

# The Optimal Size of Local Government, with Special Reference to New South Wales

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## Abstract

*The paper discusses the major criteria for determining the optimal size of local government, and advances an evidence-based critique of the New South Wales Government's program to reduce the number of local councils.*

## Introduction

In the last 20 years, the three eastern Australian states of Victoria, Queensland and New South Wales (NSW) have significantly reduced the number of local councils. In the mid-1990s, Victoria slashed the number of local councils from 210 to 79. In 2008, Queensland reduced the number from 156 to 73 but, with four de-amalgamations in 2014, the number is now 77. As of May 2016 the NSW Government had reduced the number of councils from 152 to 129 and, at the time of writing, plans to amalgamate another 19 councils subject to the outcome of legal proceedings.

These amalgamations have occurred despite much local opposition and notwithstanding that Australian local governments have an average population of 41,000, which is large by most international standards. The average population is 75,000 in Victoria and 50,000 in NSW. Among 22 'Western' countries (in Europe, North America and Australasia) only local governments in the UK,

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Ireland, Denmark and New Zealand have larger populations. On the other hand, the average population per local authority is 37,500 in the Netherlands, 32,500 in Sweden, 9,000 in Canada, 6,500 in Germany, 4,500 in the United States and only 1,500 in France.<sup>2</sup> And it may be remarked that in terms of land size, Australian local governments are also considerably larger than local governments in the UK, Ireland, Denmark and New Zealand.

In this paper, I discuss the major issues relating to the size of local government, examining four major criteria:

1. Strategic capacity to work with higher levels of government
2. Economic efficiency, sometimes described as financial capacity
3. Effective provision of preferred local services
4. Effective local democracy and social capital.

The first of these has had special prominence in NSW. The other three are classic criteria in the economics literature. It should be noted that in NSW there has also been much rhetoric about the need for 'scale' in local government. The Independent Local Government Review Panel (ILGRP 2013a, 2013b) argued that at least 200,000 people are necessary for strategic and financial capacity. Likewise, the Independent Pricing and Regulatory Tribunal (IPART 2015), following terms of reference imposed by the NSW Government, concluded that most councils in NSW were 'not fit for the future' because they lacked requisite scale of some 200,000 people. However, scale is not itself a welfare objective. It is simply a possible means to achieve other objectives. Rather surprisingly, in reviewing the criteria, IPART (2014) provided no justification for accepting the scale criterion.

While the paper draws on the NSW Government's policies to increase the size of local councils, most of its discussion and conclusions have general application both across Australia and internationally.

## **State and local government relations, and 'strategic capacity'**

The criterion that local councils must have the strategic capacity to work with higher levels of government has had a high profile in the debate in NSW. Justifying the recommendations of the ILGRP that local councils should be amalgamated into units of around 200,000 people, the Chair, Graham Sansom (ILGRP 2015: 65), stated: 'The ILGRP's concerns were with the effectiveness of

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<sup>2</sup> These data are drawn from Callanan et al. (2014).

local government as an arm of metropolitan governance.’ The rationale is that local councils should have the capacity to assist with metropolitan planning and the provision of adequate transport and housing infrastructure.

In this section I discuss first some major governance issues for urban areas (urban planning, housing and transport) and then some micro criteria for strategic capacity advanced by the ILGRP.

A major motivator of the state government’s desire to halve the number of councils in Sydney is the desire to address the problems of high house prices and transport congestion. House prices in Sydney are 40 per cent higher than the average in other Australian capital cities (Reserve Bank of Australia 2015). Local councils in inner and central areas of the city tend to oppose higher residential and commercial densities, which tends to affect house supply, and some strongly oppose new transport infrastructure, especially motorways. The state government views this opposition as not only creating unaffordable housing and traffic congestion, but also as holding back economic growth, jobs and real incomes. And some state government agencies find dealing with large numbers of councils is time consuming and resource intensive.

There are two large issues here. Is this NSW Government’s view of the problems and their causes correct? And if so, what is the appropriate response? These are complex issues, for which a brief three summary responses must suffice here.

First, as discussed by Gao and Melser (2016), high house prices are an equilibrium welfare outcome reflecting household trade-offs of incomes, house prices and amenity. The high house prices in Sydney reflect mainly the amenity premium and partly the income premium of residence in Sydney. Glaeser (2011) argues that density controls have a major impact on house supply and prices in the United States. However, increasing the flow of new housing has a small marginal impact on the house price premium. The Australian evidence suggests that increasing the flow of new housing supply by 50 per cent in any one year would have limited impact on the total stock of housing and reduce real house prices by 2 per cent (Abelson 2016).<sup>3</sup>

Secondly, the state government has responsibility for economic development, housing and transport and the power to facilitate these developments within topographical and amenity constraints. The NSW Department of Planning and Environment (2014) has developed plans for Sydney based on demographic projections and an objective to assist less well-resourced areas. Unfortunately,

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<sup>3</sup> In any year, new houses equal on average about 1.3 per cent of the housing stock. Thus a 50 per cent increase in new housing supply in any one year increases the total housing stock by about 0.65 per cent. The 2 per cent reduction in house prices estimated by Abelson implies the elasticity of real house prices to the total stock of houses is about -3.5.

the projections are not based on a credible cost–benefit methodology for allocating housing to sub-regions – for example, based on market forces subject to transport and environmental constraints. Nor, until recently, has the state government had much appetite for major transport projects.

Thirdly, and perhaps most importantly, the state government has the power (as well as the responsibility) to determine and achieve sub-regional housing targets and major transport projects without forced amalgamations. It authorises local environmental plans that determine local planning (zoning) regulations. It has the power to determine property to be taken for, and land uses around, major transport projects. And it can require councils to cooperate in sub-regional planning via sub-regional organisations.

Turning to micro criteria for strategic capacity, the ILGRP (2013a) defined strategic capacity by the following nine sub-criteria, all endorsed by the NSW government and accepted by IPART (2014):

1. More robust revenue base and increased discretionary spending
2. Scope to undertake new functions and major projects
3. Ability to employ a wider range of staff
4. Knowledge, creativity and innovation
5. Advanced skills in strategic planning and policy development
6. Effective regional collaboration
7. Credibility for more effective advocacy
8. Capable partner for state and federal agencies
9. Resources to cope with complex and unexpected changes.

These nine criteria include three that focus on councils' capacity to work with a higher level of government (criteria 6, 7 and 8), two that involve financial capacity (criteria 1 and 9), and four that are aimed primarily at improving services to the local community (criteria 2, 3, 4 and 5).

A fundamental difficulty with all these criteria is that they lack definition and metrics. Accordingly, they cannot be readily, or objectively, validated.

Three further points may be made. First, arguably, competition and motivation spur creativity and both increase with a larger number of small councils. Second, small local governments can cooperate with other councils through shared services. There are many examples of this in Sydney. Third, councils can buy in any specialist skills that they may need. Access to a skilled workforce is a function of financial capacity, not of size.

Given the above observations, it may be inferred that the arguments for strategic capacity are more about facilitating state government objectives, especially for metropolitan governance, than about increasing the internal capacity of local councils.

## Financial capacity and efficiency

A major claim of proponents of larger councils is that they produce significant cost savings. In this section, we consider the arguments, and evidence, for or against this claim.

First, a few introductory observations. Australian local governments are local public service monopolies supplying a large variety of unpriced services. There are no market metrics of prices, profits, market shares or unit service costs. Typically, we observe expenditures that are a product of the quantity of various services supplied and their average unit costs. Ideally we need to sort out unit costs from the quantities supplied. Moreover, the use of widely different depreciation rates across councils complicates expenditure and cost comparisons. These points should caution, but not disqualify, any conclusions that may be drawn from empirical analysis.

## General issues affecting size and efficiency

The key argument for the claim that larger councils produce cost savings is that they achieve economies of scale. This is typically assumed to occur with administration overheads and backroom operations, such as rate collections and IT services. This may be based on observed duplications of functions in local councils or by analogy with private commercial operations.

It may be noted that the possible technical disadvantages of small scale can be responded to, at least to some extent, by shared service arrangements and competitive outsourcing of service provision. Also, larger geographical areas create travel costs for consumers.

More importantly, there may be significant costs (diseconomies) associated with large bureaucracies with unclear metrics. Large monopolies are behaviourally less constrained. Costs are often less clear. And internal contracts are often less precisely defined. These are key management challenges. Behavioural economics indicates that the key to productivity is Intrinsic Motivation. As Frey (2013: 172) notes, 'many people intrinsically interested in the work they do have been demotivated by bureaucratic interferences'.

There is considerable literature on the costs of bureaucracy (see, for example, Parkinson 1958; Niskanen 1994). As Parkinson observed, efficiency often falls in large bureaucratic bodies. One reason for cost inflation is that managers in bureaucracies have a greater incentive to increase the number of employees reporting to them (as salaries are often linked to the number of people that they manage) than to reduce costs.

However, the key message that emerges from this brief discussion is that we must look at the *evidence* on costs and council size rather than rely on generic, high-level assertions about possible economies or diseconomies of scale.

## **Evidence in favour of the existence of economies of scale?**

As we will see, there is remarkably little evidence of economies of scale in local government jurisdictions. As noted by Bell et al. (2016), the ILGRP (2013a, 2013b) did not cite any empirical evidence of cost savings from amalgamation.

IPART (2014) attempted to rectify this omission by citing a significant inverse correlation between population size and expenditure per capita. According to IPART (p. 39), the data suggested that 'around 30% of the variation in opex per head amongst the councils of Greater Sydney is inversely associated with their population and that opex per head is lower the larger the population of the LGA'.

However, this finding failed fatally to account for the substantial inverse correlation (of -0.49) between local council population and income per capita. Abelson and Joyeux (2015) showed that expenditure per capita is largely explained by average taxable income per capita and a dummy variable for major business centres. After differences in income levels and business activity are allowed for, Abelson and Joyeux found no evidence for economies of scale in larger local councils in Sydney.

Further, drawing on the NSW TCorp (2013) financial report on councils and 2011 Census income data, financial weakness is seen clearly to be a function of income, not size. The average taxable income of the 30 council areas in metropolitan Sydney deemed by NSW TCorp (2013) to have a moderate or strong financial outlook was \$61,237. The average taxable income of the seven council areas in metropolitan Sydney deemed to have a financially weak outlook was \$42,366. No area with an average taxable income of over \$48,000 had a projected weak financial outlook.

In its assessment of council mergers proposed by the NSW government, IPART (2015) reported a financial analysis by Ernst & Young (EY). EY assumed that mergers would result in 15 per cent savings in the total operating costs of the amalgamated councils, other than the largest council, less some initial costs of the amalgamation. EY based this projection of savings on the financial targets of competitive corporates engaged in designed and selected takeover targets! As Bain & Company<sup>4</sup> has shown:

The open secret about M & A is that most deals fail to achieve the synergies that companies expect ... Most merging companies don't have a clear understanding of the level of synergies they can expect through increased scale.

Further, in IPART (2015, Annex: 30), Ernst & Young acknowledged:

the available empirical evidence on the extent to which local council amalgamations will yield net savings in costs is mixed and tends to vary with activity. Econometric analysis does not provide strong support.

Finally, in putting out its council merger proposals, the NSW Government commissioned KPMG to provide 'independent' advice on the financial impacts of the proposals. KPMG (2016) reported, *inter alia*, that they assumed 3 per cent saving on 80 per cent of expenditure on materials and contracts, 7.4 per cent overall staffing efficiencies in metropolitan areas but none in rural areas, and various savings in information, communications and technology investments. These savings were partly offset by some assumed merger transition costs. Typically, the KPMG projections produced net savings of about 2.5 per cent of expenditures over some 30 years.

Apart from the minimalist nature of the forecast outcome, there are several problems with these estimates. First, as revealed in KPMG (2015), these assumptions were based largely on *forecasts* of savings contained in reports on earlier amalgamation proposals in Queensland and Auckland.<sup>5</sup> Second, KPMG assumed that if the savings were technically achievable by a merged entity, they would occur. This assumes away bureaucratic risk and the evidence on costs cited below. Third, the analysis fails to account for some key costs such as a major new head office or the integration of different workforce systems; for example, where one council provides most services in house and another one outsources significant services. Nor does it account for the travel time costs that the merger would impose on residents.

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4 Bain & Company (2014); [www.bain.com/publications/articles/why-some-merging-companies-become-synergy-overachievers.aspx](http://www.bain.com/publications/articles/why-some-merging-companies-become-synergy-overachievers.aspx).

5 The KPMG (2015) report became available in legal proceedings only after KPMG (2016).

## **Evidence against the existence of economies of scale**

In contrast to the lack of evidence on scale economies, there is extensive peer-reviewed published work on the costs of amalgamations. Dollery et al. (2012) provide detailed and extensive evidence in Australia and internationally that forced amalgamations have not produced any cost savings. They concluded that:

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

In another major review, Dollery et al. (2013) cited 15 international studies from the United States, Canada and Europe, all of which throw doubt on claimed economies of consolidated local councils. They also examined eight Australian inquiries into the financial sustainability of local councils over the past decade and found (p. 215) that ‘with one exception, these inquiries are sceptical of the ability of forced amalgamation to improve local authority financial viability’.

In a cross-section study, Dollery et al. (2014) showed that there is no relationship between scale and financial capacity in Sydney. And Bell et al. (2016) showed that, in 2014, NSW councils amalgamated between 2000 and 2004 were no more financially sustainable than councils that had not been amalgamated.

Similar conclusions have been reached in other countries. Faulk and Grassmueck (2012) found that council mergers had not achieved expected savings in the United States. Reese (2004) and Found (2012) found that net council expenditure tended to rise after council mergers in Canada. Callanan et al. (2014) found limited, if any, economies of scale in larger local governments in Ireland.

## **Financial capacity and council size: Some conclusions**

The NSW Government has reiterated repeatedly the mantra that larger councils produce significant savings and therefore better services. But the corporate business world is not an appropriate model. Public bureaucracies are monopoly service providers; they are not competitive businesses. The larger a bureaucratic monopoly, the greater is the potential for waste. Most critically, almost all empirical studies in Australia and elsewhere have shown that larger councils do not produce savings.



## Ability to provide desired local services

It is generally agreed in the economics literature that the prime function of local government is the provision of publicly provided local goods (Abelson 2012). Local councils generally provide quite localised services, including:

- local infrastructure (roads, footpaths and drainage)
- local parks and bushland
- local planning and development approval services
- building services, including inspections and enforcement
- waste collection and management
- administration of local public spaces, parking facilities and street parking
- public health services, such as water and food inspection, public toilets and animal control
- local cultural facilities, such as libraries, art galleries and museums
- active recreational facilities, such as sports fields, swimming pools and camping grounds
- local social/welfare services for youth, families and seniors
- water and sewerage services in some areas in some states.

Many such goods – for example, local roads, waste disposal services, recreational facilities and libraries – provide mainly, and sometimes exclusively, local benefits and can be provided in varying levels to different communities. Efficient provision of these goods requires that they satisfy local household preferences.

If preferences for local goods vary, and there are no economies of scale or externalities, the *theorem of decentralisation* indicates that decentralised provision increases welfare by equilibrating output to demand (Musso 1998). Uniform services provide too few services to those who want more or higher-quality services and too much taxation on those who want fewer services.

Figure 1 illustrates the benefits of decentralisation in serving different preferences. This shows a localised service produced at constant marginal cost. The demand curves  $D_A$  and  $D_B$  show aggregate demand for the localised service in two communities,  $A$  and  $B$ . The efficient quantities would be  $Q_A$  and  $Q_B$  respectively. If a single government provided a uniform output ( $Q_U$ ) to the two communities, area  $A$  would receive too much of the localised service and area  $B$  too little. The welfare gains from decentralised provision equal areas  $ABC$  and  $CEF$  respectively.

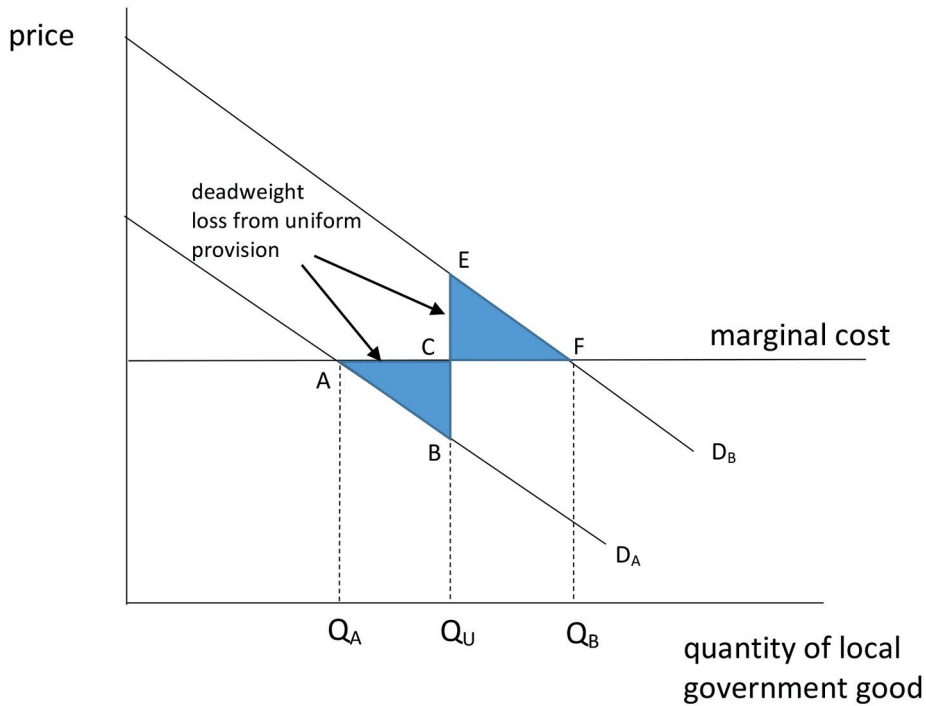


Figure 1: Deadweight losses due to uniform provision of a local government good

It is also a widely accepted principle that the allocation of public goods to different levels of government should be determined by the ‘principle of subsidiarity’. The *subsidiarity principle* states that public decisions should be made as closely as possible to the citizens affected by the decisions by the smallest, and least centralised, competent authority.<sup>6</sup>

We should note that, increasingly, many local government services are personal services (social support, cultural and recreational) provided to individuals or small groups of individuals. Over the last 30 or so years, there have been major increases in elderly people living alone, divorce rates, domestic violence, women at work and mental health problems. Prima facie, one would expect that such personal services would be provided most effectively in relatively small communities and that smaller governing units (and communities) would be able to respond to individual problems better than large ones.

More generally, the delivery of desired of local services depends on four factors:

- i. the capacity to understand local needs

<sup>6</sup> Article 5 of the Treaty of the European Union. See also [dictionary.cambridge.org/dictionary/english/subsidiarity](http://dictionary.cambridge.org/dictionary/english/subsidiarity).

- ii. the motivation to meet local needs
- iii. the ability to deliver services
- iv. the financial capacity (discussed above).

Regarding (i), understanding local needs, personal interactions of various kinds between local residents and decision makers (elected representatives and senior council officers) are highly helpful, even critical, to understanding preferences. It is generally accepted that these needs will be better known in smaller local governing units.

Regarding (ii), motivation, as Frey (2013) and other researchers have shown, productivity and meeting service demands is critically a function of the intrinsic motivation of the workforce (i.e. workers identifying with the objectives of the organisation). This again is easier to achieve in small governing bodies than in large ones.

The capacity to deliver services (iii) is a function of clearly defined tasks and delegations for council staff. It is also a function of volunteer services. In many areas, volunteers play a key role in supplementing service delivery. In larger councils, there is a real risk that potential volunteers will feel less connected with their 'local' community and therefore less motivated to contribute.

Certainly, these topics warrant more empirical investigation. But there is good reason to expect that all these key service factors will be stronger in small local government units.

On the other hand, where resident preferences vary, it is hard to produce differentiated services across a large area. Differentiated service levels for, say, cultural facilities imply (in the absence of user payments) cross-subsidies. Inevitably decision makers will tend towards uniform provision of services over cross-subsidies and the related potential charges of favouritism, or even corruption, associated with differentiated services.

Abelson (1981) showed that households in small local government areas in Sydney receive much higher levels of service (as measured by communications between elected councillors and local residents) from their elected councillors than do households in larger areas. Measured by hours of work per representative per citizen, households in local councils with 40,000 people received twice the services that households received in councils with 120,000 people. Also, households in the smaller areas made 66 per cent more telephone calls, sent 25 per cent more letters to their representatives and received twice the number of visits from their representatives than did households in areas with 120,000 people.

While there have been extraordinary changes in communication technologies, it is reasonable to assume that per-capita communications between residents and elected representatives fall significantly as the size of the governing jurisdiction rises. This reflects popular expectations, as found in a recent national survey by the Australian Centre in Excellence in Local Government (Ryan et al. 2015). This survey found that 48 per cent of respondents expected that their interests would be worse or much worse represented by councillors in an amalgamated council and only 7 per cent expected an improvement in representation, with the balance having no view either way. Regarding actual council services, 36 per cent expected that local services would be worse or much worse and only 7 per cent expected an improvement in service, again with the balance having no view either way.

## Effective local democracy and social capital

Effective local democracy means having some control over your local services and local environment. This paper contends that local democracy and social capital (a sense of community)<sup>7</sup> are strongly linked.

In his classic, bestselling book *Bowling Alone*, Robert Putnam (2000) showed that while Americans have grown more affluent, their sense of community has withered. Many cities and traditional suburbs have become anonymous places where people sleep and work and do little else. Putnam showed that as people spend more time working in their office and commuting to work and watching TV alone, they spend less time joining community groups and voluntary organisations and socialising with neighbours.

Andrew Leigh's *Disconnected* (2010) explored the decline in community in Australia. Leigh found that between the 1980s and the 2000s Australians had fewer friends they could drop in on uninvited and fewer friends they could call on for a favour. In his recent book *The Art of Belonging*, a leading Australian social analyst, Hugh Mackay (2014: 1), wrote: 'We rely on communities to support and sustain us and, if those communities are to survive and prosper we must engage with them and nurture them.' Indeed.

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<sup>7</sup> The Organisation for Economic Co-operation and Development (2009: 103) defines social capital as 'the links, shared values and understandings in society that enable individuals and groups to trust each other and so work together'.

A major finding of the 2012 Nobel Prize-winner in Economics, Elinor Ostrom (1990), is that small communities generate much greater trust and social capital. It is not credible that communities of 300,000 people, or even 150,000, can generate as much interpersonal trust and mutual social capital as communities of, say, 30,000.

Most people want some sense of control over their own lives, their local services and their local environment. A larger council does not reduce the amount of government that people experience. Instead, by disempowering citizens, it increases the sense of being governed.

Elected councillors provide an essential link between the community and the council officers and administration. Under the NSW *Local Government Act* (Section 232), a key role of a councillor is to 'facilitate communication between the community and the council'. In small local government areas, citizens are represented by local councillors, all or most of whom have extensive local knowledge, emotional connection and availability. Substantially reducing representation per head of population significantly weakens accountability and hence service levels. This was a major concern expressed in resident submissions to the NSW Government's merger proposals.

These feelings were also confirmed in the national survey by the Australian Centre in Excellence in Local Government (Ryan et al. 2015). A third of the surveyed population expected that they would experience a significant decline in their sense of local community and in belonging to their local area in a larger amalgamated council, with only 7 per cent expecting an improvement in their sense of their local community and in their belonging, with the balance having no view either way.<sup>8</sup>

In this paper's view, the democratic will of the local population is the most critical of the four major criteria. If a well-informed community prefers a smaller local governance model, this would generally indicate that they thought they were getting better value for money than they would expect in a larger local government area. In so far as the larger unit would provide savings and/or improved services, the local community is still saying that this is a cost it would willingly bear for the sake of effective local democracy and social capital.

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<sup>8</sup> We have already noted the critical role of volunteers in providing community services, both through councils and outside it. Volunteering is fundamentally a function of social capital and thus is also likely to fall as the size of local government increases.

## Conclusions

This paper has discussed four main criteria for assessing size of local government: capacity to work with state governments; economic efficiency (financial capacity); effective provision of preferred local services; and effective local democracy and social capital.

The paper finds that capacity to work with state government is not a substantive argument for larger local councils, that there is strong empirical evidence that larger governing units do not achieve financial savings, and that local preferences are likely to be better understood and served in smaller governing units.

In this paper's view the subsidiarity principle of democratic government – that public decisions should be made as closely as possible to the citizens affected by the decisions – should be the default position. In the famous words of Montesquieu (1989 [1748]): 'In a small republic, the public good is more strongly felt, better known and closer to the citizen.'

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