (ABS) census data of number of households in NSW and Victoria, adjusted by the annual ABS Buildings Approval data. Liabilities were expressed per household in response to Drew and Dollery[43] who argued that households – rather than population *per se* – are the optimal functional unit for empirical analysis in addition to being a more reliable and less volatile measure of council size (particularly in inter-census periods).

It is clear from Table 2 that municipal debt in NSW is far greater than Victoria. In fact, as at 2013 (the limit of ABS housing data), NSW councils carried around 70% more debt than their Victorian counterparts. Victorian municipal debt rose by an alarming rate in 2012, with only slight moderation in 2013. However, this can largely attributed to liabilities of about $250/household which were incurred by Victorian councils as a result of the defined benefits superannuation impost during this period.[44]

Table 2: Liabilities per Household, NSW and Victoria 2009-2013 ($'000)

	2009	**2010**	**2011**	**2012**	**2013**
NSW liabilities per household#	2.219	2.439	2.320	2.340	2.404
Victoria liabilities per household#	1.095	1.148	1.193	1.489	1.396

\# all figures have been inflated to 2013 dollars.

[43] Joseph Drew and Brian Dollery, 'Keeping It In-House – Households as an Alternative Proxy for Local Government Output' (2014) 73 *Australian Journal of Public Administration* 235, 246.
[44] Municipal Association of Victoria, above n 5.

Table 3 provides statistics on the average infrastructure renewal[45] ratio published by the regulatory authorities in NSW and Victoria. It is important to note that the two ratios are not directly comparable since each jurisdiction employs a different measure for the quantum of assets consumed (i.e. the denominator of the ratios): NSW uses depreciation accruals for the period whereas Victoria employs current replacement cost (as new) divided by useful life. Both use the quantum of asset renewals as the numerator of the ratio and both have employed consistent methodology over the period 2009-2012. Accordingly, conclusions can be drawn by comparing the *change* in infrastructure renewals over the four-year period. In this regard, it appears that NSW councils have reduced infrastructure renewal since 2009, while Victorian councils have held asset renewal at a constant level for most of this period. However, some caution needs to be exercised in judging progress on infrastructure renewals given that both ratios employ estimates as the ratio denominator.

[45] Infrastructure renewals are defined as spending on existing infrastructure assets which return same to original service potential.

Table 3: Infrastructure Renewal, NSW and Victoria 2009-2012

	2009	2010	2011	2012
Mean Infrastructure Renewals NSW	1.028	1.000	0.665	0.8088
Change from 2009		-2.74%	-35.32%	-21.32%
Average change in Infrastructure Renewal from previous year		-2.14%	-33.49%	14.39%
Avg Change in Infra Renewal since 2009				-21.24%
Mean Infrastructure Renewals Victoria	0.78	0.75	0.77	1.09
Change in Average from 2009		-4.27%	-1.31%	38.95%
Average change in Infrastructure Renewal from previous year		-3.35%	2.32%	31.57%
Average change in Infrastructure Renewal since 2009				30.55%

We now test the final claim regarding rate-capping: restricting rate revenue imposes financial discipline on municipal behaviour thereby increasing council efficiency.

7. Municipal Efficiency

In economics, technical efficiency measures the conversion of inputs into outputs in production processes. This is best assessed using the sophisticated technique of locally inter-temporal data envelopment analysis which accommodates multiple inputs (generally specified as capital and labour costs) and multiple outputs (best specified as length of municipal roads, number of households and number of employing businesses).[46] However, this technical type of analysis is beyond the scope of a policy orientated article and we have thus decided to proxy efficiency using expenditure per household (it should be noted that the NSW government uses expenditure per capita to measure local government efficiency[47]). In our analysis there is thus a single input of operating expenditure and a single output proxied by the total number of households in the jurisdiction.

Table 4 outlines the results from our analysis of expenditure per household over the period 2009-2013. Total expenditure data (less depreciation)[48] was extracted from the audited financial statements of each council within the NSW and Victoria local government systems. We have again used households as the proxy for local government output in response to empirical evidence regarding its functional compatibility, high reliability and low volatility[49]. The data in Table 4 does not provide any conclusive evidence of a statistically significant difference in efficiency between the two jurisdictions: NSW has slightly lower expenditure per household from 2009 to 2012, but higher

---

[46] Drew, Kortt and Dollery conduct a thorough analysis of the effect of various DEA specifications on efficiency analysis and interested readers are thus directed to: Joseph Drew, Michael Kortt and Brian Dollery, 'No Aladdin's Cave in New South Wales? Local Government Amalgamation, Scale Economies and Data Envelopment Specification' DOI: 10.1177/0095399715581045 *Administration & Society* 1, 21.
[47] Office of Local Government, Time series Data 2011/12 – 2013/14 (2015).
[48] Depreciation has been excluded in response to many studies which demonstrate that municipal officials regularly manipulate this accrual item to manage earnings. Studies demonstrating this include: Joseph Drew and Brian Dollery, 'Inconsistent Depreciation Practice and Public Policymaking: Local Government Reform in New South Wales' (2015) 25 *Australian Accounting Review* 28, 37.
[49] Drew and Dollery, above n 43.

expenditure per household in the final year under analysis. Moreover, we need to be mindful that this is an approximation of 'technical efficiency'.[50] We conducted locally inter-temporal data envelopment analysis (DEA) for all councils in the two jurisdictions. Our analysis suggested slightly higher average municipal efficiency for Victorian councils. Results are available from the corresponding author. However, the important thing to note is that there is no conclusive evidence to support the claim made by proponents of rate-capping that it enhances municipal efficiency.

Table 4: Expenditure per Household, NSW and Victoria 2009-2013 ($'000)

	2009	2010	2011	2012	2013
NSW expenditure per household#	2.605	2.723	2.810	2.944	3.033
Victoria expenditure per household#	2.703	2.815	2.902	3.170	3.024

all figures have been inflated to 2013 dollars. Expenditure excludes depreciation.

8. ALTERNATIVE APPROACHES TO PROBLEM

Perhaps the greatest misconception regarding rate-capping is that it is the only feasible public policy instrument for addressing the potential excesses of municipal monopoly power. In fact,

[50] The authors have in fact conducted locally inter-temporal data envelopment analysis (DEA) for all councils in the two jurisdictions. This analysis suggests slightly higher average municipal efficiency for Victorian councils. Results are available from the corresponding author.

superior alternative strategies exist.[51] In general, policies to limit monopoly excesses fall broadly under two categories which respond to the two theoretical positions outlined in Section 3 of this paper. Moreover, in terms of political realities, it is important to note that alternatives to rate-pegging are just as critical for NSW policymakers as they are for their Victorian counterparts, given that there is a strong possibility that NSW rates will spike if rate-caps are removed.

As we observed earlier, personal finance theory hinges on the perceived value of local services relative to the tax burden imposed.[52] In Australia, the value of municipal services far exceeds the local government tax impost, given substantial federal government Financial Assistance Grants (FAGs) (typically accounting for around one tenth of municipal revenue).[53] However, it is the *perception* of ratepayers not *fact* which is the critical point under this theoretical approach.

One way to reduce the demand for rate-caps would be to increase FAGs. However, this is most unlikely given the recent freeze on FAGs for a period of three years.[54] Furthermore, much more can be done with respect to intergovernmental fiscal relations. Firstly, there is a need for fairer distribution of FAGs so that the horizontal fiscal equity principle embodied in legislation - but absent in practice - is enforced. In this regard, Drew and Dollery[55] have demonstrated a failure by state Local Government

---

[51] Patricia Florestano, ‘Revenue-Raising Limitations on Local Government: A Focus on Alternative Responses’ (1981) 41 *Public Administration Review* 122, 131.

[52] Cutler, Elmendorf and Zeckhauser, above n 22.

[53] The 2014-15 total Commonwealth financial assistance grants for NSW and Victoria were $715.7m and $541.7 m respectively.

[54] Keith Rhoades, ‘Abandon Grant Freeze or Communities Lose Out’, *Local Government Association New South Wales* (Sydney) 18 May, 2014.

[55] Joseph Drew and Brian Dollery, ‘Road to Ruin? Consistency, Transparency and Horizontal Equalisation of Road Grant Allocations

Grant Commissions to allocate financial assistance grants in accordance with the principles of the enabling legislation.

Secondly, there is a need for greater clarity surrounding the sources of council funding. For example, residential rate notices could clearly state the source and level of council service subsidies. If residents are more aware of the quantum of local government grant revenue, they may reassess their local tax burden against value received. Thirdly, the fiscal imbalance which characterises the Australian federation could be addressed to provide local government sufficient and secure revenue to fund the services it provides.[56] Intergovernmental grants are just one way to address fiscal imbalance. Other options include new tax bases or quarantining taxes by higher tiers of government for councils (similar to how the GST is collected by the federal government for state governments).[57]

Finally, cost-shifting - wherein new mandates are forced on local government with only partial funding by the higher tiers of government previously responsible for provision – must be addressed,[58] if residents are to accurately appraise value relative to cost for local services.

Perceptions of the value of local services relative to the tax burden can also be enhanced through ensuring that the cost of specific services is met by the parties receiving the benefit

---

in Eastern Mainland Australian States' (2015) 39 *Public Administration Quarterly* 517, 545.

[56] Wallace Oates, 'An Essay on Fiscal Federalism' (1999) XXXVII *Journal of Economic Literature* 1120, 1149.

[57] Indeed under the Fraser government's Local Government (Personal Income Tax Sharing) Act 1976 (CTH) councils were to be allocated a fixed percentage (2.00% in 1981) of Commonwealth personal income tax collections. This approach provided secure and expanding sources of revenue for councils as a way of redress the vertical fiscal imbalance present in the Australian federation.

[58] Brian Dollery, Lin Crase and Andrew Johnson, *Australian Local Government Economics* (UNSW Press, 2006).

through more user charges,[59] as well as timing rate increases to remove periodic sharp rises. By ensuring that those who receive the benefit pay the costs associated with the service wherever practicable, residents can gain a more accurate perception of value of the municipal burden. This strategy obviously cannot be applied to pure public goods which are both non-rival and non-excludable (such as local roads and pavements), which must be met through rates. However, for some services, such as garbage collection, development applications, and public health and safety inspections, people receiving benefits could pay user fees and charges which would more *accurately reflect the cost of provision*.[60]

Unfortunately, the regulation of fees and charges – by IPART in NSW and analogous bodies in other states – as well as the failure of municipal accounting systems to accurately assess the costs of services (particularly with respect to allocating indirect costs and depreciation), has meant that full cost recovery rarely occurs.[61] The inevitable result is the cross-subsidisation of service provision by ratepayers. While for merit goods this practice might be defensible, merit goods typically represent only a small subset of the local services provided by local councils. Moreover, where services are subsidised, it is important that donors and recipients

[59] James Buchanan, 'Federalism and Fiscal Equity' (1950) 40 *The American Economic Review* 583, 599.
[60] We recognise that fees are charged for many local government services. However, it is not at all certain that fees are levied on a full cost recovery basis; see, for instance, Judith McNeill and Brian Dollery, 'Calculating Developer Charges for Urban Infrastructure: A Feasible Method for Applying Marginal Cost Pricing' (2003) 48 *The Engineering Economist* 218, 240.
[61] Garry Carnegie and Brian West, 'A Conceptual Analysis of Price Setting in Australian Local Government' (2010) 53 *Australian Accounting Review* 110, 120; Garry Carnegie, Jacqueline Tuck and Brian West, 'Price Setting Practices in Australian Local Government' (2011) 57 *Australian Accounting Review* 193, 201.

of the subsidy alike are advised on both the quantum and reasoning involved.[62]

Perceptions of value can also be enhanced by removing 'lumpy' rate rises. This requires both a higher degree of strategic planning, as well as the flexibility to increase rates on a more frequent basis. Strategic planning which accurately assesses municipal obligations five years or more into the future allows for a measured increase in rates and avoids 'rate shocks'. Similarly, the ability to increase rates on a quarterly basis consonant with the quarterly nature of rate invoices – rather than the current annual practice – means that councils can respond quickly to unexpected obligations and introduce rate increases over a longer time period, thus avoiding sudden significant rate rises.

Finally, enhancing the *actual* value of local services can also help to address public concerns underpinning rate-capping. This can be achieved by decreasing the cost of municipal debt, reducing the perceived municipal tax impost on residents, and removing the legislative power of councils to levy charges for goods and services which are not used or wanted. For instance, Dollery, Kortt and Grant[63] have demonstrated that the establishment of a national local government infrastructure finance authority would facilitate cheaper and more flexible access to capital for local infrastructure investment and renewal.[64] A second option would focus on eliminating the wide range of rate exemptions which currently exist for state and federal government commercial activities, religious and benevolent foundations, select agricultural ventures (such oyster farming and

---

[62] Carnegie and West, above n 61.
[63] Brian Dollery, Michael Kortt and Bligh Grant, 'Harnessing Private Funds to Alleviate the Australian Local Government Infrastructure Backlog' (2012) 31 *Economic Papers* 114, 122.
[64] Ibid.

cattle dipping) and commercial sporting facilities (like the Sydney Cricket Ground).[65]

Finally, removing the legislated power of councils to charge fees for services not actually used would reduce the coercive council monopoly power. For example, the current ability for councils to levy a base water charge where a water line runs past a vacant property, irrespective of whether the property is actually connected, should be removed.

In contrast to the personal finance approach, agency theory rests on the trust between residents (as principals) and municipal officials (as agents) that the latter behave in a financially prudent manner. Residents may have good reason to mistrust municipal officials in view of various allegations of waste, excess, corruption and pork-barrelling.[66] Thus the exercise of greater prudence in council spending is clearly an avenue to reduce calls for tax limitations. Moreover, measures which reduce the information costs for residents to monitor municipal officials or enhance the opportunities for residents to sanction officials might reduce the need for rate-caps.

With respect to a reduction in information costs, existing practice in both NSW and Victoria involves the compilation of comparative data published on an annual basis. This has obvious merit,[67] although the data currently disseminated – focussing mainly on average levels of rates, financial ratio data and expenditure according to functional categories – is generalised and does not inform residents about the cost of specific projects or where waste might be occurring. Moreover, in the absence of

---

[65] Independent Local Government Review Panel, above n 3.
[66] See, for example, A Current Affair 'Council Spending Sprees' *Nine MSN* July 6, 2015. For evidence of pork-barrelling see Drew and Dollery, above n 21.
[67] See, for instance, Office of Local Government, Comparative Information on NSW Local Government 2012/13 (2014); Department of Transport Planning and Local Infrastructure, Source Data 2005-2012 (2012).

data relating the number and quality of outputs for each functional category, accurate comparisons between councils is all but impossible. This could be addressed through an addendum to the existing reports providing a higher degree of disaggregation, and this in addition to details of the number and quality of outputs, would increase the information value of these reports.

However, it is far from clear that the majority of residents are aware that comparative data is available, let alone consulting this data. There would thus seem to be a good argument that a summary report of inter-temporal functional expenditure trends should be included with the rate assessment notices issued annually. Providing a report direct to residents further reduces information costs as well as ensuring awareness of the existence of comparative data. Moreover, detailed information of the cost of specific programs – rather than broad functional categories such as 'recreation' – is currently not available even in the annual audited financial statements, but it is required if residents are to closely monitor council expenditure. It could be argued that this sort of detailed information should be available to residents wishing to inquire into the costs of specific programs, although, it appears that council accounting information systems would need to be improved for this to occur.[68] Finally, there is a good case for requiring councils - perhaps by legislation - to provide accurate costings for proposals to introduce new services. Ideally these costings should be made available to residents prior to the council meeting dedicated to considering the proposal.

Even if residents are able to get detailed information on fiscal prudence, there are limited opportunities to apply sanctions. For example, in both NSW and Victoria elections occur on a quaternary basis – a considerable time before a political sanction can be applied. A partial solution would be to increase the frequency of elections, perhaps reducing the term to three years consistent with Commonwealth government elections. Moreover,

---

[68] Carnegie, Tuck and West, above n 61.

council officers are not subject to political sanction and political representatives are assessed on a bundle of attributes.[69] Penalties for councillor misconduct provided for under the respective state local government acts seem inadequate: in NSW the maximum penalty for councillor breach of duty is disqualification for 5 years whereas Victorian councillors can be liable for an $84,504 fine or 5 years imprisonment.[70] These penalties only apply to gross breaches of duty, such as an undisclosed interest or related party transaction. Thus council officers spending money unwisely and taking unwarranted (but legal) perquisites would generally fall outside of the provisions of state legislation. The relevant state ombudsman is another option for residents wishing to have sanctions applied to council staff (but not councillors in Victoria). However, the ombudsman's remit is limited: the NSW Ombudsman is generally unwilling to investigate complaints regarding the merits of specific development approvals, the adoption of particular council policies, the striking of rates or the allocation of council resources, while the Victorian Ombudsman only hears complaints concerning the 'administrative action' of council *staff*. It thus seems clear that the existing avenues for sanctioning councillors and council officers are inadequate with respect to agency theory.

The NSW Auditor-General recently called for changes to legislation to give the Office of Local Government 'greater powers to intervene, impose greater penalties and demand compliance'.[71] However, it is unclear whether the respective departments have the judicial bearing and authority to adequately enforce legislation. Moreover, the NSW Auditor General's recommendation could easily politicise disputes. Instead there would seem to be a sound argument for establishing a dedicated

[69] Cutler, Elmendorf and Zeckhauser, above n 22.
[70] Audit Office of New South Wales, New South Wales Auditor-General's Report Performance Audit – Monitoring Local Government (2012).
[71] Ibid.

and politically independent local government ombudsman in each state, with a broad remit and legislative powers to impose a wide range of penalties for councillor and staff misconduct, rescind unconscionable council policy or by-laws, oversee councillor privileges and disclosures, and otherwise act as an avenue of appeal for disgruntled residents. Without a dedicated ombudsman willing to respond on a broad range of matters, it is difficult to see how trust in council representatives and officials can be improved.

9. PUBLIC POLICY IMPLICATIONS

As we have seen, Victoria is braced for a rate-capping regime for its councils commencing in the 2016/17 financial year. Like all tax limitation measures the proposed rate-cap seeks to place limits on council monopoly power. In addition, proponents of rate-pegging suggest that the measure will enhance municipal efficiency through the fiscal discipline imposed by revenue constraints. However, the scholarly literature suggests that a rate-cap will precipitate a number of unintended consequences, specifically a reduction in the financial sustainability of local government and a reduction in inter-municipal residential revenue effort equity.

To date no empirical evidence has been provided in support of these claims. This paper thus seeks to fill a gap in the Australian local government literature. In particular, we conducted a comparative analysis between Victorian and NSW local government to determine whether almost four decades of municipal tax limits in NSW had produced any measurable differences in equity, sustainability or efficiency. We found evidence which *prima facie* suggests that NSW councils have lower levels of inter-municipal residential revenue equity, higher levels of debt and diminished levels of asset renewals. Our analysis of efficiency provided no conclusive evidence to support the claim that rate capping enhances municipal efficiency. We thus conclude that our analysis provides little support for rate-capping. Indeed, our findings support the unintended deleterious consequences cited in the international literature on property tax limitations.

Against this background, populist politics apart, it is difficult to understand why the Victorian Government seems determined to proceed with rate-capping, particularly in light of the ILGRP[72] Independent Local Government Review Panel's[73] recommendation that NSW abandon its rate-pegging regime. Moreover, the recent announcement of a three-year cap on Commonwealth FAGs to local government, coupled with extraordinary superannuation imposts on Victorian councils of around half a billion dollars suggests that the timing of the introduction of rate-pegging in Victoria is ill-advised.

Our exploration of alternative methods of addressing the avenues indicated by personal finance theory and agency theory suggested several methods by which the Victorian Government could address the pressures for rate-capping and thereby avoid the deleterious effects of rate-pegging on Victorian local government. The remedies indicated by personal finance theory include encouraging councils to practice user pricing for non-public services, removing a wide-range of rating exemptions, providing information on price subsidies, establishing a national local government infrastructure finance authority, and enabling councils to implement rate rises incrementally on a quarterly basis.

Policy alternatives informed by agency theory focus on reducing information costs for residents (by producing more detailed information on a timelier basis) and establishing a dedicated local government ombudsman with broad powers to sanction elected representatives and officials. If these remedies

[72] Independent Local Government Review Panel, above n 3.
[73] Ibid.

are applied, it may remove the need to implement a potentially deleterious rate-cap regime.