

**RATE CAPPING IN NEW SOUTH
WALES LOCAL GOVERNMENT:
ADDRESSING THE QUESTIONS
RAISED IN THE IPART (2022)
*REVIEW OF RATE PEG
METHODOLOGY: ISSUES PAPER
AND FURTHER
RECOMMENDATIONS FOR
IMPROVEMENT***

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1. Introduction

Under section 9 of the *Independent Pricing and Regulatory Tribunal Act 1992*, the NSW Minister for Local Government Wendy Tuckerman asked the Independent Pricing and Regulatory Tribunal (IPART) to investigate and report on the current NSW rate peg methodology. In particular, the Minister for Local Government sought IPART to investigate and make recommendations on the following six matters:

1. 'Possible approaches to set the rate peg methodology to ensure it is reflective of inflation and costs of providing local government goods and services';
2. 'Possible approaches to stabilizing volatility in the rate peg, and options for better capturing more timely changes in both councils' costs and inflation movements';
3. 'Alternate data sources to measure changes in councils' costs';
4. 'Options for capturing external changes, outside of councils' control, which are reflected in councils' costs';
5. 'The effectiveness of the current LGCI approach'; and
6. 'Whether the population growth factor is achieving its intended purpose'.

In reviewing these matters, the Minister for Local Government required IPART to have regard for the following factors:

- (a) 'The Government's commitment to protect ratepayers from excessive rate increases and to independently set a rate peg that is reflective of inflation and cost and enabling financial sustainability for councils.
- (b) The differing needs and circumstances of councils and communities in metropolitan, regional and rural areas of the State.
- (c) Ensuring the rate peg is simple to understand and administer'.

Following this request, IPART (2022) published its *Review of Rate Peg Methodology: Issues Paper* on 29 September 2022. In the *Issues Paper*, IPART (2022) identified twenty matters on which it sought input from both the NSW local government sector and the broader general public by 4 November 2022:

1. To what extent does the Local Government Cost Index reflect changes in councils' costs and inflation? Is there a better approach?
2. What is the best way to measure changes in councils' costs and inflation, and how can this be done in a timely way?
3. What alternate data sources could be used to measure the changes in council costs?
4. Last year we included a population factor in our rate peg methodology. Do you have any feedback on how it is operating? What improvements could be made?
5. How can the rate peg methodology best reflect improvements in productivity and the efficient delivery of services by councils?
6. What other external factors should the rate peg methodology make adjustments for? How should this be done?
7. Has the rate peg protected ratepayers from unnecessary rate increases?
8. Has the rate peg provided councils with sufficient income to deliver services to their communities?
9. How has the rate peg impacted the financial performance and sustainability of councils?
10. In what ways could the rate peg methodology better reflect how councils differ from each other?
11. What are the benefits of introducing different cost indexes for different council types?
12. Is volatility in the rate peg a problem? How could it be stabilised?
13. Would councils prefer more certainty about the future rate peg, or better alignment with changes in costs?
14. Are there benefits in setting a longer term rate peg, say over multiple years?
15. Should the rate peg be released later in the year if this reduced the lag?
16. How should we account for the change in efficient labour costs?
17. Should external costs be reflected in the rate peg methodology and if so, how?
18. Are council-specific adjustments for external costs needed, and if so, how could this be achieved?
19. What types of costs which are outside councils' control should be included in the rate peg methodology?
20. How can we simplify the rate peg calculation and ensure it reflects, as far as possible, inflation and changes in costs of providing services?

The present Report was prepared in response to the IPART request for comment on its *Review of Rate Peg Methodology: Issues Paper*. By way of background, the Report presents existing international and Australian conceptual and empirical work on municipal property tax limitations, as well as the findings of a number of recent official inquiries and reports into rate-capping in NSW. Drawing on this material, the Report then addresses the twenty questions posed by IPART (2022) in its *Review of Rate Peg Methodology: Issues Paper*.

The Report consists of ten main parts:

- Section 2 briefly summarises the main arguments that have been employed in the debate over rate-pegging in NSW local government by way of institutional background.
- Section 3 provides a synoptic outline of the theoretical literature on property tax limitations, including rate-pegging.
- Section 4 offers a succinct account of the international empirical literature on property tax limitations.
- Section 5 summarizes the extant Australian empirical literature on rate-capping.
- Section 6 considers the findings of a number of recent official reports on the operation of rate-pegging on NSW local government.
- Section 7 briefly outlines the new IPART rate-pegging methodology.
- Section 8 describes the numerous problems with the IPART methodology.
- Section 9 addresses the twenty questions raised by IPART in its *Review of Rate Peg Methodology: Issues Paper*.
- Section 10 concludes the Report by offering two alternative generic recommendations for dealing with the manifold problems besetting the current NSW rate-pegging regime.

2. Genesis and Evolution of Rate Capping in NSW

Legally enforced constraints on increases in property taxes – colloquially known as ‘rate capping’ or ‘rate pegging’ in Australia – form part of a broader category of state government imposed limitations on the expenditure and taxation by local government, including property taxation (Dollery and Wijeweera, 2010). Under its longstanding rate capping regime, the NSW Government determines the maximum annual percentage amount by which a local council can increase its rates income for a given financial year. The rate peg does not apply to stormwater, waste collection, water and sewerage charges. Moreover, local authorities enjoy

discretion to determine how to allocate the stipulated rate peg rise between different categories of ratepayer in their respective local government areas.

A rate cap was first introduced in NSW local government in 1901 and it lasted until 1952 (Dollery, Crase and Johnson, 2006), when it was discontinued due to its 'impracticality' (NSW Local Government and Shires Association, 2008, p.16). The modern NSW rate-pegging regime began with the adoption of the 1977 *Local Government (Rating) Further Amendment Bill*, which was subsequently amended to its contemporary form in 1978. The initial motivation for the imposition of the rate peg legislation derived from the period of high inflation in the 1970s. For example, over the period 1973 to 1976, property taxes rose by an average of 188 per cent, while average weekly earnings over the same period increased by only 75 per cent, with the inflation rate at 56 per cent (Johnson, 2001, p.5).

Rate pegging has been controversial in NSW since its inception and it has generated considerable debate (Johnson, 2001). IPART (2008, p.55) has summarised four major arguments that have been proposed in support of the NSW rate-capping regime. Firstly, it has been claimed that municipal revenue regulation through rate pegging prevents the exploitation of monopoly power by local authorities in the provision of local services. Secondly, advocates of rate pegging have argued that it assists in preventing 'cross-subsidisation' and imposes restrictions on the 'provision of non-core services and infrastructure that might prove unsustainable to ratepayers'. Thirdly, proponents contend that rate capping manages governance risk in the local government sector by constraining council income and thereby limiting council expenditure. Finally, it has been argued that rate pegging reduces the ability of local councils to divert funds from essential infrastructure to other projects as well as expenditure on 'marginal services' that are better provided by the private sector or the voluntary sector.

Opponents of rate pegging have contested all of these arguments (Dollery and Wijeweera, 2010). For instance, the claim that rate capping restrains monopoly power and thus increases the supply of municipal services is problematic since rate pegging curtails municipal output by restricting funding. Moreover, the rate peg does not apply to several sources of municipal income, such as water and sewage charges, where monopoly power could also be exploited. Along analogous lines, it is difficult to see how rate capping will dampen cross-subsidisation, given that municipal fees and charges are likely to rise to counteract the negative impact of

rate pegging on municipal revenue. Furthermore, rate pegging has not constrained the provision of ‘non-core’ local services.

In this regard, Dollery, Wallis and Allan (2006) have demonstrated that an ongoing shift in all Australian state and territory local government systems away from a traditional emphasis on ‘services to property’ towards ‘services to people’ has occurred, including in NSW local government. This finding also undermines the claim that rate pegging limits the ability of councils to divert funds from essential infrastructure to other projects as well as the argument that expenditure on local services is better delivered by the private sector and the voluntary sector.

IPART (2008, p.55) has also identified four main arguments against rate capping in the NSW debate. Firstly, it has been claimed that rate pegging constrains the ability of local authorities to provide local services by limiting their financial capacity. Secondly, opponents of rate capping have argued that it has generated a sizeable infrastructure backlog in NSW local government. Thirdly, it is claimed that rate pegging has obliged local councils to impose higher user pays charges to compensate for their loss of revenue from limitations on rate increases. Finally, foes of rate capping have claimed more broadly that the imposition of rate pegging is an attack on local autonomy and the accountability of local government.

Some of these arguments are convincing (Dollery and Wijeweera, 2010). For example, rate pegging clearly constrains the capacity of local councils to provide local services. If the net effect of rate pegging has been to constrain aggregate municipal income, then it must have limited local service provision to some degree. Similarly, the argument that rate capping has stimulated an increase in fees and charges is especially convincing. Indeed, the NSW Treasury (2008, p.14) has itself noted that ‘constraints on general revenue distort revenue raising sources and result in higher user charges’.

However, the claim that rate pegging has spawned a local infrastructure backlog is less convincing because it seems that the problem is endemic to the entire country. In its National Financial Sustainability Study of Local Government, PriceWaterhouseCoopers (2006) established that not only was a large number of local councils in all Australian local government jurisdictions financially unsustainable in the long run, but that most local authorities faced a massive local infrastructure backlog, regardless of the rate setting regime in their state. Since this problem is endemic to all Australian jurisdictions and it does not

seem to be more acute in NSW, the NSW local infrastructure backlog cannot thus be solely ascribed to rate pegging.

In addition to these arguments against rate capping in NSW local government, the Local Government and Shires Associations of NSW (2008) proposed a more general argument against rate capping embedded in broader political terms. It claimed that rate pegging has a wider unintended ‘dampening’ effect on rates than simply the pegged limit. Along these lines, the Association (2008, p.14) contended that ‘one likely explanation for the dampening effect is that rate pegging provides a public framework and creates public expectations about maximum rate increases, placing political pressure on councils to stay within the limit and not seek special variations’.

A second element of this argument is that rate capping provides an avenue for local councils to engage in politically expedient ‘blame shifting’ onto the NSW state government. This phenomenon has also been described as ‘learned helplessness’ by Drew (2021). The Association (2008, p.15) argued that rate capping ‘provides an easy default option from both a political and managerial perspective’ since (a) all rate increases can be attributed to the state government; (b) the need for community consultation to justify rate increases is weakened; (c) adhering to the rate peg limit avoids the problems contingent on Special Rate Variation applications; (d) ‘councils can blame the state government for their financial deficiencies’; and (e) the existence of rate capping enables councils to avoid long-term planning. The net result of these factors has been the ‘under-provision of community infrastructure and services’, the emergence of a local infrastructure backlog and an ‘undermining’ of both the financial sustainability of councils and democratic accountability at the local level.

3. Conceptual Foundations of Rate Capping

A voluminous theoretical and empirical literature has examined central and state government limitations imposed on municipal expenditure and revenue-raising activities, including property taxation or rating (see, for instance, Florestano, 1981; Temple, 1996; Mullins and Wallin, 2004; Anderson, 2006; McCubbins and Moule, 2010). Although the majority of this scholarly effort has focused on American local government, where state-imposed constraints on local fees, charges and taxes are common (Figlio and O’Sullivan, 2001), researchers have also studied other local government systems, including European local government systems (Boadway and Shah, 2009; Blom-Hansen *et al.*, 2014) and Australian state and territory local

government systems (Dollery and Wijeweera, 2010; Drew and Dollery, 2015; Dollery and McQuestin, 2017; Yarram, Tran and Dollery, 2021).

The economic foundations for rate pegging derive from the normative prescriptions of standard neoclassical economic theory: local government enjoys a monopoly in essential local service provision. Consequently, in line with other monopoly suppliers, local government will offer these local services at excessive prices and/or in an inefficient manner. This provides the justification for regulation by higher tiers of government to ensure efficient and equitable outcomes (Bailey, 1999). However, in accordance with economic theory, regulation must be judiciously employed since badly designed and implemented regulation can generate worse outcomes than an absence of any regulation (Hillman, 2005).

To maximise economic efficiency, optimal regulation should seek to achieve (a) allocative efficiency, whereby the composition of local services delivered must correspond with local community preferences, and (b) productive efficiency, where local services must be produced at the lowest possible cost. In addition, optimal regulation should attempt to ensure that equity objectives are achieved. For example, essential local services should be delivered to low income households by local authorities at reasonable prices.

It should be stressed that the effective application of regulation is notoriously difficult in all spheres of economic activity, including in local government systems (Bos, 1994). Moreover, regulation is further complicated in local government since local councils enjoy the legal authority to tax, which is a monopoly power lacking in both the private sector and in most public utilities. In addition, in local municipal revenue regulation through rate pegging, regulatory agencies face additional problems since they cannot regulate the specific prices of particular local services but rather must regulate the ‘tax-price’ of a whole genre of municipal goods and services that are mostly unpriced.

In the theoretical literature, two conceptual models have attempted to explain property tax limitations, such as rate capping (Drew and Dollery, 2015). In the first place, agency theory (Jensen and Meckling, 1976) holds that local citizens (as principals) fear that ‘agency failure’ by local councils (as agents) can induce excessive local government outlays. Accordingly, local residents thus seek state government intervention through rate pegging to limit excessive expenditure by local authorities.

Municipal councillors are typically elected every four years in NSW local government and local residents can remove elected representatives who do not embody their best interests.

However, the effectiveness of local elections for minimising ‘agency failure’ is limited in at least three ways: (a) high information costs mean that local citizens are often ignorant of excessive and/or unwarranted municipal expenditure (hence the suggestion by Drew (2021) for compulsory short financial sustainability statements to be posted to voters prior to elections); (b) the long period between elections allows extensive ‘agency failure’ to develop; and (c) Cutler *et al.* (1999, p. 320) have argued that ‘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’. Dollery *et al.* (2006) have gathered these arguments to develop a public choice approach to rate pegging based on voter scepticism over their ability to exercise control of municipal outlays, which gives rise to a desire for state government intervention.

Secondly, personal finance theory (Cutler *et al.*, 1999) holds that local citizens evaluate the value of the local services they receive from their local authorities relative to their municipal tax burden. Thus, the higher the perceived rate of property tax, the more likely it is that a local resident will support rate pegging. Furthermore, significant rises in property taxes predispose local citizens to support property tax limitations. This argument is especially relevant in NSW local government since municipal rates are highly visible as a result of regular rate bills being sent on a quarterly basis to local residents by local councils (Drew and Dollery, 2015).

4. International Empirical Evidence on Property Tax Limitations

Notwithstanding the substantial empirical literature on the impact of revenue and expenditure limitations on local government, a degree of uncertainty exists over their likely consequences (Dollery and McQuestin, 2017). However, extant empirical evidence has shown that important unanticipated and unintended effects frequently occur (Skidmore, 1999; Mullins and Wallin, 2004). For instance, Temple (1996) demonstrated that rate pegging reduced outlays on local services more than on local administration.

From an Australian local government perspective, the international empirical literature has illuminated two relevant aspects of rate pegging (Dollery and McQuestin, 2010; Yarram, Tran and Dollery, 2021). Firstly, limitations on property tax increases can encourage local authorities to raise income from revenue sources other than property taxes. For instance, in his study of 29 American states, Shadbegian (1999) demonstrated that many local governments substituted foregone property tax income with monies raised under

‘miscellaneous revenue’. Along analogous lines, Skidmore (1999) found similar outcomes for 49 American states. In a more recent study, Kousser *et al.* (2008) demonstrated that most US state local government systems increased fees and charges following the application of property tax limitations. Moreover, Mullins and Joyce (1996) examined 48 American states over the period 1970 to 1990 and established that while property tax limitations constrained local taxes, this foregone revenue was replaced by increases in fees and charges. In their study of 1,400 American local governments, Preston and Ichniowski (1991) showed that property tax limitations decreased tax revenue but boosted ‘other revenue’.

Secondly, international empirical evidence has demonstrated that property tax limitations do not have a uniform impact across all local councils in a given local government system. By contrast, the impact of rate pegging hinges largely on the characteristics of local authorities. For instance, Brown (2000) showed that in the Colorado local government system the effects of property tax limitations depended on council size by population, with their impact more pronounced in small local authorities. In an analogous study, Mullins (2004) demonstrated that property tax limitations were more potent in poor local authorities.

5. Australian Empirical Evidence on Rate Capping

To date, five scholarly studies have examined the impact of rate pegging in Australian local government. Firstly, Dollery and Wijeweera (2010) investigated rate capping in NSW local government, the conceptual basis for rate capping and the controversy over its desirability, as well as its economic impact on NSW local government financial sustainability compared to other Australian local government systems. Dollery and Wijeweera (2010, p.74) drew two major conclusions from their empirical analysis. Firstly, ‘rate-pegging has achieved its basic objective of slowing increases in NSW council rates over time relative to other Australian jurisdictions’. Secondly, ‘rate-pegging has enjoyed ongoing and strong public support’ that suggests ‘the operation of an efficient “political market” in NSW’ (Dollery, Crase and Byrnes 2006, p. 397).

Secondly, Drew and Dollery (2015) examined NSW local government with its rate peg compared with (then) uncapped Victorian local government to determine the probable impact of rate capping on Victorian local government. Three dimensions of municipal performance were considered. First, Drew and Dollery (2015) evaluated inter-municipal revenue effort equity by assessing residential tax effort. Residential tax effort measures the proportion of residential rates paid with respect to the total annual incomes accruing to local residents in a

given local government area. Drew and Dollery (2015) found that rate pegging in NSW had significantly *decreased* inter-municipal equity, possibly due to the compounding impact of a rate-cap where initial residential tax effort differed between local councils.

Second, Drew and Dollery (2015) considered the effects of rate capping on financial sustainability by considering local government liabilities per household for NSW and Victorian councils over the period 2009 to 2013. They found that NSW had much greater levels of council debt per household. They also considered the average infrastructure renewal ratio in NSW and Victoria as a measure of the infrastructure backlog and found that NSW had a much larger local infrastructure backlog.

Finally, Drew and Dollery (2015) investigated the claim that rate pegging forced local councils to become more efficient. Using data envelopment analysis (DEA) to study the relationship between inputs and outputs, Drew and Dollery (2015, p. 145) found empirical evidence indicating a 'slightly higher average municipal efficiency for Victorian councils' – a finding starkly at odds with the claims of rate cap proponents.

In a third study, following the approach used by Drew and Dollery (2015), Dollery and McQuestin (2017) empirically investigated the likely impact of the imposition of a rate cap in South Australian (SA) local government by comparing the performance of SA local government with its NSW counterpart using three separate performance indicators (revenue effort, financial sustainability and operational efficiency) for the period 2013 to 2016. Dollery and McQuestin (2017, p.84) found that for revenue effort 'the results from our stratified sample show that rate-capping in NSW has not served to reduce inter-municipal revenue effort inequities'. Furthermore, rate capping is thus 'most unlikely to minimise these inequities in SA local government'. Secondly, they established that the 'claims made by advocates of rate-pegging that it improves financial sustainability are rebutted by our findings'. Employing council debt per capita as a proxy for financial sustainability, Dollery and McQuestin (2017) showed that 'NSW local authorities have much higher debt than their SA counterparts despite the four decade long rate-pegging regime in NSW'. Dollery and McQuestin (2017, p.84) found that the operational efficiency of local councils did not increase under rate capping. Using council expenditure per capita as a measure of the operational efficiency of local authorities, Dollery and McQuestin (2017, p.84) showed that 'rate-pegging does not increase the efficiency of local councils: for each year in our sample, the efficiency of NSW councils falls well below SA councils'.

Dollery and McQuestin (2017, p.84) determined that ‘on all three dimensions of local government examined in our empirical analysis, we find SA councils performance better than NSW local government notwithstanding the latter’s longstanding rate-pegging policy’. Moreover, relative to NSW, ‘SA municipalities exhibit superior performance’. Given these findings, Dollery and McQuestin (2017, p.84) argued that ‘the empirical evidence presented in the paper demonstrates that rate-pegging should not be imposed on SA local government and instead other more promising policies [should be] considered’.

In the fourth study, Yarram, Tran and Dollery (2021) employed expenditure data covering the period 2014/15 to 2017/18 to empirically investigate the short-term effects of rate capping on municipal expenditure in the Victorian local government system to determine whether it had differential effects on expenditure by different categories of local council. Yarram, Tran and Dollery (2021, p.11) determined that ‘it is clear that the impact of rate capping varies between urban and rural councils’. Moreover, ‘rural councils that generally rely more on assessment rates are unsurprisingly unable to incur higher expenditure following a rate-capping’. This contrasts sharply with urban councils ‘that are able to increase total expenditure, perhaps through other sources of funding’. Moreover, with respect to the impact of rate capping on different kinds of municipal expenditure, Yarram, Tran and Dollery (2021, p.11) found that ‘rate-capping reduces outlays, especially on aged and disabled services, in both rural and urban councils’. Furthermore, they found that ‘there is a reduction in expenditure on family and community services in urban councils’.

Yarram, Tran and Dollery (2021, p.17) concluded their study by considering it in the context of the earlier empirical studies on the impact of rate capping on Australian local government. They noted that ‘the findings of this study are broadly consistent with previous results of Drew and Dollery (2015) who found that rate-capping in NSW made its local councils more constrained compared to councils in Victoria before the rate-capping’. They noted further that ‘our findings are also consistent with Dollery and McQuestin (2017) who established that NSW councils under a rate-capping regime suffered in terms of unsustainable financing and lower operational efficiency compared to councils in SA, which did not have any rate limitations’.

In terms of the international empirical literature on the impact of property tax limitations, Yarram, Tran and Dollery (2021, p.17) noted that ‘the findings of this study are also consistent with the findings of Skidmore (1999) and Kousser *et al.* (2008), who established

that limitations on tax and expenditure at the state level are often frustrated by increased user charges’.

Finally, Nahum (2021) considered the impact of the imposition of a rate cap on Victorian local government. Nahum (2021, p.5) argued that ‘far from “protecting” ratepayers (that is, residents), rate caps hurt them, in several different ways’, including ‘compromised service delivery’, lower employment levels and/or lower employee wages amongst those local residents employed in local government, higher fees and charges by local councils and ‘lower expenditures flowing back into the private sector’.

Nahum (2021) examined the empirical magnitude of some of these negative effects. He found that rate capping reduced aggregate Victorian employment by 7,425 jobs in the 2021/22 financial year. This comprised both local government jobs *per se* and indirect private sector positions. Moreover, rate pegging also reduced state gross income by \$890 million in 2021/22. Nahum (2021, p.5) concluded that ‘the costs of suppressed local government revenues, and corresponding austerity in the delivery of local government services, will continue to grow with each passing year if the policy is maintained’.

6. New South Wales Official Reports on Rate Pegging

Numerous official inquiries and reports have considered the impact of rate capping on local government in Australia. Given that NSW local government has had a rate cap continuously since 1977, unsurprisingly most of these official documents have focussed on rate capping in NSW local government. In section 6, we briefly consider recent important official reports and their findings on rate capping in NSW.

In May 2006, the Independent Inquiry into the Financial Sustainability of NSW Local Government published its *Are Councils Sustainable? Final Report: Findings and Recommendations* (sometimes known as the Allan Report) that was prepared for the (then) Local Government and Shires Associations of NSW (LGSA). The Allan Report (2006, p.29) adopted Recommendation 21: Rate Pegging which held that ‘the State Government free councils to determine their own income by removing statutory limitations on their rates (i.e. rate-pegging) and certain fees (e.g. development application processing fees) in return for councils adopting longer term strategic and financial planning with outcome targets’. The Allan Report (2006, p.29) argued that rate deregulation of this kind would ‘bring NSW into line with all other states and territories’ and make each local authority ‘answerable to its local constituency rather than the state for its taxation policy’.

In support of Recommendation 21, the Allan Report (2006, p.202) argued that ‘a sound local government rating system should ideally exhibit four traits; it should be financially adequate, administratively simple, vertically and horizontally equitable and economically efficient’. However, the Allan Report (2006, p.2007) argued that in NSW local government ‘rate-pegging had been a major constraint on councils’ revenue raising capacity causing it to fall behind other states, notwithstanding NSW’s relatively strong property market’. Consequently, in NSW the rating system did not deliver a financially adequate stream of income and hence numerous NSW local authorities could not sustainably finance service provision as well as local infrastructure maintenance and renewal.

In 2015, the NSW Government charged the Independent Pricing and Regulation Tribunal (IPART) with critically examining the municipal rating system in NSW and offering recommendations on how to improve the equity and efficiency of the rating system in order to enhance the financial sustainability of NSW local government in the long-run. IPART examined the valuation method used to calculate rates in NSW, exemptions and rating categories, the impact of population growth on council revenue, the distribution of rates across different ratepayers, as well as rate exemptions and concessions. IPART made various recommendations that sought to maintain average rates paid by current ratepayers, but make rate revenue collection more efficient and equitable.

In its 2016 *IPART Review of the Local Government Rating System: Final Report*, IPART offered various recommendations for improving the NSW local government rating system. These recommendations targeted six main aspects of the rating system. Firstly, IPART called for the adoption of the Capital Improved Value (CIV) valuation method to levy local council rates. Secondly, IPART recommended that the rate cap calculation methodology be modified to include population as part of its formula. Thirdly, IPART proposed that local authorities should be accorded greater flexibility in rate setting in their residential areas. Fourthly, IPART argued that rate exemption eligibility should be revised and based on land use rather than land ownership. Fifthly, IPART called for greater rate relief assistance for pensioners. Finally, IPART recommended that local councils enjoy a greater range of options with regard to setting rates within rating categories. These recommendations were designed to mesh with the existing *Local Government Act 1993 (NSW)*. Indeed, IPART specified in detail how changes to the Act should be framed to embody its recommendations.

In November 2020, the NSW Productivity Commission published its *Review of Infrastructure Contributions in New South Wales: Final Report*. The NSW Productivity Commission (2020, p.39) argued that in NSW ‘local government is constrained in its ability to service growing communities due to the long-standing practice of rate-pegging’, especially since the rate capping formula ‘does not allow councils to increase their rates revenue with population’. A consequence of this constraint has been ‘declining per capita revenue for high growth councils’ that has acted as a ‘disincentive for councils to accept development’. The NSW Productivity Commission (2020, p.39) argued that reform of the rate cap methodology was required to allow for the inclusion of population growth. It argued that rate cap reform along these lines would increase aggregate council revenue by \$18.5 billion over 20 years. This additional revenue could be employed to ‘fund local operating and maintenance costs of providing services to a growing population’, as well as ‘service debt to forward fund infrastructure’, thereby enabling local authorities ‘to better coordinate infrastructure with development’. It thus recommended that subject to review by IPART, the NSW Government should ‘reform the local government rate peg to allow councils’ general income to increase with population’.

In December 2020, the NSW Productivity Commission released its *Final Report: Evaluation of Infrastructure Contributions Reform in New South Wales* prepared by the Centre for International Economics. The *Final Report: Evaluation of Infrastructure Contributions Reform in New South Wales* (2020, p.2) held that there should be ‘reform of the local government rate peg to enable rates revenue to grow in line with population, removing the existing financial disincentive councils face with respect to growth’. The resultant growth in rates revenue would ‘enable councils to recoup the operating and maintenance costs associated with providing services to a larger population’. Moreover, ‘extra revenue can help service debt to forward fund infrastructure, improving the coordination of service delivery with development’.

The *Final Report: Evaluation of Infrastructure Contributions Reform in New South Wales* (2020, p.3) further argued that if this was done, then ‘we estimate that rates revenue would be around \$925 million per year higher’. This additional income could fund ‘the operating and maintenance costs of a growing population, to increase borrowing capacity and help finance debt’.

The *Final Report: Evaluation of Infrastructure Contributions Reform in New South Wales* (2020, p.51) argued that the impact of rate capping on NSW local government had been deleterious, particularly on local authorities with high population growth rates. This sub-category of council had experienced ‘slower growth in revenue per capita’, ‘slower growth in expenses per capita’ and ‘less improvement in their net operating balance’.

Flowing from the earlier reports by IPART and the NSW Productivity Commission, the NSW Government asked IPART to investigate methods of improving the NSW rate cap regime, including explicit incorporation of population growth. On 25 March 2021, IPART released *Issues Paper - Review of the rate peg to include population growth*, followed by its *Draft Report - IPART Review of the rate peg to include population growth* on 29 June 2021 and its *Final Report - Review of the rate peg to include population growth* on 5 October. In these reports, IPART developed a new methodology to enable local councils to maintain per capita general income over time as their local populations grew. This was done on the assumption that maintaining per capita general income would assist local councils to maintain existing service levels, as well as provide those local services their growing local communities required.

On 9 October 2021, (then) Minister for Local Government Shelley Hancock announced that the NSW Government had accepted IPART’s recommended rate peg methodology that incorporated population growth. She argued that the new methodology would generate at least \$250 million in additional municipal revenue (Hancock, 2021). The new rate peg calculation methodology would operate from July 2022 onwards.

7. IPART Rate Peg Methodology

In its *Review of the Rate Peg to include Population Growth: Final Report*, IPART (2021) outlined its new methodology and then applied it to each NSW local council for the 2022/23 financial year to determine the rate cap for each council. The new formula included a population factor that varied for each local council depending on its rate of population growth (IPART, 2021):

Rate peg=change in LGCI–productivity factor+other adjustments +population factor

The new formula employs four independent variables as the basis for calculating the annual rate cap for each council:

- (a) *Change in LGCI* comprises the annual change in the Local Government Cost Index (LGCI). The LGCI measures price changes over a given year for goods, materials and labour employed by an ‘average council’. In particular, the LGCI computes the average change in prices of a fixed 'basket' of goods and services used by councils relative to the prices of the same basket in a base period. The LGCI has 26 cost components, containing *inter alia* employee benefits and on-costs, as well as building materials for bridges, footpaths and roads. These cost components embody the purchases made by an average council to pursue its ‘typical activities’. IPART employs ABS price indexes for wage costs, producer prices and consumer prices. In calculating these price indexes, the ABS includes quality adjustments in its price measures to accommodate increases in capital and labour productivity.
- (b) *Productivity factor* is included in the formula since productivity increases offset changes in the LGCI. For example, if labour productivity rises, then this will decrease the net price of labour by the extent of the productivity increase. However, as we have seen, since the ABS price index data has already been adjusted for productivity, in practice IPART sets the productivity factor at zero in the formula.
- (c) *Other adjustments* is included in the formula to make provision any additional payments or transfers to local government that may have occurred. For instance, in its 2022/23 rate peg calculations IPART (2021, p.2) included a downward adjustment of 0.2% to remove the additional revenue that was included in the 2021-22 rate peg to meet the costs of the 2021 local government elections.
- (d) *Population factor* is calculated for each local council. The population factor is equal to the annual change in residential population adjusted for revenue derived from supplementary valuations. In particular, the population factor equals the maximum change in the residential population less the supplementary valuations percentage or zero. Local authorities with negative population growth receive a population factor of zero. This means that no local council accrues a smaller increase in general income, relative to a rate peg calculated using the LGCI, a productivity factor and any adjustments. Those local councils that accrued more from supplementary valuations than required to maintain per capita general income as their population grows will also have a population factor of zero. The population factor is computed employing the following formula: *Population factor* = $\max(0, \text{change in population} - \text{supplementary valuations percentage})$

The change in population is calculated using the *Estimated Residential Population* (ERP; emphasis added) published by the ABS.

IPART calculated the rate peg for the financial year 2022/23 using the new formula embodying LGCI change, a population factor and an adjustment to remove the costs of the 2021 local government elections that were included in the 2021-22 rate peg. This generated a 2022/23 rate peg for each NSW local authority at between 0.7% and 5.0%, contingent on its population factor. The population factor ranged between 0% and 4.3% (IPART, 2021, p.1).

8. Problems with the IPART Rate Peg Methodology

In addition to the myriad of conceptual and empirical problems with property tax limitations, such as the NSW rate capping regime, identified in the scholarly literature that we considered in sections 2, 3, 4 and 5 of this Report, several analysts have found significant flaws in the new IPART rate peg methodology with its population factor approach. In particular, while acknowledging that the introduction of different rate caps for different local councils represented a significant improvement in NSW rate pegging, Drew (2021; 2022) recognized three major problems with the new IPART rate cap formula.

Firstly, the use of population size in the IPART rate peg methodology is highly problematic for at least three reasons (Drew (2021; 2022)). Firstly, given the composition and range of services provided by NSW local councils, which concentrate on ‘services to property’ rather than ‘services to people’ (Dollery, Wallis and Allan, 2006), the number of rateable assessments in a given local government area is a much more accurate proxy variable for municipal size than absolute population size (Drew and Dollery, 2014). Secondly, it is universally recognized that population estimates of intercensal years contain significant errors, ranging from 2.4% in large councils to 15.6% in small local authorities (Drew, 2022). Thirdly, given the potential magnitudes involved, annual population changes can generate significant changes in rates under the IPART methodology, which can be highly destabilising to municipal financial planning. It follows that *if*¹ we incorporate a population factor into the rate cap, then it is best to employ a five-year moving average to reduce volatility and partially mitigate the large intercensal errors (given that censuses only take place every five years).

Secondly, the LGCI is plagued by a number of problems that render it entirely inappropriate as a reliable index of municipal costs. Drew (2022) has identified six main problems with the

¹ As we will show, there are much more appropriate ways of compensating councils for growth rather than by using a population number known to be both inaccurate and irrelevant.

LGCI. Firstly, the LGCI contains too few items and thus cannot accurately represent the typical ‘basket of goods and services’ purchased by NSW local councils. Secondly, given the fact that the composition of municipal input consumption changes over time, the weightings embodied in the LGCI should be calculated as a three-year moving average rather than a fixed ratio recalculated every four years (IPART, 2021). The current approach of altering the weightings is too infrequent and accordingly exacerbates volatility. Thirdly, given that the LGCI data employed to calculate rate caps in the forthcoming financial year reflects the previous annual price data, it is ‘rearward facing’. This is particularly problematic when cost inflation occurs, as it is at present with all the various supply shocks escalating prices. Fourthly, the LGCI represents a composite of cost indexes derived from different tiers of government - as IPART (2021) itself has conceded - rather than a cost index of NSW local government *per se*. Fifth, the LGCI has no regional weightings for NSW local government despite significant regional cost disparities across NSW (arising from the very disparate municipal service profile between various regions). Finally, the LGCI ignores the operating environment in which local authorities operate, even though this represents a major cost factor for local councils.

Finally, the IPART methodology for annual rate cap determination places two important categories of NSW local council at greater financial risk: rural local authorities and retirement community councils. For example, many rural councils have experienced ongoing population declines, together with an ageing population profile. This not only diminishes their rateable base, but also generates a higher proportion of pensioner rate rebates, which are not fully funded by NSW government grants (Dollery, Johnson and Byrnes, 2008). Similarly, for local councils with growing populations substantially comprised largely of retirees, like Port Stephens Council, a high proportion of older residents typically impose substantial additional service demands on local councils. A rate cap calculation formula that does not recognise the differential demands on different kinds of local council will thus place more councils at risk.

9. Twenty Questions in the IPART *Review of Rate Peg Methodology: Issues Paper*

Before embarking on the journey of answering IPART’s twenty questions, it is apposite that we first pose a question of our own:

What is the goal of the NSW Rate Cap regime?

Until IPART and the NSW Government are able to clearly articulate the basic aim of their rate cap regime, it is hard to believe that they will ever experience any success in achieving its unstipulated aim.

Official documentation implies various objectives, including: (a) reduced rates, (b) maintain financial sustainability, (c) simplicity and (d) accuracy. However, most of these implied goals contradict with one another. For instance, it is difficult to see how reducing rates might be expected to result in financial sustainability (without additional measures being implemented). In similar vein, it is clear that a myopic pursuit of simplicity must result in concomitant loss of accuracy (and hence also financial sustainability).

Thus, the most important question that ought to have been posed at the outset has been sadly eschewed and this will likely prove to be the Achilles heel of any review of the rate cap.

1. To what extent does the Local Government Cost Index reflect changes in councils' costs and inflation? Is there a better approach?

As we have seen in section 8 of this Report, the Local Government Cost Index (LGCI) is highly problematic and it is entirely inappropriate as a reliable index of municipal costs in NSW local government. Drew (2022) pinpointed six major deficiencies the IPART LGCI. In the first place, the LGCI comprises too few items and thus does not accurately depict the typical 'basket of goods and services' purchased by NSW local councils. Secondly, given the fact that the composition of municipal input purchases evolves through time, the weightings embodied in the LGCI should be calculated as a three-year moving average rather than a fixed ratio recalculated every four years (IPART, 2021). The present method of changing the weightings is too infrequent and thereby exacerbates the volatility of the LGCI. Thirdly, since the LGCI data employed to calculate rate caps in the forthcoming financial year reflects the previous annual price data, it is 'rearward facing'. This is particularly problematical when cost inflation arises, as it presently has, with various supply shocks escalating prices. Fourthly, the LGCI represents a composite of cost indexes derived from different tiers of government - as IPART (2021) itself has conceded - rather than a cost index of NSW local government *per se*. Fifth, the LGCI has no regional weightings for NSW local government despite significant regional cost disparities across NSW. Finally, the LGCI disregards the operating environment in which local authorities operate, even though this represents a major cost factor for local councils. In other words, the local government taxes in each council area are the price for quite disparate baskets of goods and services: it thus follows that changes to

these prices should vary in response to the different goods and services that make up the particular baskets.

A much better approach can easily be identified. As we have seen, the current LGCI employed by IPART is awash with problems that render it unsuitable as a basis for determining cost increases in operation of NSW local government. Given the spatial variation in municipal costs and municipal resource use across NSW, especially between metropolitan councils and their regional, rural and remote counterparts, Drew (2021) has argued that different cost indexes should be employed for – at a minimum – the four main categories of council (i.e. metropolitan, regional, rural and remote councils). The construction of these indexes should include the use of three-year moving averages of the mix and weighting of the basket of items in the index, a price increase projection for the forthcoming financial year and consideration of the operating environment of the four different categories of council. In particular, the environmental cost factor could be calculated in a precise manner by using econometric techniques on a three-year panel of socio-demographic data along with publicly available financial information. Moreover, using moving averages as suggested would considerably reduce volatility and thereby partially mitigate the problem whereby some local councils find it difficult to predict future rate caps for budgeting purposes.

It is also important to take into account the macro-economic challenges and trends that might face councils in the forthcoming financial year in determining the final rate cap. Put differently, the rate cap cannot entirely comprise an empirical exercise, since judgement must be exercised on future inflationary pressures.

2. What is the best way to measure changes in councils' costs and inflation, and how can this be done in a timely way?

As we have noted under question 1 above, much better approach exists. Given the geographical variation in municipal costs and municipal resource employment across NSW, particularly between metropolitan councils and their regional, rural and remote counterparts, Drew (2021) contended that different cost indexes should be employed for metropolitan, regional, rural and remote councils. These indexes should be constructed on the basis of three-year moving averages of the mix and weighting of the basket of items in the index, a price increase projection for the forthcoming financial year and an assessment of the operating environment of the four different types of council. Moreover, the environmental cost factor could be computed with precision by using econometric techniques and a three-

year panel of socio-demographic data together with publicly available financial information. Furthermore, employing moving averages would substantially reduce volatility and thereby partially mitigate the problem whereby some local councils find it difficult to predict future rate caps for budgeting purposes.

Moreover, if we are truly interested in accuracy then a number of changes to extant practice must follow. First, the rate cap needs to be issued far more precisely – to at least three decimal places – which would be reasonable given that it is multiplied through to millions of dollars of revenue². It is simply not acceptable to have material and avoidable rounding errors given that much more precise figures could easily be generated from index numbers and the like. Second, we need to use far more inputs to mitigate extant extreme synecdoche. We also need to use more precise inputs, rather than relying on known inaccurate proxies (such as wage price indexes³, CPI, or population estimates that we can be certain do not reflect actual costs). Third, this considerably expanded basket of goods and services purchased by local councils need to be re-priced at least annually and at a time more proximate to the use of the LGCI.

In addition, as we noted under question 1 above, it critical to consider the main macro-economic trends that might face local authorities in the forthcoming financial year in determining the final rate cap. In essence, the rate cap cannot entirely consist of an empirical exercise; judgement must be exercised on future inflationary pressures.

3. What alternate data sources could be used to measure the changes in council costs?

There is a wide range of actual and accurate data that ought to be used in place of the proxies that are currently heavily relied upon. This includes: (i) actual wage increase data for local government employees, (ii) actual auditing costs, (iii) actual audit committee costs, (iv) number of assessment data (that is both more closely related to the cost of local government provision and also far more accurate and timely), (iv) actual remuneration rulings for councillors, (v) the actual costs for hundreds of major items used by local governments on a regular basis, (vi) precise operating environment factors generated econometrically, (vi)

² Moreover, it would seem a relatively straight-forward matter to ensure that any rounding error in a given year was mitigated in the next year.

³ The use of the WPI is particularly perplexing given both the ease of using actual local government wage cost data and the size of this component (about a third of most NSW local council costs).

reevaluation adjustment data⁴, (vii) precise costs for holding elections and (viii) precise compliance costs.

4. Last year we included a population factor in our rate peg methodology. Do you have any feedback on how it is operating? What improvements could be made?

As we demonstrated in section 8 of this Report, the adoption of population size in the IPART rate peg methodology is highly problematical for three main reasons. In the first place, if we consider the mix of municipal services provided by NSW local authorities, which comprise mainly ‘services to property’ rather than ‘services to people’, the number of rateable assessments in a given local government area represents a much more accurate proxy variable for local government size than absolute population size, as demonstrated by Drew and Dollery (2014). Secondly, it is widely agreed that population estimates of intercensal years typically contain substantial errors, ranging from 2.4% in large councils to 15.6% in small local councils (Drew, 2022). Moreover, the ABS population data is often lagged by one or two years. Thus it is known to be inaccurate and irrelevant at the time of its use in the construction of the rate cap. Third, given the population magnitudes involved, annual population changes can produce significant changes in rates under the IPART methodology, which can be highly destabilising to local government financial planning. As we showed in section 8 of this Report, if we incorporate a population factor into the rate cap, then we should use a five-year moving average to reduce rate income volatility and partially alleviate the large intercensal errors (given that censuses only take place every five years).

The simplest and most effective way to compensate councils for growth in the local government area – consistent with one of the stated goals of the rate cap (to reduce pressure on the tax liability for the average ratepayer) – is to apply the cap to the average rate for each of the categories. As we have already described in previous submissions, this automatically adjusts for growth in a way that uses reliable and timely data (number of assessments⁵). It also has the benefit of discouraging the use of minimum and base rates that are clearly contrary to another purported goal of the rate cap (distributive justice (Drew (2021))).

⁴ The aggressive revaluation of assets by the Auditor-General is significantly affecting the income statements of Councils – if we want local governments to aspire to balanced budgets then these costs ought to be recognised (because it can’t be reliably assumed that previous rate caps recognised the costs of these long-lived assets in earlier periods of cost-allocation).

⁵ Notably organic growth (for instance births in an existing household) exert very limited cost pressures on councils compared to the subdivision of properties and establishment of new developments. Thus, responding to new assessments is likely to be much more important than responding to additional people.

However, the fact remains that a factor for growth disadvantages most rural and remote communities in a relative sense. These rural and remote councils are the most financially unsustainable category of local governments in NSW. Thus, a factor to compensate for operating environment (as we outlined earlier) is an absolutely essential element of any new rate cap methodology if we are to avoid further financial collapses in NSW local government.

5. How can the rate peg methodology best reflect improvements in productivity and the efficient delivery of services by councils?

If the NSW Government wishes to reflect improvements to efficiency and productivity, then it will be necessary to first accurately measure these constructs. Extant measures – such as operational expenditure per capita – are woefully inadequate as proxies for efficiency (Drew and Dollery, 2015). Instead, intertemporal data envelopment analysis (with appropriate adjustments) would need to be employed. Moreover, it would be essential to have an annual consistent survey of citizen satisfaction (or another reliable proxy for service quality) to ensure that supposed efficiencies were indeed the case (rather than merely reductions to service quality).

However, there is significant potential that policy adjustments to reflect efficiency would have serious, undesirable and unintended consequences. First, it would entirely remove the incentive for local councils to improve efficiency, because doing so would reduce their revenue. Accordingly, an efficiency dividend could well run contrary to the long-run interests of ratepayers. Second, it would further exacerbate the financial sustainability crisis that already grips around two-thirds of NSW local councils. At present, most councils actively seek out efficiencies as a way to partially-mitigate perceived inadequacies in rate cap dictates. If IPART or the NSW Government were to reduce the rate cap according to efficiencies achieved, then this would likely bring forward the time for a looming local government financial crises.

Most councils in NSW are active in pursuing efficiencies to try to maintain a semblance of financial sustainability. It would thus be a grave mistake to do anything to dissuade or punish them for these efforts (especially if we were to use inaccurate measures of efficiency as is currently the case).

6. What other external factors should the rate peg methodology make adjustments for? How should this be done?

As we have noted earlier, any rate peg calculation method must embody ‘forward facing’ elements, especially with respect to inflationary pressures. This means *inter alia* that the computation of the rate cap will embody forecasts of future cost increases and price rises that NSW local councils will experience. As we have suggested under section 10 of this Report, a rate cap setting panel should be established comprising *bona fide* experts on local government economics who can offer informed judgements on future cost increases and price rises in NSW local government.

Moreover, as the RBA (Lowe, 2021) has graphically illustrated in recent times, making predictions regarding likely inflation outcomes is thwart with danger. For this reason, it is essential that our recommendation for a rate cap range, made in earlier submissions, be adopted. Specifically, offering councils a rate cap range reflective of the uncertainty in both future predictions and past data⁶ allows local decision-makers to better tailor their tax increases to their local knowledge regarding the specific challenges emerging in their council area. It also improves democratic accountability and reduces the problem of learned helplessness that has been noted in the literature (Drew, 2021).

7. Has the rate peg protected ratepayers from unnecessary rate increases?

In the short-run a rate peg might protect ratepayers from increases to their tax liability. However, this protection currently comes at significant costs especially to the most vulnerable in the community.

What typically occurs is that councils delay required tax increases because of the expense and political controversy likely to be engendered by a Special Rate Variation (SRV). However, ultimately matters come to a crisis point and then ratepayers are confronted with an extraordinarily large rate increase. It is not hard to find evidence of hefty local rate increases in the IPART determinations, such as 94.787% for Balranald in 2018-19 and 53.5% for Cootamundra-Gundagai in 2021-22. Indeed, there are dozens of SRVs of thirty percent or more. It is hard to believe that residents in these areas would agree that the rate cap saved them from unnecessary rate increases! It is much more likely that they would contend that the rate cap merely spared them a little bit of pain over many years that metastasized into a great burden later because it had been left un-checked.

⁶ Able to be precisely quantified using relatively rudimentary statistical measures.

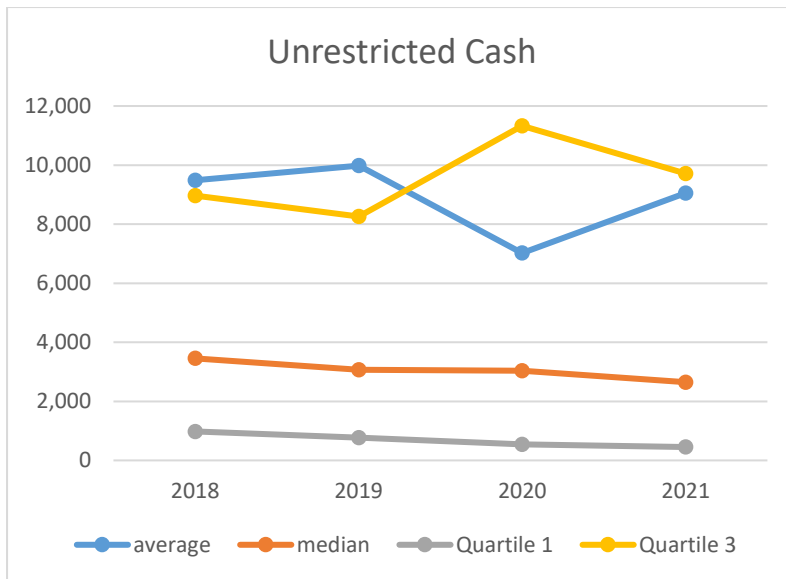
Moreover, deferral of needed rate increases, which is a prominent feature of the rate cap regime, also presents significant intergenerational equity risks. This occurs because existing residents may avoid needed rate increases for a decade or more which are ultimately forced onto contemporary ratepayers who may not have been beneficiaries of past expenditure (for instance if they only recently became homeowners in the local government area).

Furthermore, large and unexpected SRVs needed to mitigate inadequate rate caps over many years tend to disproportionately hurt the most disadvantaged in our communities. These people are the least likely to have savings to draw on to mitigate unexpected rate shocks that accompany SRVs. In addition, the services most likely to be cut by councils to cope with constraints on rate revenue tend to be discretionary projects such as programs tailored to the aged, unemployed, disabled or culturally diverse groups. This is the stark consequence of less-than-competent execution of seeking to reduce ‘unnecessary’ tax increases.

For all these reasons, in our previous work, we have strongly advocated for automatic triggers linked to a competent financial sustainability monitoring system (which sadly is not our current system). Automatic triggers would force councils to apply for a SRV when data demonstrated that financial sustainability had waned significantly, thus avoiding inappropriate delays to adjust rates which ultimately result in unacceptable large rate shocks.

8. Has the rate peg provided councils with sufficient income to deliver services to their communities?

Financial failures in NSW local government, together with dwindling cash reserves (that have now reached critical levels for median and quartile 1 councils) clearly demonstrate that the rate peg has not delivered sufficient income for councils and their communities. Indeed, frequent approvals of hefty SRVs to address ‘financial sustainability’ submissions to the IPART, also underline the inadequacy of current practice.



It is unlikely that a ‘one-size-fits-all’ rate cap will ever be able to provide the disparate NSW cohort of councils and communities with sufficient income to deliver needed services. In accordance with the decentralization theorem, each council provides a different set of goods and services tailored to the particular tastes and preferences of their citizens. This is the whole point of decentralized local government. Furthermore, each community faces different challenges, operating and economic environments. Thus, it follows that each local council needs the flexibility to set the particular rate of the increase to their specific basket of goods provided according to their superior local appreciation of local conditions. This can best be achieved by providing a short range of rate cap for each major category of local government and trusting the democratic accountability and high professionalism of local government decision-makers to make appropriate decisions about the precise price rise required for their specific councils.

9. How has the rate peg impacted the financial performance and sustainability of councils?

As we have seen in section 5 of this Report, Dollery and McQuestin (2017) empirically investigated the likely effects of a rate cap on South Australian (SA) local government by comparing the performance of SA local government with NSW local government employing three performance indicators (revenue effort, financial sustainability and operational efficiency) over the period 2013 to 2016. Dollery and McQuestin (2017, p.84) established that ‘rate-capping in NSW has not served to reduce inter-municipal revenue effort inequities’. Moreover, rate capping is thus ‘most unlikely to minimise these inequities in SA local government’. In addition, Dollery and McQuestin (2017) found that the ‘claims made by proponents of rate-pegging that it improved financial sustainability’ were falsified by their

findings. For example, comparing council debt per capita as a proxy for financial sustainability, Dollery and McQuestin (2017) found that ‘NSW local authorities have much higher debt than their SA counterparts despite the four decade long rate-pegging regime in NSW’. Furthermore, Dollery and McQuestin (2017, p.84) established that the operational efficiency of local councils did not increase under rate capping. Using council expenditure per capita as a measure of the operational efficiency of local councils, Dollery and McQuestin (2017, p.84) demonstrated that ‘rate-pegging does not increase the efficiency of local councils: for each year in our sample, the efficiency of NSW councils falls well below SA councils’.

In sum, Dollery and McQuestin (2017, p.84) found that ‘on all three dimensions of local government examined in our empirical analysis, we find SA councils performance better than NSW local government notwithstanding the latter’s longstanding rate-pegging policy’. Furthermore, compared to NSW, ‘SA municipalities exhibit superior performance’. In light of their findings, Dollery and McQuestin (2017, p.84) concluded that ‘the empirical evidence presented in the paper demonstrates that rate-pegging should not be imposed on SA local government and instead other more promising policies [should be] considered’.

10. In what ways could the rate peg methodology better reflect how councils differ from each other?

Following from our observations under question 1 above on regional variations in the LGCI, different rate caps should be calculated for councils falling in (at least) the four main municipal categories in NSW local government (metropolitan, regional, rural and remote councils). This will not only more accurately reflect the different operating environments facing these categories of council, but also facilitate comparisons between the performance of local councils in each category. As a consequence, there will be greater transparency for local residents and more accountability for local councillors.

As noted in this Report as well as in our earlier submission, the rate cap should also be provided as a range for these four main categories of councils. This will allow local government decision-makers to use their superior knowledge of local conditions to set a precise price increase for the basket of goods and services that best reflects their community’s specific needs and circumstances. It will also promote democratic accountability and combat learned helplessness.

People outside of Sydney rarely understand the importance of rural councils having the flexibility to tax at higher rates in good agricultural seasons to build up reserves against local economic shocks arising from poor agricultural seasons at other times. Rural economies are very dependent on weather conditions, as well as commodity prices, and a failure to provide the flexibility to properly respond to prevailing conditions has caused much harm to rural communities. Accordingly, a flexible range of rate caps is especially important in rural areas.

11. What are the benefits of introducing different cost indexes for different council types?

As we have observed, given the spatial variation in municipal costs and municipal resource use across NSW local government, especially between metropolitan councils and their regional, rural and remote counterparts, Drew (2021) and others have argued that different cost indexes should be employed for (at a minimum) four main categories of council (metropolitan, regional, rural and remote councils). The construction of these indexes should include the use of three-year moving averages of the mix and weighting of the basket of items in the index, a price increase projection for the forthcoming financial year and consideration of the operating environment of the four different categories of council. In essence, using moving averages as suggested would considerably reduce volatility and thereby partially mitigate the problem whereby some local governments find it difficult to predict future caps for budgeting purposes.

However, if we truly wished a rate cap to be responsive to the particular needs and circumstances of different communities then it would either be: (a) necessary to have a much more carefully assembled LGCI constructed for each individual council, or (b) a rate cap range provided to each category of local government so that relevant decision-makers might use their superior local knowledge of the precise circumstances faced by their communities to set an appropriate price increase.

12. Is volatility in the rate peg a problem? How could it be stabilized?

A certain degree of volatility in the rate cap is to be expected. However, what is problematic is when the volatility is *unanticipated* and out of line with official Australian Bureau of Statistics (ABS) CPI and PPI data. Put differently, it is the volatility between the expected rate cap and the actual rate cap proclaimed that is the real problem for local government. Indeed, current instructions for councils to assume a rate cap of 2.5% (which does not seem to have changed for well over a decade) should be reviewed far more regularly to avoid significant errors creeping into LTFP and thereby exposing communities to fiscal risk.

As we have already detailed, the rate cap can be stabilized by using moving averages. However, it is also important that far more up-to-date data is used in the calculation of the rate cap. Moreover, the gap between expected rate cap and actual rate cap can be redressed by also considering forward-looking indicators when determining the rate, as well as issuing a final cap at a time much closer to when councils might reasonably be expected to be incorporating it into their decision making (i.e. March-May each financial year). In this regard it would seem prudent to provide an indicative rate cap early on for the drafting of budgets, but only proclaim the final rate cap proximate to its final use.

13. Would councils prefer more certainty about the future rate peg, or better alignment with changes in costs?

It should go without saying that local councils and local communities alike would prefer a rate cap that was accurate and adequately met the demands of financial sustainability. Certainty that the rate cap would be appropriate and responsive to actual economic conditions is much preferred to certainty about it being a particular number. At present, there is little confidence in the NSW local government community that future rate caps will be appropriate for the economic conditions that actually prevail at the relevant time. This represents a substantial problem that IPART and the NSW government must respond to.

14. Are there benefits in setting a longer term rate peg, say over multiple years?

Given that the RBA informed us in November 2021 that inflation would be transitory (Lowe, 2021), it is hard to imagine how IPART might think that an accurate long-term rate cap could possibly be divined. As we have already stressed, it is not certainty in a particular number that is at stake here. Rather local councils simply need to be certain that the rate cap will be appropriate for the specific conditions that they face at the relevant time.

15. Should the rate peg be released later in the year if this reduced the lag?

As we have already outlined, an indicative rate cap should be released at around the same time as occurs at present to assist with forward budgeting. However, the final rate cap should certainly be proclaimed as late as practical (i.e. April-May each financial year) in order to ensure that it is sufficiently responsive to prevailing macro-economic conditions. This is particularly important in a high inflation environment where macro-economic forces are volatile and unpredictable. Indeed, had this practice been adopted in the past, local councils

and local communities would have been spared the unnecessary cost and time involved in the recent ASV.

16. How should we account for the change in efficient labour costs?

As we detailed in our response to question 5 it would be a grave mistake to penalize councils for efficiency improvements. First, it would be necessary to measure efficiency correctly (which is presently not done owing to methodological and data problems). Second, it would likely result in deleterious unanticipated consequences.

17. Should external costs be reflected in the rate peg methodology and if so, how?

It is not quite clear what IPART means by ‘external costs’. However, certainly all costs must be considered as part of the compilation of a competent rate cap.

At present it appears that many important costs are not considered, such as new compliance costs (like the ARIC committees and the significantly higher audit costs after central auditing), cost-shifting and aggressive revaluations of existing assets pursued by auditors (that should have been reflected in past rate caps but certainly have a large bearing on current bottom lines).

Moreover, sensible adjustments need to be made to the permissible general income calculation to account for the portion of the pensioner rebates *not* refunded by the NSW Government (i.e. the notional general income should be increased by the amount of the rebates *not* received back as a subsidy). This simple change would mean that rural and fringe councils, which are often in the most precarious financial position, would no longer be penalised by the higher and increasing proportion of pensioners that choose to live in their areas.

In addition to calculating the rate cap so as to minimise uncertainty and reduce income volatility, it is also important to take into account the macro-economic challenges and trends that might face councils in the forthcoming financial year(s) under the stipulated rate cap. Put differently, the rate cap cannot be a purely empirical exercise; judgements must also be made about future inflationary pressures and other external forces that will impinge upon council costs.

18. Are council-specific adjustments for external costs needed, and if so, how could this be achieved? Please see our response to question 17.

19. What types of costs which are outside councils' control should be included in the rate peg methodology?

As detailed in our response to previous questions, adjustments must be made for a range of compliance, audit revaluation, cost-shifting and pensioner-discount costs. Indeed, adjustments should have been made for the substantial direct and indirect costs associated with COVID requirements and it would be appropriate to include a catch-up factor for this in the next rate cap.

Given the problem with sourcing appropriately trained staff, especially in rural and remote areas, it would also be appropriate to adjust rate caps for staff training and relocation expenses (or alternatively these costs could be reflected in the notional general income calculation).

In addition, it is absolutely essential that costs associated with local economic shocks are reflected in rates. This is particularly important in rural areas where climatic conditions and changes to commodity prices can have large effects on both 'capacity to pay' and 'need' for local government services (and hardship provisions).

As we have suggested a number of times, a rate cap range will often be the best way to reflect external costs that are specific to particular councils. Often it would not be possible for IPART to understand or quantify the myriad of specific external costs faced by various local communities at particular times. We need to trust to the superior local knowledge of local decision-makers to do so. Moreover, the democratic process has a built-in accountability mechanism to ensure that a rate cap range would not be exploited (although we note that simple reporting by IPART, along with pre-election fiscal statements long championed by scholars such as Drew (2021), could also act as an effective check on opportunistic behavior).

20. How can we simplify the rate peg calculation and ensure it reflects, as far as possible, inflation and changes in costs of providing services?

As we laid bare at the outset, a competent rate cap needs to have a clearly articulated purpose. We do not believe that simplicity ought to be the primary purpose of a rate cap. Indeed, most of the inaccuracy and subsequent fiscal damage caused by the rate cap has come about because of a desire to make things simple (often through the inappropriate use of indexes).

The costs of getting rate caps wrong are substantial, both in terms of financial sustainability as well as the broader social costs to the most vulnerable in our communities. We suspect that simplicity is a goal motivated in part by the desire to keep IPART/NSW government costs down. However, there is clearly a multiplier effect on the costs of inaccurate rate caps. Thus, it should be clear that the prudent course of action would be to invest more adequately in an accurate rate cap, better tailored to the needs of particular communities. To borrow a phrase from Bird et al. (2015): ‘to buy cheap methodology is to buy dear in the longer term’.

10. Recommendations

In this Report, we have (a) considered the major arguments in the ongoing debate in NSW local government over the impact of rate capping; (b) we examined the various theoretical considerations on the nature of property tax limitations and their regulation; (c) we surveyed the international empirical literature on the impact of property tax limitations; (d) we discussed the Australian empirical literature on the impact of rate pegging in local government; (e) we considered the findings of recent inquiries and official reports on rate capping in NSW local government; (f) we outlined the new IPART methodology for calculating the annual rate cap that includes a population growth factor; (g) we examined various problems inherent in the IPART methodology; and (h) we provided answers to the twenty questions provided by IPART (2022) in its *Issues Paper*. We now offer several recommendations for improving the municipal rating system in NSW local government.

As we have demonstrated in this Report, the longstanding rate cap regime in NSW local government has had a damaging impact on municipal performance, especially the continuing inadequacy of income from rates, related ongoing problems with the financial sustainability of NSW local government and associated inadequate infrastructure maintenance and renewal (Dollery, Johnson and Crase, 2006). Moreover, as we have shown in the Report, the new IPART rate cap methodology is seriously deficient and it will accordingly further damage the financial sustainability of NSW local government (Drew 2021; 2022).

Two alternative generic approaches of improving the NSW local government rating system exist:

RECOMMENDATION 1: ‘FIRST-BEST’ APPROACH ABOLISH RATE CAPPING

A ‘first-best’ approach would be for the NSW Government to simply abolish rate pegging and grant local councils the freedom to strike their own rates and be held accountable by their

own local residents. As we have demonstrated in this Report, this approach accords with both economic theory on optimal municipal property taxation and local democratic accountability, as well as the weight of international and Australian empirical evidence on property tax limitations.

However, this optimal approach involving the abolition of the rate cap in NSW local government faces the harsh political reality that it is politically extremely difficult to remove rate pegging from NSW local government. In this regard, Drew (2021, p.111) observed that ‘no political party is likely to voluntarily remove existing tax limitation regimes because there is a considerable risk that taxes would be increased soon after, and the party facilitating this would be greeted with the displeasure of voters at the next higher tier election’.

Moreover, ‘because taxation limitations are a politically popular way of responding to cost of living pressures – at no immediate cost to the instigator – their incidence is only likely to increase in future’.

RECOMMENDATION 2: ‘SECOND-BEST’ APPROACH REDESIGN RATE CAPPING

A ‘second-best’ pragmatic approach must accept that rate capping will remain an unassailable feature of NSW local government, regardless of the political complexion of the state government. We thus contend that reform should instead focus on removing the worst features of the NSW local government rate pegging regime. Put differently, a ‘second-best’ approach should concentrate on improving the IPART rate cap methodology.

Drew (2021, pp.111-114; 2022) has advanced several recommendations for reforming rate caps which we have augmented with additional suggestions. Firstly, as noted earlier, we recommend different cost indexes be employed for metropolitan, regional, rural and remote councils. As we have seen, the current LGCI employed by IPART is awash with problems that render it unsuitable as a basis for determining cost increases in operation of NSW local government. Given the spatial variation in municipal costs and municipal resource use across NSW, especially between metropolitan councils and their regional, rural and remote counterparts, Drew (2021) argues that different cost indexes should be employed for – at a minimum – the four main categories of council (metropolitan, regional, rural and remote councils). The construction of these indexes should include the use of three-year moving averages of the mix and weighting of the basket of items in the index, a price increase projection for the forthcoming financial year and consideration of the operating environment

of the four different categories of council. In essence, using moving averages as suggested would considerably reduce volatility and thereby partially mitigate the problem whereby some local governments find it difficult to predict future caps for budgeting purposes.

It is also important to take into account the macro-economic challenges and trends that might face councils in the next year when determining the final cap. Put differently, the rate cap cannot be a purely empirical exercise; judgements must also be made about future inflationary pressures and the like.

Secondly – and following from our first recommendation - we contend that different rate caps be calculated for councils falling in the four main municipal categories in NSW local government (metropolitan, regional, rural and remote councils). This will not only more accurately reflect the different operating environments facing these categories of council, but it will also facilitate comparisons between local council outcomes in each category. Accordingly, there will be greater transparency for local residents and more accountability for local councillors.

Thirdly, we recommend that a rate cap setting panel, as well as the SRV assessment panel, should include at least one scholarly local government expert. Scholarly knowledge of rate cap theory and sophisticated empirical techniques are clearly important for the development of a sound cap. Moreover, scholars are perceived to have greater independence (thus strengthening perceptions for a range of rate cap stakeholders) and can bring new insights to deliberations. Many of the problems associated with the recent changes would have been avoided if a suitably credentialed person was on the deliberative panels. It is thus wise to address this gap to avoid problems in the future.

Fourthly, we recommend that the rate cap should be based on the average rate for each category of property. As we have seen, the IPART rate cap methodology calculates the annual rate cap for each council based on its total property tax revenue from the previous financial year. Changing to a calculation based on typical (mean) rate impost will have significant benefits for local authorities. For instance, it will mean that the construction of new dwellings and businesses in a given local government area will increase the total tax intake. This will better enable local councils to absorb the costs of growth, including the need for additional local infrastructure investment. It would also mean that the inaccurate and controversial population growth factor would be rendered redundant.

To calculate the cap, the average of each category (from the previous period) would need to be inflated by the specific cap for the particular type of council, then multiplied by the number of assessments in the given category as at the most recent record date. The total tax take would then be equal to the sum of the various category calculations.

A rate cap based on the averages for each category will also encourage more prudent use of minimum rates and base rates. This implies that it will thus contribute to greater distributive justice. Furthermore, an approach based on averages is more consistent with the objectives of a rate cap; that is, to avoid rate shock for the typical resident. By setting rate caps on the foundation of the typical rate imposed on each category of ratepayer we are much more likely to avoid rate shock for the typical ratepayer.

Fifthly, we recommend that the rate cap should be provided within a small range rather than as a single set number. A rate cap should not be a single figure for each council, but instead encompass a small range of potential rate increases (thus, for instance, a rate cap can be expressed as 2.4 to 3.0% rather than simply 2.7%). This would have a number of advantages. Firstly, it would diminish much of the ‘learned helplessness’ and ‘blame shifting’ inherent in the current rate cap regime. Second, it would enable councillors to lessen any error in the calculation or calculation methodology. Third, it would allow for local councils to adjust to changes in conditions that occur in the long time-span between promulgation of the rate cap and the start of the new financial year. Fourth, it would empower regulators to explicitly include the statistical error term associated with any empirical calculation. Fifth, it would reassert democratic accountability and would give councillors greater opportunity to respond to community circumstances and community preferences. A rate cap incorporating a small range would still reduce the potential for monopolistic excesses, but it would do so in a manner that respects both the uncertainty of the rate cap construction as well as local democratic principles.

Sixthly, we recommend more sensible timelines should be established for SRV nominations and applications. The current timeline for SRVs in NSW could hardly be worse and contribute to a range of avoidable costs (see Table 1 below). In practice, it often means that local councils are breaking bad news to their local communities immediately prior to Christmas. In the most recent year of delayed elections, the early nomination date meant that

many councils delayed their SRV by an additional year which may well have caused serious financial sustainability problems. Moreover, it increases stress on council staff who often have to give up customary extended periods of leave typically taken over the festive season. In addition, it adds to consultant costs because companies are often forced to pay premiums to staff to work over the festive season.

In Victoria much more reasonable date are employed, as we can see from Table 1. Intent to apply is purely optional, as it should be. Moreover, the applications roll in over a long period which allows for much better assessment turnaround times. In addition, it also makes it much more likely that applications get assessed on their own merits rather than being sub-consciously compared to other applications.

Table 1: Special Rate Variation Key Dates for NSW and Victoria

Event	NSW Date	Victorian Date	Recommendation
Notification of Intent to apply for a SRV	26 November	31 January*	End of January (optional)
SRV application due date	7 February	1 February until 31 March	Should be submitted any time prior to mid-April
Determinations announced	May 2022	Within two months of receiving the application	Within six weeks of application

* Note this is only an option in Victoria. It is not mandatory to give notice of intent.

Our seventh recommendation suggests automatic triggers should be employed. One of the significant problems associated with a rate cap regime is that it is associated with steep political costs. This explains why many local councils are hesitant to indicate intent to apply for an SRV in election years. The problem with delaying SRVs is that a council may fail financially in the interim. Moreover, it also tends to mean that increases need to be higher to make up for foregone rate revenue for the year(s) deferred.

Political costs could be reduced substantially by making SRVs mandatory when certain triggers are met. This would indicate that the local community in question would perceive the SRV as an act required from fiscal prudence rather than political choice. It would also mean

that the rate cap regime would not add further to the already deplorable record of local government financial failures in the NSW local government system (Drew et al., 2021).

Triggers should include standard ratios already in use. However, they would require the NSW OLG to employ more reasonable benchmarks based on empirical evidence (rather than the current apparently arbitrary numbers). In particular, the following ratios represent excellent candidates:

- Operating ratio (over *three* years)
- Unrestricted Current ratio (with a more appropriate benchmark)
- Debt ratio (with more suitable benchmark)
- Cash expense ratio (using a more appropriate benchmark)
- Rates outstanding (currently there is no benchmark and it should be noted that a ceiling - rather than a floor - would be most appropriate here to protect ratepayers).

We have specifically excluded the asset maintenance ratios because they are typically too unreliable at present. Moreover, their use may exacerbate the already high levels of distortion to these numbers.

Regulators might also consider introducing a trigger whereby a certain turnover in councillors following elections would establish a presumption that a new rating policy should be constructed, where a new rating policy might result in a reduction to total tax take, different categories, changes to minimum and base rates and hence greater distributive justice (Drew, 2021). This would be consistent with calls for greater political accountability with respect to municipal finance.

In addition, given the extreme fiscal distress currently experienced by forcibly amalgamated councils as a result of the disastrous NSW local government *Fit for the Future Program* (Drew et al., 2021), it should be considered essential that all compulsorily consolidated councils submit an SRV application as a matter of urgency.

Our eighth and final recommendation prescribes that the burden of proof should rest with the assessing panel or those who object to the proposed rate cap to offer sound reasons for why it should be rejected or reduced. Given that SRV applications are publicly available, and should also be based on thorough and robust proof of need according to prescribed criteria, the burden of proof should rest with the SRV assessment panel or those who object to the proposal to provide compelling reasons for why the SRV should be rejected or reduced. This

is especially the case when local councils have availed themselves of suitably qualified experts to assist in the preparation of the SRV and where they have provided robust empirical evidence in support their claims. In essence, reversing the burden of proof along the lines we suggest would more appropriately respect the efforts of council staff and the deliberations of politically accountable councillors.

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