Assessing Local Government Revenue Raising Capacity: Looking to the Future

Submission by the Australian CEOs Group

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Productivity Commission Inquiry Into Assessing Local Government Revenue Raising Capacity

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Executive summary

Introduction

Local government is an integral part of the Australian community and economy. It is responsible for a wide range of economic, environmental and infrastructure services at the local level. Moreover, local councils often provide services that improve the 'social capital' for their communities such as services in health, welfare and cultural areas. Local governments are often-times the service provider of 'last resort' in communities where higher levels of government and the private sector have not provided adequate services. While the provision of services by local governments is critical to their communities, those services are provided as a consequence of a local government's statutory requirement to be responsible for 'the peace, order and good government' of their municipal districts and for generally ensuring the wellbeing of their communities. However, many local governments are facing severe financial pressures, caused by both revenue constraints and increasing expenditure burdens.

Cost pressures

On the expenditure side, the role of local government has expanded considerably over the last 30 years. It continues to maintain its primary function of providing 'services to property' within its boundaries. However, in addition local government now undertakes a growing range of social functions or 'services to people'.

This expansion of functions is due to a number of external pressures, primarily delegation of responsibility or cost-shifting by other levels of government and rising community expectations. Cost-shifting by higher levels of government onto local governments has occurred in a number of different ways including: direct shifting of responsibilities from higher levels of government to local governments; new or increased compliance requirements (that is, 'raising the bar') for which local government is not adequately compensated; and new or increased fees and/or charges on local government in order for State agencies to recover their own operating expenses, with no offsetting benefit to local government.

The cost to local governments of providing services (and some goods) to their communities has also grown considerably. This has been as a consequence of the economic boom that Australia has been experiencing for over a decade, which has been accompanied by rising wage costs due to acute labour and skills shortages and rising infrastructure costs — creating service 'bottlenecks'. Average employee expenses in the local government sector have grown faster than economy-wide average wage increases, due to the growth in services rather than the rising cost of salaries. Such increases have a significant impact on local government finances given the relatively high labour intensity of the sector.

The financial pressures imposed on local government are not necessarily obvious from the income statements and balance sheets of the sector. Local government finances are ostensibly financially sound as there is no apparent growing wedge between local government revenues and expenditures, nor is there an excessive reliance on debt. In fact, local government has often been criticised for not increasing its reliance on debt in order to finance capital expenditures.

The financial pressures experienced by local governments are most clearly exhibited in the inadequate funding of asset maintenance of local government infrastructure. This neglect has worrying long-term financial implications as it reduces the useful life of local government infrastructure (hence bringing forward the need for expensive replacement of assets) and exposes local government to greater risk from litigation. It also has intergenerational implications as persistent infrastructure gaps eventually manifest by shifting the burden from current ratepayers to future ratepayers to fund infrastructure renewal or replacement.

Increasing cost pressures raise issues about the adequacy and ability of local government to raise revenue.

Revenue adequacy

Unlike Commonwealth and State governments, local governments have few options open to them to raise revenues — own-revenue sources are primarily derived from property taxes and sales of goods and services (or user charges and fees).

Over the past decade, growth in local government revenues has been inadequate to cope with the expanding role of local governments. Local government revenue (including grants and subsidies) as a share of total revenue raised by Australian and State governments declined from 5.7 per cent in 1998-99 to 5.4 per cent in 2005-06. If local government revenues as a share of total Australian government revenues had been maintained over this period, the local government sector would have received an additional $3.4 billion (nominal terms) between 1998-99 and 2005-06.

This report assesses the major revenue sources against tax policy principles — against the four basic requirements (criteria) of good public finances — namely efficiency, equity, administrative simplicity and financial adequacy. In addition, revenue sources are evaluated from local government's perspective, that is, the extent to which a revenue source allows local autonomy to be exercised.

In summary, there are several broad revenue pressures facing local government which diminish their ability to raise their own revenue:

- limited access to a sufficiently broad range of revenue, including ability to access a growth tax or taxes;
- legislative restrictions on its ability to raise revenue in certain areas (in particular the setting of rates and user fees/charges); and
- reduced or limited capacity for some residents to contribute further to own-source revenues.

Property rates

Council rates are the single most important source of own-revenue for local governments. Australia is unique among federated OECD counties in its total dependence on property as essentially the only form of local government taxation.

While property rates are a relatively efficient and administratively simple form of taxation, the major disadvantage is that it is a narrow tax and the tax base is shared with State governments who concurrently levy land tax on it. As a result of not having exclusive access to the property tax base, local governments may be limited to raising property rates. Such arrangements further limit local government autonomy in its revenue raising capacity. Crucially, rates fare poorly in the context of providing a growing source of revenue to match growing community demands for services.

Another disadvantage of the property tax is that it conflicts with the equity criterion in the relative burden it places on local government citizens. As rate payments are made from an individual's disposable income, increasing the rating effort would fall heavily on those who have a lower ability to pay, such as elderly residents, those with low incomes or those residing in rural and remote or other economically lagging areas. Property rates are also a relatively unpopular tax as they are subject to direct annual or semi-annual payments and highly visible to the taxpayer. Therefore, while local governments may seek to increase rates, community resistance may deter any such movement.

Moreover, State Government legislative restrictions on the valuation method, rate capping and making properties exempt from tax render it more challenging for local government to increase rates in line with demand for, and the cost of providing, local government services. Revenue figures show that those jurisdictions that allow councils themselves to choose between the three main rate calculation methods[1] tend to have the highest average rate revenue per capita, and also the highest rate revenue increases.

User fees and charges

An alternative major source of revenue for local governments is user charges and fees. There is already a high degree of reliance on user charges by the local governments with the sector recovering almost 35 per cent of all expenses via these, compared to 13 per cent for all tiers of government. Within statutory limits, councils could further expand revenue generated by user charges where they can increase cost reflectivity.

However, there are significant challenges for some councils in being able to increase user charges. While having strong support from an economic efficiency perspective, user charges are often difficult to apply efficiently without adequate cost data. In addition, local governments need to balance competing efficiency and equity concerns and consider their community's ability to pay for higher charges.

More specifically, user charges are appropriate for services that are able to clearly allocate the benefits to the particular user. However, many local government services are 'mixed goods', that is, they have characteristics of public and private goods. This requires local governments to determine the extent to which the liability for a given service should be apportioned between the individual (through user fees) and the wider community (through tax revenue).

The following box summarises the assessment of property taxes and user charges/fees against the criteria. The box highlights the financial inadequacy of both property rates and user fees/charges to meet current demands on local government budgets.

[1] The three methods include the unimproved capital value (UCV), the improved capital value or the annual rental value of the property.

SUMMARY OF FINDINGS

Criteria	Property taxes	User fees and charges
Efficiency	✔ Land is immobile and therefore taxing it does not significantly distort economic behaviour. (There may be some effect to the extent that land is complementary to mobile factors of production).	✔ Reinforces market signals and thereby improves the efficient pricing of services.
Equity	✘ Vertical equity — The tax relates to the value of the property which is not always a good indicator of the ratepayer's current ability to pay. ✘ Horizontal equity — exemptions are allowed for those with a capacity to pay (such as Commonwealth and State owned land).	✘ Vertical equity — May exclude some community members from accessing services.
Administratively simple and practical	✔ Changes in ownership are notified to councils that are then relatively straightforward to raise a rate notice.	✔ /✘ Lack of reliable cost data and impracticality for collections and administration may preclude some councils from setting efficient prices.
Financially adequate	✘ Not a robust growth tax. Councils in States that restrict the valuation approach tend to have lower per capita revenue.	✔ /✘ Cost recovery ratio is much higher than those for the Commonwealth and State government sectors. Any further reliance needs to bear in mind the mixed good characteristics of local government services and practicality for collections and administration.
Local autonomy	✘ State government restrictions.	✘ State government restrictions.

Note: Ticks and crosses relate to whether the tax is favourably (✔) or not (✘) meeting the relevant criteria.

Commonwealth and State grants

Given that local governments have few options open to them to raise their own revenue, they consequently rely heavily on transfers from the Commonwealth and State governments. Over recent years, there has been an insufficient indexation of grants from higher levels of government with grant funding not being maintained in real per capita terms. The declining share of Financial Assistance Grants (FAGs) as a proportion of Commonwealth tax revenues, let alone with broader income measures (such as Gross Domestic Product or Gross State Product) means that local governments have difficulty meeting the needs of the community in maintaining infrastructure and delivering community services, or are unable to do so.

Full equalisation, either vertical or horizontal is currently unachievable because the Commonwealth is not putting sufficient funds in the pool. The issue is not the method of distribution in the first instance but measures to increase the size of the pool.

Reform options

The Australian CEOs Group therefore considers that vertical fiscal imbalance, insofar as it is constraining local government from carrying out its functions adequately, can only be remedied if either:

- sufficient taxation powers are transferred from the State to the local government sector; and/or
- additional funding is provided by increasing Commonwealth FAGs to local government.

These reforms aim to address the failures of the current local government revenue raising capacity — characterised by diminished local autonomy, financial inadequacy and inequitable rate exemptions.

The reform options and recommendations below should not be considered in isolation from each other. There are considerable advantages in combining several recommendations to ensure that the failures of local government revenue raising are adequately and effectively addressed in a balanced way.

The Australian CEOs Group considers that Recommendations 1-5 should be jointly undertaken as a package of reform measures, and require significant collaboration with State governments and the Northern Territory government. Recommendation 6 requires leadership by the Australian Government in FAG arrangements to minimise vertical fiscal imbalance.

Broadening local government's rate base

Local government taxation revenue is limited to rates charged to property owners, generally based on the land value of council-provided services. The approach to calculating and applying rates is determined by State governments and varies significantly between jurisdictions, but in some States is restricted to unimproved value of the land.

Local government would have a broader tax base if all councils were free to levy rates on the capital improved value of property, recognising that this could require States to monitor the joint impact with their own land taxes. Rates based on the capital improved value may be more equitable than rates based on the unimproved value, as income is related more closely to property values than to land values. Local government should also be free to maintain the same rate percentage (cents in the dollar) on this base, rather than deriving the rate as what would be required to achieve a given revenue.

By allowing local councils to levy the improved value of property and by maintaining the same rate percentage, such reforms would grow revenues more closely in line with the economy than the value of the land alone, so over time councils would have greater capacity to meet their service and infrastructure responsibilities through their own revenue sources.

Recommendation 1

State governments should allow local governments the unrestricted ability to set their rates (for example, by maintaining the same rate percentage between years). The tax base should be amended to allow the capital improved value of property to be used as the base.

Removing barriers to local government raising revenue

There are significant legislative restrictions on a local council's ability to raise revenue in certain areas, in particular, in setting rates and user fees/charges.

For property rate setting, New South Wales is the only State that places a cap on local government rates. Rate deregulation would therefore bring New South Wales into line with all other States and Territories. Local councils should be accountable to their local constituents — rather than the State government — for their taxation policies. This would allow the local community to have its say on the level of service delivery that it is willing to support through rate payments.

The removal of State government regulations on local government fees and charges would also increase the flexibility of councils to manage their finances. Councils could determine the appropriate level of fees and charges to recover the costs of their activities, taking account of the demand for services, cost pressures, its other revenue streams and the community's ability to pay. User fees and charges could then be automatically adjusted to reflect cost pressures. As with rate deregulation, voters would have the opportunity to hold councils accountable for the fees and charges that were levied. Councils with a strong potential revenue base and a more affluent community could be expected to match increases in their financial requirements with additional own-source revenues.

Recommendation 2

The New South Wales Government should remove its restrictions on rate pegging, leaving councils to determine the appropriate rate levels for their communities.

Recommendation 3

All State Governments should review their regulations on local government fees and charges with the objective of removing all regulatory restrictions where there is not a clear public interest in the State Government retaining such powers. Councils should be allowed to automatically adjust user fees and charges in line with cost pressures.

The majority of State governments provide rate exemptions and concessions to a range of potential ratepayers, including State government bodies, charitable and benevolent organisations including schools and hospitals, and pensioners. These exemptions and concessions are inconsistent across jurisdictions and do not always equitably reflect the ability of ratepayers to pay.

Reform of rate exemption and concession arrangements could significantly improve the revenue raising capacity of local government. Exemptions and concessions can be very expensive for councils. The cost of maintaining services and infrastructure to exempt organisations such as government agencies, schools and hospitals can be considerable. Some State governments do not fully compensate councils for mandatory exemptions and concessions, despite the State governments being responsible for them.

Recommendation 4

Australian Government and State government organisations should pay rates to local government to reflect the cost of servicing those properties.

Recommendation 5

State governments should review their requirements for rate exemptions to take into account the ability of exempted groups to pay. State governments should fully compensate local government for those exemptions that are retained.

Reform to Financial Assistance Grants

Recommendations 1-5 presented in the previous sections would not represent a funding panacea for local government. While the financial position of all councils would stand to improve, many would remain unable to raise sufficient revenue due to the relatively narrow tax base and the regressive impact of council rates on communities with limited ability to pay. Councils without strong revenue bases would remain dependent on Australian Government FAGs to meet their service delivery and infrastructure responsibilities.

Options to reform the purpose and administration of FAGs can assist local governments to meet their core responsibilities. The capacity of local governments to perform these roles requires consistent reform across Australia. This in turn may lead to savings, which could be redirected into the FAGs quantum and redistributed to councils most in need. With this financial support comes a clear responsibility on local governments to manage their expenditure responsibly and to be accountable to their constituents.

At present FAG funding is escalated at the national level by CPI and population growth indexation. As a result of this approach, local government has not shared in the substantial growth in federal taxation revenue of recent years.

One reform option that would be relatively simple to implement would be to change the escalation rate of the FAGs. The current indexation approach based on inflation and population could be replaced by:

- setting FAGs as a proportion of gross domestic product (GDP);
- setting FAGs as a proportion of Australian Government tax revenue; or
- escalating FAGs annually by a specially constructed local government cost index.

The first two approaches would effectively provide local government with funding support based on a growth tax. Indexation based on tax revenue may be simpler to implement as taxes could be easier to audit than GDP and not subject to extensive and frequent revision like national accounts data. The third approach, using a local government cost index, could be less arbitrary than the first two approaches, but its merit would depend upon the accuracy with which such an index could be constructed.

All of the approaches would provide local councils with greater certainty of income going forward.

Recommendation 6

The Australian Government should reform its Financial Assistance Grants to local government by:

- *setting FAG funding as an appropriate fixed proportion of Australian Government taxation revenue, such that local government's share of overall government revenue adequately reflects its share of responsibility for national infrastructure and service delivery; and*

Chapter 1

Introduction

This submission is provided to the Productivity Commission on behalf of the Australian Chief Executive Officers Group. The Group consists of local government chief executive officers committed to reform: improving inter-government co-operation, reforming local government financing, and incentives for sustainable long-term services and infrastructure.

This submission:

- places in context, the current and expanding role and functions of local government in the community and the national economy;
- assesses the major revenue sources (rates, fees and fines and grants) against tax policy criteria — equity, efficiency, administrative simplicity and revenue stability — and examines whether these revenue sources are adequate for local governments to meeting their current and future functions; and
- identifies and assesses reform options to improve local government revenue raising capacity and to achieve adequate, efficient and sustainable funding of local government functions.

The remainder of this submission is structured as follows:

- *Chapter 2*: provides a summary overview of the local government sector, including its changing role, its revenue and expenditure patterns;
- *Chapter 3*: assesses the adequacy of local governments to raise revenue both now and in the future; and
- *Chapter 4*: identifies reform options to address key impediments to local government having more appropriate revenue levels given their responsibilities and contribution to the national economy and community well being.

Chapter 2

What is the role of the local government sector?

The purpose of this chapter is to provide an overview of the local government sector including its changing role and diversity within the sector. The chapter also summarises trends in local government revenues and analyses the key pressures on local government expenditures.

2.1 Introduction

Local government is an integral part of the Australian community and economy. It is responsible for a wide range of economic, environmental and infrastructure services at the local level. Moreover, local councils often provide services that improve the 'social capital' for their communities such as services in health, welfare and cultural areas. While the provision of services by local governments is critical to their communities, those services are provided as a consequence of a local government's statutory requirement to be responsible for 'the peace, order and good government' of their municipal districts and for generally ensuring the wellbeing of their communities.[2]

The local government sector, however, is facing significant financial pressures due to inadequacies in the revenues available to the sector and external pressures which have required local governments to provide an increasing range of services to the communities that they represent. These financial pressures are manifested in the large and growing 'renewal gap' for local infrastructure and the expansion of community services beyond local government's means.

Local governments represent an incredibly diverse collection of communities and geographical areas and this diversity has implications for the financial issues confronting individual local governments and the appropriateness of policy measures to address these issues.

This chapter explores the causes of the financial difficulties being experienced by the local government sector and is structured as follows:

- a discussion of the evolving role and diversity within the sector;
- an overview of trends in local government revenues; and
- a discussion of local governments expenditures, factors that are contributing to cost pressures and manifestations of these cost pressures.

2.2 The changing role and diversity of the local government sector

Local governments represent an incredibly diverse collection of communities and geographical areas. The electorates that local governments represent vary dramatically across all major indicators, including:

- size and dispersion of the population;
- the socio-economic, cultural and demographic features of the constituents;

[2] This is a requirement of Section 3A, *Local Government Act (Victoria) 1989*.

- the area and other geographical and environmental aspects of the land; and
- financial capacity, including differences arising from cost structures, revenue raising capacity and financial management abilities.

In response to this diversity, there is significant variation in the roles and functions undertaken amongst the local government sector, as individual local governments have developed policy responses that best fit the needs of the communities that they represent. This variation between roles and functions is apparent both within States (that is, between capital cities, metropolitan areas, regional areas and remote areas) and between States and has implications for the nature of the financial pressures that individual councils are confronted by. For example:

- Capital cities and some regional and metropolitan centres, must service the needs of a highly transient, non-rate paying population (tourists, workers, shoppers), but also have access to a significant revenue base reflecting the high-density of primarily commercial property owners, who have a strong capacity to pay local government rates.
- Due to their small population bases, rural and remote councils have a limited rating base to finance vast road networks and higher than average staff costs needed to attract and retain staff. These councils may also have to undertake a range of services that would typically be undertaken by higher levels of government or the private sector.

The role of local government has evolved considerably over the last 40 years. In the past, the primary function of a local government was to provide 'services to property' within its boundaries. These core services included supplying and maintaining local infrastructure (such as local roads, footpaths and drainage), responsibility for waste disposal and recycling services, and regulation of building and planning. In addition to providing services to property, local governments now also undertake an increased range of social functions or 'services to people'. These services often include community housing, health services (such as drug counselling and vaccinations) and education and child care.

Moreover, there is an increasing and more formal role of local government, for example, the inclusion of local government in Part IIA of the Constitution of Victoria and the Partnerships Agreement between the Tasmanian State and local governments.

This expansion of functions is due to a number of external pressures, community expectations, critical unmet need and cost-shifting by other levels of government. These pressures, and the relative importance of various expenditure functions, are discussed in more detail in section 2.4. The following section provides an overview of local government revenues.

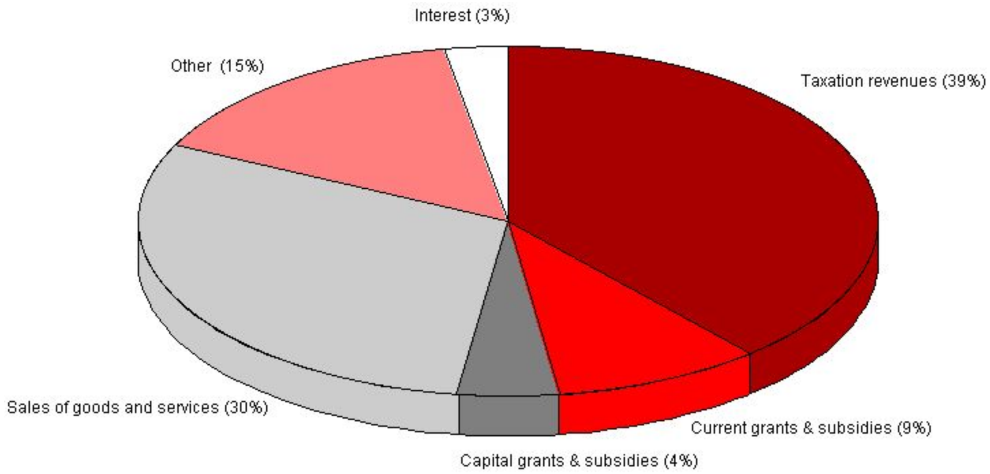
2.3 Overview of local government revenues

The revenue bases available to local government are not sufficient to continue to support the expanding role of the local government sector.

Local government revenues come from a number of sources. The major sources are council rates (accounting for 39 per cent of total local government revenues), sales of goods and services (30 per cent), other own-source income including developer contributions and fines (15 per cent) — see Figure 2.1.

Figure 2.1

CATEGORIES OF LOCAL GOVERNMENT REVENUE – 2005-06



Source: ABS 2007a

Reflecting the inadequacy of these revenue sources, local governments are also reliant on financial grants from Commonwealth and State governments. Grants (both current and capital) from other levels of government accounted for around 13.5 per cent of local government revenues in 2005-06 (ABS 2007a and Commonwealth Treasury 2006).

These revenue proportions reflect averages over all local governments. In practice, the revenue raising capacities of individual local governments vary considerably. Within States, rate income tends to account for a much larger share of revenue in capital city and metropolitan councils (reflecting their large rate base) than they do in rural and remote councils. Conversely, regional and remote councils tend to be highly dependent on grants and subsidies from other levels of government (reflecting their lower rating capacities). For example:

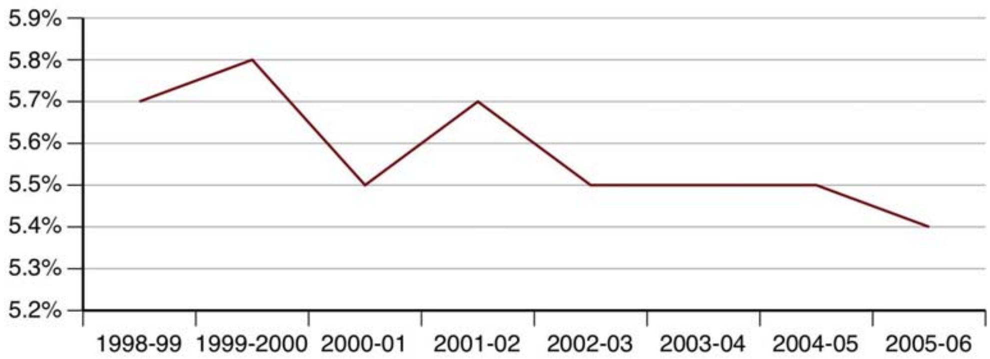
- the remote Shire of Yalgoo in Western Australia received $348 540 in rate revenue in 2006-07 compared to $63 million received by the Stirling City Council (WALGGC 2007); and
- Adelaide City Council received $16.20 per capita in financial assistance grants from the Commonwealth Government compared to the $6768 per capita received by the rural and remote town of Murchison in Western Australia in 2004-05 (DOTARS 2006).

There are several factors that affect the ability of local governments to raise revenues from their own sources, including the affluence and size of the population, commercial and industrial activities undertaken within local government boundaries, value of the rating base, the extent of rate concessions and exemptions required by State governments (for example, for charities, pensioners and seniors), and willingness of local governments to raise revenues from their constituents.

Over time, growth in local government revenues has not kept pace with the revenue growth experienced by the Commonwealth and State Governments. Local government revenues (including grants and subsidies) as a share of total revenues for all (Australian and State) governments declined from 5.7 per cent in 1998-99 to 5.4 per cent in 2005-06 (ABS 2007a) — Figure 2.2. If local government revenues as a share of total Australian government revenues had been maintained over this period, the local government sector would have received an additional $3.4 billion (nominal terms) between 1998-99 to 2005-06.

Figure 2.2

LOCAL GOVERNMENT REVENUE AS A PROPORTION OF ALL GOVERNMENT REVENUE

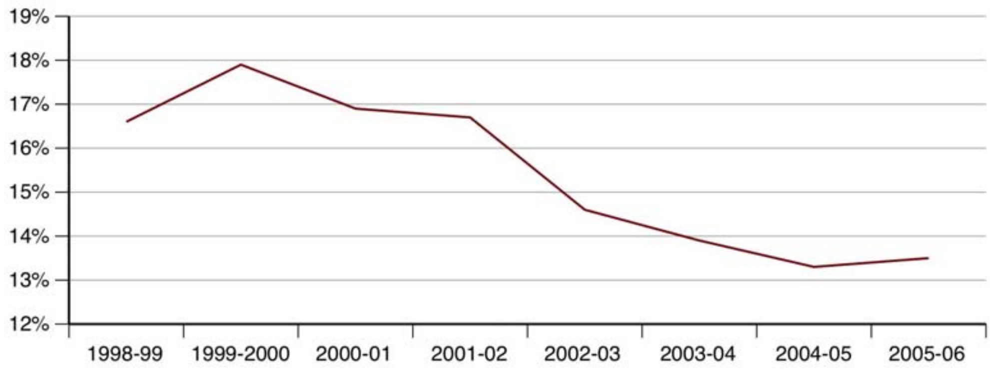


Source: ABS 2007a.

Grants to local government declined as a share of total local government revenue from 16.6 per cent in 1998-99 to 13.5 per cent in 2005-06 (ABS 2007a and Commonwealth Treasury 2006).

Figure 2.3

GRANTS TO LOCAL GOVERNMENT AS A PROPORTION OF LOCAL GOVERNMENT REVENUE



Source: ABS 2007a and Commonwealth Treasury 2006.

To make up for this decline, the local government sector increased its reliance on taxation revenue somewhat (up from 38.1 per cent in 1998-99 to 38.6 per cent in

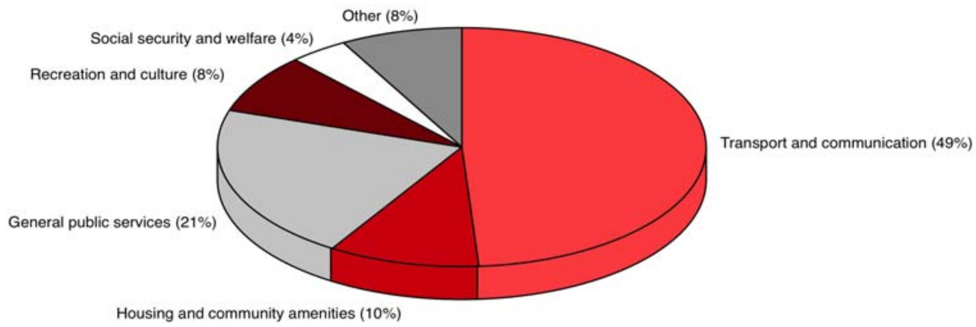
2005-06) and other income[3] (up from 10.3 per cent in 1998-99 to 14.9 per cent in 2005-06) (ABS 2007a).

2.4 Trends in local government expenditures

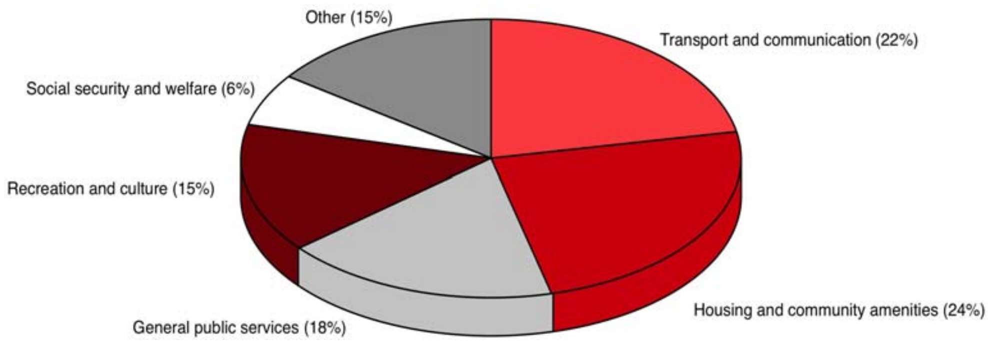
Figure 2.4 shows the shares of the major expenditure categories of local government expenditure between 1961-62 and 2005-06. The composition of expenditure categories has evolved over the four decades. Reflecting the changing role of local government from 'services to property' to 'services to people', the expenditure on transport and communications (predominantly roads) has declined significantly from 49 per cent of expenditure in 1961-62 to 22 per cent in 2005-06, while housing and community amenities increased its share of expenditure up from 10 per cent in 1961-62 to 24 per cent in 2005-06 (CGC 2001 and ABS 2007a).

Figure 2.4

CATEGORIES OF LOCAL GOVERNMENT EXPENDITURE — 1961–62



CATEGORIES OF LOCAL GOVERNMENT EXPENDITURE — 2005–06



Source: ABS 2007a and CGC 2001.

The major local government cost drivers are employee expenses (accounting for 39 per cent of local government expenditure in 2005-06), other operating expenses, which are the costs local governments incur in providing goods and services and infrastructure (41 per cent) and depreciation expenses (21 per cent) (ABS 2007a).

[3] This includes developer contributions and fines but excludes capital grants and subsidies from other levels of government.

The local government sector is responsible for the planning, construction and maintenance of significant infrastructure assets. This is of primary importance to developing the national economy. It is estimated that the value of local government infrastructure is in the order of $198 billion (ABS 2007a). Infrastructure assets include local roads, kerbing and pavements, land, buildings (such as libraries and community centres), stormwater drains, and water and sewerage (in some States).

2.5 Cost pressures on local government

It is widely recognised and reported that the local government sector faces significant cost pressures. This has also been recognised by the Australian Government:

> Local government in Australia is confronting significant financial pressure as service demands rise faster than revenue. The unbalanced growth of revenues and expenditures experienced by councils is described as 'structural gap' in the local government literature (DOTARS 2006, p. 61).

There are several reasons for these cost pressures:

- cost shifting from higher levels of government;
- community expectations; and
- rising input costs (particularly labour costs).

Cost-shifting by higher levels of government

Cost-shifting by higher levels of government onto local governments can occur through a number of different ways. One of the most common forms of cost-shifting involves a direct delegation of responsibilities from a higher level of government to the local government sector. Local government provides many services on behalf of State and Commonwealth governments. The fees a council can charge those who benefit from these services is typically set by other tiers of government, and usually do not reflect the costs of providing the service. The net result is that local government is obliged to use its general revenue to provide services on behalf of other tiers of government. An example of this is the immunisation services provided by Glen Eira City Council (see (see Box 2.1, next page).

In other cases, a higher level of government ceases to provide a service that they are responsible for, leaving the local government to either provide the service from its own resources or leave a service gap. This type of cost-shifting is a particular issue for local governments in remote or regional areas, especially as these councils may also be required to deliver services that would normally be provided by the private sector.

Higher levels of government may also shift costs onto local government through new or increased compliance requirements (that is, 'raising the bar'), for which local government is not adequately compensated. Examples of this form of cost-shifting include requirements to comply with enhanced building regulations for pre-schools (costing up to $3 million in total) and requirements to enforce 'dangerous dog breed' legislation ($10 000 per annum) (Manningham City Council 2003).

Another example of cost-shifting occurs when a government agency imposes a new or increased fee or charge on local government in order to recover its own operating expenses, with no offsetting benefit (in terms of increased services) to local government.

Box 2.1

CASE STUDY: GLEN EIRA CITY COUNCIL IMMUNISATION COSTS

Most councils provide health services for their communities, including administering thousands of immunisations each year. Costs for local governments involve not only administering the injection but also managing the information and the process of obtaining parental consents.

The health benefits of immunisation are undoubted. The funding, however, is more problematic. The following is a snapshot of the funding arrangements.

Vaccine	Funded Amount		Cost to Council #
	Council	GPs	
Childhood Vaccinations (Australian Government funding)			
All children 0-7 years	$11.00	$50.70 - $68.70	$17.80
School vaccinations (State Government funding)			
Hepatitis B for Year 7's	$8.36	$50.70 - $68.70	$17.80
Boostrix for Year 10's	$8.44	$50.70 - $68.70	$17.80
Chicken Pox for Year 7's	$5.00	$50.70 - $68.70	$17.80
Gardisal for Year's 7,10,11 & 12	$15.00	$50.70 - $68.70	$17.80

Based on MAV Costing

Following on from the lower than desirable immunisation rates, Commonwealth and State governments provided financial incentives to general practitioners (GPs) to monitor, promote and provide immunisation services to children under the age of seven years. In addition to the funding under Medicare of $32.10, the government pays GPs:

- $18.50 for vaccinations of children under 7 when records are provided to the Australian Childhood Immunisation Register; and
- $18 Immunisation Outcome bonus for practices that achieve 90% or greater proportions of full immunisation.

The result is that GPs are funded a minimum of $50.70 per child up to a maximum of $68.70 per child.

This case study highlights the disparity in funding to GPs at around $50-$68 and funding to the Council at around $5-$15. A differential of around 400 per cent seems difficult to reconcile. As a consequence, such health programs are being under-funded by Commonwealth and State governments and instead being subsidised by local government revenue.

ource: Glen Eira City Council.

The total value of cost-shifting by higher levels of government onto the local government sector is difficult to quantify. The Municipal Association of Victoria estimated cost-shifting to be in the order of $60 million per annum most as a result of inadequate indexation of grants and increased conditions on their expenditure in 2002 (Dollery et al 2006, p. 243). The Local Government Association of Queensland estimated that cost-shifting was in the order of $47 million per annum in 2002 arising from transfers of responsibilities and increased compliance requirements (Dollery et al 2006, p. 243).

Estimates by individual local governments of the value of cost-shifting that they have been subjected to are outlined in Box 2.2.

Box 2.2

VALUE OF COST SHIFTING BY OTHER LEVELS OF GOVERNMENT

The Manningham City Council (MCC) and the Stonnington City Council (SCC) undertook analysis across its service delivery areas to estimate the value of cost-shifting imposed on it by Commonwealth and State government policies.

The MCC reported cost-shifting across the range of its service delivery areas amounting to $4 million for recurrent expenditure and $3.5 million for capital expenditure in 2002.

The analysis undertaken by the MCC indicates that the primary mechanisms for cost shifting are through additional compliance requirements (41 per cent), under funding (36 per cent) and direct transfer of responsibilities (17 per cent).

The major service delivery areas that the MCC experienced cost shifting in were:

- building refurbishments for preschools to meet changes in Children's Services Regulations ($1.6 million);
- community services including libraries, Home and Community Care, maternal and child health, day care ($1.6 million);
- road funding reflecting shifts in responsibilities and under-funding ($965,000); and
- infrastructure upgrades to meet the requirements of the Disability Discrimination Act ($800,000).

SCC estimates that between 1997 and 2002, cost shifting resulted in it incurring additional expenditures of $6.7 million (net of revenue shifts) or a cost increase of 16 per cent. Major areas of cost-shifting experienced by the SCC were integrated planning ($2.5 million), road infrastructure ($1.7 million), leisure, culture and youth services ($1.2 million), civic legislation ($1.1 million), and community services ($760,000).

An example cited by the City of Port Phillip demonstrate how cost-shifting can occur through inadequate indexation of grant funding by a higher level of government The City reported that it had received $1.10 per meal delivered from the State Government under the Home and Community Care program for over ten years, whereas the City estimated that the cost of delivering a meal had increased to $8.30 by 2000-01. It estimated that inadequate indexation by the State was costing the City $20,000 per annum.

Source: Manningham City Council, Stonnington City Council and City of Port Phillip.

Increased community expectations

Local governments have also experienced increased pressure from the communities that they represent to supply services that have not typically been part of local government responsibilities. The increased demands from communities have resulted in 'services to people' accounting for an increased share of local government expenditure relative to 'services to property'.

Some of the reasons that local governments have experienced increased pressure from the communities for additional services include:

- that of the three levels of government operating in Australia, local governments are most easily accessed by the community;
- local government representatives are often more directly involved within their communities and is therefore the level that is most 'in touch with', and sympathetic to, the needs of local constituents; and

- a positive correlation between economic development and the proportion of public expenditure on public goods, known as 'Wagner's law' (Dollery et al 2006, page 30).

Box 2.3 summarises Wyndham City Council's experience in pressure from the community to develop Youth Services programs to support the rising number of youth and strengthen social capital in the area. Given the strong link between early school leavers, social dislocation and unemployment, it would appear to be in the Commonwealth and State government's interests to support such programs. However, support from higher tiers of government is less than 10 per cent of the program's cost.

Box 2.3

CASE STUDY: WYNDHAM CITY COUNCIL

Background

Wyndham City Council is one of Australia's fastest growing municipalities. As an interface council, Wyndham supports the creation of some of Melbourne's newest suburbs. The cost of creating new communities cannot fall to the new home buyers. These people are likely to move to the outer suburbs in search of affordable housing. They are also likely to feel the burden from a lack of transport, health and community services. Youth in the interface are less likely to complete secondary education and are more likely to demonstrate depressive symptoms.

Youth in growth municipalities need significant support to reverse the trends of unemployment, early school leavers and social dislocation. Young people need to be supported and connected into their communities. Council has continued to advocate for a range of services including: mental health, general counselling and intervention services.

Increasingly, community demand for "non-core" service provision due to rising community demands, coupled with a related tendency by some councils to step in to provide non-traditional services can cause financial sustainability problems for Council.

The population of the City of Wyndham in 2007 is 123 842. Of this, 23 498 are between the age of 12 and 24 years. This figure represents nearly 19% of the total population. It is forecast that by 2011 this figure will rise to 26 971 which will see over 25 per cent of the population being categorised as youth. This presents a big challenge for Council as a very minor amount is provided by either State or Federal Governments grants to Wyndham City Council to fund youth services.

A total of $1 514 987 is committed in 2006-07 to Youth Services program with:

- Commonwealth and State governments committing $93 618;
- Other revenue (fees, user charges) raising $146 680; and
- the Council supporting $1 274 689 from own-source revenues.

Wyndham City Council has made a significant contribution to developing a variety of youth services for the growing population of the City. There will be an increasing demand placed on youth services as the youth population grows. For Council to fund the growing demand for youth services the community will see a continuing increase in the proportion of revenue from rates going to this vital service. The challenge for this community is to seek assistance from either State or Federal Governments to ease the financial burden.

Source: Wyndham City Council

Rising input costs

In addition to increased demands for services, local governments are confronted by cost escalation which increases the costs of providing services. The Australian economy has experienced a prolonged period of economic growth, driven in large part by the resources sector. This economic boom has been accompanied by some acute labour and skills shortages, rising infrastructure costs and 'bottlenecks'. This set of circumstances has had profound implications for the cost structures faced by local government.

Local government expenditure is characterised by (MAV 2007, p. 2):

- a service-based industry, with a significant proportion of expenditure in the from of the delivery of human-based services to the community;
- extensive utilisation of contracts to deliver services as an alternative to in-house delivery; and
- the requirement to maintain, renew, upgrade and construct new assets.

Local government must compete with the private sector and other levels of government for skilled staff. These entities, which have a greater capacity to pay attractive wages, have bid up the price that the local government sector must also pay for staff. Employee expenses in the local government sector grew on average by 7.0 per cent per annum between 1998-99 and 2005-06 (ABS 2007a). This is much higher than economy-wide average wage increases (3.5 per cent), Commonwealth employee expenses (3.8 per cent) and State employee expenses (6.7 per cent) (ABS 2007a). As a consequence, employee expenses as a share of total local government expenditure increased from 34.6 per cent in 1999-2000 to 38.5 per cent in 2005-06 (ABS 2007a).

Local government services are also characterised by its relatively high level of direct employees costs, reflecting the service-based nature of a significant proportion of its activities (aged care, child care, library provision, planning etc). A significant proportion of council expenditure (possibly up to 40 per cent) is directed to contracting out of services (such as Home and Community Care, property values, and waste management and collection) (MAV 2007).

Local governments have also experienced increased construction costs. Construction materials for the construction sector grew on average by 4.4 per cent per annum between 2000 and 2007 (Reserve Bank of Australia 2007). This compares to an average inflation rate of 3.2 per cent per annum over the same period (ABS 2007). Strong growth in construction costs has significant implications for local government budgets given that the local government sector is responsible for 35 per cent of Australian government non-financial assets, yet only receives 5.4 per cent of Australian government revenues (ABS 2007).

Inflation (CPI) is therefore not necessarily applicable to local government which has a significant proportion in the form of wages and buildings and construction costs. A recent study by the Municipal Association of Victoria (2007) estimates the Local Government Cost Index of local government input costs to increase by 5 per cent per annum in the short term, strongly driven by a tight labour market and high construction costs. This is much higher than average inflation of around 2.8 per cent per annum.

Implications of cost pressures

The financial pressures imposed on local government are not necessarily obvious from the income statements and balance sheets of the sector. Local government finances are ostensibly financially sound as there is no apparent growing wedge between local government revenues and expenditures, nor is there an excessive reliance on debt. For example, 90 per cent of councils in New South Wales have a debt-service ratio less than 10 per cent (DOTARS 2006, p. 36). In fact, local government has often been criticised for not increasing its reliance on debt in order to finance capital expenditures.

The most obvious manifestation of the financial pressures experienced by local governments is exhibited in the neglect of local government infrastructure, whose economic importance is often not recognised (e.g. as providing the final links in national transport chains — to local businesses or logistics hubs). This neglect is a consequence of the external pressures to expand the range, and increase the standard, of services provided by local government which has resulted in local government expenditure being diverted away from construction and maintenance of infrastructure.

There is a large and growing gap between what needs to be spent to maintain local government infrastructure and what is being spent in practice (that is, the renewal gap). In May 2006, the *Independent Inquiry into the Financial Sustainability of NSW Local Government* found that local governments would need to borrow $6.3 billion to overcome its infrastructure backlog and would need an additional $900 million in revenues per annum to service the debt and address the annual capital works shortfall. Nationally, it is estimated that the backlog is worth around $14.5 billion with the estimated funding gap per council being $3.1 million per annum (PwC 2006, p. 11).

Neglect of infrastructure reduces its useful life and brings forward the need for expensive replacement of assets. Deteriorating of infrastructure assets may expose local governments to greater risk of litigation (for example, in response to personal injuries).

Rural agricultural, rural remote and, to a lesser extent, the urban fringe categories of councils experience an even greater financial burden associated with their operations. This is due to a large number of these councils (approximately 60 per cent) experiencing static or declining population bases, which translates to stable or declining council revenue (PwC 2006). These councils are shown to have:

- higher debt-service ratios — in New South Wales, 13 of the 15 councils experiencing high debt-service ratios (above 10 per cent) are regional and rural councils (DOTARS 2006, p. 33);
- potential liquidity problems — 25 per cent of urban fringe and 50 per cent of urban development council areas have a median current ratio (defined as current assets/current liabilities) of less than 1 (PwC 2006, p. 100); and
- lower rates coverage (defined as total rates received as a percentage of total costs) — 25.4 per cent of rural remote councils compared with 66.5 per cent in the urban regional category (PwC 2006, p. 104).

These trends suggest that rural and remote areas have pronounced viability problems and 'battle against lack of scale and extra funding for renewal of existing community infrastructure is required for most' (PwC 2006, p. 117). Trends in urban fringe councils also show mixed viability problems. This is in contrast with the experiences in the majority of larger metropolitan councils who are generally viable and have the ability to meet their obligations.

The development of policy measures to address the financial circumstances of the local government sector must take this diversity into account. Approaches that assume 'one size fits all' will be detrimental to the local government sector.

2.6 Summary

Local governments are responsible for delivering a diverse range of services to the communities that they represent and are often-times the service provider of 'last resort' in communities where higher levels of government and the private sector have failed to provide adequate services. However, this important service provider is facing severe financial pressures, caused by both revenue constraints and expenditure burdens.

On the expenditure side, the role of local government has expanded considerably over the last 40 years. It continues to maintain its primary function of providing 'services to property' within its boundaries. However, in addition local government now undertakes a growing range of social functions or 'services to people'.

This expansion of functions is due to a number of external pressures, primarily cost-shifting by other levels of government and rising community expectations. Cost-shifting by higher levels of government onto local governments can occur in a number of different ways.

Growth in local government revenues has been inadequate to cope with this expanding role. Local government revenue as a proportion of total Australian and State government revenue has declined over time, due in part to insufficient indexation of grants from higher levels of government, which have not even been maintained in real per capita terms. As a consequence, local government has needed to become increasingly reliant on own-source revenues, which are very difficult to increase adequately.

The cost to local governments of providing goods and services to their communities has also grown considerably. This is a consequence of long economic boom that Australia has been experiencing, which has been accompanied by rising wage costs due to acute labour and skills shortages and rising infrastructure costs and 'bottlenecks'.

The financial pressures experienced by local governments are most clearly exhibited in the inadequate funding of asset maintenance of local government infrastructure. This neglect has alarming long-term financial implications as it reduces the useful life of local government infrastructure (and hence bringing forward the need for expensive replacement of assets) and exposes local government to greater risk from litigation. It also has intergenerational implications as persistent infrastructure gaps eventually manifest by shifting the burden from current ratepayers to future ratepayers to fund infrastructure renewal or replacement.

Chapter 3

How adequate is the local government revenue raising capacity both now and in the future?

The previous chapter highlighted the growing pressure building up on local government finances. This chapter assesses whether the local government own-source revenue raising capacity is adequate to meet its obligations both now and in the future.

Chapter 2 highlighted that local governments are currently facing increasing cost pressures on the infrastructure and services that they provide.

But there is also pressure on the other side of the equation that is drastically affecting local governments' revenue streams. This chapter examines the fundamental issue before the Inquiry — is the revenue base adequate for local governments to meet their statutory obligations, both now and in the future?

In summary, there are several broad revenue pressures facing local government which diminish their ability to raise their own revenue:

- limited access to a sufficiently broad range of revenue, including the ability to access a growth tax;
- legislative restrictions on its ability to raise revenue in certain areas (in particular in setting rates and user fees/charges); and
- reduced capacity for some residents to contribute further to own-source revenues.

Given the challenges for many local councils to keep relying on their own-source revenues, the increase in financial assistance from Australian and State/Territory governments (through intergovernmental grants) becomes of paramount importance to the viability and success of the local government sector.

This chapter assesses the adequacy of the major local government revenue sources (property rates, charges/fees, and Commonwealth and State grants) against the four basic requirements (criteria) of good public finances — namely efficiency, equity, administrative simplicity and financial adequacy. In addition, revenue sources are evaluated from a local government's perspective, that is, the extent to which a revenue source allows local autonomy to be exercised. The criteria are summarised in Box 3.4

Box 3.4

PRINCIPLES OF GOOD TAX DESIGN

The standard criteria for assessing the merits of a given taxation instrument applies to all tiers of government, including local government. Specifically, taxes should be:

- *efficient* — a tax system should minimise inhibiting or distorting effects on economic activity; it should not restrict economic growth or divert resources away from the uses that would produce most for the economy;
- *equitable* — the system should treat everyone fairly, with those in a similar position paying the same amount of tax (horizontal equity), and should contribute to a more even distribution of income, with those on higher incomes paying a higher proportion of their incomes in tax (vertical equity);
- *administratively simple and practical* — a relatively simple, practical (and enforceable) system aids transparency, makes inequities in the distribution of taxation and unintended inefficiencies in its effects on economic activity less likely, and minimises administration and compliance costs; and
- *financially adequate* — the tax system should raise adequate revenue to support the government's role in providing services, and overall fiscal stance. Within the overall tax system, property taxation should raise the proportion of total taxes expected of it by the government, and in a way that is, preferably, predictable and sustainable.

In addition, *local autonomy* is required to match local public provision to local needs and preferences.

Source: See, for example, P. van den Noord and C. Heady 2001, *Surveillance of tax policies: a synthesis of findings in economic surveys*, Organisation for Economic Co-operation and Development (OECD) Economics Department Working Papers, No. 303, www.oecd.org, pp 16-21.

3.7 Council rates

As noted in Chapter 1, property taxes, or council rates, account for around 39 per cent of local government operating revenue and are the only direct source of taxation revenue available to local government. Australia is unique among federated OECD counties in its total dependence on property as the only form of local government taxation (Dollery et al 2006, p. 92).

While property taxes can be considered a single form of taxation, significant variations exist by which rates are charged between jurisdictions (see DOTARS 2006, p. 28). The way in which tax rates or the valuation of the property are determined can vary markedly across jurisdictions. For example, there are broadly two approaches of either using the unimproved capital value (UCV) (used in New South Wales, Queensland and ACT) or allowing councils to choose between UCV, the improved capital value or the annual rental value of the property (used in Victoria, SA, Tasmania and NT).

Taxation of property values is generally considered non-distortionary and therefore efficient due to the relative immobility of the tax base (OECD 2003, p. 151). That is, taxation of property values does not change the total supply of land.[4] Related to the non-mobility of land is the administrative simplicity of property taxes for local governments. Changes in ownership are notified to councils that are then relatively straightforward to raise a rate notice.

[4] As a qualification to the extent that land is complimentary to mobile factors of production (e.g. business capital) it can affect location decisions.

Whether property taxes are adequate as a tax base depends on the equity of property tax, financial adequacy and local autonomy. These, in turn, depend on the ability of councils to raise revenue — determined by local household disposable income (as rates are paid from disposable income — that is, after Commonwealth taxes and transfers) as well as the constraints imposed by State/Territory governments.

While local governments have some discretion to increase rates, this is not always feasible for economically lagging areas such as many rural areas and drought affected communities. Councils in rural and regional areas receive, on average, four times the funding per person when compared with councils in major cities (DOTARS 2006, pp. 52-53).

However, even where financial autonomy is possible, reliance on property taxes pose a number of problems for local government councils.

The major disadvantage associated with local government's reliance on property taxes is that it derives from a narrow tax base, which is also shared with State governments. While local government's taxation revenue is exclusively raised through land taxes, State governments raise almost twice as much in taxes on (financial and capital transactions of) property (DOTARS 2006, p. 17). State governments derived 38.2 per cent of their taxation revenue from property taxes in 2005-06 and thus are a key revenue source for state governments (ABS 2007b). As a result of not having exclusive access to the property tax base, local governments may be limited to raising property rates. Such arrangements further limit local government autonomy in its revenue raising capacity. Crucially, rates fare poorly in the context of providing a growing source of revenue to match growing community demands for services.

Crucially, however, rates fare poorly in the context of providing a growing source of revenue to match growing community demands for services. While property taxes collected by local government have increased since 2000-01, revenue from this source has not grown as fast as GST and company tax collections by the Commonwealth. Consequently, in its 2007-08 Budget, the Australian Government has been able to provide personal income tax cuts worth $31.5 billion over four years, in addition to the $36.7 billion worth of tax cuts announced in the previous year's budget (Costello and Minchin 2007a, p. 18). That is, the Commonwealth Government has the ability to adjust the rate of tax to a growing tax base at their own policy discretion. Local government councils, on the other hand, have a limited capacity to tap into growth taxes and have very little policy discretion to adjust rates ahead of community expectations. This arrangement severely compromises local governments ability to both fund existing infrastructure services and provide additional investment. This limitation is exacerbated by the erroneous public view that an increase in property valuations has a direct relationship with increased rate revenue, and ignores the fact that the property tax rate has changed or reduced.

Other disadvantages of property rates relate to the potential violation of the equity criterion. The tax relates to the value of the property which is not always a good indicator of the ratepayer's current ability to pay. Some ratepayers may be asset rich but have comparatively low incomes, for example, pensioners or super annuitants living in highly demanded areas whose property values reflect the past income of residents, rather than the current capacity of landholders to pay the tax. To this extent, while the rating system is relatively neutral in its design, the incidence of the tax is particularly regressive.

Second, rates paid may bear little relationship to the level of council services used by a household. For instance, the average rate paid by households in a wealthy council area (i.e. where numbers of households have high disposable incomes) is likely to be higher compared with the average payment made by a comparable household in a poorer council area even if councils in both areas provide similar services. Box 3.5 provides an example of the divergence in average property rates paid.

Box 3.5

DIVERGENCE IN AVERAGE PROPERTY RATES PAID

There is a significant divergence in the degree of rate raising efforts across different categories of councils. This is seen in the average rate income collected per residential household. For example, in Western Australia, the lowest 10 per cent of councils (in terms of household incomes) charged less than $300 per annum and councils in the top 10 per cent collected more than $729 per annum.

In Victoria, the City of Melbourne was able to collect on average around $1920 from residents and other rate payers compared with the average amount of $314 collected from citizens of Warrnambool Council.

Sources: PwC 2006, p. 60 and DOTARS 2006, p. 11.

Third, in most States and the Northern Territory, some organisations and individuals are granted concessions or exemptions from paying council rates. These concessions and exemptions are often required by State law.[5] The main recipients are State/Territory Government entities, charitable and organisations and pensioners. In all jurisdictions, exemptions are provided to Crown Land, including defence land and national parks. Otherwise, the definition of exempt and non-exempt organisations and activities is inconsistent between the States.

Under the competitive neutrality principle of National Competition Policy, State enterprises should pay all applicable taxes, including council rates. The application of this principle to local government has been inconsistent across the States and the Northern Territory. In some jurisdictions State and Territory corporations pay the equivalent of local government rates to their State/Territory treasuries in order to meet competitive neutrality requirements. This revenue is not passed on to local government. However, as local government is often exempt from State/Territory land and payroll taxes, the net effect on local government finances is unclear.

Rates are a highly visible form of tax compared with income taxes. Ratepayers receive a rates assessment at the beginning of each year, followed by an invoice for each instalment of rates. Ratepayers are very conscious of the amount paid, and changes from year to year. This poses a challenge for local governments to adjust taxes. This is generally not true of most other forms of taxation.

[5] See, for example, sections 555 and 556 of the *Local Government Act (NSW) 1993,* section 154 of the *Local Government Act (Victoria) 1989,* and Western Australian *State Agreement Acts.*

Moreover, State government legislative restrictions on local governments and their ability to raise funds. A particularly acute example is the New South Wales Government's policy of rate pegging, where the State government arbitrarily sets a ceiling on percentage rate increases. This policy has been a 'major constraint on councils' revenue raising capacity causing it to fall behind other states' (NSW Independent Inquiry 2006, p. 207). Comparisons across jurisdictions also show that those States that allow councils to choose between the three rate valuation and calculation methods tend to have the highest average rate revenue per capita, and also the highest rate revenue increases over the five years to 2004-05 (PwC 2006, p. 49). Such policies limit local council autonomy and diminish their accountability in serving their communities.

Findings

Table 3.1

SUMMARY OF FINDINGS: PROPERTY RATES

Criteria	Comment
Efficiency	✔ Land is immobile and therefore taxing it does not significantly distort economic behaviour. (There may be some effect to the extent that land is complementary to mobile factors of production).
Equity	✕ Vertical equity — Property tax relates to the value of the property which is not always a good indicator of the ratepayer's current ability to pay. ✕ Horizontal equity — exemptions are allowed for those with a capacity to pay (such as Commonwealth and State owned land).
Administratively simple and practical	✔ Changes in ownership are notified to councils that are then relatively straightforward to raise a rate notice.
Financially adequate	✕ Not a robust growth tax. Councils in States which restrict the valuation approach tend to have the lowest per capita revenue.
Local autonomy	✕ State government legislative restrictions and sharing of tax base.

Note: Ticks and crosses relate to whether the tax is favourably (✔) or not (✕) meeting the relevant criteria.

3.8 User charges and fees

The inability of local government's tax base to keep pace with expenditure demands and economic growth has forced councils to look to alternative financing arrangements. In addition, local government user charges and fees warrant specific investigation because of their supposed efficiency gains. That is, user charges stand to reinforce market signals and thereby improve the efficient pricing of services, and the efficient use of resources and an efficient output of services.

As noted in Chapter 2, sales of goods and services[6] — that is, user charges and fees — are the second largest source of revenue for local governments nation-wide and account for around 30 per cent of local government operating revenue (PC 2006, p. 14). As revenue from such sources is aggregated within this category, it is not possible to separately identify their value and growth in recent years.

One way of determining the extent to which user charges are efficiently set is to compare it with operating expenditure (including allowances for depreciation). This allows us to determine the sector's 'cost recovery ratios', summarised in Table 3.2.

Table 3.2

USER CHARGES AS A PROPORTION OF OPERATING EXPENSES (PER CENT)

	2000/01	2001/02	2002/03	2003/04	2004/05	2005/06
Commonwealth government	8%	7%	7%	7%	8%	8%
State government	13%	13%	13%	12%	12%	13%
Local government	35%	35%	35%	35%	36%	35%
All governments	14%	13%	13%	13%	13%	13%

Source: ABS 2007a.

Table 3.2 reveals significant differences in cost recovery between the different spheres of government. The local government sector's cost recovery ratio is much higher than those for the Commonwealth and State government sectors. In the main, this reflects considerable variation in the responsibilities of the different tiers of government, with the local government in a better position to recover the costs of delivering its services.

Wider adoption of user charges for local government services have come about through enthusiastic microeconomic reforms negotiated between the State and Federal governments over the past two decades. Greater scrutiny and application of charge-setting principles have helped local governments to recover the costs of services and help to maintain them over the long term. Box 3.6 summarises the City of Port Phillip's new child care policy and its approach to meeting a shortage of supply, ever increasing unmet demand for child care places and the depleting standard of child care building infrastructure. This was achieved by full cost recovery of some of the services and by introducing a levy on the costs of maintaining and replacing existing buildings.

6 An important point regarding this data is that user charges *per se* are not separately defined, and the term 'sales of goods and services' by local government is used. By far the majority of revenues in this category are derived from local government charges for services such as domestic waste removal and water supply. If we accept that the 'sale of goods and services' by local government acts as a reasonable proxy for user charges, the data in the table can be used to gain a qualified perspective on the status quo.

Box 3.6

CASE STUDY: CITY OF PORT PHILLIP CHILDCARE POLICY

Background

The Best Value Review process in 2005 considered child care in Port Phillip in the context of the additional challenges faced by inner metro municipalities. The panel found that high land prices, shortages of available land and ageing infrastructure, all place increasing pressure on the inner metro child care system. Increasing community expectations that quality childcare is a fundamental right and that government should retain a major role in childcare planning, provision and funding added to this pressure.

The review also found that the existing childcare system in Port Phillip was not sustainable and that it is unable to meet current and future demand. Centres required significant subsidisation to operate and had no capacity to review their assets, build capacity, or offer affordable care to those who need it most.

New Child Care policy

The review recommended a new approach to delivering child care and creating more places in the City was critical. As part of this policy, all public expenditures on childcare will be required to be transparent and clearly show:

- costs of providing services;
- costs of providing quality buildings;
- charges to users; and
- council subsidies and incentive payments.

Fees have also been set to recover the costs of services — for example, the council set out to recover the full costs of building services such as cyclic maintenance, minor maintenance, cleaning, security and fire services. In addition, a Quality Building Levy (based on total building replacement costs) was introduced. In the 2005-06 budget, an estimated $934 875 of revenue was collected from these sources.

However, the Council noted that this approach would not represent a full fee cost recovery model, as Council will continue to provide significant support for eligible low and middle income families to benefit from childcare places. An estimated $436 498 was allocated as an ‘Affordability Subsidy’ for these purposes. In addition, the additional revenues funded a $355 827 Quality Incentive Program to ensure continuing access to high quality childcare.

Furthermore, the introduced user charges supported a capital investment program to fund asset renewal and replacement and new places in existing centres. A total of $407 000 was allocated for this purpose in 2005-06.

Source: City of Port Phillip.

The new child care policy in the City of Port Phillip also envisaged general ratepayers making a corresponding contribution to childcare through council rates. This is not surprising given that most local government services are categorised as a mixed good — with positive externality or public good features (Dollery et al. 2006, p. 63).

While some local councils have been able to rely on user fees and charges, their pricing strategies are unlike those that may be used by commercial entities. In particular, State government legislation directs local councils to meet community obligations by setting fees and charges to be politically acceptable to local constituents.[7] The fact that local governments have to consider a range of factors when setting a fee or charge does imply that they may be prevented from full cost recovery in some cases. In addition, local governments are expected to conform with policies set out by higher tiers of government (for example, water and wastewater charges where a national reform agenda exists).

[7] See, for example, section 6.17 of the *Local Government Act (Western Australia) 1995*.

In addition, increasing reliance on user charges by local governments is often criticised because it may exclude some community members from using services by not addressing equity goals. In the City of Port Phillip's case study (see Box 3.6), community feedback supported the need to respond to the lowest and middle income earners in the city and that pricing principles should take into account the high cost of living and any negative impact this may have on families. As a consequence, the Council offset increases in user charges through payments (through an Affordability Subsidy) made to low and middle income families to enable concessional pricing.

Moreover, councils whose communities have lower disposable incomes may find it more difficult to raise user charges to recover service costs as residents may have a lower ability to pay for additional fees. This is particularly evident in remote and rural councils. Consequently, a 'poor' council has limited opportunities to require users to pay for services, and also has constraints on its ability to set rates at a higher level to provide additional services to its residents.

The gains in economic efficiency may also not be realised in practice as it is often difficult to assign user charges in a manner that achieves perfectly efficient pricing. This is because there is a lack of data on the supply-side, for cost-based charges, such as development applications, approvals, etc. Cost data is usually incomplete, and represents an amalgam of imperfections ranging from shifting accounting conventions to arbitrary cost-allocation or cost-sharing principles.

While some scope exists for local government to provide further analysis of the costs of providing services and infrastructure, other councils would find it more challenging to develop transparent pricing and user charges. This is because it is difficult to determine what the optimal price should be. Problems include the public good characteristics, externalities, economies of scale and congestion problems of local government services. That is, it is not practical to assign charges to some services due to collection and administration difficulties. Many local governments are probably close to the practical maximum for the type of user charges while other services rely on rates to provide public good services.

Even where user charges are used more widely, the application of more commercial pricing may be restricted due to statutory limitations. For example, in New South Wales, State government restrictions on local government's user fees and charges are applied to development and building application fees; animal registration fees; fees for requests for planning information relating to property on transfer; and other fees (Dollery et al 2006, p. 32). Setting the user charges for a range of local government services prevents individual councils from having the necessary flexibility — since the cost of providing these services varies from council to council, there are significant shortcomings of a 'one size fits all' policy on fees for all municipalities.

It is important to recognise that if it were feasible for user charges to raise sufficient funds to cover the cost of an infrastructure investment, the investment would, or could have been carried out by the private sector. As noted in a recent study:

> User charges that are considered practical in relation to the use of public infrastructure are generally insufficient to provide a risk-adjusted rate of return. It is not unusual for public infrastructure investments to be funded with a user charge and for the capital cost element to be met through budget support. Additionally, sudden, substantial increases in user charges are generally not feasible, which further mitigates against their effectiveness as an instrument for financing investment in infrastructure in a timely manner (Allen Consulting Group 2003, p. 60).

Findings

Table 3.3

SUMMARY OF FINDINGS: USER FEES AND CHARGES

Criteria	Comment
Efficiency	✔ Reinforces market signals and thereby improves the efficient pricing of services.
Equity	✕ Vertical equity — May exclude some community members from accessing services.
Administratively simple and practical	✔/✕ Lack of reliable cost data and impracticality for collections and administration may preclude some councils from setting efficient prices.
Financially adequate	✔/✕ Cost recovery ratio is much higher than those for the Commonwealth and State government sectors. Any further reliance needs to bear in mind the mixed good characteristics of local government services and practicality for collections and administration.
Local autonomy	✕ State government restrictions.

Note: Ticks and crosses relate to whether the tax is favourably (✔) or not (✕) meeting the relevant criteria.

3.9 Commonwealth and State grants

The discussion above highlighted the financial inadequacy of property taxes and user charges to meet current demands placed on local government budgets. Those councils that have limited capacity to raise revenue through rates and user charges that rely mostly on grants and are being handicapped by the decline in tax revenue share going to local government. A transfer of taxation revenues from higher tiers of government to local government warrants consideration.

As documented in a number of studies (for example, Garnaut and FitzGerald 2002) intergovernmental financial arrangements in Australia are characterised by an extreme vertical fiscal imbalance — that is, large differences between the relative revenue raising and expenditure responsibilities of the three tiers of government. Table 3.4 compares the proportion of taxes collected by different levels of government in 2005-06 and each level of government’s proportion of tax-funded own-purpose expenses.[8]

[8] Own-purpose expenses of a particular level of government are the total expenses of that level of government excluding the grants paid to other levels of government.

Table 3.4

TAXATION REVENUE AND EXPENSES BY LEVEL OF GOVERNMENT 2005-06

	% of total taxation raised	% of total tax-funded own-purpose expenses	Ratio of tax raised to own-purpose expenses
Commonwealth	82.3%	72.5%	1.14
State/Territory	14.8%	39.1%	0.38
Local	3.0%	6.1%	0.49
Total	100.0%	100.0%	

Note: Commonwealth Government revenue includes GST collections.
Source: ABS 2007a and 2007b.

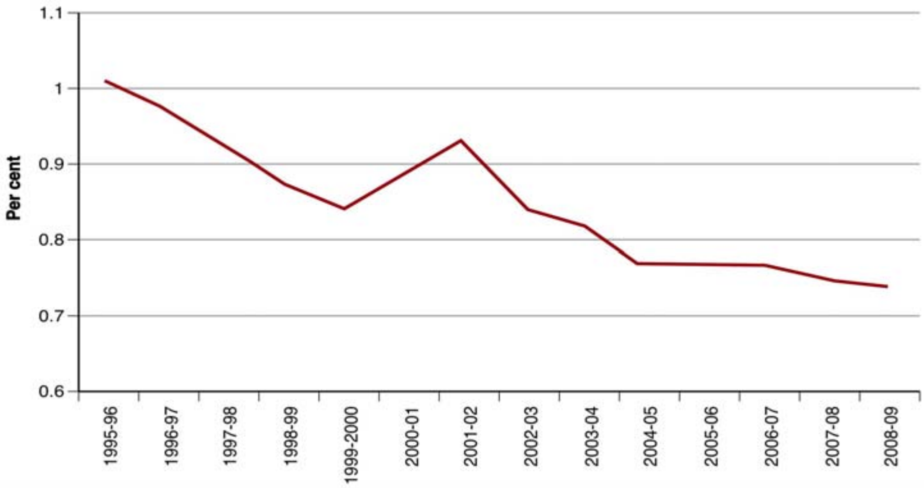
The table above shows that the local sector raised 3.0 per cent of total (Australian and State) taxation revenue and was responsible for 6.1 per cent of total funded government expenses in 2005-06. As the Australian Government collects over 80 per cent of all taxes, the transfer of revenue through grants to local government, is therefore critical to delivering horizontal and vertical fiscal equity.

The Commonwealth Budget Papers indicate that total Financial Assistance Grants (FAGs) payments to local government, combining general assistance and untied local road funding, are estimated to be $1.69 billion in the current financial year in 2006-07 (Costello and Minchin 2007b, p. 21). In addition, payments made directly to local government are estimated to be $0.3 billion in 2006-07 (Costello and Minchin 2007b, p. 21). The total amount of Commonwealth grants represents around 0.88 per cent of total Commonwealth tax revenue in 2006-07.

The Australian Government annually adjusts the quantum of FAGs using an escalation factor based on inflation and population growth. Figure 3.5 shows that the payment of FAGs as a proportion of total Commonwealth tax revenue has declined from 1.01 per cent in 1995-96 to just 0.74 per cent in 2008-09. This decline in FAGs as a proportion of Australian Government tax revenue has been due to substantial growth in GST and company tax collections by the Commonwealth, which has benefited from the current resources boom and the multiplier effects to the wider economy. The State Governments have benefited to a lesser extent, given that the Commonwealth assigns to them, as untitled grants, the net proceeds of its GST; but growth in other grants to the States (tied grants or Specific Purpose Payments) has not kept up with growth in broad national income measures. Grants to local governments have not matched the growth of the economy either, and local governments have not enjoyed a share of the GST.

Figure 3.5

FINANCIAL ASSISTANCE GRANTS AS A PROPORTION OF COMMONWEALTH TAX REVENUE

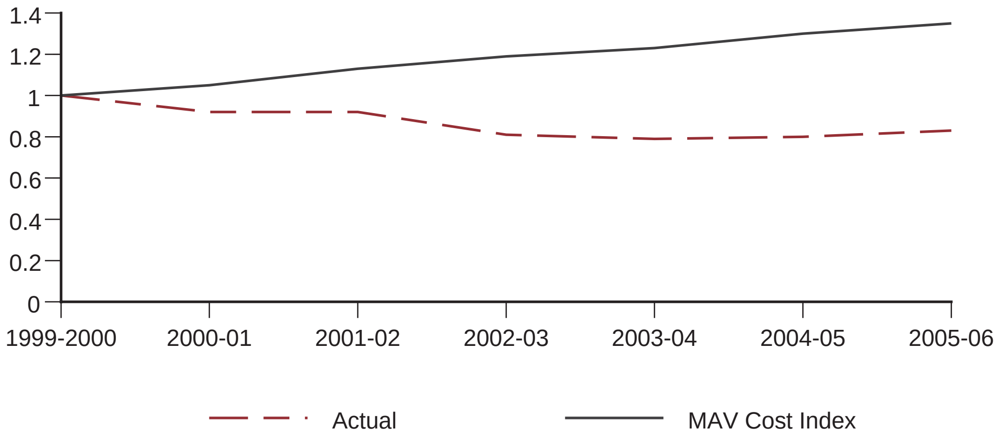


Source: Australian Local Government Association 2007, p. 9.

While the annual escalation of FAGs delivers a small annual increase in grants to local government, it is insufficient to meet growth in demand and the escalating cost of providing infrastructure and services. The growth in financial grants to local government in real per capita terms remained fairly stable over this period while there was growth in local government costs see Figure 3.6

Figure 3.6

GROWTH IN LOCAL GOVERNMENT GRANTS (REAL, PER CAPITA) RELATIVE TO LOCAL GOVERNMENT COST INDEX



Sources: ABS cat. no. 5512.0 and 6345.0 and MAV 2007.

While local governments are also reliant upon State/Territory grants, the relationship and extent of collaboration differs between jurisdictions. More importantly, as was apparent through the *Review of Commonwealth-State Funding*, the states have only spasmodically managed to achieve access to 'growth' taxes or intergovernmental grant arrangements (Garnaut and FitzGerald 2002). Such increases are unlikely to adequately account for the cost increases attendant on wages, technological change and expanded community expectations. These factors limit the extent to which State governments are able to assist local governments through financial transfers.

Full equalisation, either vertical or horizontal is currently unachievable because the Commonwealth is not putting sufficient funds in the pool. The issue is not the method of distribution in the first instance but measures to increase the size of the pool.

It therefore follows that reform of FAGS distribution is a secondary issue. The first priority is to expand the resource pool available to Local Government. The existing pool is inadequate to fund:

- The expanded role
- The infrastructure gap
- The diminishing share of commonwealth revenues allocated to local government

The Commonwealth system by definition implies ongoing taxation transfers to other levels of government to deliver vertical fiscal equalisation. Local government is a net spender and the Commonwealth a net collector.

Accordingly this submission does not address horizontal equalisation and the issue of minimum grants. The focus is squarely on increasing the overall pool. Only then can the issue of horizontal distribution be considered. It is clear however that there are many justifiable instances of remote municipalities, for instance, being retained and supported with a higher level of commonwealth grant than other municipalities. These arrangements need to be continued.

The formula for distribution of these funds varies from State to State. We note that in the past there have been proposals to review these formulae and the minimum grant arrangement. There would be significant shortcomings associated with altering the quantum of minimum grants:

- it may penalise councils that may have worked hard to minimise their costs and increase their efficiency; and
- many minimum grants councils still have some viability issues that would be exacerbated if minimum grants where reduced or eliminated.

The current level of intergovernmental grants (and the lack of appropriate indexation) arguably does not achieve efficiency and equity in local government operations nor help to:

- realise service outcomes for the community beyond those that could otherwise be achieved through local government revenues;
- support facilities that have positive externalities; or
- meet the growing cost of delivering services, undertaken for other tiers of government, that benefit the community.

This makes it more difficult to ensure horizontal equity between councils and to allow all councils to have the opportunity to provide minimum acceptable standards of service, and to provide and maintain efficient infrastructure to support commerce including important transport links – the 'last link' in national transport chains.

3.10 Summary

Council rates are the single most important source of own-revenue for local governments. Australia is unique among federated OECD counties in its total dependence on property as the only form of local government taxation.

While property rates are a relatively efficient and administratively simple form of tax, the major disadvantage is that it is a narrow tax and the tax base is shared with State governments. Consequently, local governments may face challenges in increasing property rates without exclusive access to the property tax base, further limiting their autonomy. Crucially, rates fare poorly in the context of providing a growing source of revenue to match growing community demands for services.

Another disadvantage of the property tax is that it potentially violates the equity criterion among local government citizens. As rate payments are made from an individual's disposable income, increasing the rating effort would fall heavily on those who have a lower ability to pay, such as elderly residents, those with low incomes or those residing in rural and remote areas. Property rates are also a relatively unpopular tax as they are subject to direct annual or semi-annual payments and highly visible to the taxpayer. Therefore, while local governments may seek to increase rates, community resistance may deter any such movement.

Moreover, State government legislative restrictions on the valuation method, rate capping and making properties exempt from tax render it more challenging for local government to increase rates in line with demand for local government services. Revenue figures show that those jurisdictions that allow councils themselves to choose between the three main rate calculation methods[9] tend to have the highest average rate revenue per capita, and also the highest rate revenue increases.

An alternative major source of revenue for local governments is user charges and fees. There is already a high degree of reliance on user charges by the local governments with the sector recovering almost 36 per cent of all expenses, compared to 13 per cent for all tiers of government. Within statutory limits, councils could further expand revenue generated by user charges where they can increase cost reflectivity.

However, there are significant challenges for some councils in being able to increase user charges. While having strong support from an economic efficiency perspective, user charges are often difficult to apply efficiently without sufficient cost data. In addition, local governments need to balance competing efficiency and equity concerns and consider their community's ability to pay for higher charges.

[9] The three methods include the unimproved capital value (UCV), the improved capital value or the annual rental value of the property.

More specifically, user charges are appropriate for services that are able to allocate the benefits to the user. However, many local government services are 'mixed goods' — this requires local governments to determine the extent to which the liability for a given service should be apportioned between the individual and the wider community (through general revenue).

Given that local governments have few options open to them to raise their own revenue, they consequently rely heavily on transfers from the Commonwealth and State governments. Over recent years, there has been an insufficient indexation of grants from higher levels of government with grant funding not being maintained in real per capita terms. The declining share of FAGs as a proportion of the Commonwealth tax take means that local governments are not able to meet the needs of the community in maintaining infrastructure and delivering community services.

The Australian CEOs Group therefore considers that vertical fiscal imbalance can only be achieved if either:

- sufficient taxation powers are transferred from the Commonwealth to the State and/or local government sectors; and/or
- additional funding is provided by increasing Commonwealth FAGS to local government.

These reform options are discussed in Chapter 4.

Chapter 4

What reforms could be achieved to improve local government revenue raising capacity?

This chapter identifies reform options to address key impediments to local government having more appropriate revenue levels given their responsibilities and contribution to the national economy and community well being.

4.11 Introduction

Chapter 3 identified three main impediments to local government having more appropriate revenue levels.

- First, local government draws upon a relatively narrow tax base, which is also taxed by State governments via land tax. Moreover, the tax base available to local governments is restricted to the unimproved value of land in some States, as distinct from the broader base of capital improved value (land and buildings).
- Second, there are significant restrictions on the ability of local government to raise its own revenue:
  - the New South Wales Government's policy of 'rate pegging' sets an arbitrary ceiling on rate increases in that State;
  - some State governments place restrictions on the fees that local government can charge for some services;
  - in most States, State government entities, charitable and benevolent organisations and pensioners are granted concessions or exemptions from paying council rates — often by State law; and
  - even without these restrictions, many local governments experience difficulties in setting rates at levels that would generate sufficient revenue, given the inherently regressive impact of the tax and their community's capacity to pay.
- Third, Australian Government FAGs to local government have not matched growth in the economy or maintained their share of overall taxation revenue. This has a particular impact on councils with limited capacity to generate their own revenue, given the size and ability to pay of their local populations and the extent of the commercial and industrial activities undertaken within their boundaries.

This chapter puts forward reform options to address these issues:

- Section 4.2 puts forward a proposal to broaden local government's rate base;
- Section 4.3 examines opportunities to deregulate State government restrictions on local government's ability to raise revenue from its own sources; and
- Section 4.4 considers reforms to FAGs that would better support the sustainability of the local government sector.

The reform options and recommendations below should not be considered in isolation from each other. There are considerable advantages in combining several recommendations to ensure that the failures of local government revenue raising are adequately and effectively addressed in a balanced way.

The Australian CEOs Group considers that Recommendations 1-5 should be jointly undertaken as a package of reform measures, and requires significant collaboration with State governments and the Northern Territory government. Recommendation 6 requires leadership by the Australian Government in FAG arrangements to minimise vertical fiscal imbalance.

There are many potential benefits from improved funding of local councils in its ability to respond to the demands of a community (summarised in Box 4.7).

Box 4.7

POTENTIAL COMMUNITY BENEFITS FROM IMPROVED FUNDING OF LOCAL GOVERNMENT

- Strengthen local communities by ensuring an adequate standard of facilities for the ongoing provision of a range of significant social and recreational services.
- Provide for greater choice and consultation on council provided services and infrastructure, and encourage more participation in community activities raising levels of inclusion and wellbeing. This would promote increased community cohesion and safety, particularly in rural areas.
- Enable the implementation of local programs that recognise the diverse needs of communities and support cultural diversity, access and equity, equal opportunity, involving minority groups.
- Support sustainable environmental strategies for each community to improve local environmental outcomes.
- Enhance business and community links with regional areas to promote regional equity and development.
- Promote further economic development and the generation of employment benefits through links with the business community.
- Improve the quality of life of local residents through the support and alignment of health and welfare agencies within the area.
- Support local recreation, arts and culture and an appreciation of heritage in order to promote vibrant and active communities.
- Basic roads, drains, paths, car parks and open spaces.
- More pro-active role in community health and healthy ageing activities.
- Indoor sports and cultural services.

4.12 Broadening local government's rate base

Local government taxation revenue is limited to rates charged to property owners, generally based on the land value of council-provided services. The approach to calculating and applying rates is determined by State governments and varies significantly between jurisdictions:

- rates charges in New South Wales, the ACT and Queensland are based on the unimproved capital value of the land;
- councils in Victoria, South Australia, Tasmania and the Northern Territory are able to choose between a range of valuation systems; and

- rates in non-rural areas of Western Australia are based on the net rental value of the land, while rural land is predominantly assessed on the unimproved capital value.

Local government would have a broader tax base if all councils levied rates on the capital improved value of property, recognising that this could require States to monitor the joint impact with their own land taxes. In addition, rates based on the capital improved value may be more equitable than rates based on the unimproved value, as income is related more closely to property values than to land values. It may be perceived as a fairer system as ratepayers would be better able to relate the value of their property to the rates they are levied (NSW Independent Inquiry 2006, p. 213).

Local government should also be free to maintain the same rate percentage (cents in the dollar) on this base, rather than deriving the rate as what would be required to achieve a given revenue. Currently, councils in some jurisdictions commonly change their property tax rate after properties are revalued to achieve a given — restrained — rise in revenue to appease State governments should they exercise the power to cap rates.[10]

By allowing local councils to levy the improved value of property and by maintaining the same rate percentage, such reforms would grow revenues more closely in line with the economy than the value of the land alone, so over time councils would have greater capacity to meet their service and infrastructure responsibilities through their own revenue sources.

There are two potential disadvantages of this reform whose effects would need to be carefully managed:

- *efficiency* — rates levied on the improved value of property would be a tax on capital, and may discourage development (unless there were offsetting reductions in land tax). The current system of unimproved capital value operates as an economic incentive to develop land (other than owner-occupied residential property) to be productive in order to meet the level of rates; and
- *administratively simplicity* — the valuation of properties for rates purposes would become more complex.

However, these two impacts are likely to be smaller for local government and the community.

Recommendation 1

State governments should allow local governments the unrestricted ability to set their rates (for example, by maintaining the same rate percentage between years). The tax base should be amended to allow the capital improved value of property to be used as the base.

[10] For example, the *Local Government Act (Victoria) 1989, Part 8A* allows the State Minister to limit (by giving directions to) a local council's income from rates and charges.

4.13 Removing barriers to local government raising revenue

Deregulation of local government rates and charges

New South Wales is the only State that places a cap on local government rates. The Hawker Committee (2003, p. 118) found rate pegging to be a major issue that was 'raised by nearly all councils in [New South Wales] as a significant impediment to revenue raising.'

Rate deregulation would bring New South Wales into line with all other States. New South Wales councils should be accountable to their local constituencies — rather than the State Government — for their taxation policies. This would allow the local community to have its say on the level of service delivery that it is willing to support through rate payments. A 2005 poll found that a majority of New South Wales residents (61 per cent) have either high or medium confidence in their councils setting their own rates and charges and spending the money efficiently on relevant local services (IRIS Research 2005).

State governments also regulate a significant number of the fees and charges that are levied by local government. These include planning fees, developer contributions, waste inspection and control fees, parking fines and some community service fees. Where the State government regulated fees do not adequately reflect local government's costs in delivering particular services, general rates can end up excessively subsidising users of those services (Financial Sustainability Review Board 2005, p. 56).

The City of Stonnington in Victoria described its situation at a public hearing for the Hawker Committee (2003, p. 120):

> One of the big causes of cost shifting is revenue denial, in effect, by the State, which could be looked at in the next agreement. I will give you a very practical example. In my city between 15 and 20 per cent — I cannot remember the exact percentage — of my revenue comes from fees I charge which are totally controlled by the state. …. I have probably 70 or 80 statutory charges which they have not put up for five years … [which] effectively means that I have to put another 1 per cent of rates on, because I have a section of my income that is going nowhere.

Deregulation of local government fees and charges would provide greater autonomy for councils to manage their finances. Councils could determine the appropriate level of fees and charges to recover the costs of their activities, taking account of the demand for services, cost pressures, its other revenue streams and the community's ability to pay. As with rate deregulation, voters would have the opportunity to hold councils accountable for the fees and charges that were levied. Councils with a strong potential revenue base and a more affluent community could be expected to match increases in their financial requirements with additional own-source revenues.

The Hawker Committee (2003, p.120) concluded that rate capping and the regulation of fees and charges is inconsistent with local government being fully accountable for its own financial circumstances. Similarly, the NSW Independent Inquiry (2006, p. 306) recommended that NSW State Government free councils to determine their own income by removing statutory limitations on their rates and fees in return for councils adopting longer term strategic and financial planning with outcome targets.

In sum, the potential benefits from removing statutory limitations on local government rates, charges and fees include:

- *greater local autonomy* — councils would be more accountable to the local community in general and ratepayers in particular and would have greater flexibility to meet changing community needs;
- *increased financial adequacy* — without revenue flexibility, the infrastructure backlog faced by local government is likely to escalate; and
- *improved efficiency* — user charges that more accurately reflect the costs of service provision would improve market signals and reduce excess demand.

Recommendation 2

The New South Wales Government should remove its restrictions on rate pegging, leaving councils to determine the appropriate rate levels for their communities.

Recommendation 3

All State governments should review their regulations on local government fees and charges with the objective of removing all regulatory restrictions where there is not a clear public interest in State governments retaining such powers.

Reform of rate exemptions and concessions

The majority of State governments provide rate exemptions and concessions to a range of potential ratepayers, including State government bodies, charitable and benevolent organisations including schools and hospitals, and pensioners. These exemptions and concessions are inconsistent across jurisdictions and do not always equitably reflect the ability of ratepayers to pay. For example, in some jurisdictions, quasi-commercial entities such as private and independent schools, hospitals and aged care facilities are classified as charitable and benevolent organisations and are exempt from paying rates, despite having significant asset and resource bases (PwC 2006, p. 127). In addition, some State government corporations pay the equivalent of rate payments to their State treasuries (to meet competitive neutrality requirements) without this money being transferred to local government.

Reform of rate exemption and concession arrangements could significantly improve the revenue raising capacity of local government. Exemptions and concessions can be very expensive for councils. Pensioners can comprise a large proportion of a council's constituency. Some State governments do not fully compensate councils for mandatory exemptions and concessions, despite the State governments being responsible for them. Councils still have to meet the service and infrastructure needs of exempt and concession-status properties. The cost of maintaining services and infrastructure to exempt organisations such as government agencies, schools and hospitals can be considerable due to their large land holdings and the traffic generated by their operations (PwC 2006, p. 127).

Potential reform options include:

- Australian Government and State government organisations could pay rates to local government to reflect the cost of servicing those properties (Hawker Committee 2003, p. 50);

- State governments could review rate exemption categories to take into account the ability of exempted groups to pay (PwC 2006, p. 127);
- State governments could fully compensate local government for those exemptions required by State law (PwC 2006, p. 127); and
- State governments could repeal their requirements for rate exemptions and concessions, leaving them to be determined by local government (Hawker Committee 2003, p. 50).

In sum, the potential benefits from reforming rate exemptions and concessions include:

- *greater horizontal equity* — by not allowing exemptions for those with a capacity to pay (such as Commonwealth and State owned land); and
- *increased financial adequacy* — increased revenue from those with a capacity to pay.

Recommendation 4

Australian Government and State government organisations should pay rates to local government to reflect the cost of servicing those properties.

Recommendation 5

State governments should review their requirements for rate exemptions to take into account the ability of exempted groups to pay. State governments should fully compensate local government for those exemptions that are retained.

It is noted that freeing up the ability of local governments to raise own revenues via the means discussed in the sections above could increase disparities as between better off and less well off councils. However, this could be addressed through reform of the way that FAGs are distributed (increasing the degree of distribution effected). The next section covers this issue.

4.14 Reforms to Financial Assistance Grants

Recommendations 1-5 presented in the previous sections would not represent a funding panacea for local government. While the financial position of all councils would stand to improve, many would remain unable to raise sufficient revenue due to the relatively narrow tax base and the regressive impact of council rates on communities with limited ability to pay. Councils without strong revenue bases would remain dependent on Australian Government FAGs to meet their service delivery and infrastructure responsibilities.

This section provides several options to reform the purpose and administration of FAGs which can assist local governments meet their core responsibilities. The capacity of local governments to perform these roles requires consistent reform across Australia. This in turn may lead to savings, which could be redirected into the FAGs quantum and redistributed to councils most in need. With this financial support comes a clear responsibility on local governments to manage their expenditure responsibly and to be accountable to their constituents.

As shown in section 3.3, the level of FAGs has been inadequate to meet growth in demand and the rising cost of providing infrastructure and services. Some councils facing funding constraints have diverted capital expenditure to meet operational needs, exacerbating the infrastructure backlog across the country (PwC 2006, p. 136). As local government is responsible for a large proportion of Australia's physical infrastructure, this is an issue of significant concern, not limited to local government, which needs to be addressed on a national basis. There is a need to increase both the quantum and growth rate of FAG funding to better support the sustainability of the local government sector.

This section considers the merits of three approaches to reforming FAGs:

- increase FAGs and change the FAG escalation method;
- top-up FAG funding and distribute to councils most in need; and
- reduce minimum grants so that FAG funding is distributed to councils most in need.

Increase FAGs and change FAG escalation method

At present FAG funding is escalated at the national level by CPI and population growth indexation. The intention is to maintain FAG funding at a constant real rate per capita. As a result of this approach, local government has not shared in the substantial growth in federal taxation revenue of recent years.

At the same time, the role of local government has been expanding (see Chapter 2), and the community has grown to expect better quality service delivery from all levels of government. As a consequence there is now a growing mismatch between service delivery responsibilities and revenue raising capacities, exacerbating vertical fiscal imbalance.

As noted in Chapter 3, if local government revenues as a share of total Australian government revenues had been maintained over this period, the local government sector would have received an additional $3.4 billion (nominal terms) between 1998-99 to 2005-06.

One reform option that would be relatively simple to implement would be to change the escalation rate of the FAGs. The current indexation approach based on inflation and population could be replaced by:

- setting FAGs as a proportion of gross domestic product (GDP);
- setting FAGs as a proportion of Commonwealth Government tax revenue; or
- escalating FAGs annually by a specially constructed local government cost index.

The first two approaches would effectively provide local government with funding support based on a growth tax. Local government has repeatedly called for tax sharing arrangements that are supported by a growth tax to ensure that funding to local government grows at roughly the same rate as national taxation revenue and as community expectations of service delivery. For example, the Australian Local Government Association has called for an increase in FAGs to 1 per cent of total Australian Government taxation revenue (Australian Local Government Association 2007).

In terms of simplicity, Commonwealth taxes may be easier to audit than GDP and not subject to extensive and frequent revision like national accounts data (NSW Independent Inquiry 2006, p. 308).

The third potential approach is to link funding increases to the increase in a local government cost index. Local government costs have typically grown at about 2 to 3 per cent above inflation, thus constantly eroding the value of the FAGs to local government (PwC 2006, p. 137). This would provide better support to local government service delivery, putting less pressure on their capital renewals spending. Using a local government cost index would avoid one potential shortcoming of the previous two approaches: that the rate at which FAGs funding is fixed could be considered arbitrary. The merit of a cost index approach would, however, depend upon the accuracy with which such an index could be constructed.

Each of these approaches would provide local councils with greater certainty of income going forward.

Top-up FAGs and distribute to councils in need

A second reform option is for the Australian Government to provide an increase in FAGs funding, with the proviso that the funding is distributed only to those councils most in need. The existing allocation approach sees 70 per cent of FAGs funding directed to councils most in need. The quantum of the additional funding that could be directed to councils most in need could be apportioned according to the following:

- 10 per cent of current FAGs funding levels, which would be approximately $170 million in 2006-07; or
- the quantum of the shortfall in FAGs from there being no increase in funding for inflation in 1997-98, which was about $171 million (PwC 2006, p. 137).

Not surprisingly, these two top-up approaches would result in similar outcomes. However, there would be significant improvements to the financial adequacy for individual local councils with limited revenue bases.

Conclusion

The options for reform to FAGs are concerned with one outcome:

- the adequacy of the overall quantum of FAG funding to local government; and

A more adequate level of FAG funding would be best achieved and maintained by increasing the quantum of FAGs and changing the escalation method. Indexing FAG funding so that it is tied to the growth of the economy — after setting a more appropriate level — would be preferable to providing top-up funding, which would improve the adequacy of local government funding in the short term, but would not provide for longer term sustainability.

Recommendation 6

The Australian Government should reform its Financial Assistance Grants to local government by:

- *setting FAG funding as an appropriate fixed proportion of Australian Government taxation revenue, such that local government's share of overall government revenue adequately reflects its share of responsibility for national infrastructure and service delivery; and*

Appendix A

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