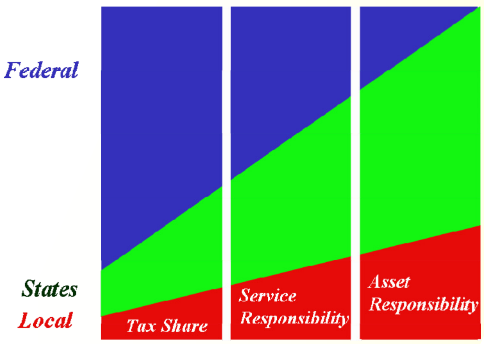
LOCAL GOVERNMENT MANAGERS AUSTRALIA

Productivity Commission Study

Local Government Revenue Raising Capacity

SUBMISSION BY:
LOCAL GOVERNMENT MANAGERS AUSTRALIA

August 2007



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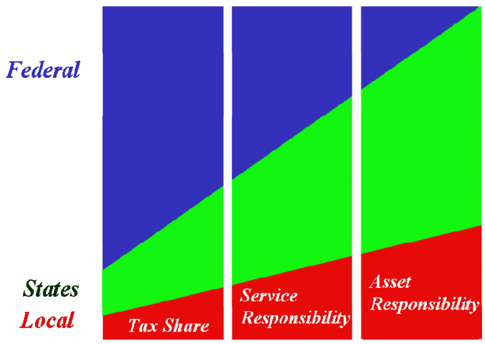


Federal
States
Local
Tax Share
Service Responsibility
Asset Responsibility

Forward

Steve McGrath

President

LGMA National

After the Federal Treasurer released the Productivity Commission's Terms of Reference for a Study into Local Government Revenue Raising Capacity in April, LGMA was keen to contribute from a practitioners' point of view.

LGMA engaged Mark McKenzie-McHarg, Mach II Consulting, to assist with the research, coordination and development of a submission to the Productivity Commission.

LGMA developed a methodology to:

- identify the key issues to the sector's revenue raising capacity through consultation with the sector and the key practitioners;
- using the sector's skills and expertise undertake detailed analyses of the issues and bring forward practical ideas to benefit the sector's revenue raising capacity; and
- move the debate towards a long term solution to achieve financial sustainability for the sector.

In response to the Productivity Commission's Issues Paper, an Industry Issues Paper was prepared and referred to authorities for comment. LGMA identified two ways forward in tackling the submission to the Productivity Commission. To respond:

- by reiterating the results of the road well travelled by the Hawker Inquiry, Financial Sustainability studies and the PWC Report, which identified the key issues surrounding Local Government Financial Sustainability.

- along the lines of what will suit Local Government in 2050/2100. That we use the Study process and our submission to explore a new fiscal direction for Local Government in a nation building context.

What is the fiscal financial structure that will support
a well resourced and autonomous system of
Local Government in 50 years time?

Whilst the overwhelming response from the sector invited the LGMA to follow the more strategic and futuristic option, there were words of caution that we shouldn't leave the obvious unsaid.

The LGMA ran a National Forum in conjunction with the Revenue Management Association and the Local Government Finance Professionals where considerable debate took place about the issues impacting on local government revenue raising capacity.

The Productivity Commission representatives, Presiding Commissioner Judith Sloan and Associate Commissioner Cliff Walsh, attended the National Forum and heard the conclusions drawn by the Forum participants.

As a result of the Forum, we decided to enter into a dialogue with the Productivity Commission to ensure that there was a degree of understanding of how the sector works and the limitations in relation to the current fiscal/financial system.

The LGMA National Board at its August meeting adopted this submission for referral to the Productivity Commission's Local Government Revenue Raising Capacity Study.

LGMA National will undertake detailed consultation with the sector over the next six months to identify the essential ingredients for a new fiscal/financial system that will direct Local Government towards 2050/2100.

I look forward to your ongoing support and input in this important process that will lead to a stronger and more autonomous Australian Local Government.

Steve McGrath
President
LGMA National

1.0 Introduction

"…in order to make a meaningful contribution to the debate about long-term revenue-raising by local governments, LGMA has deemed it necessary to make this submission that addresses issues and extends beyond the Study's Terms of Reference."

1.1 Study Context

This Study by the Productivity Commission was instigated by the Federal Treasurer following the Government's consideration of and response to the Hawker Inquiry into local government rates and taxes.

The key focus of the Hawker Inquiry was on:

- 'cost-shifting' (by Federal and State Governments onto local governments); and
- the financial sustainability of councils across Australia and the ability of Australia's local governments to meet and maintain the community's infrastructure needs now and in the future.

In responding to the Hawker Report, the Federal Government stated that:

> "The Government does agree with the Committee (Hawker) on the importance of local government

> authorities having the capacity to raise revenue from their own sources ..." [1]

This submission examines the underlying assumptions about local government's capacity to raise its own revenue (through property taxes and other 'own-sources') and the legal, political and fiscal factors that impact on that capacity.

At a higher, more strategic level, this submission also addresses the role played by property taxes in today's overall public sector taxation context, the equity of those taxes and the relationship between local government autonomy and its own-source revenue streams. Finally, this submission examines attributes of a local government fiscal system that might be relevant in the year 2050. Importantly, this submission seeks to provide the Commission with a practitioner's insight into the practicalities of local government revenue raising, as well as educate the Commission about the nature and culture of the local government sector.

1.2 Who is LGMA?

Local Government Managers Australia (LGMA) is the sector's peak professional body in Australia. LGMA seeks to work closely on sectoral and policy issues with other peak bodies such as the Australian Local Government Association (ALGA) which represents the views and interests of councils themselves.

LGMA's State Divisions have a total membership of some 2,500. These are mostly senior and middle managers working in a range of professional disciplines throughout Australia's 700 local government authorities.

[1] Australian Government Response to Hawker Report, p.9.

This submission outlines LGMA's views in relation to a range of local government revenue raising issues. Our submission presents these views in the widest possible strategic context (and free of parochial and political bias) with a view to assisting the Commission in it deliberations and in undertaking a complete, relevant and well-informed Study.

The LGMA represents the vast majority of Local Government Chief Executives who have the operational responsibility for day to day management of Councils and have valuable input to make in this study process.

1.3 Terms of Reference

The terms of reference for this Study were received by the Commission on 4 April 2007. The Study's terms of reference:

- are clearly focused on local government's **'own-source'** revenue raising capacity; and
- specifically exclude local government borrowing powers/limits and government grants and subsidies.

The Commission's Issues Paper acknowledges that borrowing powers (and the extent of use of borrowing as a capital funding source) are ultimately tied up in any discussion about the capital funding needs of councils, inter-generational equity issues and the appropriateness of councils accumulating cash reserves as an alternative and/or adjunct thereto.

Despite the above scope limitations, the Issues Paper discusses the extent of State/Federal Government grants and subsidies (by way of context) and the vastly differing levels of reliance on those government funding sources by councils in different geographic situations and of different type/scale.

In considering the terms of reference, LGMA formed the view that to ignore grants and subsidy issues and borrowing powers will significantly limit the scope that this Study offers to have a meaningful engagement with the Productivity Commission on the very serious underlying long-term revenue raising and capital funding issues facing local government in a ‘Nation-building’ context.

(NB: It is noted that invitation for submissions that go beyond the issues addressed in the Issues Paper, offering some latitude to the submission by LGMA [2].)

1.4 LGMA’s Approach to this Study

A cornerstone of LGMA’s approach and response to this Study (including this submission), has been to seek and conduct an open dialogue with the Commission.

Our response has included:

- review of the Commission’s Issues Paper by the LGMA Financial Sustainability Working Group;
- preparation of an ‘Industry Issues Paper’ (in response to the Commission Issues Paper) and circulation of this to all CEOs throughout Australia with and invitation for comments/feedback;
- conduct of a National Forum with the Presiding Commissioner and Assisting Commission and staff (Melbourne, 31 July 2007); and
- preparation of this submission.

[2] Productivity Commission Issues Paper, 18 May 2007, p.12

The responses and feedback received from CEOs across Australia overwhelmingly supported a **strategic/visionary** submission to the Commission's Study (as opposed to a **reiterative** response). Despite the clearly limiting terms of reference, the views expressed by the CEOs overwhelmingly supported the proposal that LGMA's submission to the Study should:

1. re-state LGMA's established, widely-accepted and well documented sector views on the underlying financial sustainability/infrastructure funding issues facing local government such as cost-shifting and rate-pegging;
2. seek to outline LGMA's views on the **underlying flaws** in the local government fiscal/taxation/revenue-raising system generally; and
3. outline (in terms of outcomes/attributes) **LGMA's vision** for a new fiscal system for local government that is consistent with the sector's aspirations as a **genuine and autonomous partner** in Australia's Federation.

2.0 21st Century Local Government: - Our Role Today

> *"…over the past 30 years, the role of local government has changed substantially from being limited largely to property-based services and infrastructure provision, to being heavily focused on community, health, social, cultural and human services."*

2.1 The Changing Local Government Sector

Australia's systems of local government are constituted under legislation of the various States/Territory. As such, all councils are 'creatures' of the States/Territory. The sector comprises some 700 bodies that continue to exist at the pleasure of the State/Territory governments. Local government is not presently a genuine partner in Australia's Federation as it does not enjoy constitutional recognition.

Local government in Australia pre-dates Federation. Many councils have their origins as roads districts where their role and focus was clearly and exclusively on the provision of physical infrastructure such as roads and drainage.

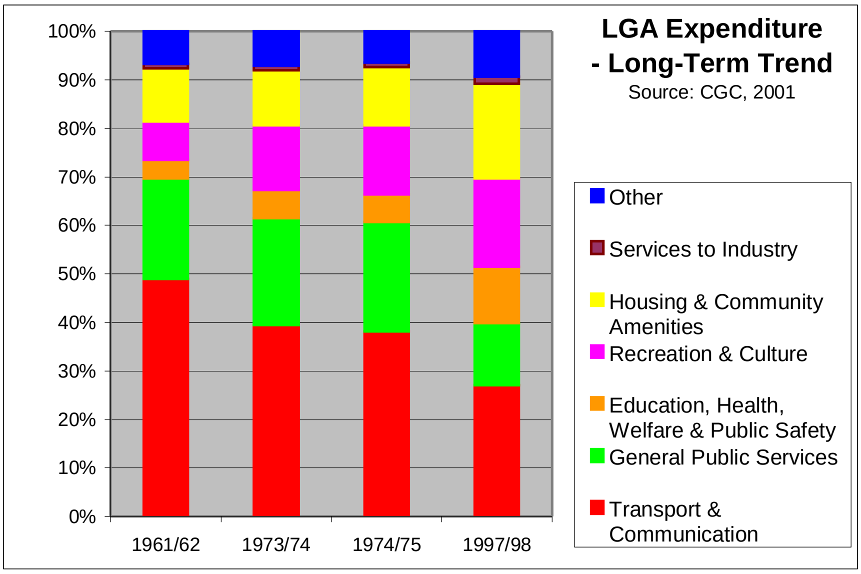
In the latter part of the 19th century and the first half of the 20th century, the emergence and constitution of new local governments throughout Australia was prolific. The successful petitioning of a local shire, town, borough or city was seen as synonymous with the community's aspirations for self-determination. The role of these councils was generally still limited to the provision of physical infrastructure and regulatory functions. In the latter part of last century, the role of local government shifted substantially from infrastructure/transport and physical services into community/recreation and human services.

This was a shift from largely property-based services into people-based services. It was due to the pioneering of recreational services, community support services such as libraries, immunisation, maternal and child health and aged care where subsidies were provided by States and territories with local government's being (appropriately) the preferred service delivery agents.

Local government expenditure on 'Transport and communications as a proportion of total expenditure has fallen significantly from around 50% in the early 1960s to 28.9% in 1999/2000 [3]. This has been matched by a proportionate increase in expenditure on human, welfare, housing, community amenities, recreation and culture to 40.64% of total expenditure in 1999/2000. [4]

This long-term change in the local government expenditure (and service) profile is illustrated in the graph below (using ABS/CGC data). It clearly shows the reducing proportion of expenditure on transport/communication and the increasing proportion on housing, community amenities, education and other welfare services over the period 1961 to 1998.

3 ABS Publication No. 5512.0
4 ABS Publication No. 5512.0



2.2 Sector Diversity and Service Profile

The Productivity Commission's Issues Paper identifies the vast diversity of Australia's local government sector, in terms of geographic area covered, population and service profile.

Today, the role of local government can be described as **potentially** including a wide range of functions, as identified in the Issues Paper. However, given the diversity of councils, including the needs of the community and the financial capacity of the council, it is dangerous to generalise about what is 'local government's role'. The role of Australia's 700 councils varies considerably depending on local needs, scale and financial capacity.

The following table shows the diversity of Australia's 700 local government authorities:

LGA Category:	% of Total	% of Pop'n .	Population Range
Urban Capital City	1%	6.1%	8,733 - 917,216
Urban Metro. Developed	13%	34.6%	789 - 270,109
Urban Fringe	10%	19.6%	208 - 191,635
Urban Regional Town/City	18%	26.3%	57 - 434,473
Rural Agricultural	42%	8.8%	254 - 54,226
Rural - Significant Growth	1%	0.7%	7,636 - 24,368
Rural Remote	16%	0.7%	392 - 13,673

Source:

DOTARS Annual Report 2004-2005 (NB: Excludes current review of Qld. local government structures)

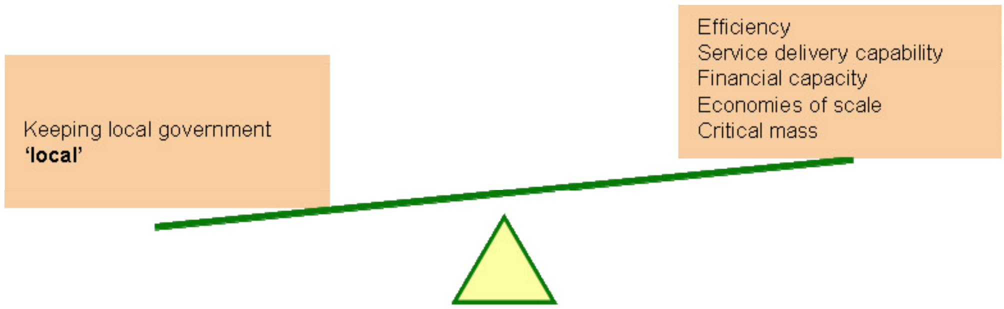
The range includes the NSW City of Blacktown with a population of 273,000 and a density of 1,137 people per km^2 to the outback Queensland Shire of Diamantina with a population of 304 and a density of 0.003 people per km$^{2.}$

2.3 The Importance of 'Local' in Local Government

As noted, the above statistics do not reflect the most recent/current local government boundary structure reviews process that is underway in Queensland and Northern Territory.

In the Queensland review (as in all other reviews in other states over past years) the key question of **'what is local'** when determining local government structures has been grappled with, along with complex, multi-dimensional issues such as **'community'** and **'community identity'**.

All such reviews have sought to achieve a difficult balance as shown below:



In the current Queensland review, it has been recommended that in the Queensland system of local government in future the remote Shire of Diamantina (incorporating the well-known community of Birdsville) continue as a separately constituted local government authority (alongside the City of Brisbane, the City of Logan and the City of Gold Coast),

Diamantina Shire has population of 304 people and an area of 94,000 square kilometres – **roughly half the size of the State of Victoria**.

A local government structure review process is also underway in the Northern Territory. It is also grappling with vast, sparsely populated geographic expanses and very small communities to draw jurisdictional boundaries for local governance.

This serves only to illustrate the importance that is placed on retaining some semblance of the notion of 'local' in local government. By implication, it also underscores the importance of the local government fiscal structure having the capacity to service the needs of such a diverse system, not only today, but also into the future.

It is noted that in South Australia, 100% of its area is not incorporated by local governments. Substantial areas (totalling 65% by area) remain unincorporated and subject to separate administrative/financial arrangements.

LGMA considers that, given the vastness of the Australian continent and the diversity of communities (in terms of population density), it is ridiculous to continue to consider and treat (in a financial, public policy and strategic sense) local governments such as the City of Brisbane and the Shire of Diamantina under the same administrative and financial structures and arrangements. Similar examples such as this also exist in other States (particularly West Australia). By any measure, these are vastly differing situations and circumstances that warrant differing forms of governance and administrative and financial treatment.

LGMA Position:

Because of the vast size on the Australian continent (and population dispersal across it), Australia's vast range of cities, townships, communities and localities will always include a substantial number of low population, large area, large asset-base areas.

We submit that where special remote community circumstances exist due to large area/remoteness/low population (as could be defined in specific threshold tests developed for this purpose), separate administrative, governance and financial arrangements and systems should be applied that are specifically designed for the democratic rights and service needs of such remote areas/communities.

2.4 What is 'Core': Community 'Expectation Creep'

The widening of local government's role continues steadily with new functions and activities emerging all the time. This is no accident: it generally happens with the encouragement of State/Territory governments, with innovation and new ideas about what is the role of government and with emergent demand for services.

What constitutes **'core services'** is a very subjective issue: it is at the heart of local government's role and funding debates. Whatever one considers being core or otherwise, it is certainly not static: what is 'core' today is very different to what 'was core' 50 and 100 years ago and so it will again be very different in 2050/2100.

The focus of our submission is that funding structures must be flexible enough to meet community demands of tomorrow, as well as today. They must meet emergent as well as existing demands.

One of the pressures, we submit, that leads to this ongoing expansion of local government's role is called **'expectation creep'**. This occurs when larger, better resourced councils innovate and expand their role (on their own initiative or with the encouragement of State/Territory governments) into new service areas. This can emerge from 3 sources:

> ***Community-Driven:*** It may occur due to perceived local community needs and what a council should be doing (irrespective of constitutional arguments as to who ought to be responsible).

Philosophically-Driven: Often, emergent demand for local government services is led/driven by the philosophical views of councils themselves as to what the rightful role of the local government ought to be.

Void-Driven: Often, emergent demand for local government services is led/driven by perceptions of councils that the onus is on them to fill the void or service gaps, irrespective of their views as to what the rightful role of the local government ought to be.

Australia's general economic prosperity over the last two decades has lead to a rise in living standards, which has also influenced community expectations.

New services set new benchmarks as to what is expected by the community as standard (or 'core'). In today's highly mobile and connected community, these **expectations are infectious**. Once a service has been received in a community, it is more likely to be expected. Examples of this abound with services regarded as core today (swimming pools and libraries) not being regarded as core in years gone by. An example of expectation creep is the widely-held expectation simply of having a sealed road to the property entrance. Another is the expectation of a kerb-side waste collection service (firstly in urban areas but increasingly becoming an expectation in rural areas across Australia as well) and recycling services.

Expectation 'creep' occurs within specific local areas as well as across the wider community.

It leads, we submit, to ever-increasing service expectations in the wider community, with many smaller, less resourced local governments not having capacity to meet them.

In more recent years, functions such as advocacy on behalf of the community, community research programs, economic development and community arts and culture and community engagement have emerged as legitimate functions of local government. Councils throughout Australia are also providing services such as medical centres, and community safety programs, security/crime prevention services.

Responding to these widening expectations is generally not a problem for larger, better resourced and developed local authorities such as the City of Brisbane or the City of Boroondara: these councils, whilst constantly having to balance resources with needs and demand in a normal strategic and budgetary context, generally have a level of resource capacity.

The difficulty is generally with rural/remote councils with low populations and large geographic areas to manage and service and fast growing areas.

LGMA Position:

The diverse nature of our local government structure (and the economics of providing services to them) means that underlying financial capacity limitations faced by many rural and remote councils cannot be solved by simple council amalgamations.

We submit that the local government structural and fiscal system should be flexible enough to respond to the future needs of the community (however these may evolve) as well as current known needs, and recognise the ever-emergent and non-static nature of those needs and community expectations generally.

It is incumbent on our system of government to provide the fiscal means through which at least the basic needs of these communities can be met, if not the more diverse service profiles enjoyed by communities in larger, more populous, better resourced areas.

3.0 Our Current Fiscal Structure: - The Flaws

"…that the local government fiscal structure is seriously flawed is not news. Up to 35% of Australia's 700 councils could be regarded as ***'financially unsustainable'.***

Most councils whose financial sustainability is ***at risk*** *are rural-remote and developing/fringe metropolitan councils."*

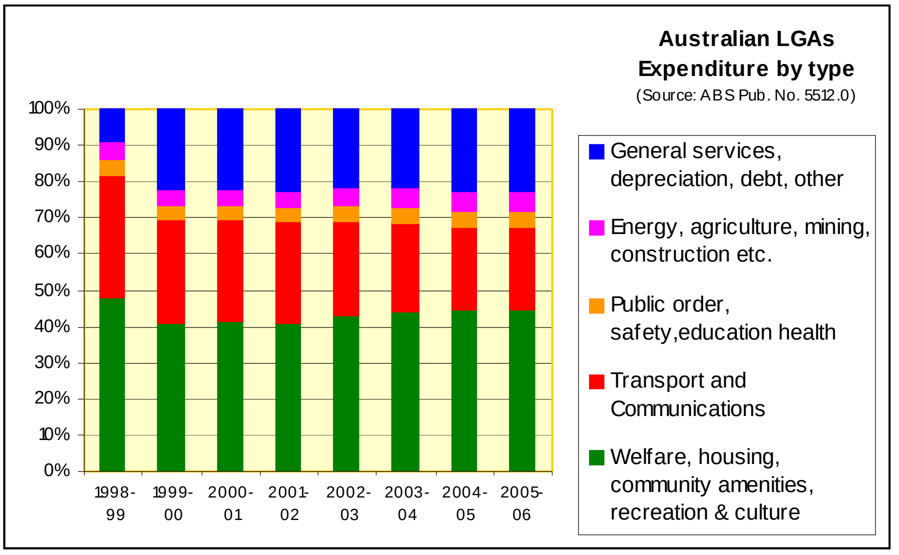
3.1 Financial Sustainability: *What is it?*

The financial sustainability (or otherwise) of Australia's 700 local government authorities has become an industry 'mantra' over the last 5 to 10 years. It has become the focus of numerous State-level and National studies and reviews examining, benchmarking and reviewing the levels of 'financial sustainability' of councils.

There are various technical definitions of financial sustainability. It is generally accepted to mean the ability of a council to sustain itself financially into the future. This can be held to mean at least maintaining net underlying community equity in the council's balance sheet. Factors impacting on this include debt position, rating/revenue-raising capacity and growth forecasts. It is generally indicated by a council's ability to sustain ongoing operating surpluses whilst renewing its asset base.

3.2 A New 'Visibility' of a Decaying Asset Base

The background to this was the introduction of Australian Accounting Standard 27 (AAS27) in the mid 1990s. This new standard, among other things, required all councils to introduce full accrual accounting. That included the bringing of all infrastructure assets to account on council balance sheets by 1999. The impact of this can clearly be seen in the local government expenditure trend graph below:



The graph shows the quantum leap in the 'general/other' expenditure category (including depreciation expense) from 1998/99 to 1999/2000 (blue).

This is largely attributable to the depreciation expense resulting from the bringing to account of local government's multi-billion dollar asset base by that year.

Of course the depreciating nature of Australia's asset base was nothing new: the bridges, roads and drains had always been there, always had limited life-spans (albeit very long life-spans for most assets) and had always been slowly wearing out.

The depreciation is exacerbated by the fact that public buildings on Crown land depreciate and no value is attributed to the land as it's owned by the Crown and vested in Local Government for specific purpose.

What changed was that after 1999, the expense (real) associated with the depreciation of that asset base was no longer hidden from view in the Nation's public accounts as it had been in the past. Now, it was there for all to see.

This has led councils across Australia to no longer being able to ignore the very real and significant 'slow-drip' costs associated with the construction of infrastructure assets. Today, the impact of these costs are visible in every council budget in terms of their contribution to operating surpluses or deficits and the resultant balance sheet equity positions of councils.

They are also visible in the form of the so-called **'infrastructure renewals gap'** which (appropriately) has become a core part of the local government financial indicator and fiscal management 'tool-box'. Associated with these changes, we submit that the management standards and systems applied by local government management professionals across Australia has simultaneously become vastly more capable, sophisticated and responsive to accrual accounting principles. This includes not only financial, budgeting and performance management systems but also technical tools such as asset management systems and capital investment planning processes.

We submit that the increased attention by all governments since 1999 on the financial sustainability of local government is attributable substantially to a **new 'visibility'** of Australia's decaying infrastructure base, rather than the emergence of a 'new' issue/problem per-se. Similarly, we argue, that this heightened awareness amounts to a positive step forward for the local government sector in an inter-generational governance context.

3.3 The 'Infrastructure Funding Gap'

As stated, the aforementioned **'infrastructure funding gap'** has not just emerged recently: it has just become visible. It has opened the local government sector's eyes and is now a widely accepted phenomenon and sector-wide issue.

In 2006, ALGA commissioned PwC to conduct a National Financial Sustainability Study of Local Government. This study conducted prime research of councils across Australia. It also sought to collate and summarise the data and findings of numerous previous State-based studies (MAV, Access Economics etc.) into local government financial viability issues to provide a national picture of the financial status of the sector.

The PwC Report (including the collation of findings of other studies) included the following key findings:

1. A mid-case estimate is that **35% of all Australia's councils** (245 councils) could be financially unsustainable in the long-term (ie; within current geopolitical and fiscal structures).
2. This ranges from 10% of councils in Victoria to 58% of West Australian councils that could be (or are arguably are) financially unsustainable.
3. The average **infrastructure renewals underspend** (ie mid-case estimate of the gap between depreciation expense and capital expenditure on the renewal of non-financial assets) by local governments is **$1.129 million per council**, with an

average infrastructure investment backlog of $14.5 million per council.[5]

As stated, the precise definition of financial sustainability can vary, as do the factors that contribute to it. These factors include:

- Rate-base - static or declining property values;
- Population decline - static or declining;
- Excessive population growth - resultant demand on capital investment in community infrastructure;
- Non-rate revenue -raising capacity/potential (fees and charges); and
- Debt levels.

The PwC Report also found that, due to these varying (and sometimes conflicting) contributory factors impacting on the financial sustainability equation of councils, the incidence of the category of councils most likely to be unsustainable also varied. The Report concluded that:

- the majority of **large metropolitan councils** are generally viable (or have the ability to self-effect improvements in financial viability on their own initiative);
- **urban fringe councils** are mixed (in terms of financial viability), largely due to their mixed profiles and the high capital investment demands these councils typically face;
- **rural /remote councils** and **rural agricultural councils** have the most pronounced financial viability problems, typically characterised by limited scale, limited revenue-raising/rating capacity, infrastructure renewals

[5] National Financial Sustainability Study of Local Government, PwC (ALGA, 2006)

> backlogs/gaps, ongoing capital investment requirements and ever-increasing community service demand sand expectations.[6]

There is also concern, not specifically picked up by the PWC Report, that some Metro Councils are facing significant financial pressures in meeting their infrastructure obligations and maintaining service standards at an acceptable level.

LGMA Position:

That 35% of Australia's councils could be financially unsustainable is of serious concern to all levels of government and should be addressed at the highest political levels as a matter of urgency.

The fact that generally, the larger metropolitan councils have sufficient revenue raising capacity is not at issue. Hence, global/sectoral (high-level) analyses of financial sustainability and revenue raising capacity (as opposed to a more targeted/stratified analyses) are not helpful to the real debate.

The focus of the debate should be on **defining the governance, administrative and fiscal systems** that will meet the needs of the mainly rural and remote councils/communities across Australia, as well as fringe/developing council, that are financially at risk.

It is also important to ensure that any systemic/structural changes to local government brought in to address the financial capacity issues of those councils with financial sustainability issues/problems not reduce or undermine existing levels of financial capacity/autonomy of the larger metropolitan councils.

[6] National Financial Sustainability Study of Local Government, PwC (ALGA, 2006)

3.4 Rate-Pegging

The Productivity Commission Issues Paper identifies rate pegging as a key limitation on local government's own-source revenue raising capacity (currently applied in NSW only).

Rate pegging is a blunt public policy instrument: those that use it (the NSW Government) are fully aware of this but continue to use it nonetheless. The reason they use it is that it works … for them. It curtails public sector expenditure (by local governments) irrespective of the service/infrastructure implications or long-term costs. Presumably this is politically expedient and consistent with NSW State Government goals, for the time being.

In Victoria in the 1990s, rate pegging was used in a similarly blunt manner but in a different context. It was used to deliver the promised 'efficiency savings' from local government boundary/structural reforms under the Kennett Government.

The inference/sub-text was that the restructure process could not be justified politically on the basis of 'better quality local government' alone: politically, it was necessary for actual rate reductions to be delivered and rate pegging was the chosen instrument to deliver this outcome.

In this respect, it worked (in the short-term)! But (arguably), it set the local government sector in Victoria back a decade in terms of infrastructure investment levels and delivered an even wider infrastructure gap. Arguably, rating levels have since caught up out of necessity and in the face of widespread community opposition.

Rate Pegging and Local Government Autonomy:

As stated, local governments are creatures of State/Territory statutes. We submit that the use of rate pegging is symptomatic of a broader attitude to local government held by States/Territory (presently evidenced in NSW only but potentially elsewhere). That is, an attitude that local government is in fact just a network of ‘far-flung out-reach workers’ and service providers working on behalf of the State/Territory governments, rather than a genuine third autonomous tier of government in our Federation. The extension to this argument is that local autonomy of local government is of value only to the extent that service delivery and philosophy are consistent with State/Territory policy/goals/philosophy.

Rate pegging has been used in NSW for 30 years. It successfully limits the size of the local government sector in that State which, presumably, is the goal of the State Government. Typically, rates are pegged at around CPI, even though local government costs are widely understood to be more closely linked to wage movements at a level higher than CPI.

The inevitable outcome of rate pegging in NSW is that ‘now’ needs and ‘now’ demands facing local governments and the associated ‘now’ costs (generally for operations and recurrent services) continue to be met by local governments in response to community demand. To balance the books, the ‘tomorrow’ costs are being sacrificed. ‘Tomorrow’ costs are the hidden (or less apparent/visible), slow-cooked long-term infrastructure costs associated with the depreciation of long-lived assets (particularly community infrastructure assets and facilities as identified in the PwC Report).

The fact is, people generally don't march in the streets demanding a capital renewal funding allocation for an underground drain that is 10 years out from the end of its useful life. People march when the drain ultimately fails or for services they want and see as needed today. That long-term infrastructure investment is sacrificed ought to come as no surprise.

It could also be argued that an outcome of rate pegging in NSW has been an increasing propensity on the part of councils to allocate additional indirect costs to its water and wastewater functions (through generous relative cost apportionments) to enable these to be recouped through users fees and charges and relieve pressure on rates. This, of course, is a distortion of the taxation and user-pays balance and would compromise principles of accountability and transparency.

The very existence of rate-pegging in Australia's most populous State underscores the mixed messages that are sent by Federal and State governments to local government: they either want local government to use rating powers and tax or not tax. Governments can't have it both ways!

LGMA Position:

LGMA considers that rate-pegging (in NSW) undermines local government's autonomy, limits the capacity of councils to exercise prudent long-term financial planning and limits the capacity of councils to provide for the costs associated with the provision of long-lived infrastructure assets, as well meeting recurrent service needs of the community.

Rate-pegging distorts the local government fiscal system, undermining principles of accountability and transparency.

LGMA submits that the practice of rate-pegging should be discontinued.

3.5 Cost-Shifting

Like financial sustainability, cost shifting has had much focus in recent years. It was a core component of the Hawker Inquiry.

Cost shifting could be described as a form of **slow-rot**: it unarguably represents a serious and long-term fiscal challenge for local government. All recent authoritative reports on local government finances acknowledge that cost shifting is a genuine financial impost on local government, even though it is hard to define conclusively. Some components of what is regarded as cost-shifting by local government are challenged by State and Federal Governments and bureaucrats. Despite these definitional differences, no-one credibly questions that it exists.

What many in local government call cost shifting, is (not unreasonably) seen by State/Territory governments as local government stepping outside/beyond local government's traditional/widely accepted jurisdictional territory. Councils do this on their own initiative and their own perception of community needs or what constitutes 'minimum acceptable service standards'.

The fact that a local government's assessment or judgement as to what constitutes 'need' differs to the State/Territory assessment of need (and backed through the allocation of resources to deliver a service level to meet that need) is seen by many as not constituting a genuine cost shift.

We submit that the real issue is that perceptions of 'need' and the relative weight of priorities inevitably vary from the local town hall to the State/Territory legislature. This, we argue, is symptomatic of the closeness of local government to the people. It presumes a closer/better comprehension of real need on the part of local government than that of the States/Territory.

Politically, local governments cannot (or at least find it difficult to) use jurisdictional demarcation debates as an excuse for tolerating service level decreases/erosion/withdrawals by other levels of government. The community sees this as blame-shifting and just want something done. The reason councils step in is because the community wants them to and they want to do what they perceive to be genuinely needed. State/Territory governments, on the other hand, are more distant from the immediate community level impacts of service level decreases in their own spheres of responsibility (ie; liquor licensing control/policing/security/ crime prevention). Local governments are less likely to tolerate service level erosions.

In a way, local government has become the **'soft touch'** for localised service level backfills when gaps emerge. The sole interest of service advocates is in how to expedite the delivery of a perceived service gap most efficiently and that usually ends up on the town hall steps.

Hence, we see local governments throughout Australia increasingly involved in community safety, crime prevention programs, health, education and medical service provision/facilitation and such activities where State/Territory resources for these functions/services are insufficient to meet locally perceived needs.

Other forms of cost shifting (subsidy not taking account of real cost growth over time) are more widely accepted as genuine cost shifts. These occur in services such as libraries and home/aged care.

In these cases, States/Territory pioneer new services into a community where there has been no expectation. Over 30 to 40 years, services such as these grow and expand into new, innovative and specialty areas (special needs home care, respite care, training and support for carers etc.) in response to emergent demands, with service costs far outstripping any funding growth. Community expectations as to what constitutes a 'minimum acceptable service level' expands, with local government left to fill most of the funding gap.

Much of cost shifting is achieved through stealth where Councils enticed by Government Grants set up services, including provision of buildings such as community centres and recreation centres, leaving Councils with ongoing costs including asset replacement.

Other forms of cost shift occur as a result of withdrawal of services or hand-over by other levels of government (ie; airports) with short-sighted funding arrangements and support that fails to address long-term costs. Cost-shifting also occurs through increasing compliance costs associated (mandated by higher levels of government) with the delivery of service such as with OH & S requirements and these not being recognised in funding levels.

Inter-Governmental Service-Level Agreements:

However, in some cases the argument as to what constitutes a cost shift gets tied up in arguments and differences of opinion about what is a minimum standard or acceptable standard of service delivery. The definition of what is acceptable/minimum standard is subjective and (in any case) is not static: it is dynamic and changes with community expectations about a particular service over time.

LGMA supports the recently negotiated Inter-Governmental Agreement on cost-shifting but submits that its application ought to be widened. This agreement basically stipulates the principles and processes that ought to be followed by governments when negotiating intergovernmental service delivery and funding agreements. The goal is to eliminate/minimise the risk of cost-shifting occurring in future service/funding arrangements.

The processes/principles contained in the Inter-Governmental Agreement should be extended to existing agreements as they come up for renewal.

The Hawker Inquiry identified that some $20 billion is wasted on duplication and coordination of services provided by Commonwealth, State and Local Governments. $20 billion would go some way in eliminating the sector's infrastructure backlog.

The Hawker Inquiry also recognised that one of the reasons cost shifting occurs is that Local Government is a more efficient service provider than the other levels of Governments.

LGMA Position:

We submit that the ongoing tolerance of cost-shifting in governments in Australia today undermines and damages the financial sustainability and autonomy of the local government sector.

We submit that the processes/principles contained in the Inter-Governmental Agreement should be extended to apply to the renegotiation of existing inter-governmental services/funding arrangements, as well as new agreements.

We submit that there should be a review of Commonwealth, State and Local Government roles and responsibilities with a view to clarifying roles, eliminating duplication and overlaps in service delivery.

4.0 Revenue Raising Capacity

"…rates are a property tax that has it origins in a feudal society with a property-based electoral franchise.

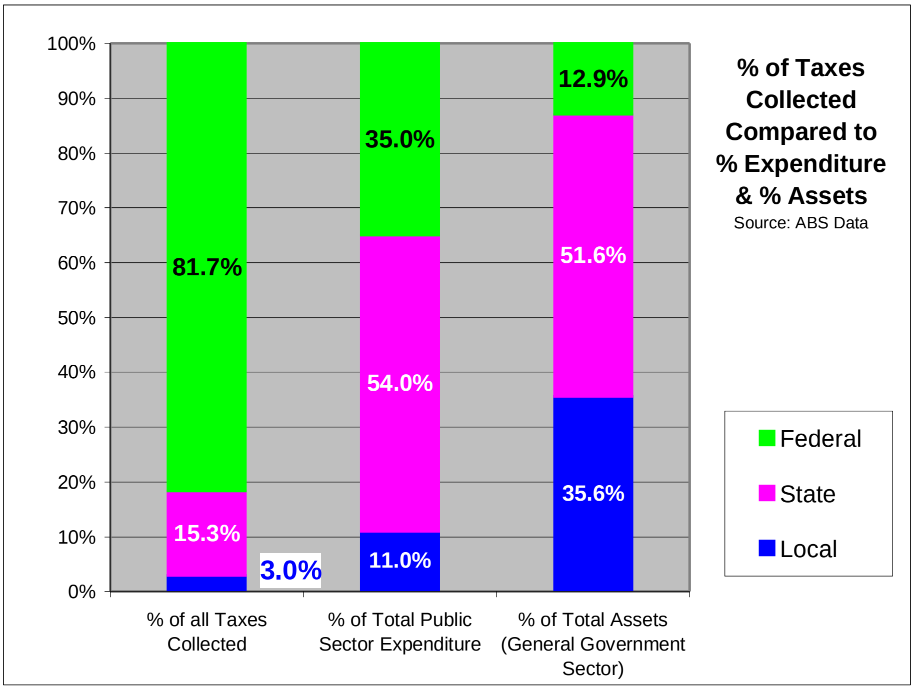
*Valuation-based rates reflect **wealth** rather than **capacity to pay** and are not consistent with basic equity principles implicit in other aspects of Australia's taxation system."*

4.1 Introduction – A National Taxation Context

As stated earlier, the role of local government has traditionally been focused on the provision of services related to property (infrastructure). These have been largely funded from property taxes. However, over recent years (as pointed out earlier in this submission), the focus has shifted away from property-related services to being substantially focused on the provision of human, social and cultural services.

We submit that a meaningful debate about the underlying financial issues in local government today must take account of not only local government's own-source revenue streams (including property taxes). It must also look at Australia's overall taxation revenue position across all three levels of government and the relative service delivery profiles of those levels of government.

The graph below shows each level of government's share of total taxation 'take' compared to the % of total expenditure and % of total assets owned.

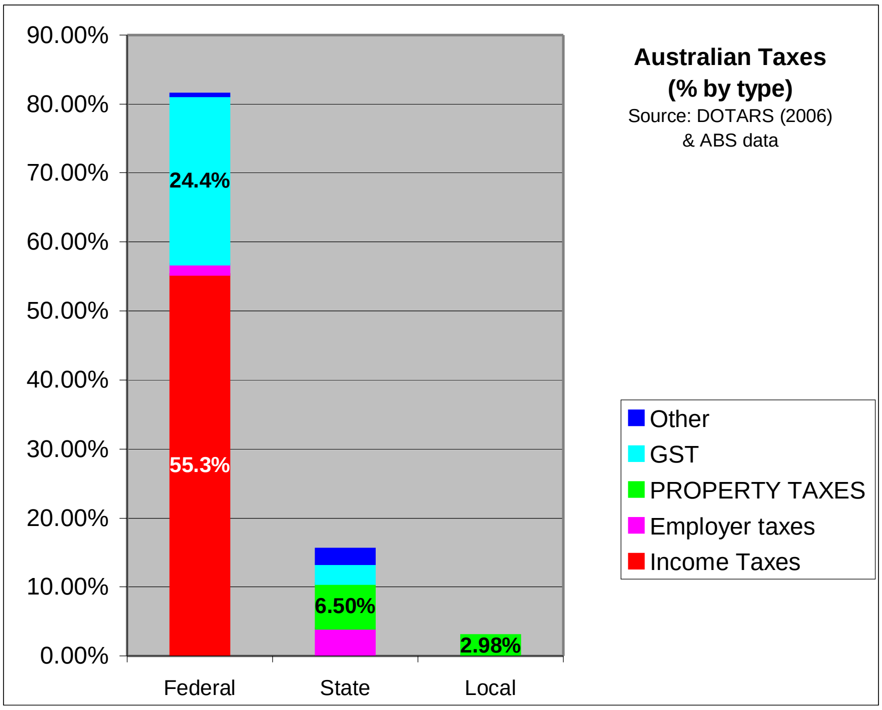


The graph clearly shows that the states/territories and local government are 'net receivers' of Australia's total taxation funds, with the Federal Government the 'net provider'. Local governments own-source funds raised through property rates account for a mere 3% (which has declined from 3.2% since 1999/2000) of total taxation whilst it spends approximately 11% of total public expenditure.

Importantly, local government accounts for over $170 billion (35.6%) in publicly-owned non-financial assets on their balance sheets. [7] Councils bear the depreciation expenses associated with those assets. These expenses represent a substantial and real cost to local government, even though they are a non-cash component of the operating statement.

[7] ABS, Publication No. 5512.0 Australian Government Financial Statistics

It is well-known that income tax and GST are the main sources of taxation and both are collected by the Federal Government (even though GST is channelled through to the States). The emergent nature of Australia's taxation systems is illustrated by income tax. Income tax was introduced by the Federal Government in 1942 (in the face of unanimous opposition from the States) as a 'temporary measure' to fund Australia's War effort. It is now difficult to envisage an Australian society without income tax as the prime source of public funds. GST as a consumption tax is a relatively recent addition. The following graph shows the share of funds raised by various taxation sources in Australia by type and by government level:



This graph shows that, whilst local government is widely regarded as the level of government that charges property-based taxes, in fact local governments levy less than half the property taxes (2.98% of total taxes) levied by State/Territory governments (6.5% of total taxes) in quantum even though these account for a relatively higher proportion of local government's total revenue base.

It should be noted that in recent years Commonwealth and State Governments have announced significant budget surpluses and established "Future Funds" to fund long-term commitments. Local Government remains the poor relation responsible for major community assets and infrastructure.

LGMA Position:

We submit that whilst Australia's public sector accounting standards now reflect public equity positions on a full accrual basis (including the asset bases of governments), the current public sector funding processes substantially remain in a 'cash accounting era' paradigm.

The fiscal and funding processes within which local government operates do not sufficiently reflect the long-term financial impact on councils of its significant infrastructure asset base.

Funding/fiscal processes and structures should be over-hauled to reflect the substantial long-term weight of the local government asset burden.

4.2 Rates – The Oldest Tax

The Productivity Commission Issues Paper focuses on the changes in revenue mixes that have occurred across the local government sector nationally over a 9 year period from 1996/97 to 2005/06 (using ABS data). The paper acknowledges the fact that such global (sectoral) trends can mask the many localised trends and issues that inevitably become apparent in a stratified data analysis by State/Territory, council type, scale and geographic location.

The focus of the Issues Paper seems to be on the (apparent) global trend (using ABS data) that sees local governments in Australia deriving increasing proportions of their total revenue from ‘other’ sources (developer contributions, penalties and the like) and decreasing proportions of their total revenue from rates (rating effort) and fees and charges (user pays effort).

The Paper identifies that over the period from 1996/97 to 2005/06, total local government revenue raised has increased by an average of 6.6% annually, not keeping pace with total sector expenditure which has increased by an average of 7.0% annually over the same period.

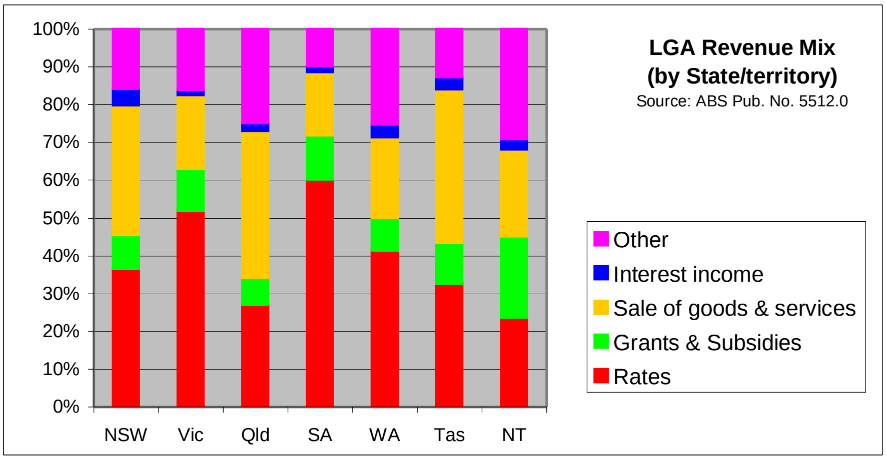
Rating Effort:

The notion of rating effort has existed in local government for many years. The implication is that councils have the taxation power so, assuming they are committed to their chosen service levels/programs, they should make the political effort to use it.

This line of argument is sound and (to greater and lesser extents) councils across Australia do exactly that. Councils are typically very politically sensitive to rating levels and all expenditure needs careful justification through budgetary processes.

Councils are susceptible to ballot box pressures and short terms, which is not conducive to responsible long term fiscal planning and asset management.

The graph below shows the variation in the rate self-sufficiency by local governments in each State/Territory across Australia (based on 2005/2006 ABS data).



The graph shows:

- substantially higher rating levels in Victoria and South Australia compared to other States;
- income from grants and subsidies (excludes capital grants) is proportionately higher in South Australia and the Northern Territory than other states; and
- income from the sale of goods and services is generally higher in NSW, Queensland and Tasmania than other States and territories (local government is responsible for water and wastewater in these states which has a significant impact on this).

Within each State/Territory there are also substantial variations across different council types/locations in the % of total income derived from rates.

In many rural and remote councils, the capacity of the rate base is extremely limited, leaving the council heavily reliant on government grants and subsidies (up to 80% of revenues in some cases).

This again underscores the diversity of the local government sector.

Valuation Bases:

Local government rates are governed by legislation in each State/Territory which varies from jurisdiction to jurisdiction. However, in all cases, rates are based on property valuations. The valuation bases applied include:

Capital Improved Value (Improved Capital Value):	**Unimproved Capital Value (Site Value)**	**Net Annual Value (Assessed Annual Value)**
The estimated value attributed to property at a point in time including all buildings & improvements.	The estimated value attributed to property at a point in time excluding all buildings & improvements.	The estimated annual rental value attributed to property & improvements. (NB: In some states assumed to be 4% or 5% of the CIV/ICV for purposes of residential valuations)

In NSW and Queensland rates are levied on the site value (or unimproved capital value of land. In Victoria, rates are levied mostly on the capital improved value (with 6 councils including the City of Melbourne applying net annual value). In other States, councils can choose the valuation base applied.

There are many arguments about the relative merit and equity of using different valuation methods for rating purposes. These issues are not proposed to be addressed in this submission.

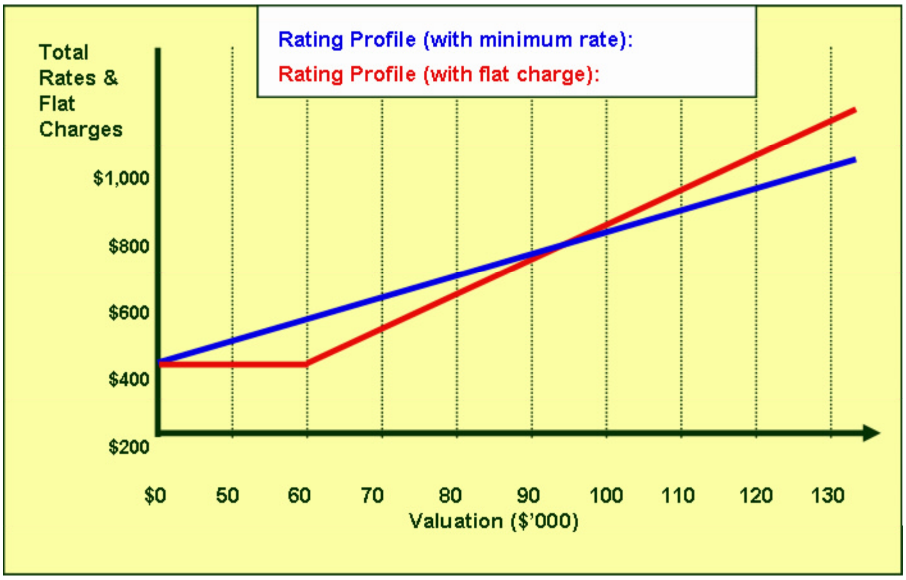
Minimum Rates and Flat Charges:

In addition to 'ad valorem' rates, councils in some States/Territory can levy minimum rates and/or levy a flat charge per property to generate a base/floor revenue stream.

The amount of revenue that can be raised from such measures is generally limited. In Victoria, for example, the amount of revenue that can be raised from a municipal charge is capped at 20% of total rates and charges and in Tasmania, it is capped at the amount of administration costs incurred by the council.

Municipal charges are a relatively recent addition to the 'suite' of local government revenue raising tools available. They offer the advantage of transparency (ie as a flat charge per property). In past years, municipal charges have been encouraged by State/Territory jurisdictions over the use of minimum rates for this reason. In some cases, in some jurisdictions, minimum rates were perceived to be 'over-applied', with substantial proportions of income being derived from the minimum rate.

The following graph illustrates the statistical relationship that exists between minimum rates and flat charges on the total rate distribution/profile.



As this graph illustrates, the impact of applying a flat charge is to make the rating profile less progressive (or flatter) than applying a minimum rate.

Differential Rates:

In addition, councils in some states (under varying structures and arrangements) may levy differential rates - that is, a rate in the dollar that applies to different property types and/or geographic locations. The tests required to substantiate the striking of a differential rates generally relate to the need to be able to demonstrate **equity** and **efficiency** of a proposed differential.

Wealth v. Capacity to Pay:

The use of property values as a basis for rating assumes that a property's value reflects a person's (owner or occupier) capacity to pay. We submit that this assumption is flawed. Property values do provide a limited measure of **wealth** but are extremely limited as a reliable measure of **capacity to pay**. We submit that this undermines the equity of the municipal rating system.

The table below provides examples of situations where we submit the property rating system fails to adequately recognise capacity to pay.

SITUATION:	FEDERAL GOVERNMENT Income Tax Treatment	LOCAL GOVERNMENT: Rating Treatment
Pensioners	$0 tax paid on income up to $6,000 p.a.	Full rates assessed. Partial remission schemes apply in different States – remissions range from 20% to 50% of total cost. Some council supplement State remissions with local rates remission schemes.
Farmers during drought	$0 tax paid on income up to $6,000 p.a. Capacity to apportion income across years Special circumstances assistance packages	Full rates assessed.
Residents in older inner city suburbs	$0 tax paid on income up to $6,000 p.a.	Full rates assessed.

This table illustrates that our primary taxation system in Australia (income tax) defines **equity** clearly in terms of **capacity to pay** rather than **benefit derived**.

A hallmark of our tax systems (as these have evolved) is that, as a general rule, where it is determined that a financial contribution should be made by service users (either on a commercial, full cost recovery or partial cost recovery basis), these contributions are extracted through users fees and charges – **not** through tax. This applies in all public sector spheres including health, welfare services and other service areas.

As illustrated above, this equity/capacity to pay principle does not extend to local government rates. Rates are levied irrespective of capacity to pay.

Pensioners for example, who unquestionably consume a significant proportion of public resources are not expected to pay for this on a benefit derived basis (either in the public health system or for local government services). This would be considered inequitable. Pensioners are only assessed for taxation on their \$6,001st dollar. However, in local government, we tolerate a system that is prepared to tax pensioners simply because they choose to continue to live in a capital improving house, despite real capacity to pay.

Further, as a society, we recognise this fundamental inequity and engineer a range of remission schemes that partially (but not wholly) undo the damage done.

In the City of Ballarat (Victoria), about 20% of residents are pensioners. This presents the Council with a challenge in determining a rating level that not only meets **fiscal goals**, but also takes account of **equity considerations**. With Australia's ageing population, this example is not atypical and the impact of such situations will only increase over the next 20-30 years.

We submit that this fact consigns the local government sector's primary taxation stream to being unreasonably clouded by non-fiscal, equity-related considerations, undermining its efficiency as a progressive tax base.

The 'Whim' of Property Markets:

A key weakness of local government rates is that they behave largely at the whim of property markets rather than on any proactive public policy determinations. In fact, we submit that, more often than not, public policy decisions by councils in relation to rating levels (including the setting of rate differentials) are made by councils in an attempt to **counter** or **minimise** the random (or at least benefit-neutral and capacity-to-pay neutral) effects of property value movements.

In effect, the relative values of different classes of property (by zone or use) and/or geographic areas are the basis upon which the cost burden of local government service delivery is apportioned to various groups and geographic areas in the community. We submit that this takes no account of equity considerations or benefits derived. This is particularly significant in coastal areas experiencing high growth rates, developed inner city areas. In the case of productive rural farmland near populated urban centres, it also allows distortions to occur in the relative contributions made by the farm sector to local government costs, due to demand for lifestyle properties pushing property values beyond parameters defined by underlying economic productive capacity.

We submit that property value movements occur independently of any consideration of community equity issues or public policy determinations. As such, to allow an entire tax base (rates) to be driven by property value relativities in the 21st century is anachronistic and inequitable.

Community Confidence in Rates:

We submit that the potential for these large fluctuations in final rate bills driven by property market shifts also undermines **community confidence**. The ability to sustain community confidence in any form of taxation ought be a fundamental test.

In an overall taxation context, rates account for a small proportion of household expenditure in pure quantum terms (typically between $3.50 and $4.00 per day per household).

This compares roughly to electricity and telephone bills in relative cost terms. Income tax, by comparison, typically accounts for vastly more, as does GST. However, these other forms of tax do not suffer the same constant challenges as do municipal rates, despite the greater quantum. Whilst inevitably no tax is popular, the community accepts taxes that they have confidence in and confidence emerges from **predictability**, **stability** and a transparent **rational** underlying basis.

Where rating levels are stable, people generally accept the need to pay rates in order to finance local services. However, the community generally has a limited understanding of the fact that the rate in the dollar levied is simply a calculation of the amount required to raise a budgeted sum (as defined in the council's budget) from the total valuation base in the municipality, rather than a fixed taxation rate (as in the case of land tax or income tax for example). Accordingly, the community widely perceives that property value increases lead to windfall gains in local government revenues which is not the case. Similarly, the community generally does not appreciate that, proportionately, rate bill increases for one sector of the community or geographic area, are (by definition) countered by proportionate decreases in rates in other property classes and areas.

We submit that the community is generally accepting of rates as a tax, where they are **stable** and **predictable**: however, large shifts in rate-burden distribution brought about by property value shifts at the whim of real estate markets undermine the community's confidence in rating and, by extension, their confidence in local government.

There are numerous technical/economic arguments that can be advanced about the immobility and administrative efficiency of rates as a taxation method. A purely technical analysis also suggests transparency of rates as a property tax.

However, these factors ignore the practical reality that local governments must deal with across Australia on a daily basis. A pragmatic assessment of the efficiency of rates as a method of taxation in the 21st century leads to a different conclusion to a pure economic assessment.

LGMA Position:

We submit that valuation-based property rates are in fact an **inefficient** and **inequitable** form of taxation that undermines the confidence of the wider community in the integrity of local government fiscal management. We base this view on 4 prime reasons:

Firstly rates reflect **wealth** rather than **capacity to pay**. In the 21st century, the community expects taxation to be linked to capacity to pay (either directly or indirectly) rather than wealth.

Secondly, the community expects that any user payments deemed appropriate for a service (through normal public policy processes) for **benefit derived** from a service should be made through user fees and charges, rather than tax.

Thirdly, despite widespread community lack of understanding about the mechanics of the rating system, they understandably recent large, unexplained shifts in the distribution of the cost burden of local government services (by area and property use/type) that are dictated only by property market movements, rather than by conscious public policy decisions. Because of this, rates fail to meet the community confidence tests of **predictability** and **stability**.

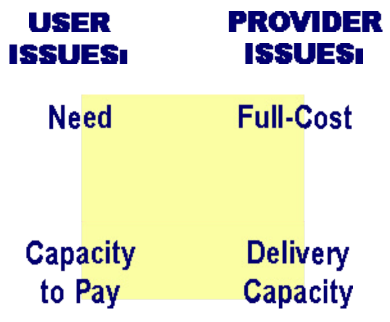
Finally, the use of **differential rates** by councils is more often linked to a politically-driven desire on the part of councils to 'smooth out peaks and troughs' in cost burden distribution, rather than to any objective assessment of underlying equity considerations.

4.3 Fees and Charges – Balancing Need and Capacity to Pay

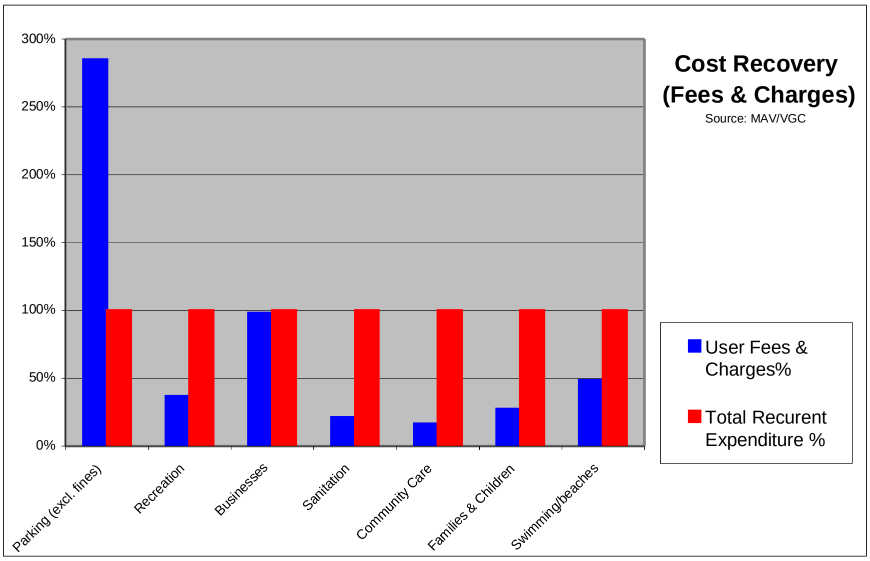
The notion of full cost recovery in setting prices for services is generally well understood in the local government sector today. In addition, since 1999, the public accounts of local governments have (for most councils) provided data on the full costs of service provision including recurrent and capital/depreciation costs.

Local government has traditionally and for the most part remains a provider of public goods and services rather than private goods and services. Where needed goods and services cannot be efficiently provided by the private sector, governments (including local governments) step in to provide these. These services have varying levels of elasticity, with a wide range of user groups with varying capacity to pay.

The recovery of full costs is **only one parameter** (important though it is) considered by local governments in the determination of user charges for services. The setting fees and charges is generally a multi-dimensional equation, as illustrated below:



The graph below illustrates the typical cost recoveries achieved in local government (in Victoria) by various different types of services as an illustration. It is submitted that these trends, to a significant extent, are largely reflective of the variations in cost recovery by service type.



Parking:

Fees charged for parking services in Victoria (excluding fines and penalties) by councils achieve vastly better than full cost recovery. Of course councils that are in a position and market where they can charge for a commercially valuable, inelastic commodity such as parking services are generally not those rural and remote councils that are in a parlous financial state.

Where Local Government are active in collecting parking fees there is usually heavy vehicle activity, increasing the demand for parking. Fees collected from parking are normally used to maintain the amenity of the area to offset the burden falling on local residents.

Recreation:

Fees charged for recreation services in Victoria by councils achieve around 36% recovery of recurrent costs. Within this broad category are included council-operated/managed pools, aquatic centres and sports stadiums (which typically operate at between 60% and 100% of recurrent operating costs). It also includes many club-tenanted pavilions, rooms and sports facilities that (typically) are charged at lower cost recovery levels. Despite the 36% average cost recovery for this category, within this latter sub-category (tenanted club-rooms and facilities) the range of cost recovery achieved through fees charged by councils is itself very broad and would range from 0% to full-cost recovery. This range includes the many small, volunteer and community-based/ junior sporting clubs, through to large highly commercial sports clubs, many of which have independent revenue streams of their own.

Clearly, in this category, to focus on the overall average of 36% recurrent cost recovery (as in others) ignores the fact that that setting fees and charges for recreation facilities is a multi-dimensional policy function undertaken by local government. Fee levels determined take account of the market for these services/activities, combined with public policy assessments as to access, fairness and equity etc. These fee levels also recognise the non-financial goals of councils in terms of maximising community access to affordable recreational pursuits that will contribute to its community health and well-being goals. In this context, a discussion about full-cost recovery seems somewhat superfluous.

Community Care:

As could be expected, the illustrative Victorian data shows that the lowest level of cost recovery achieved through fees and charges is for community care services (16.3%). This relates typically to services for the aged and people who have been assessed to be in **genuine need**, rather than having capacity to pay. In many cases, access to these services (such as home care) is means-tested and demand for the service significantly outweighs supply. In such cases, to charge more may violate funding agreement. In any case, to charge more for those in need (just because you can) would appear to contravene principles of fairness and equity.

Clearly, the fee levels charged for community care services reflects the market for these services, combined with public policy assessments as to access, fairness and equity. These fee levels recognise the non-financial goals of councils in terms of maximising community access to affordable essential care for those in need. In this context, a discussion about full-cost recovery also seems superfluous.

Council-Owned Businesses:

The graph shows that council businesses typically achieve around 100% recovery of recurrent costs (excluding capital costs). These businesses generally include livestock saleyards, produce markets, quarries, small community-based enterprises or corporatised/semi-autonomous council business units (civil contracting etc.). In some cases, these council businesses do achieve full cost recovery (including capital costs) and generate significant operating surpluses. Others operate on a basis where recovery of the operating costs only (or cash outflows) is acceptable to the council.

Again, the rationale for setting of fees and charges by council-owned businesses is the same as that for other services: that is, fee levels are determined to take account of council's financial and commercial goals, balanced with council's non-commercial/community development/service goals.

An example is livestock saleyards. Whilst saleyards broadly have the capacity to operate on a commercial basis (with reasonable scale and animal throughput), the benefits they deliver to the communities they are located within extends well beyond the financial/ revenue outcomes. These facilities provide employment and generate economic development benefits and have the effect of bringing rural communities together on sale-days. Hence, councils often set fees and charges for these facilities at levels that take account of the non-financial benefits derived.

Other Council-owned businesses (large produce markets, contracting businesses etc.) do operate on purely commercial terms, in which case full-cost recovery plus a profit margin would be expected.

State/Territory – Regulated Fees and Charges:

As identified in the Productivity Commission's Issues Paper, most statutory fees and charges (excluding fines and penalties) are substantially regulated by the States/Territory. The precise arrangements vary from State to State. Other fees and charges, if not directly regulated, are subject to limitations imposed via government funding/subsidy agreements that have underlying service level presumptions.

These include:

FEES/CHARGES:	State Regulated:	Funding Agreement:	Market-Driven:
Planning application/permit fees	☑		
Building approvals/permit fees	☑		
Animal registration fees	☑		
Health license/permit fees	☑		
Home care/support fees		☑	
Child care fees			☑
Aged accommodation fees			☑

In each of these service areas, it is widely acknowledged that increases in the costs of service delivery have risen faster that the legal capacity available to councils to recoup those costs through fees and charges.

We submit that this disparate growth in costs (compared to fees that can be charged by councils) has arisen from the following sources:

- Growth of direct service cost (salaries etc.) that generally outstrips CPI increases;
- Disproportionately higher indirect cost growth (training requirements, occupational health and safety, insurances [public liability/professional indemnity], compliance costs etc.);
- Increased government requirements/expectations in terms of strategic planning and consultative activities associated with delivery for a range of services (requirements for stormwater management plans, public health plans, children's services plans etc.);
- Political sensitivity of State/Territory governments that are generally resistant to enabling fee levels increases and the existence of an underlying **conflict of interests** (on the part of State/Territory governments) where they exercise the power to make and have the political exposure to the decision, without being exposed to its cost/revenue impacts; and
- Increased community expectations in terms of service levels.

It is widely accepted that the permissible fee ceilings applied by State/Territory governments in regulated fees and charges enable councils to recoup a decreasing proportion of full service delivery costs. Whilst there have been reviews/increases in most States/Territory over the years, these increases more often than not take account of direct costs only and rarely reflect real cost growth. In cases where a need/capacity to pay argument applies on the part of the service user consumer (ie; older people, disabled etc.), fee limitations are acceptable. However, we submit that in many cases (registered businesses, property developers etc,), the customer has both the capacity to pay full-cost recovery fees and the capacity to pass on such costs to their customers.

Regulated fees and charges are a more significant source of income for larger, developed and growing local authorities. Enabling these revenue sources to more accurately reflect full delivery costs would significantly benefit the fringe metropolitan category councils that are identified as having financial sustainability problems. This is because these functions (ie; planning, building, development approvals) typically comprise a substantial proportion of council resources in these areas. However, these revenue sources are relatively insignificant for the most ‘problematic’ council category – rural/remote councils. For these rural/remote authorities, regulated fees and charges generally offer limited capacity to address underlying sustainability issues.

LGMA Position:

We submit that State/Territory regulated fees and charges have failed to keep pace with the true costs of service delivery and have failed to recognise increases in all the direct and indirect costs associated with service delivery.

We submit that States/territories should ensure that local government's have the capacity to achieve full cost recovery for these regulated statutory services/ functions.

We submit that once the regulated fees and charges have been set to achieve full cost recovery State/Territory Governments should introduce statutory fee indexation systems that operate free of political interference and automatically trigger annual increments in the levels of statutory fees that councils are able to charge, in line with a specific **Local Government Cost Index** that reflects the real cost profile in the local government sector.

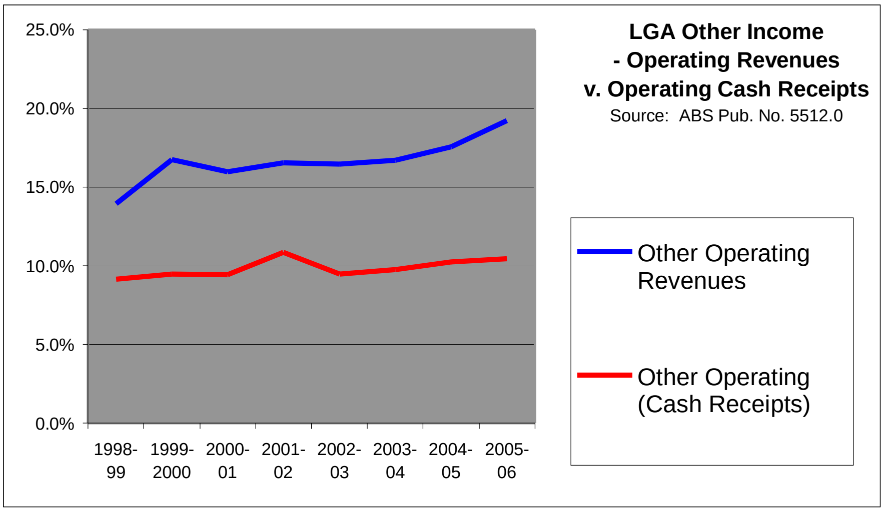
4.4 Developer Contributions – It's Not All Cash!

The Productivity Commission Issues Paper identifies that in the period 1996/97 to 2005/06 'other income' (including developer contributions, fines and penalties) increased from $1.4 billion to $4.5 billion. Our analysis of ABS data shows that annual growth in other operating revenues received by local governments averaged 12% over the period 2005/06. By 2005/6 it represented (as a proportion of total local government revenue and as identified in the Productivity Commission Issues Paper) 19% of all revenue.

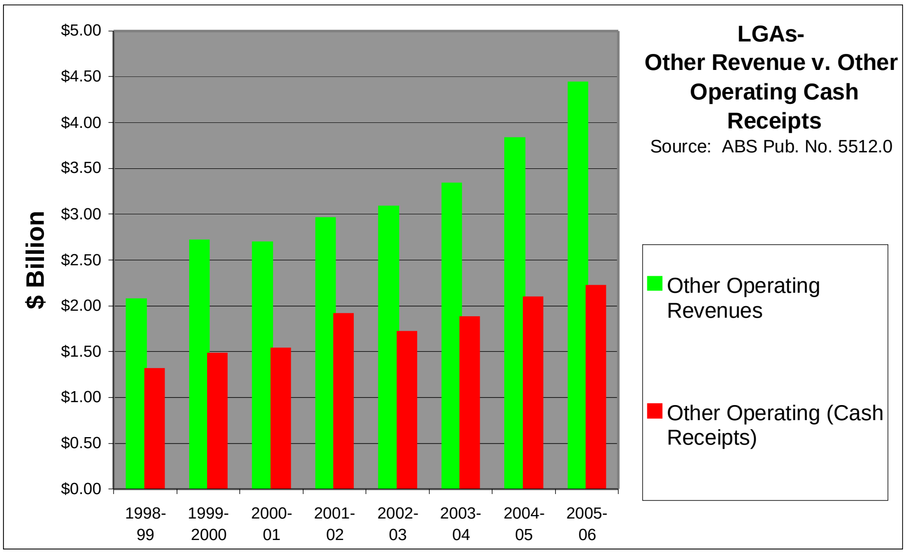
We submit that the relative role played by developer contributions ought to be seen in an inter-generational context of local government's role and governance capacity (ie; the relatively recent and emergent nature of local government powers to levy these contributions).

We also submit that this trend must be seen in the context of relatively recent changes to Australian Accounting Standards. Since the introduction of AAS 27 in the 1990s, councils have been required to bring contributed (or donated) infrastructure assets (contributed by developers) to account as income through the operating statement, even though there is no cash involved. A substantial component of the increase in developer contributions is attributable to non-cash contributed assets and the new requirement and accounting treatment.

The difference between the growth rate in other operating cash receipts and other operating revenue booked by councils is illustrated in the graph below:



This graph shows that, despite the substantial growth that has occurred in other operating revenues (average of 12% per annum over the period), other operating cash receipts by local governments has had a more modest proportionate increase (average of 8% per annum) which more in line with overall revenue growth. The difference between the growth in cash receipts and operating revenues is more apparent when viewed in absolute terms, as shown below:



4.5 *Developer Contributions – A Relatively 'New" Source of Tied Revenue*

As recently as 30-40 years ago, the notion of developer contributions was relatively unheard (certainly in cash terms and varying from State to State). These grew out of original concepts of developer contributions that were in the form of requirements for one block in any subdivision to be set aside for public purposes/open space. Originally, such blocks (today often known as 'pocket parks' in many areas) were contributed in an unimproved state and it was up to councils to develop facilities on them at their own expense.

Today, legislation has evolved considerably. It generally allows councils (in many forms) to require road, drainage and basic infrastructure to be constructed to high standards by the developer at their own cost as a condition of development approval. Developers then pass costs on to purchasers.

It also enables councils to require cash contributions from developers in many cases for long-term purposes such as car parking provision, though these are generally required to be closely linked to a local, direct delivery plan for such a purpose.

Where cash contributions are made by developers they simply reflect cost recovery due to the new development demands for additional service delivery or new or upgraded infrastructure which invariability assists the developer to enjoy substantial income. Such contributions are regularly received due to the State Planning conditions imposed on the developer in recognition of the cost burden placed on the Local Government. Similar payments are made to public utilities for extension or upgrading of their services.

Local governments today are able obtain through developer contributions the costs associated with most direct forms of infrastructure (roads, drainage, open space etc.). The ability to require contributions for less direct infrastructure costs (ie; community infrastructure) is limited.

The relative growth of developer contributions as a local government revenue source reflects a natural progression in the role of local government and its capacity to require new developments to be completed to acceptable standards. The ability of local governments to require developer contributions is in most States/Territory limited by legislation/regulation.

We submit that (as in the case of statutory fees and charges), State/Territory governments are politically sensitive to allowing increases in developer contributions to more accurately reflect the real costs associated with infrastructure investment and they have an underlying conflict of interests in this respect. We also submit that State/Territory governments allow goals relating to recoupment of long-term infrastructure costs to be inappropriately influenced by their goals in relation to the creation of economic activity and affordable housing.

Further, we submit that it could be argued that this is tantamount to yet another form (the most insidious form) of cost-shifting, where the higher level of government allows **'incremental cost creep'** to occur in order to protect its political sensitivities and/or it is consistent with its goals in unrelated jurisdictional areas.

Potentially Conflicting Goals –
Revenue V. Community Viability

Like regulated fees and charges, an increased capacity to levy higher developer contributions that are more closely aligned with real long-term infrastructure costs will substantially benefit the high-growth/developing fringe councils that have been identified as having financial sustainability problems. It has marginal impact on the situations of larger and developed councils.

For rural and remote councils (identified as having the core of the sector's financial sustainability problems), developer contributions presently do not and are not likely to offer any solutions, irrespective of ceilings imposed by States/Territory.

Many rural-remote councils choose not to levy developer contributions, despite their parlous financial State even though they legally can. In fact, many such councils have been known to offer significant financial incentives to developers (cash and kind) in the form of land give-aways and excusing basic permit fees to attract development which will lead to economic activity (let alone requiring developers to pay additional infrastructure levies).

The reason is that many rural/remote councils recognise that the very survival of their community depends on attracting economic development and jobs in the immediate term. The notion of a 'community multiplier' suggests that one additional job attracts one family to a town, potentially 2 - 3 children for the school, underpinning community viability and the flow-on economic benefits. Again, the underlying rationale implicit in this is that long-term infrastructure investment (whilst costly and well understood) can be compromised in order to achieve basic community survival. This is sound at the micro level.

Hence, for many rural and remote councils, a conflict emerges between its revenue-raising goals and its economic development/community viability goals. In these instances, the community viability outcome usually (understandably) wins.

LGMA Position:

We submit that the capacity of local governments to recoup long-term infrastructure investment costs through developer contributions should be extended so as to ensure that all long-term costs (direct and indirect) are able to be fully reflected in property developments and passed on (subject to local market conditions) to property purchasers.

We submit that allowing the proportionate relationship between long-term infrastructure investment costs and the permitted levels of developer contributions that are allowed to be charged by councils to provide for this is another form of cost shifting, even though it is gradual and less apparent.

We submit that State/Territory governments ought to develop policy in relation to developer contribution systems independently of other policy goals and considerations such as affordable housing.

4.5 Fines and Penalties

A discussion about the levels of fines and penalties in the context of a study on the revenue raising capacity of local governments is dangerous and fraught. Arguably, fines should be excluded from the discussion on the basis that the goals relate to behavioural outcomes and not to revenue-raising.

Fines and penalties imposed by local governments are substantially regulated by States/Territory. Many penalties are specified and others have ceilings imposed. In other cases, these penalties are empowered in local government laws.

We submit that, irrespective of the head or power for fines and penalties, the primary consideration in setting levels of these ought to be on behaviours associated with the penalty, the relativity of the acts that are being penalised and the need to change/deter certain behaviours.

In the case of parking fines, this is obviously a significant source of revenue for many inner metropolitan councils. As parking is a very inelastic commodity, the revenue from parking fines in densely populated urban areas typically outweighs costs considerably. Despite this, the consideration of the penalty level is based on the underlying behaviour, rather than the revenue outcome.

Also, like many other revenue sources addressed earlier, fines and penalties is a source of revenue that is generally closely associated/correlated with population density rather than growth rates or areas. As such, it is not a significant source of revenue for local governments identified as having significant financial viability problems.

LGMA Position:

We submit that in determining the levels of fines and penalties, the policy focus of State/Territory governments (and local governments in the case of local laws) ought to continue to be on the need to deter and change the underlying behaviours associated with penalised acts, rather than on revenue generation.

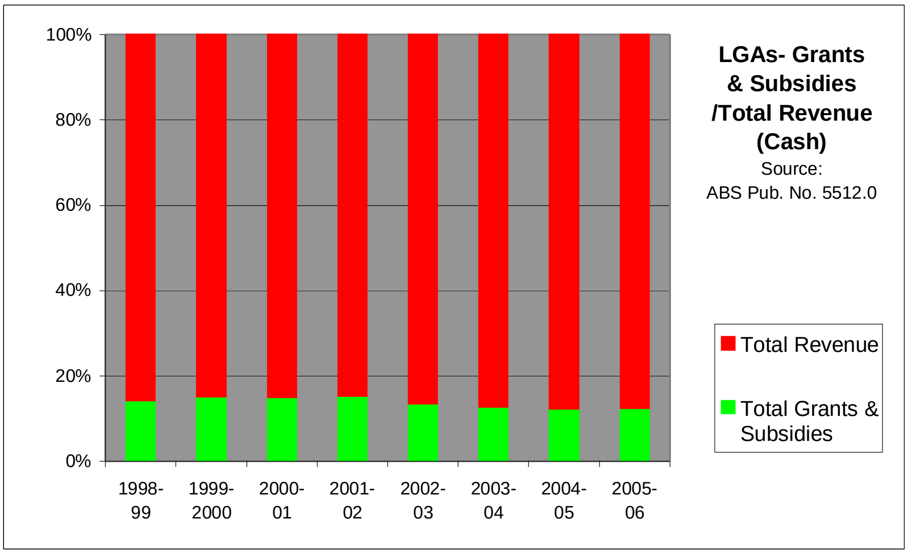
4.6 Grants and Subsidies

The Productivity Commission Study explicitly excludes grants and subsidies from its terms of reference. However, the Issues Paper identifies (in a summary sense) the variation that exists in grants and subsidies received by councils on a per capita basis throughout Australia. We submit that this Study of local government's own-source revenue-raising capacity must examine **the overall role played by grants and subsidies**, if not the detailed methods and calculation formulae applied for it distribution.

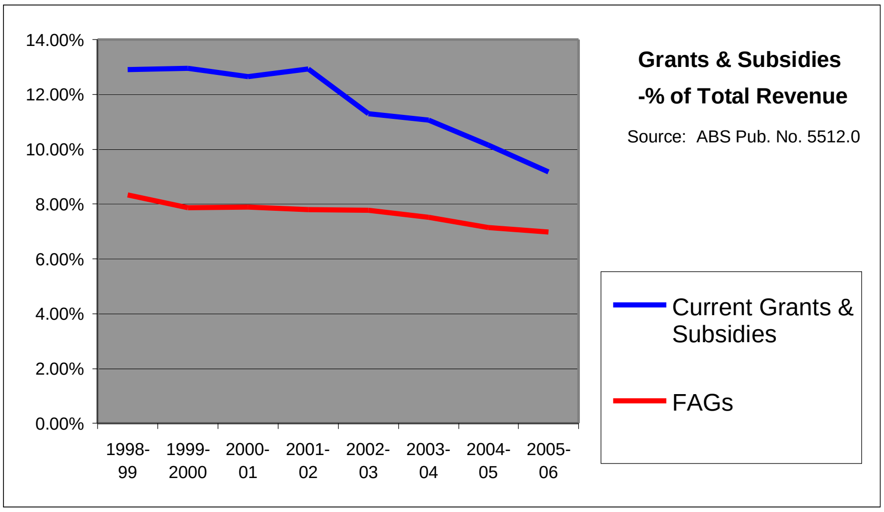
Overall Context and Trends:

Table 1 in the Productivity Commission Issues Paper shows that in 2004/05 total grants per capita received by Australia's local governments varied widely from $22.80 for the City of Melbourne (Victoria) to $1,164.63 in the Barcaldine Shire (Queensland). This of course reflects the underlying principle of **'horizontal fiscal equalisation'** which is a stated goal of the Commonwealth and State Grants Commissions.

The fact that total grants and subsidies to local governments have been declining as a proportion of total revenue is well documented. This decline has been steady though consistent over the longer-term since the introduction of direct financial assistance grants to local government were introduced by the Whitlam Government in 1972. The recent decline is illustrated below (cash grants/total cash receipts).



The decline is similarly illustrated in the graph below. This shows the recent decline in % terms of current operating grants and FAGs as a proportion of total revenue.



In the lead up to the 2007 Federal Election, the Government has cherry picked issues for intervention and spending. There should be a Federal framework that provides for certain and direct intervention and funding of Local Government projects.

Tied Grants and Subsidies:

As stated in this submission's section relating to cost-shifting, State/Territory governments continue to allow real levels of purpose-specific operating subsidies to decline in the face of demonstrable increases in community expectations and service delivery costs (including indirect and compliance costs). This applies for a range of what are today considered to be core local government services (libraries, home care, immunisation, libraries etc.).

Financial Assistance Grants:

Financial Assistance Grants (FAGs) apply complicated formulae (varying from State to State within an overall Federal policy context) to address underlying local financial capacity and disability factors across local government, with a minimum grant (calculated as a per capita entitlement) for each council. The goal is generally to equalise (or reduce disparity between) the fiscal/service delivery capacity of councils across Australia.

LGMA Position:

We submit that the ongoing steady real-terms erosion in Financial Assistance Grants to local governments undermines the goal of equalisation of local government financial and service delivery capacity.

We submit that local governments should receive a defined share of the national taxation 'cake' that is linked to economic activity/prosperity of the nation and has the capacity to grow.

We submit that access to a defined share of a growth tax is necessary to enable local government to respond to future community demands and needs, as well as presently known demands and needs.

4.7 Capital Funding and Interest Income

The Productivity Commission Issues Paper identifies that interest income represent about 3% of local government revenue and has been relatively stable at that level over the past 9 years. The paper questions the efficiency of using cash reserves (savings) as a method of funding infrastructure investment. It identifies that this may reflect State/Territory imposed limitations on borrowing by local governments as a source of capital raising. Such limitations do apply in some States though not universally.

Whilst borrowing has specifically been excluded from the Study's terms of reference, the following observations are made:

- State/Territory imposed limitations on local government borrowing powers are further evidence of underlying attitudes to local government autonomy held by those governments.
- If councils are to plan for and fund (from their own revenue sources) long-term infrastructure needs (ie be financially sustainable), this can only be achieved through cash reserves and/or debt (or in some cases using profits generated from council-owned businesses). In this context, the existence of borrowing limits leaves little option but to accept sustained operating deficits.
- In many cases, councils have large cash reserves that have been accumulated not through excess rating, but from the proceeds of sales of assets or business enterprises (ie; In Victoria, several councils received compensation for the sale of electricity supply undertakings as part of a restructure process during the 1990s, creating substantial capital resources for those councils). A basic principle for the

application of such windfall capital gains is that they ought to be applied for debt reduction or capital investment purposes, rather than to subsidise recurrent revenue sources. To use such windfall gains to offset rating levels (as implied in the Issues Paper) would be short-sighted. It fails to recognise the inevitability of councils having significant legitimate capital requirements and the political context in which rates are determined and levied.

- It is also noted that councils generally carry substantial liabilities for financial obligations such as staff long-service leave and superannuation and are required to hold sufficient non-discretionary cash reserves to match that liability.
- Most councils also hold cash accumulated over several years from **tied sources** (ie; developer contributions) which must be held separately and applied for the express purpose for which those funds were levied in the first place (ie; cash in-lieu car-parking contributions in accordance with an adopted car-parking plan).

The degree of latitude that councils have over cash reserves and financial contributions and levies varies by type and by State/Territory.

Contrary to comments made in the Commission's issues paper local government should be permitted to create responsible reserve funds to provide for long term asset costs. Local Government must be encouraged to provide for long term financial planning by taking the emphasis off the twelve month budget cycle.

The financial pressures facing some Councils has resulted in the pursuit of higher risk investment products to generate additional revenue.

The final point that is salient in relation to interest income and the holding of cash reserves is the political context in which local government debt is generally perceived.

In terms of technical efficiency and **inter-generational equity**, properly-managed, revenue-proportionate and risk-assessed debt is clearly an efficient instrument for the raising of capital. However, widely held community attitudes do not generally reflect this and tend to shun debt. Debt is an instrument that can serve a positive purpose in prudently managed circumstances and whilst servicing costs remain in manageable proportion to total revenues of the council, and within reasonable interest rate risk profiles. However, the widely-held negative attitudes to debt (often reflecting past 'bad experiences') are often reflected at the political levels of councils, limiting it (in practical terms) as an avenue for capital funding.

LGMA Position:

We submit that councils ought to be accountable to their community to fund their adopted and publicly-scrutinised capital program using borrowings and/or rates as they see fit.

We submit that local governments should continue to report to the community and State/Territory governments highlighting debt levels, debt servicing levels compared to total revenues and debt-related risk exposures of the council.

We submit that Local Government should be able to continue to use a mix of borrowings and accumulated cash reserves to provide for long term asset needs.

5.0 A 2050 Vision:
- an equitable taxation sharing system

"…the 21st century is worthy of a truly equitable taxation system, with local government as a ***genuine partner*** *in a* ***'New Federation':*** *A tax system that genuinely passes the tests of equity, efficiency, enforceability." To develop such a system is a significant Nation-building task."*

5.1 Why Change is Needed – Summary of Our Position

This submission seeks to provide the Productivity Commission with a pragmatic insight into the local government financial system from the practitioners' perspective. It seeks to provide these views on issues frankly and free from political or parochial influences. This practical focus is chosen rather than to enter into an academic dialogue regarding technical issues relating to taxation methods.

In so doing, LGMA seeks to constructively contribute to the study by offering views on issues raised in the Productivity Commission Issues Paper. However, we stop short of seeking to offer a view on a neatly packaged 'solution' to the significant problems we consider to exist in the local government fiscal system. It is far more complex than that.

We believe that the ultimate solution to the issues relating to local government financing that are raised in this submission warrant a far greater and wider-ranging debate than are open to this Study (within your defined terms of reference).

These issues are intrinsically linked to the issue of **genuine local government autonomy** and the relationship that presently exists between local government's notion of what comprises autonomy and its own-source revenue raising capacity. It is linked to what LGMA considers is the absence of a genuine role for local government as a partner at the Federation table.

We submit that presently, the only semblance of real autonomy experienced by the local government sector is in the form of being able to raise a substantial component of revenue from its own sources (rating). Own-source revenue raising is not presently a characteristic of the States/Territory yet these governments have genuine autonomy. What is undeniably an autonomy 'pre-requisite' for the States/Territory is **revenue certainty and security** and a **revenue stream that is linked to the nation's prosperity/economic growth**.

LGMA Position:

We submit that presently, in local government, the notion of autonomy is linked substantially to its own-source revenue-raising capacity, only in the absence of a more meaningful form of political autonomy and fiscal autonomy.

We also submit that the local government sector ought to continue to seek a more genuine form of autonomy (in the form of constitutional recognition) and access to a more secure and equitable source of taxation that is linked to economic activity and growth.

5.2 Characteristics of an Equitable Taxation/Governance System

The characteristics we submit ought be reflected in Australia's taxation and governance system in 2050 are:

- local government with constitutional recognition;
- local government having a defined share of a growth/economy/prosperity -linked taxation source that is proportionate to the asset management and service responsibility of local government;
- minimisation of local government's reliance on property taxes;
- freeing up of the State/Territory imposed restrictions on local government's ability to recoup infrastructure costs through developer contributions to levels that reflect direct and indirect infrastructure costs;
- increases in State/Territory regulated fees and charges to levels that reflect real full cost recovery (including direct and indirect costs);
- the absence of rate pegging;
- genuine commitments on the part of State/Territory governments to eliminate cost shifting through intergovernmental service level agreements (and attached funding-cost sharing agreements) that realistically reflect community standards and expectations in relation to service standards and the full-cost (direct and indirect costs) of service delivery;
- clearer definition of Commonwealth, State and Local Government roles and responsibilities reducing the cost of duplication and coordination.
- extension of the scope of the Inter-Governmental Agreement on service levels and cost shifting to apply to the

renegotiation of existing services/funding arrangements, as well as for new service agreements;

- Local Government Impact Statements should be provided for in future Commonwealth and state legislation, where applicable, identifying where costs will need to be incurred by local government. This should also include any additional duties to be performed by local government staff;
- consideration of a **'new local governance system'** (potentially including substantial unincorporated areas/zones throughout Australia under which administrative, fiscal and political structures would be different) that is capable of delivering basic services and governance to Australia's vastly diverse communities. Such a system would be characterised by political, administrative and fiscal structures that recognise the underlying realities of each community. This governance system of 2050 may include threshold tests for different levels of governance, political structures and fiscal arrangements that apply in differing circumstances.