

PRODUCTIVITY COMMISSION
**STUDY INTO LOCAL GOVERNMENT'S OWN-SOURCE
REVENUE**
Australian Local Government Association submission
July 2007

Background

i. Australian Local Government Association

The Australian Local Government Association (ALGA) is constituted as a federation of the peak local government associations in the six states and the Northern Territory, together with the Government of the ACT. ALGA provides a focused and representative voice for local government and also speaks for local government nationally through its membership of the Council of Australian Governments (COAG) and a number of ministerial councils.

ii. Submissions from local government

In order to cover the range of issues experienced by the local government sector, the Australian Local Government Association and the State Local Government Associations have agreed on the following approach in the preparation of individual submissions to the Productivity Commission:

- ALGA's submission will cover issues associated with local government revenue raising capacity – at the national level. It will explore the principle of vertical fiscal imbalance, the need for a growth tax (ie a fixed share of commonwealth revenue), the changing role and demands placed on local government over recent decades and the issue of long term financial sustainability of local councils.
- State Associations submissions will directly address the questions raised in the Productivity Commission's issues paper. These are focused at the regulatory regimes, and outcomes, at state/local level.

- Where possible, individual councils will make submissions focused on local issues as they affect the day to day operations of councils.

iii. Summary of key issues

ALGA's submission provides a summary of local government's financial position – outlining the revenue sources and expenditure trends (ie changing service delivery, changing community expectations) over time.

Local government collects some 85 per cent of its revenue from its own sources – predominantly municipal rates, and fees and charges. However, due to the diversity of local councils, capacity to raise own-source revenue varies significantly.

This is in part recognised by the application of the principle of horizontal equalisation in the distribution of the Federal Government's Financial Assistance Grants to local government.

The changing demographic characteristics of the Australian community have seen the range of services provided by local government change over time. In addition to traditional property services, councils now also provide a wide range of regulatory, planning, coordination and human services. Taxpayers do not generally distinguish (or care) which sphere of government is responsible for service delivery.

Under Australia's Federal system, more than 80 per cent of all tax is collected at the national level. However, in line with the principle of subsidiarity, government services are provided by that level of government able to deliver the services most effectively. To address the disparity between service delivery responsibilities and revenue collection, a system of intergovernmental financial transfers exists. Local government has been a part of that system since the 1970s following the establishment of the Local Government Financial Assistance Grants (FAGs). The relative value of the FAGs, however, has declined from 1.01 per cent of total Commonwealth revenue in 1995-96 to an estimated 0.74 per cent in 2008-09. This has exposed local government to considerable financial stress.

Local government has undertaken an analysis of its long-term financial sustainability at the national level with a PricewaterhouseCoopers (PwC) report identifying significant backlogs in infrastructure investment and renewals as a symptom of financial sustainability challenges. Rural and remote councils are more likely to be under financial stress.

PwC acknowledged the significant progress made by local government to improve its own efficiency but also noted the need for further internal reforms to ensure that councils are operating as efficiently as possible. Local government recognises the need for efficiency improvements and has made significant progress in this area over the past

decade. However, this reform process needs to continue, particularly in the area of asset management.

Local government has access to a very narrow tax base. Only 3-4 per cent of the nation's total tax is collected at the local government level – resulting in a major disparity between revenue collection and service delivery/community expectations.

Local government's only tax is property tax (ie rates). However of the total property tax collected across Australia, only one third is collected by local government, with the other two thirds being an integral part of state governments' revenue base.

Services now being provided by local government have become very diverse, calling into question the suitability of property taxes as a key revenue source. Rates are an appropriate tax to fund services to property, but they are far less appropriate to fund broader community services which address general issues of redistribution.

iv. Key principles for consideration in reading this submission

The Productivity Commission study into local government's own-source revenue follows on from the Report of the House of Representatives Standing Committee on Economics, Finance and Public Administration Inquiry into Local Government and Cost Shifting (Hawker Report) which was released in October 2003. The Hawker Report was one of a number of reports and reviews undertaken both by local government and other bodies to examine local government funding and related issues.

Own source revenue has an important part to play in local government resourcing but it is only one part of a very complex issue. Local government own-source revenue is predominantly rates and fees and charges, and there are limitations on using these sources of funding:

- Councils provide a wide range of 'non-commercial' infrastructure and services (eg youth services, aged care, sporting facilities and other community programs) Not all of these activities can be cost-recovered through user pays fees and charges (but where they can they should be)
- Changing demographics have seen the types of services provided by councils change dramatically over time. While councils still provide property services, they now also provide a wide range of human services (redistributive services). Attempting to fund these redistributive services through increased property-based taxes is not appropriate and could result in high need/low capacity to pay councils not being able to provide adequate service delivery.
- The capacity of individual local councils to raise own-source revenue varies dramatically. However the expectation of local communities across Australia for

the types of services provided by local councils, especially community-based services, is relatively consistent.

- Redistribution of taxes should be based on the principle of horizontal equalisation to ensure that a similar level of service is provided across local government boundaries.
- Total taxation should pay for all non-commercial government services. Local government is primarily a service provider with limited taxation and revenue raising capacity under the federation, which provides that surplus federal funds should be redistributed to address the issue of vertical fiscal imbalance (VFI).
- Rates as the only form of local government taxation cannot be redistributed between councils. This means that high capacity to pay councils would have a greater level of service than low capacity to pay councils.

Councils have made considerable efforts to exploit own source revenue to the greatest degree – demonstrated by the increase over time in rate revenue and in fees and charges. However, this has not been enough for councils to avoid financial sustainability problems (see PwC and state reports).

Councils have made themselves more efficient (see PwC) and will continue to do so.

There has been recognition at the Federal level that provision of equitable standards of local government services can only be achieved through inter-governmental financial transfer. The Financial Assistance Grants, which have been in place since 1974-75, recognise in their distribution mechanism the relative capacity of councils to raise revenue.

A review of own source revenue-raising will not address the circumstances and differences facing individual councils. It will not address the changing nature of services provided by councils and the growing demand for broad social services best funded through general tax transfers. And it will not address the adequacy of the current intergovernmental transfer mechanism.

The PC review is focused quite narrowly on whether local government is getting the most out of its own source revenue. However this should not be considered in isolation from the bigger picture of the increasing demands on local government service delivery and the need to ensure local government is properly resourced to undertake its role.

The ALGA submission provides an overview of the local government sector as it currently exists in Australia.

Issues

1. Overview of local government sector

Local government is an integral element of the governance of Australia, accounting for around 2% of GDP, employing around 165,000 people and being responsible for an estimated \$183 billion of non-financial assets/infrastructure. There are currently around 700 local governing bodies. The sector is very diverse with councils ranging from the Brisbane City Council, with a population of almost one million and a budget of around \$1.7 billion, to small remote councils with populations of less than 500 and annual budgets of a few million dollars.

Local government's revenue was around \$21.4 billion in 2004-05, with about 85% of this revenue raised by local government itself, primarily through rates and the sale of goods and services. Grants from other governments in 2004-05 totaled about \$2.9 billion (around 14% of local government's revenue), with grants from the Australian Government accounting for about \$2.0 billion.

Local government's expenditure matches its level of revenue and is directed to four major activities: transport and communications; housing and community amenities; general public services and recreation and culture. Expenditure on human services has increased markedly since the 1960s with a corresponding fall in the proportion of expenditure on transport and communication services.

Local government raises around 85 per cent of its revenue from its own sources. It has three major sources of revenue: municipal rates (ie. taxation, which accounted for 38% of revenue in 2004-05), charges for goods and services (31% of 2004-05 revenue) and grants and subsidies from other levels of governments (around 15% of 2004-05 revenue).

Over the period 1998-99 to 2004-05 local government's own-source revenue stream increased from 83.5 per cent to 86.6 per cent of its total revenue.

Local government's ability to collect more revenue is limited by a number of factors. These limitations include legislative and regulatory restraints imposed by State and Territory Governments. However, it needs to be recognised that even if these restrictions were lifted, the community's capacity to pay additional taxes, fees and charges to local government would be unchanged. Rates, which constitute local government's only form of tax revenue, account for only a third of the property taxes levied on the community. The states now collect two thirds of all property tax, having effectively crowded out the ability of local government to raise more revenue through property taxes. At the broader level, local government rates account for less than three percent of taxation, with the Federal Government raising well in excess of 80 per cent of taxation revenue.

Furthermore, local government revenue and expenditure is evenly matched (with many councils confronted by long-term financial sustainability issues), state governments

generally run only small surpluses, while at the Federal level major budget surpluses have become commonplace – demonstrating the structure of the Australian tax system, whereby services are predominantly delivered at the state and local level and the majority of revenue is collected at the national level.

2. Summary of local government financials

Table 1 provides a breakdown of the revenue received by local government from its own sources, compared to state and federal transfers for the period 1998-99 to 2004-05.

Table 1: Local Government Sources of Revenue from 1998-99 to 2004-05

	1998-1999	1999-2000	2000-2001	2001-2002	2002-2003	2003-2004	2004-2005
States	1,013	1,432	1,482	1,199	1,023	958	1,020
Total Commonwealth	1,473	1,476	1,436	1,889	1,729	1,853	1,859
<i>Commonwealth SPPs</i>	240	205	111	503	279	368	311
<i>FAGs</i>	1,233	1,271	1,328	1,394	1,455	1,501	1,555
Local government own source revenue (incl. taxation, sales of good and service, interest and other)	12,498	13,249	13,993	14,761	16,338	17,313	18,580
Total	14,974	16,157	16,911	17,849	19,090	20,122	21,459

Source: ABS unpublished data, DOTARS *Operation of the Local Government (Financial Assistance) Act 1995* reports and state data

Rates

There is a large disparity between individual local governments in their ability to raise revenue due to large differences in local tax bases (rating ability) and differential ability to levy user charges among urban, regional, rural and remote councils. Variables that influence an individual council's rating ability include unimproved capital values of ratable land (residential, commercial and rural), and the number of ratable properties within a jurisdiction.

There is only modest consistency in the rates methodology used between the states. However there are broadly two approaches either using unimproved capital value (UCV) (used in NSW, Qld and ACT) or allowing councils to choose between UCV, the improved capital value or the annual rental value of the property (Vic, SA, Tas and NT). In WA local governments have both unimproved and annual rental value applied to rural and urban land respectively.

There are also significant rate exemptions and concessions that are usually required by state governments and often supported by local governments, which typically include:

- pensioner concessions (funded by state governments in some jurisdictions)

- charitable/benevolent organisations often receive rate exemptions, which can include public schools and hospitals, and
- government-owned land may get either concessions or exemptions.

Additionally, mining and pastoral properties are exempt from rates in some jurisdictions. In WA, Agreement Acts prior to January 2005 restricted rating of mining leases to UCV, though certain areas used for buildings can be rated at annual rental values. State governments do however also provide some concessions to local government, e.g. payroll tax exemptions.

Local government taxation revenue has increased steadily by around 2.8% per annum in real terms from 1974-75 to \$8.1 billion in 2004-05. As a proportion of total public sector tax revenue, local government taxation revenue fell from 3.54% in 1998-99 to 2.97% in 2004-05.

Sales of goods and services

In the 1970s revenue from the sale of goods and services comprised 13% of total local government revenue. In 2004-05, revenue from the sale of goods and services accounted for about 30.8% of total revenue (\$6.6 billion) and has remained around 31% of total revenue since 1999-2000.

This reflects the significant increases in the number and diversity of services and more disciplined cost recovery pricing for water and sewerage services under National Competition Policy. Revenue from the sale of goods and services also includes charges for development applications and approvals and use of recreational and cultural facilities. In many jurisdictions state governments set statutory limits on fees and charges.

The proportion of revenue attributable to the sale of goods and services varies between jurisdictions from a high of around 40% for Queensland and Tasmania (jurisdictions in which local government provides water and sewerage) to less than 20% in Victoria and SA.

Other revenue sources

Revenue from interest earned amounted to \$591 million in 2004-05 (about 2.7% of total local government revenue).

Other revenue, not identified elsewhere (which includes asset transfers and tied revenue such as contributions by developers to the cost of associated infrastructure works) accounted for \$3.3 billion in 2004-05.

Grants

Grants from other spheres of government are an important component of local government revenue.

Current grants and subsidies to local government are provided by either the Australian or the relevant state government and can be untied, specific purpose payments or made under partnership funding arrangements. There are also capital grants to local government for specific purposes, although these tend to be relatively minor overall, but significant at the state level. While as a whole local government derives around 14% of its revenue from all types of grants and subsidies, the level of reliance on grants varies significantly between local governments, with rural and remote councils generally far more reliant.

Current grants and subsidies to local government accounted for \$2.2 billion of local government's revenue in 2004-05 and have increased in real terms by 3.3% pa since 1974-75. Capital grants accounted for an estimated \$0.7 billion in 2004-05.

Australian Government transfers – Financial Assistance Grants (FAGs)

The Australian Government has been providing untied financial assistance to local government since 1974-75. Grants for local governing bodies in the Northern Territory began in 1979-80 after the Territory achieved self-government, and a grant to the ACT for municipal services began in 1988-89, again after self-government was granted.

Australian Government assistance through Financial Assistance Grants (FAGs) has grown from \$56 million (1974-75) to \$1.55 billion in 2004-05, an increase of 5.8% pa in real terms. Much of this growth relates to the untying and incorporation into FAGs of roads grants in 1991-92, grants which were formerly SPPs paid through the states. Between 1976 and 1985 the FAGs were set as a proportion of net personal income tax collections. From 1986 to 1995 the FAGs generally increased at a rate equal to the increase in the general purpose payments to the states. Since 1995 the rate of increase has generally been equal to growth in population and the consumer price index, with a one-off exception in 1997-98 when grants were escalated only for CPI and not for population growth.

The FAGs are provided under the *Local Government (Financial Assistance) Act 1995* and are paid through the states. The FAGs have two components: general purpose grants (\$1.1 billion in 2004-05) and identified roads grants (\$0.48 billion in 2004-05).

General purpose grants increased from \$56.3 million in 1974-75 to \$1.1 billion in 2004-05, an increase of 4.5% pa in real terms. The FAGs included untied local roads grants (previously provided as tied roads grants through the states). The identified roads grants are escalated at the same rate as the general purpose grants and have grown from \$303 million in 1991-92 (the first year the grants were untied) to \$478 million in 2004-05.

The objective of the grants is to improve the capacity of each local governing body to provide its residents with a level of services that is equitable with the level of services provided by other local governing bodies in a particular state. These grants are untied and can be spent according to the priorities of their communities. The identified local

roads grants were introduced in 1926 as tied grants allocated by state road authorities and were originally intended to help councils with the cost of maintaining their local roads.

The general purpose component of the FAGs is divided amongst the states on a population basis. In contrast, the identified roads grants are allocated to the states on the basis of fixed shares, inherited from the tied grant arrangements that applied before 1991. The grants can be expended by local governments according to their own priorities, and there is no compulsion to expend funds on local roads (although under the Roads to Recovery program councils are required to maintain previous levels of road spending in order to qualify for funding under the R2R program).

The total amount of funding is escalated each year (based on population growth and the increase in the consumer price index) to maintain the real per capita value of the FAGs. However, there is no consideration of the level of real cost growth being experienced by local government in determining the annual escalation.

Under the auspices of the *Local Government (Financial Assistance) Act 1995*, the states and the Northern Territory distribute the funds to local governing bodies in accordance with recommendations by local government grants commissions (LGGC). Each jurisdiction has developed its own model. They are required, however, to adhere to seven national principles, the purpose of which is to ensure that there is a nationally consistent basis for distributing FAGs to local government under the Act.

The minimum grant principle establishes that 30% of the general purpose grants within a state are allocated to councils on the basis of population. Thus each council receives a minimum grant (currently equal to just under \$16 per capita) independent of its needs. The allocation of the remaining general purpose grants within a state is on an equalisation basis as recommended by the relevant LGGC, taking account of the assessed needs of each council (revenue raising capacity versus required expenditure). Distribution of the local road component is based on assessment of councils' road expenditure needs.

After a LGGC has determined the grant distribution, the state Minister recommends the allocation to the Australian Government Minister. The Australian Government provides funding to each state government as a tied grant to be passed on to councils without undue delay or condition in accordance with the approved distribution.

Since 2004, South Australia has received a supplementary SPP for local roads (\$13 million in 2006-07). This funding to South Australian councils is to address the funding disadvantage experienced by South Australia under the local roads component of the financial assistance grants.

Other Australian Government transfers - SPPs

In addition to FAGs, the Australian Government also provides funding directly to local government under a number of specific purpose payments (SPPs). SPPs help fund local roads, child-care programs and facilities for the seniors and people with a disability. The

Roads to Recovery Program (R2R) is a major SPP to local government that is underpinned by legislation. The total value of SPP payments direct to local government in 2004-05 was \$311m.

Local government is also eligible to apply for funding under programs administered by a number of Australian Government departments. This is program specific funding and local government must enter into a competitive process with other potential recipients. This funding is not reported to the ABS and is not included in this submission.

State government transfers

The states (including the Northern Territory) provide grant funding to local government for specific purposes and services – directed at a wide variety of purposes.

It is difficult to measure the quantum of this funding. Some jurisdictions do not identify such funding separately in state budget documents, grant income is not accurately reported by all local governments, and definitional differences exist in ABS data. Nevertheless, available data show that the quantum of state funding to local government (and consequently the balance between Commonwealth and state funding to local government) differs significantly between states and territories.

2.2 Expenditure

Over the past 40 years, the local government sector has provided increasingly diverse services and functions.

The Commonwealth Grants Commission (CGC) in its ‘Review of the Operation of the Local Government (Financial Assistance) Act 1995’ released in June 2001 analysed local government expenditure over the period 1961-62 and 1997-98 and stated that the composition of services being provided by local government had changed markedly with local government increasingly providing human services at the expense of traditional property-based services (particularly roads). ABS figures for the period 1998-99 to 2004-05 confirm that the composition of services provided by local government has remained relatively stable during that period.

The CGC noted that local governing bodies stated that some changes were the result of the changing priorities of local government, whereas others were imposed on them by other spheres of government. The CGC identified the following local government expenditure trends in its review:

- adding a range of social services to the traditional planning and building approvals, road maintenance and waste services
- increase in the relative importance of recreation and culture, and housing and community amenities
- expansion of education, health, welfare and public safety services, and

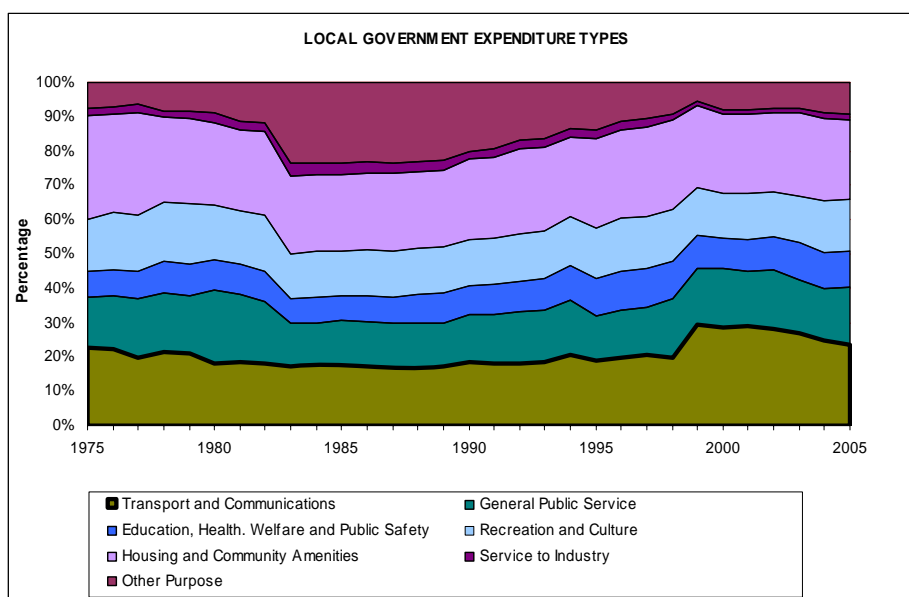
- gradual decline in the relative importance of road expenditure as spending on other services has seen faster growth rates.

Figure 1 shows the breakdown of expenditure for local government according to service and infrastructure requirements aggregated on a national level. Expenditure patterns are relatively evenly spread over the following four major categories:

- Transport and communications;
- Housing and community amenities;
- General public services; and
- Recreation and culture.

Expenditure patterns spread over a number of different areas demonstrate the importance and diversity of the services and infrastructure provided by local government.

FIGURE 1 – LOCAL GOVERNMENT EXPENDITURE TYPES



Source: ABS Government Finance Statistics (Cat. No. 5512.0) and unpublished Government Finance Statistics

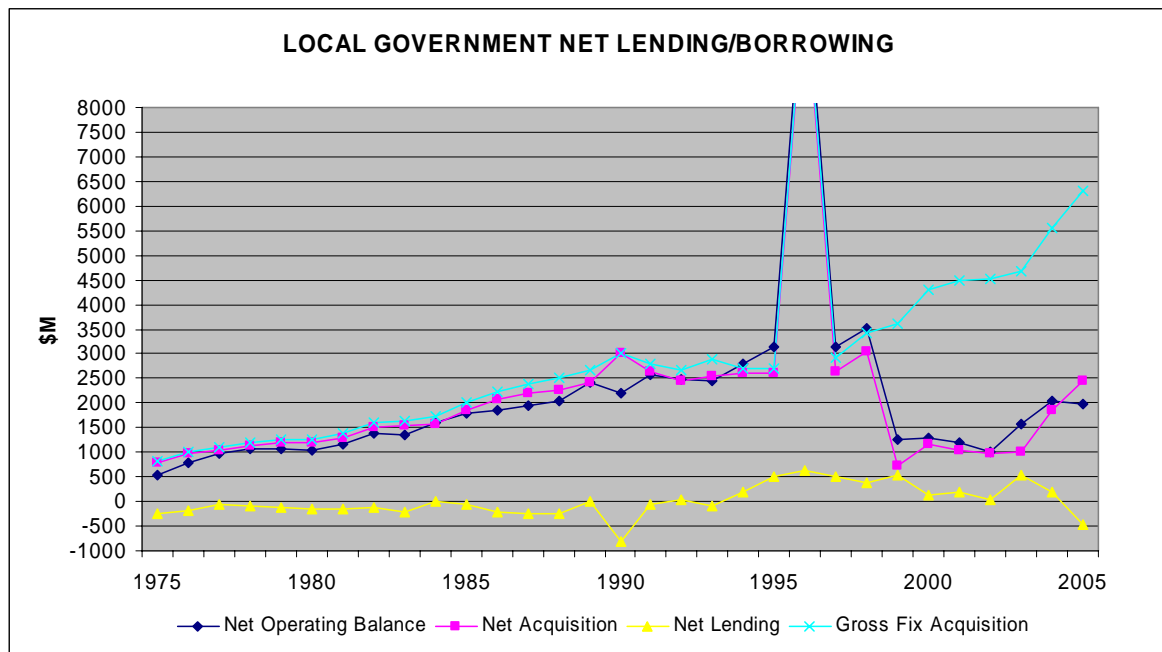
‘Transport and Communications’ has decreased quickly from around 50% of local government expenditure in the early 1960s to 22.8% in 1974-75 and since then the level has varied between 17% and 31% and was around 23% in 2004-05. For local government the key component of this expenditure is road related, though there is some spending on community transport and a more recent trend of spending on communication technology such as broadband. At the same time ‘Housing and Community amenities’ has significantly increased from around 10% in the early 1960s to as high as 30-40% in the mid-1970s but has since stabilised around 24% in 2004-05.

2.5 Trends in local government's financial position

In real terms revenues have been increasing at 2.4% pa since 1974-75 and expenses have been increasing by 3.1% pa. The overall net operating balance for local government has declined from 26.2% of revenue in 1974-75 to 9.3% of revenue in 2004-05. (Note – accrual accounting was introduced by local government in 1998-99. Prior to that time, figures were reported on cash accounting basis.)

Statistics show that local government is increasing its spending on infrastructure renewals particularly from 2000 (see Figure 2). In 2005, local government's non-financial assets had an estimated value of \$170 billion. Net lending (ie. borrowing) in that year was minus \$475 million, following a decade of positive net lending. This is a consequence of local government's operating balance of \$1985 million in 2004-05 being insufficient to fund the acquisition and renewal of assets. Local government has been in cash deficit position since 2003, reflecting the increased need for spending on infrastructure (see Figure 6).

FIGURE 2 – LOCAL GOVERNMENT NET LENDING/BORROWING

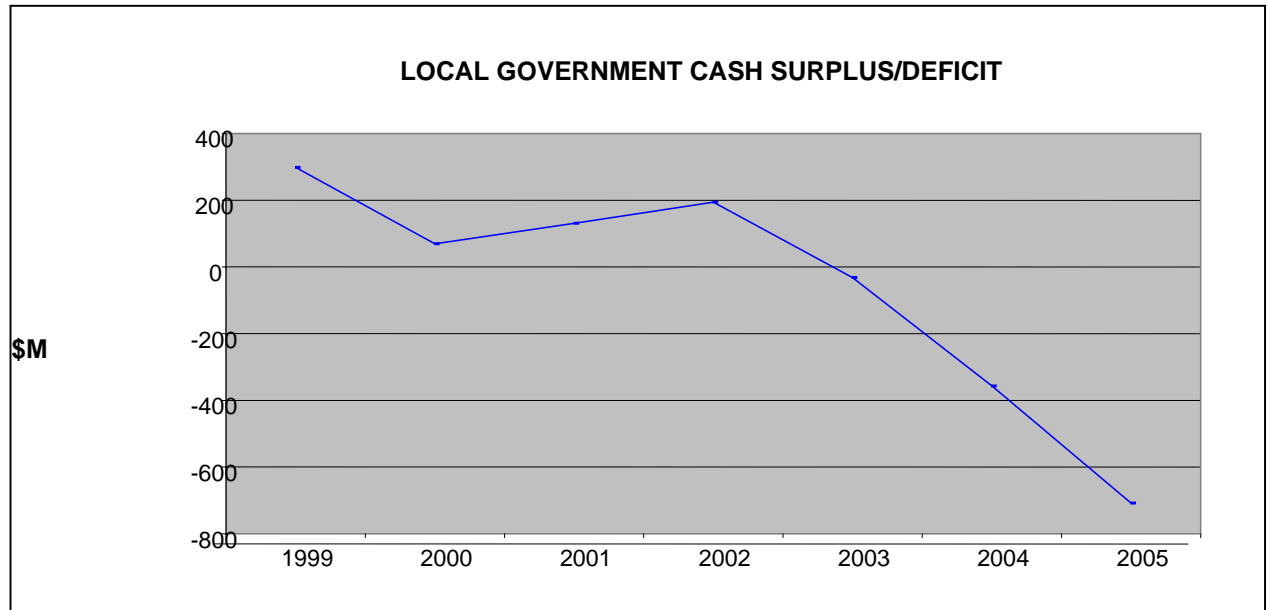


Source: ABS Government Finance Statistics (Cat. No. 5512.0) and unpublished Government Finance Statistics

Note – accrual accounting was introduced by local government in 1998-99. Depreciation may not have been identified or reported by all councils prior to that time.

Gross Fix Acquisition is defined as the total cost of acquisition of non-financial assets

FIGURE 3 – LOCAL GOVERNMENT CASH SURPLUS/DEFICIT



Source: ABS Government Finance Statistics (Cat. No. 5512.0)

The financial position of local government in four states (Tas, SA, NSW, and WA) and at the national level has been the subject of recent reports, prepared by Access Economics and PricewaterhouseCoopers. In summary, the reports suggest that a significant proportion of councils (up to 30% nationally) are under financial stress, that their current positions are unsustainable under current revenue and expenditure policy settings and that their problems will need to be addressed through reductions in expenditure (through efficiency measures or reductions in service or infrastructure levels), increased revenue and continuing to improve financial management and asset planning.

3. Federal Arrangements

While the Australian Constitution provides the formal legal framework and prescribes the division of responsibilities between the Commonwealth and the states/territories at the broadest level, government services and infrastructure in Australia are provided across the three spheres. For most Australians, the relative roles of the different spheres of government are immaterial. Put simply, taxpayers expect a seamless delivery of services, and expect the taxes and government charges that they pay to cover the cost of those services.

Notwithstanding the Australian Constitution, the efficient and effective delivery of government services can only be achieved through application of the principle of subsidiarity – whereby services are provided by the “smallest” or “lowest” level of competent authority, i.e. where a service or piece of infrastructure can be competently delivered by local government it should be. Underpinning this is the principle that the

sphere of government delivering the service or infrastructure should be adequately resourced through inter-governmental transfers.

On the revenue side, there is general acceptance that in a Federation it is most efficient for the central government to raise income and company taxes thus avoiding any geographic distortions arising from different treatment at a sub-national level. The combination of these two issues, however, gives rise to a problem of vertical fiscal imbalance and the need for inter-governmental transfers. In Australia more than 80 per cent of taxation revenue is collected at the Federal level, while service delivery takes place at the state and local level.

The mechanism for inter-governmental transfers has changed over the course of the last century. At times it has involved reimbursement of taxation by the Federal Government (as was the case with the *States Grants (Tax Reimbursement) Act 1946*) or tax sharing which applied from the mid-1970s to the mid-1980s. At other times it has involved financial assistance through grants unconnected with tax revenue (e.g. through the *States Grants Act 1959*, and post 1985).

While the principle of inter-governmental transfer between the Commonwealth and States was established at the time of Federation, it was only in 1974-75 that local government became a party to these transfers.

When in 1974 the Commonwealth introduced a program of untied financial assistance to local government the reasons cited by the Federal Government for providing this financial assistance were to “make the third tier of government a genuine partner in the (Federal) system and to give local government access to the nation’s finances” (The Hon Gough Whitlam, Second Reading Speech, Grants Commission Bill 1973, House of Representatives 17 May 1973).

The most recent step in the evolution of inter-governmental transfers was the proposal under the Australian Government’s new tax system to replace Financial Assistance Grants to both the States and local government with the GST revenue. Prior to this, both the states and local government received general purpose assistance in the form of Financial Assistance Grants. In 1996-97, the States received \$15.4 billion in FAGs and local government received \$1.2 billion. Both sets of FAGs were escalated on the same basis and both were untied in the hands of the intended recipients – each state government and individual local governments.

Following the 1998 Federal Election the Australian Government moved to implement its new tax system, including a GST, and provide all GST revenue to the states and territories and to abolish the FAGs. The inter-governmental transfer of funding from the Australia Government to local government was to be rolled into the GST transfer to the states and it would then be a state responsibility to transfer funding to local government. However, the Australian Government ultimately made changes to the scope of the GST which reduced the revenue to be raised and transferred to the states. The Federal Government also decided to retain the responsibility for the payment of financial

assistance grants (inter-governmental transfers) to local government rather than transfer this responsibility to the states (Prime Minister John Howard, Press Release, 17 May 1999).

The result of this was to remove local government from direct tax sharing and enshrine SPPs (the untied financial assistance grants and other specific purpose payments) as the mechanism for inter-governmental financial transfers from the Federal Government to local government.

At the same time, the states and territories moved to a funding mechanism that more directly reflected the level of the nation's economic prosperity – the GST.

Demand for services including government services is a direct consequence of the strong performance of the national economy. Demand for local government services has grown consistently over the past 30 years. Growth in demand for local government services has increased more rapidly during the past decade corresponding to the substantial growth in the national economy. To meet this demand local government revenues including grant funding, must increase in line with the growth in the economy and its major cost drivers.

Over recent decades, the range and scope of local government functions have expanded, moving beyond the traditional local government services, such as roads and waste management, to incorporate a growing range of human services, environmental and other services. This trend is expected to continue given settlement patterns and demographic changes such as the ageing of the population.

Federal and state and territory governments increasingly require, often through legislation, local government to undertake a greater role in the areas of development and planning, public health and environmental management; however, this has occurred without the provision of commensurate funding.

In order to meet the increasing demands, and in recognition of the Commonwealth holding the tax collecting powers, local government has long advocated for a return to a fixed level of intergovernmental transfer from the Commonwealth to local government. Local government believes that this should be maintained at a level equivalent to at least one per cent of Commonwealth taxation revenue, net of GST.

The relative decline in the value of FAGs over time has put increasing pressure on local councils to deliver services at the level that is required by local communities. In 1995/96 the level of FAGs was around one per cent of Commonwealth taxation revenue. By 2004/05, this had declined to only 0.8 per cent of Commonwealth taxation revenue (net of GST). This decline is forecast to continue over coming years.

This is in stark contrast to the growth in the Australian economy and the consequent growth in Federal taxation revenue over the past decade. In the period 1994-95 to 2004-05 Federal taxation revenue (incl GST) grew by 121 per cent, whereas over the same period the value of FAGs to local government grew by only 42 per cent.

Under current arrangements, indexation of the FAGs is at the discretion of the Treasurer. In 1997-98, the Treasurer made the decision to increase the FAGs for inflation but not for population growth. The reduction in the FAGs was equivalent to about 1.2% of the funding or \$14 million. This was a reduction in the base of the FAGs which has never been made up. As a consequence, each year's FAGs have been lower than would otherwise have been the case. The total cumulative loss of FAGs since 1997-98, taking into account the escalation in the FAGs over the last 10 years, is now in the order of \$170 million.

In addition to the cumulative impact that this decision has had on local government, the discretionary element of the FAGs indexation removes a level of certainty for local government in planning service and infrastructure delivery beyond the current year.

The *Local Government (Financial Assistance) Act 1995* provides for local government FAGs to be increased each year in accordance with an escalation factor which takes account of movements in the CPI and population growth. Prior to the GST, the annual increase in local government FAGs was determined by the Treasurer in line with the underlying movement in general revenue assistance provided to the States. The inadequacy of the current indexation arrangements as a way of maintaining the value of the FAGs in the hands of local government is clearly illustrated by the fact that the rate of increase of the major costs facing local government (construction and wages) is nearly double the annual increase in FAGs. In 2005, the general costs faced by local government in Queensland (as measured by a Local Government Cost Index developed by the Local Government Association in Queensland) was 5.7%, compared with the FAGs increase in 2005-06 of just 3.6%.

Local government believes that a specific local government cost index should be developed. This index would incorporate real cost growth for the local government sector – across all expenditure items, ranging from construction to staff costs. Specific local government program funding and ongoing SPPs should then be escalated against this cost index, ensuring that that local government funding is maintained in real terms. Simply applying the CPI does not reflect the true costs incurred by local government and has seen the real value of SPPs decline over time.

4. Financial sustainability

The most significant challenge facing local government in Australia today is that of financial sustainability.

The Australian Local Government Association, commissioned PricewaterhouseCoopers (PwC) in April 2006 to undertake a National Financial Review of Local Government Sustainability. The final report was launched in December 2006.

The purpose of the PwC study was to provide a considered assessment of the financial sustainability of the local government sector – nation wide.

PwC set out to:

- Assess the financial viability of local government – nationally and by council types
- Identify the main issues affecting sustainability
- Recommend ways to improve financial sustainability, and
- Investigate the merit of reforming intergovernmental funding in order to improve financial sustainability.

PwC's conservative estimate is that between 10 and 30 per cent of councils have financial sustainability issues.

The PwC work built on similar reports commissioned by the NSW, SA and WA Local Government Associations (completed Access Economics) and a similar report undertaken in Victoria by the Municipal Association of Victoria. The Tasmanian Local Government Association has also recently finalised a report by Access Economics. All state reports were consistent with the national report – that without significant reform, local councils would struggle to remain financially sustainable.

PwC identified a national total backlog in local government infrastructure renewal work of some \$14.5 billion, or an annual underspend on renewals of \$1.1 billion. This has resulted from the growing gap between councils' revenue base and the funding required to both deliver a broader range of services, as well as maintain and renew the infrastructure that supports these services

PwC found that the underspend by local government is resulting in deterioration in the condition of local infrastructure, such as roads, libraries, community halls, galleries, museums, swimming pools, drainage, sea walls, and sports fields.

Much of this infrastructure was constructed in the 1960s, 70s and 80s as a result of capital grants from state and federal governments, and is now reaching the end of its useful life.

While roads are being addressed through the Roads to Recovery program, councils are faced with the real prospect having to retire community infrastructure that they cannot afford to renew – infrastructure that in many cases is vital to community wellbeing and cohesion.

The PwC report recommends a “twin-track” approach to improving financial sustainability, through:

- the pursuit of further internal efficiency reforms – building on past efforts to improve financial performance and management, and
- reforms to inter-government transfers

The report provides a profile of the type of council that might be likely to face financial sustainability issues:

- minimal (or negative) revenue growth

- cost growth which has exceeded revenue growth
- increasing involvement in non-core service provision due to rising community demands
- tendency to operate deficits, creating a need to defer or under-spend on renewal of infrastructure
- limited access to strong financial and asset management skills
- in some cases limited access to rate revenue due to small or declining population bases

5. *Transparency/reporting*

Transparency and reporting across the local government sector varies by jurisdiction, and is limited at the national level.

Accurate information about the level of grants, particularly from state and territory governments, varies. This reflects the fact that the grants information collected by the Australian Bureau of Statistics (ABS) is based on data supplied by local authorities to the states, and subsequently reported to the ABS. Definitional differences exist between the states and the level of information captured varies. As a result, discrepancies exist between data sets held by states and the ABS.

One means of addressing the transparency of reporting that exists at the Federal level, and allow local government to have a fuller picture of its true financial position would be the production of a local government budget statement. This document would report on all funding from the Commonwealth to local government – both specific SPP funding (eg FAGs, R2R) as well as grant funding to local government through competitive programs, one-off SPPs and other funding mechanisms.

6. *Efficiency measures and other internal reforms*

At the local level, a range of methods have been adopted by individual councils or groups of councils to achieve greater levels of efficiency.

Outsourcing through competitive tendering has long been common place within local government and spans the fields of IT and telecommunications, legal, office support etc. For example, during the major reforms of local government in the 1990s Victoria formalised the concept of outsourcing through compulsory competitive tendering. This was followed in 1999 by the Best Value Policy which is a more holistic approach by ensuring that councils are primarily accountable and responsive to the needs of the local communities.

Under a joint initiative of the Local Government Association of Queensland and Queensland Treasury Corporation, the corporation Local Government Infrastructure

Services was formed to provide local government in Queensland with assistance in evaluating and delivering infrastructure in a cost effective and efficient manner.

Structural reforms have been adopted by councils in order to provide more cost-effective local services. Thirty years ago there were a much higher number of councils in Australia, over 100 councils have been consolidated over the past 20 years.¹ NSW, Victoria, South Australia and Tasmania have undergone periods of municipal consolidation of differing degrees in recent years. The Northern Territory is currently undergoing a structural reform process, and the Queensland State Government has recently announced proposed structural reforms in that state (which are subject to an ongoing consultation process and no final decision has been reached).

Many councils have been actively engaged in improving the efficiency of their operations through regional cooperation and service delivery. This model has been applied in a number of service areas such as: waste services, purchasing and procurement, road and infrastructure maintenance, park upkeep, recruitment etc. The more integrated and ongoing collaboration of the councils in the Hunter region of NSW provides a good example of such a model.

Shared service projects have been progressively adopted to take advantage of economies of scale. A growing number of councils have been making greater use of shared services, for example the Road Alliance between the Local Government Association of Queensland and Queensland Main Roads. The NT LGA has also implemented shared services for financial management, information technology, human resources management, transport and infrastructure.

The local government sector acknowledges that more needs to be done by local government in improving its own financial efficiency. Areas where additional efficiency reform could be pursued by local government include:

- Pursuit of greater economies of scale through regional or shared service provision, outsourcing, state-wide purchasing agreements
- Greater clarity of services to be provided by local government, and how these services will be provided
- Caution in the decision making process regarding expanded or additional services
- Improved asset management
- More regular asset condition reporting for key infrastructure
- Improved data collection and management – particularly in relation to financial and asset management.

¹ Commonwealth Government 1985, National Inquiry into Local Government Finance Report, p3.

7. *Local government tax base*

Table 2 – Total public sector tax revenue

	1998- 1999	1999- 2000	2000- 2001	2001- 2002	2002- 2003	2003- 2004	2004- 2005
Local Government Taxation	6,301	6,002	6,388	6,749	7,201	7,663	8,146
All Australian Governments Taxation Revenue	177,971	192,944	209,771	213,481	234,037	252,406	274,487
%	3.54%	3.11%	3.05%	3.16%	3.08%	3.04%	2.97%

Source: ABS Government Finance Statistics (Cat. No. 5512.0)

The property rates revenue collected by local government in Australia comprises just under 3% of total taxation revenue across all three spheres of government. This same property base is also subject to state government revenue measures where a far greater quantum of revenue is collected. According to the ABS, the states' share of all property taxation revenue was 66% in 2004-05, while local government collected the remaining 34%.

The land boom in Australia increased the self perceived wealth of households across the nation. The rise in household debt has driven the boom in land values. However the boost in property values does not necessarily mean a windfall for council rate revenue because the mortgage burden on home owners and higher costs on businesses associated with the boom hits their capacity to pay higher rates.

Historically local government provided property-based services – roads and waste collection - and collected a property-based tax (rates) to fund those services. Since the 1960s, however, local government has increasingly provided a range of human services and it is no longer possible (or appropriate) to fund this broader range of services from a narrow property based tax. The decision of all state and territory jurisdictions in the 1990s to move away from prescriptive legislation which set out local government's areas of responsibility to legislation which provided local government with general powers of competence has accelerated this move into non property-based services.

Given the ever expanding range of services being provided at the local government level, rates as a major source of revenue has two major limitations²:

1. Rates are not suitable for redistributive purposes – on the basis that poor households tend to have high needs for these services and low ability to pay, while wealthy households have a low level of need and high capacity to pay. This results in the accumulation of high need households in poor municipalities, with low capacity to pay, while richer municipalities have a higher concentration of households with a higher ability to pay, but less need of services. The tradition of

² State of the Regions Report 2006/07. ALGA/National Economics

- cost-shifting from other spheres of government has seen local government use rates for redistributive services to a greater degree than anticipated in the constitutional structure. The principle of horizontal equalisation applied to financial assistance grants attempts to address this issue.
2. Rates are a poor source of finance for roads. Roads are increasingly used by through traffic which neither starts nor stops in the municipality and has no relationship to local land values. Even for traffic that is local, councils have no influence over the make-up of the fleet/usage of the roads. As a result, theory suggests that road funding is more appropriate from road user charges rather than through the rate base.

Property rates are the only taxation that local government is able to impose on its residents. Increasing the level of council revenue derived from property tax would continue the application of this narrow tax base to cover the cost of a broad range of council services.

8. Conclusions

Local government's great strength lies in the fact that it is close to the people. It can respond to local need in a way no other sphere of government can, be it regional, state or federal.

Local government embodies the spirit of subsidiarity, a principle which holds that the functions of government should be exercised as closely as practicable to the affected citizens.

Local government delivers services and facilities on a human scale. It is responsive to local need, provides local leadership and advocacy, fosters civic pride and reflects local priorities in a way state and federal governments never can.

Given the demand upon local government and its constraints, adequate revenue growth (for general purposes) can only be achieved through improved intergovernmental financial transfers - a fair share of Commonwealth taxation revenue.

ALGA believes that the quantum of Commonwealth transfers should increase to at least 1% of total Commonwealth taxation revenue (excluding GST). This would ensure that councils gain access to a revenue stream that grows in line with the growth of the economy and therefore can keep pace with demand for service delivery and infrastructure provision.

In light of solid growth in Australian Government revenue and substantial budget surpluses, ALGA considers the annual transfer of at least 1% of total Commonwealth taxation revenue to local government to be both justifiable and affordable.

Such reform would address vertical fiscal imbalance and more adequately meet the Commonwealth's objectives as set out in the Financial Assistance Grants Act (1995) by:

- improving the delivery of services to local communities;
- maintaining and improving the quality of social and physical infrastructure across Australia;
- helping to counter growing regional inequality;
- assisting in the repair of environmental degradation across Australia; and
- improving community cohesion.

Given the expanding range of services being provided by local government and the almost unprecedented level of growth being experienced across the national economy, it would not be prudent for local governments to increase the level of revenue gained through imposition of property taxes (ie rates). This is a narrow tax base, which is not appropriate for the funding of redistributive services now being provided by local governments.