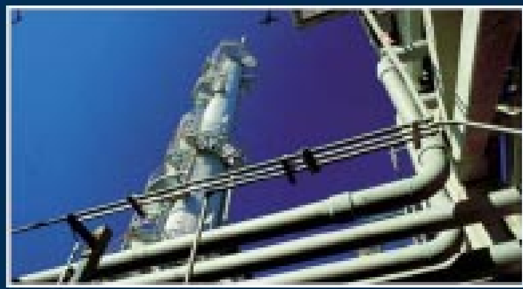

Local Government Revenue Raising Capability

Submission to the Productivity Commission

July 2007

Prepared by the Chamber of Commerce and Industry of Western Australia

CHAMBER OF COMMERCE AND INDUSTRY
WESTERN AUSTRALIA

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About CCI

The Chamber of Commerce and Industry of Western Australia (CCI) is the leading business association in Western Australia.

It is the second largest organisation of its kind in Australia, with a membership of 5,000 organisations in all sectors including manufacturing, resources, agriculture, transport, communications, retailing, hospitality, building and construction, community services and finance.

Most members are private businesses, but CCI also has representation in the not-for-profit sector and the government sector. About 80 per cent of members are small businesses, and members are located in all geographical regions of WA.

Context

This submission is in response to the Productivity Commission's inquiry into local government revenue raising capability. The Productivity Commission's study is timely given the state of the WA economy and the importance of local government in promoting social and economic development. The rapid expansion currently underway in WA is being hampered by critical capacity constraints that threaten to undermine continued business investment. With unemployment at record low levels and business's citing the skill shortage as a major inhibitor of expansion, adequate economic and social infrastructure are required to maintain a strong and vibrant Western Australian economy. Local government's role in delivering key social services and local infrastructure is critical in ensuring the WA's continued prosperity.

The Productivity Commission's study is also very relevant given the slew of recent research that has revealed deep structural issues with local government. This research has highlighted significant problems both with individual Councils and with the structure of local government.

The Productivity Commission is undertaking research assessing the capacity of local government to raise revenue including:

- the capacity of different types of councils (e.g. capital city, metropolitan, regional, rural, remote and indigenous) to raise revenue and the factors contributing to capacity and variability in capacity over time;

- the impacts on individuals, organisations and businesses of the various taxes, user charges and other revenue sources available to local government; and

- the impact of any State regulatory limits on the revenue raising capacity of councils.

CCI believes that it is important for local government to have access to sufficient revenues that they can execute their responsibilities to local communities and local businesses. The cyclical pressures affecting the WA economy are revealing deep structural problems with the local government sector. In addressing these issues, it is important to consider different structural arrangements that would best facilitate local government service delivery and what services are appropriately delivered.

In determining the service mix between the different spheres of government there are a number of issues need to be considered. CCI has recently detailed these issues in its discussion paper *Federalism in Australia*. This discussion paper identifies the basis for determining appropriate service provision and the policy underpinnings that facilitate effective government. Objective research and member feedback suggests that these policies are not being followed in regard to local government.

The failure of local government to be adequately resourced and organised has two significant categories of impacts on business and the broader community. The first is that important social and economic infrastructure is not being maintained in WA at appropriate levels and significant services are not being delivered. As a consequence, WA is a less attractive place to live in and conduct business. The second pertains to the execution of local government's governance role over business which creates serious problems, in part because it is inadequately organised, and in part because it is under funded.

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Executive Summary

The Western Australian economy has been growing at a very fast pace for a number of years, resulting in economic outcomes much higher than Australia as a whole. As a consequence, the State's economy is operating at a very high level of capacity utilisation, despite record amounts of potential investment by business yet to take effect. This strained economy is revealing critical economic bottlenecks that are threatening to undermine the potential expansion of the economy. One of these bottlenecks is the ability of local government to effectively execute its responsibilities.

Another consequence of the State's economic growth is that the demand and use of social and economic infrastructure being maintained by local government has grown dramatically. In certain regional centres this infrastructure is at critical capacity levels. A study into local government sustainability conducted by the Western Australian Local Government Association (WALGA) found:

- the sector ran an operating deficit of 2004-05 that amounted to 4.5 per cent of their own-source revenue;

- 83 local governments were financially unsustainable in that they would require an increase in Council rates of greater than 10 per cent to eliminate their underlying operating deficits according to a methodology developed by Access Economics;

- financially unsustainable local governments are universally concentrated in rural and remote areas of the state;

- the financial reports of local government are inconsistent and incompatible between Councils or between the same Council over a number of years, reducing the community governance capability;

- there is a large intergenerational equity transfer occurring through current asset management practices; and

- the sector faces critical capacity constraints that impinge its ability to execute its duties. These constraints are partially structural and partially cyclical with the current state of the economy.

These findings highlight the critical need to assess local government's ability to play its role in the Western Australian economy.

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Key Findings

This submission of the CCI makes the following findings for the Productivity Commission:

1. CCI believes that there is a need to reassess the distribution of responsibility and funding within the Australian federation, including the role of local government in Western Australia.

2. CCI believes having 29 metropolitan town planning schemes impairs the development of efficiency in the construction industry, a critical issue given the low levels of housing affordability. Knowledge of the different regulatory regimes represents a significant cost and adds uncertainty to investment decisions of all kinds. There is a need to reassess the regulatory regimes operating in Western Australia.

3. Where regional communities have grown strongly, there is a need to ensure all members of the community contribute to common infrastructure. It is also important that the local government has the resources to provide for future growth and is not stymied by outdated boundaries that reduce the level of investment in infrastructure necessary for the local community's continued growth.

4. There is also a need to co-ordinate State service delivery with local knowledge. One suggestion would be that the State Government establishes a Council of State Government Heads to take responsibility for collaborative delivery of state and local government programs in a manner tailored to respond to local priorities as determined in regional strategic plans. The Council's secretariat functions could be provided by local government or Regional Development Commissions with appropriate funding.

5. CCI believes that Councils should utilise more debt for capital expenditures associated with long-term infrastructure. The current reliance on rates to fund such infrastructure developments represents an intergenerational equity transfer from current ratepayers to future ratepayers. Further, capital expenditure will be limited to available rates revenue which may act to prohibit infrastructure investment, to the detriment of all generations. Debt funding will also act as a governance mechanism on Council spending through forcing financial rigour on expenditure decisions.

6. CCI believes that the current systematic practice of Councils running operating deficits financed through running down important infrastructure needs to be addressed. Appropriate adjustments in expenditure should be taken to ensure local government can maintain the infrastructure for which it has responsibility. The current practice of funding operating deficits through

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delaying infrastructure maintenance avoids the democratic governance checks that would occur if these deficits were funded through debt or through increasing revenues.

7. Current arrangements allow fees and charges to cross-subsidise other services provided by local government. Since fees and charges receive less public scrutiny than rates, that is they are paid by a smaller section of the community, Councils are not subject to the same democratic governance measures as general rate increases. CCI believes that local governments in WA should identify the beneficiaries of services that they provide and justify their rates, fees and charges on the basis of this assessment.

8. Another source of concern for CCI is that local government fees and charges are not co-ordinated with State or Federal Government. This is particularly noteworthy for developer charges and processing business approvals where imbalances between the two being likely to distort the pricing of residential and commercial land and add uncertainty in investment decisions.

9. CCI believes that local government in Western Australia must embrace these changes. The current practice of delaying infrastructure maintenance to fund current expenditure is detrimental to the development of Western Australia and avoids the democratic governance of increasing general rates or the financial governance of increasing debt levels.

10. The disbursement of royalties from major projects that place considerable strain on local infrastructure needs to be assessed to ensure an equitable distribution and also an economic level of investment.

11. CCI believes that it is important for local government to have comparable financial reports on which communities and business can assess their effectiveness. As such, CCI endorses the recommendations made by the Systemic Sustainability Study (SSS) aimed at improving the consistency and quality of financial reporting within the local government sector.

12. CCI agrees that there are substantial benefits that could be achieved by a more comprehensive and structured approach to delivering local government services that is not determined by vested interests. Based on research conducted by CCI, Western Australian business would benefit most from consolidation of local government planning regimes and through streamlining business approvals. Given the widespread financial unsustainability of local governments in Western Australia, CCI believes it is important for local governments to adopt a more comprehensive review of their services to ensure that economies of scale and scope, as well as access to appropriate skills, be available to local government.

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Overview

Local government in Western Australia provides an array of essential community services. From local roads and other key infrastructure, to child care an aged care services, open space, waste management and land use planning, every West Australian is affected by local government services. The sector is also a significant mobiliser of human capital, with almost 13,000 staff and over 1,400 elected members who voluntarily serve their communities, making it the largest voluntary organisation in the State. Local government represents a key part of Western Australia's development as a worthwhile place to live and plays an important role in its economic development.

Economic Profile

The Western Australian economy has been growing at a very fast pace for a number of years, resulting in economic outcomes much higher than Australia as a whole. As a consequence, the State's economy is operating at a very high level of capacity utilisation, despite record amounts of potential investment by business yet to take effect. This strained economy is revealing critical economic bottlenecks that are threatening to undermine the potential expansion of the economy. One of these bottlenecks is the ability of local government to effectively execute its responsibilities. The inability of local government to properly fulfil its responsibilities represents a significant constraint on the productive capacity of the Western Australian economy.

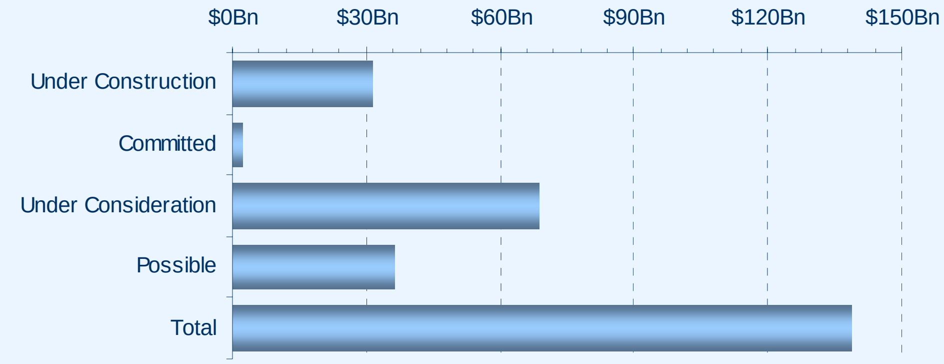
The high level of business investment over the last few years means that the outlook for the Western Australian economy remains very healthy. Economic growth is forecast to reach 7 per cent in 2006-07, and a further 6.5 per cent in 2007-08 and similarly strong rates of growth thereafter[1], courtesy of a balanced economic growth profile, and in particular, surging business investment and exports – both of which are reflective of the importance of, and requirements for, the State's dominant resources sector.

While there has been a large amount of business investment in WA already, there are also a significant number of major resource projects that are currently in the planning stages in WA and which look likely to proceed to the development phase. Prime among these is the $15 billion Gorgon Gas Project, the $6 billion Pluto LNG Project, the $2 billion Fortescue Iron Ore Project, and the $1.7 billion Alcoa Wagerup Alumina Refinery Expansion.

High quality economic infrastructure, appropriately-placed suitable land and efficient planning processes are key enablers for industry growth and the attraction of business investment to Western Australia, particularly for industries where the investment location is flexible. Access to appropriate infrastructure is also fundamental to ensuring that the whole community can contribute to, and share in, the State's wealth and quality of life.

Potentially, Western Australia is on the verge of a further acceleration in the current investment cycle given the number and scale of potential large scale projects currently being considered. Chart 1 reveals the level of investment that is currently under consideration or potentially possible in WA, and is an important factor in ensuring the State's long-term economic prosperity. This investment will not occur if business does not have access to suitable human capital or does not receive appropriate approvals.

Chart 1
Investment Projects, WA
Value by Status, March 2007



Source: Access Economics Investment Monitor

The high level of business investment, and overall economic development, in Western Australia continues to be driven by a dominant resources sector which is highly dependent on having appropriate infrastructure. The strong private investment that has already occurred in the economic cycle has placed considerable strain on existing social and economic infrastructure throughout the state. High rates of population growth, not only in the Perth metropolitan area, but also across regional Western Australia, are acerbating the infrastructure issue and bringing to the fore the quality of local government infrastructure.

According to the 2007-08 State Budget submission of WALGA:

> *"Local government invests in and maintains almost $12.5 billion in State infrastructure. Many of these assets are crucial for the daily economic activity of the State while community infrastructure provides an important role in maintaining the social fabric of Western Australia."*[2]

The infrastructure provided by local government is very significant for attracting business and people to the State and making WA a place worthy of living. Local government is experiencing pronounced difficulties in adequately maintaining this

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infrastructure. The SSS, conducted by WALGA, found that there is a recurrent infrastructure renewal gap in WA of approximately $110 million in 2004-05, which means that approximately only 75 per cent of the amount required to maintain local government's non-financial assets in their current condition is being provided. Further, the local government sector faces an infrastructure backlog in the vicinity of $1.75 billion or 14 per cent of the total value of non-financial assets managed by the local government sector[3].

WA's demand for, and cost of, local government infrastructure is significantly above the national average for a number of reasons, including:

- its above-average economic growth, and the importance of investment-intensive resource investment to that growth profile;
- its above-average population growth; and
- its harsh environment, large geographical area and low population density, which means that the cost of maintaining infrastructure is high, and shared among relatively few taxpayers.

These reasons make it particularly important for local government to effectively manage its infrastructure assets. Existing labour and capacity constraints are making Western Australia an expensive place to invest and there exists the real potential to turn away prospective businesses and people from the State. For instance, the cost of the Ravensthorpe Nickel Project is now expected to be double the original estimate when construction first started three years ago. This makes it all the more important that local government have the revenue capacity to deliver its services.

Local Government Condition

WALGA has suggested that:

> *"While every other sector of the economy has undergone a significant period of infrastructure investment, local government has completely missed the benefits of the current economic boom. As a consequence of underinvestment in local level infrastructure, bottlenecks may develop in the future that will hamper the State's economic development."* [4]

There are other reasons to suspect that the local government sector in Western Australia is confronting substantial challenges to its ability to execute its responsibilities. The SSS found a number of key indicators that highlight sustainability issues in local government, these are[5]:

- the sector ran an operating deficit of 2004-05 that amounted to 4.5 per cent of their own-source revenue;

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- 83 local governments were financially unsustainable in that they would require an increase in Council rates of greater than 10 per cent to eliminate their underlying operating deficits according to a methodology developed by Access Economics;

- financially unsustainable local governments are universally concentrated in rural and remote areas of the state;

- the financial reports of local government are inconsistent and incompatible between Councils or between the same Council over a number of years, reducing the community governance capability;

- there is a large intergenerational equity transfer occurring through current asset management practices; and

- the sector faces critical capacity constraints that impinge its ability to execute its duties. These constraints are partially structural and partially cyclical with the current state of the economy.

While conducting a process designed to equip local government with the ability to address these issues themselves, WALGA identified the following four key challenges to local government sustainability[6]:

1. the existing fiscal imbalance within Australia's federation;

2. structural problems arising from social and demographic changes;

3. asset management practices, past and present; and

4. critical capability issues.

CCI finds that these four key challenges have contributed to the bottlenecks that are impacting on business activity in the State. This has resulted in:

- approvals processes that are slow, cumbersome or unnecessarily different across jurisdictions;

- regulatory overlap between different spheres of government; and

- diminishing quality of social and economic infrastructure, particularly for regional and remote communities.

Two of these are based on the way in which local government activities are organised, while the third is due to the level of revenue collected by the sector. All three are pertinent to the study of local government revenue raising capacity because the level of revenue required by the sector is directly related to the efficiency of its structure and operations. There is a critical need to ensure that local government has the capacity to execute its responsibilities.

Federalism

CCI is concerned that there is a critical breakdown in governance, with the existence of the vertical fiscal imbalance between the levels of government resulting in a continual diminishing of responsibility amongst the different spheres of government. This is particularly pertinent to local government, a sphere with limited fiscal capacity and yet responsibility to deliver critical services and infrastructure. A blurring of responsibilities for infrastructure and social services reduces the capacity of local communities to hold elected officials personally responsible for the decisions they make. The SSS final report stated in their findings that:

> *Most authorities cite cost shifting and the growing compliance roles determined by over 400 pieces of state legislation as significant drivers of cost and sustainability challenges facing Councils across the state*[7].

This breakdown in responsibility is critically impeding economic growth and social well-being in WA.

A well functioning federation is particularly pertinent because of the large geographic size of the State. Prominent historian Lord Acton once said:

> *'in any country of significant size, popular government could only be preserved through a federal structure. Otherwise the result would be elite rule by a single city, such as London or Paris'*[8].

Following South Africa's move towards a federal structure, all the world's physically large countries are now federations, except for China—and even that country has become a de facto federation by devolving more and more autonomy to the provinces (Walker, 1999).

With three quarters of WA's population centred in Perth, it is increasingly important that regional local governments become the effective and powerful voice of their constituents. Lacking this representation, policy and infrastructure provision will be Perth centric and ignore the needs of regional and remote communities, a trend cited as being equally important in the relationship between WA and the national government[9]. This will have a detrimental impact on the social and economic development of the State as regional centres become trapped in a situation where they do not have the funds to provide the infrastructure necessary to attract sufficient population to finance the infrastructure. The discussion in the section on local government Financial Sustainability highlights how local government has failed to finance its responsibilities.

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> *In our view, the prevalence of operating deficits and their frequent co-existence with substantial infrastructure backlogs are symptomatic as much of deficiencies in council spending and revenue policy frameworks – compounded by poor information and understanding of asset management – as they are of shortfalls in the level and escalation of grants from other governments and any past cost shifting.*[10]

The fiscal unsustainability of over half of all Western Australian local governments is undermining an important element of the Australian federation. With 70 per cent of the 80 regional local governments deemed to be financially unsustainable according to the Access Economics methodology, there is a clear structural issues associated with the sector that needs addressing.

Principles for determining responsibilities

In determining the service mix between the different spheres of government, there are a number of issues need to be considered. CCI has recently detailed these issues in its discussion paper *Federalism in Australia*. This discussion paper identifies the basis for determining appropriate service provision and the policy underpinnings that facilitate effective government. Objective research and member feedback suggests that these policies are not being followed in regard to local government. The broad policies for that should underpin a well-functioning federation are:

- **subsidiarity**: requiring power to be exercised at the lowest level that produces efficient results;

- **competitive federalism**: emphasising the benefits of diversity, experimentation and a degree of rivalry between different local government's policies and practices;

- **cooperative federalism**: which identifies the benefits of a cooperative, consistent and co-ordinated policy approach on some issues, especially those which have effects beyond the jurisdiction of the government with authority or resources to implement them, or where there are significant benefits from a unified approach;

- **financial adequacy**: which requires that governments have secure access to the funds necessary to implement their programs, which in turn demands that the drawbacks of vertical fiscal imbalance be addressed; and

- **appropriate redistribution**: which demands an appropriate means of distributing funds between jurisdictions, and requires a fresh look at the objectives and processes of horizontal fiscal equalisation.

Finding: CCI believes that there is a need to reassess the distribution of responsibility and funding within the Australian federation, including the role of local government in Western Australia.

The work commissioned by WALGA has highlighted the lack of financial adequacy and appropriate redistribution that is occurring. CCI's discussion paper *Regulation and Compliance* highlights the following additional failures that indicate a breakdown of appropriate application of subsidiarity:

- different compliance regimes between Local and State Government spheres;
- multiplicity of jurisdictions that work against effective delivery of services (key elements of federalist principles do not apply because there is no governance of local government); and
- regulatory overlap, particularly in business approvals processes that prohibit economic development.

Box 1 highlights the impact of these issues both *for* local government and on business *by* local government.

Box 1: The Swan River

An excellent example of the breakdown of responsibility for critical social and economic infrastructure regards the Swan River.

The responsibility for maintaining the foreshore of the Swan River has historically been vested with a State Government Department. When this Department was disbanded, and the Swan River Trust formed, no clear responsibility was assigned.

Local Government has come to be seen as responsible for the Swan River foreshore, but this responsibility was never accompanied by any revenues. Consequentially much of the foreshore levies require considerable injections of funds to bring to a reasonable standard. Considering estimates of improving the foreshore put the cost at $50,000 per meter Local Government lacks the capacity to rejuvenate the infrastructure.

There are also difficulties for business when foreshore management and planning regimes of various Local Governments abut. There can be considerable uncertainty of operating conditions based on the placement of a business.

Before considering the financial adequacy of local government's capacity, it is important to consider if the principle of subsidiarity is being applied. CCI believes that there is strong evidence to suggest that an assessment of local government service delivery would result in considerable cost savings for both the sphere of government and the broader business community by gaining substantial economies of scale and scope, and also through eliminating unnecessary duplication.

In efficiency terms, there is a clear difference between local service 'provision' and local service 'production'[11]. Local service provision involves determining whether to provide a particular service; the regulation of local activities; local revenue raising; the quantity and quality of local services provided; and how these services should be produced. Production of these services, in contrast, involves the

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actual creation of a product or the rendering of a service rather than its financial provision.

Local government, relative to the other spheres of government, is positioned to have superior knowledge of local demand and local supply conditions, making it an effective deliverer of certain services. This does not necessarily translate to the production of those services. Local government can improve its financial sustainability, and reduce its fiscal requirements, by pursuing greater levels of shared services for the delivery of particular products or projects. The interim report of the SSS stated:

> *The Panel has found little evidence that there is currently a willingness in the local government sector to think beyond the boundaries of the individual employing Council. While there are some useful and practical resource-sharing arrangements for key personnel between neighbouring Councils, these rarely extend beyond specific cases.*[12]

There is also a need to reassess the multiple jurisdictions of local government, particularly from a metropolitan perspective and from regional centres that have undergone strong growth. These tend to be known as 'donut Councils' and there are a number of them identified in the local government Advisory Board's report *Local Government Structural and Electoral reform in Western Australia* and its findings that they should be amalgamated.

Finding: CCI believes having 29 metropolitan town planning schemes impairs the development of efficiency in the construction industry, a critical issue given the low levels of housing affordability. Knowledge of the different regulatory regimes represents a significant cost and adds uncertainty to investment decisions of all kinds. There is a need to reassess the regulatory regimes operating in Western Australia.

Where regional communities have grown strongly, there is a need to ensure all members of the community contribute to common infrastructure. It is also important that the local government has the resources to provide for future growth and is not stymied by outdated boundaries that reduce the level of investment in infrastructure necessary for the local community's continued growth.

There is also a need to co-ordinate State service delivery with local knowledge. One suggestion would be that the State Government establishes a Council of State Government Heads to take responsibility for collaborative delivery of state and local government programs in a manner tailored to respond to local priorities as determined in regional strategic plans. The Council's secretariat functions could be provided by local government or Regional Development Commissions with appropriate funding.

Local Government Financial Sustainability

The Productivity Commission's investigation of local government revenues follows on from two important reports into the financial position of local governments in Western Australia. The Department of local government and Regional Development (DLGRD) found that certain "local governments are not generating enough revenue to meet their operating demands and are likely to have difficulty in meeting long-term infrastructure funding needs[13]." The DLGRD believed that the appropriate response to the financial challenges was extensive structural reform involving the amalgamation of a large number of Councils. The financial analysis on which this assessment was formed was not published.

The link between revenue and infrastructure was publicly articulated in a report by Access Economics, *Local Government Finances in Western Australia*, commissioned by WALGA. Access Economics reported on the status of Councils finances in 2004-05 on a macro basis and found systemic financial sustainability challenges to the sector. This analysis presents some important implications for considering local government's revenue capabilities in Western Australia and is explored in the next section of the report. The following material is based on the analysis commissioned by WALGA and conducted by Access Economics.

Financial Position

Examining local government's financial position reveals that Councils employ around $13 billion in capital, of which 96.6 per cent is invested in non-financial assets such as infrastructure. The principle form of funding for local government is through ratepayer equity as the sector is a net creditor with holdings of unrestricted cash and securities exceeding their total liabilities.

The Access Economics analysis distinguished between different categories of Councils to assess trends within the sector. The following categories were compared:

- metropolitan and regional councils, with regional councils in turn separated into those with and without large towns;
- councils with above-average growth and those with declining populations; and
- the largest 25 per cent of Councils with the smallest 25 per cent based on operating expenditure.

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Looking at the differences between Councils based on these categorisations and the average capital they employ per assessment as at 30 June 2005 reveals sharp differences in the sector. Table 1 reveals that metropolitan councils tend to use less capital than their regional counterparts, no doubt due in part to the generally larger areas serviced by the road networks in non-metropolitan areas. More efficient councils are also expected to employ less capital than less efficient ones.

Table 1

Average Capital Employed Per Assessment

WA Councils, 30 June 2005

	# Councils		
Metropolitan	29	$	10,017
Regional, with large town	27	$	15,498
Regional, without large town	86	$	34,431
Above average growth	30	$	12,662
Declining growth	71	$	26,265
Largest 25 Councils	35	$	11,044
Smallest 25 Councils	35	$	37,305
All WA Councils	142	$	13,864

Source: Access Economics, 2006

This strongly suggests that there are different capital needs for Councils in different areas of the State.

The debt ratio of Councils is also a source of concern. The net financial liabilities ratio of all WA Councils, as at the 30th of June 2005, was 0.2 per cent. This means that WA Councils on average are net creditors, with their holdings of unrestricted cash and securities exceed their total liabilities. As a result, there is a strong reliance on rate revenue to fund infrastructure development and maintenance. In considering the revenue requirements of Councils it is important to consider their reluctance to use debt funding for long-term infrastructure.

Finding: CCI believes that Councils should utilise more debt for capital expenditures associated with long-term infrastructure. The current reliance on rates to fund such infrastructure developments represents an intergenerational equity transfer from current ratepayers to future ratepayers. Further, capital expenditure will be limited to available rates revenue which may act to prohibit infrastructure investment, to the detriment of all generations. Debt funding will also act as a governance mechanism on Council spending through forcing financial rigour on expenditure decisions.

Operating Surplus

The operating surplus or deficit of a local government is a key measure of their financial sustainability. It distinguishes between current and capital expenditure, and between the financing of current spending through rates (the price imposed on current taxpayers) and the financing of capital spending through debt (to be

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serviced by future taxpayers). When an operating surplus occurs, then this is evidence that rate revenues are more than sufficient to finance current operations. When the operating surplus is negative (indicating a deficit), rates revenue is insufficient to finance current operations.

Access Economics defined the operating surplus or deficit so that a surplus indicates that costs incurred in the year in question are at least being met by today's ratepayers and not being transferred to tomorrow's ratepayers. An operating deficit indicates that the portion of costs incurred in the year in question that is being transferred to tomorrow's ratepayers and so is not being met by today's ratepayers. Therefore, the existence of an operating deficit indicates that intergenerational equity transfers are occurring as costs are being shifted from today's ratepayers to tomorrows.

Table 2

Operating Surplus Ratio

All WA Councils, 30 June 2005

Operating revenue ($M)	$	1,703
less		
Operating expenses ($M)	$	1,336
less		
Net interest expense ($M)	-$	19
less		
Depreciation expense ($M)	$	450
equals		
Operating surplus / (deficit) ($M)	-$	64
divided by		
Own-source revenue ($M)	$	1,415
equals		
Own-source revenue ($M)		-4.5%

Source: Access Economics, 2006

Table 2 shows that, on average, WA Councils registered operating deficits in 2004-05 amounting to 4.5 per cent of their own-source revenue. In comparison, the WA State Government recorded an operating surplus in 2004-05 of 12.3 per cent. This means that local government expenditure and revenue raising policies are resulting in a substantial intergeneration equity transfer of costs from current ratepayers onto future ratepayers.

Table 3 highlights the substantial differences in performance within the local government sector that hint at substantial structural issues at play. It also shows that metropolitan Councils have a substantially different operating outcome, with a positive surplus of 1.3 per cent, compared to the rest of the State, particularly regional Councils without large towns, which recorded a massive operating deficit of around 23 per cent.

Table 3

Operating Surplus Ratio, By Type Of Council

WA Councils, 30 June 2005

	# Councils	**Ratio**
Metropolitan	29	1.3%
Regional, with large town	27	-12%
Regional, without large town	86	-23%
Above average growth	30	-3.3%
Declining growth	71	-18.8%
Largest 25 Councils	35	-1.2%
Smallest 25 Councils	35	-15%
All WA Councils	142	-4.5%

Source: Access Economics, 2006

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Infrastructure Backlog

Councils have been running substantial operating deficits for a number of years. They have avoided funding these deficits through debt with revenue from capital grants, contributions and asset sales proceeds, and by postponing expenditure on maintenance and asset renewal/replacement. This has created an ongoing annual asset renewal gap and an infrastructure backlog. Considering a great deal of local government infrastructure is reaching the end of its usable life in the coming decade[14], this issue is set to become more pressing.

A similar situation was found to exist in New South Wales where an inquiry into local government sustainability there found:

> *Reductions in capital spending (both renewals and upgrade/expansions) may be a common means of balancing budgets. In fact, compelling evidence has been presented to the Inquiry that Councils' operating deficits are funded largely by running surpluses on their capital accounts rather than resorting to borrowing. This means capital contributions, capital grants and proceeds of asset sales are used mainly to prop up operating costs rather than to finance capital renewals and upgrade/expansions.*[15]

Access Economics calculated the infrastructure backlog amongst Western Australian Councils to be around 13.8 per cent or around $1.75 billion of the $12.7 billion in infrastructure assets held by the sector. The magnitude of the backlog varies dramatically amongst the different categories of Councils (Table 4) with metropolitan councils having the smallest infrastructure backlog. In contrast, the infrastructure backlog for regional Councils with large towns is approximately 22.2 per cent and that for regional Councils without large towns is approximately 20.6 per cent.

Table 4
Infrastructure Backlog Ratio By Type Of Council
WA Councils, 30 June 2005

	# Councils	Backlog Ratio
Metropolitan	29	5.8%
Regional, with large town	27	22.2%
Regional, without large town	86	20.6%
Above average growth	30	11.1%
Declining growth	71	21.6%
Largest 25 Councils	35	9.6%
Smallest 25 Councils	35	19.4%
All WA Councils	142	13.8%

Source: Access Economics, 2006

Access Economics concluded that:

> *"We are convinced that, rather than incurring debt in order to finance their annual operating deficits, WA councils – like their NSW and SA counterparts – have been relying for some time instead on capital revenue (such as capital*

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contributions, capital grants and the proceeds of asset sales) for this purpose."[16]

Finding: CCI believes that the current systematic practice of Councils running operating deficits financed through running down important infrastructure needs to be addressed. Appropriate adjustments in expenditure should be taken to ensure local government can maintain the infrastructure for which it has responsibility. The current practice of funding operating deficits through delaying infrastructure maintenance avoids the democratic governance checks that would occur if these deficits were funded through debt or through increasing revenues.

Own-Source Revenue

While the 2004-05 operating deficit indicates that a substantial intergenerational equity transfer occurred, this is actually an improvement over past years. In 2001-02 WA Councils operating deficit was approximately 12 per cent. Local government in WA has systematically operated with substantial operating deficits.

Table 5

Source of Operating Deficit Reduction

All WA Councils, 2001-02 to 2004-05

Operating expenses	2.9 %
Own-source revenue	5.7 %
Of which: Rates revenue	3.8 %
Of which non-rates own-source revenue	9 %
Operating grants from other governments	1.1 %

Source: Access Economics, 2006

The improvement in WA Councils operating deficits has been achieved through growth in Council's own-source revenue that is well above their operating costs (Table 5). Of particular interest to CCI is the growth in non-rate own-source revenues. In WA, Councils raise non-rate own-source revenues through investments, fees and fines, operating contributions and from other sources. Generally, the basis for determining a fee or charge is not limited to the cost of providing the service or goods. While CCI supports the practice of cost-recovery in government service delivery, it is important that fees and charges are appropriately established and do not service to inappropriately subside other services.

Table 6

Fees and Charges by Type

All WA Councils, 2004-05

	Million
Fees and fines	$15.2
Service charges	$97
User charges	$322.1
Operating contributions	$32.3
Operating contributions	$51.3
Other income (not including investment income)	$517.9

Source: Access Economics, 2006

Basic rate-setting practice is that fees and charges should be used to finance services with a predominately 'private' component, while rates (which are a general tax) should be used to finance services with a substantial 'public' component. There is a considerable degree of variation across local government functions in the degree to which benefits are believed to be public or private and many services involve a combination of these two. There is no clear evidence that local governments are apportioning costs between rates and fees and charges appropriately.

New Zealand legislation requires Councils to identify the beneficiaries of services that they provide and to apportion costs between them. Councils are then expected to raise funds according to these cost attributions, with some adjustments based equity concerns. Under this legislation:

- if those that benefit directly cannot be identified and/or if those that benefit directly cannot be excluded from using the service, the costs should be allocated to the community and it is a public good;
- if a service (or activity) benefits identifiable individuals or group(s) the costs should be allocated to those individuals or group(s) as the user should pay;
- if there are indirect or 'flow-on' benefits and those that receive these benefits cannot be identified, then the costs should be allocated to the community as it is also a public good; or
- if the service prevents the negative effects of the actions of (identifiable) persons, the costs should be allocated to those individuals that cause the cost to occur.

Finding: Current arrangements allow fees and charges to cross-subsidise other services provided by local government. Since fees and charges receive less public scrutiny than rates, that is they are paid by a smaller section of the community, Councils are not subject to the same democratic governance measures as general rate increases. CCI believes that local governments in WA should identify the beneficiaries of services that they provide and justify their rates, fees and charges on the basis of this assessment.

Another source of concern for CCI is that local government fees and charges are not co-ordinated with State or Federal Government. This is particularly noteworthy for developer charges and processing business approvals where imbalances between the two being likely to distort the pricing of residential and commercial land and add uncertainty in investment decisions.

While Councils raise 36.6 per cent of their revenue from fees and charges, the majority of their own-source revenue comes from rates which provided operating revenue in WA of $869.7 million in 2004-05. Thus the majority of local government revenues come from their capacity to rate land.

For a rating system to be efficient, collection costs (administration, enforcement and taxpayer compliance costs) should be low. The present rating system is administratively cost-efficient, in that the tax base is not mobile and stays broadly the same in physical and usage terms from one year to the next. Changes in ownership are notified to councils and so it minimises administrative and enforcement costs. Overall, the rating system could be considered an efficient taxation system, which is administratively simple and, if used properly, is vertically and horizontally equitable. It also serves to be a predictable and stable form of revenue that enables both ratepayers and Councils to budget for its impact with relative ease.

As previously discussed, local government rates revenue has contributed 3.8 per cent of the reduction in the sectors operating deficit since 2001-02. This represents local government's willingness to use the rating mechanism to fund their operating expenses and its ability to fund the sectors activities.

Financial Sustainability

Access Economics developed a methodology for assess the financial condition of Councils based on an adjusted operating deficit which included a nominal interest figure for a Council's infrastructure deficit and added additional revenue. If this produced an adjusted operating (deficit) greater than 10 per cent of its own-source revenue, then the Council was deemed to be financial unsustainable.

This was defined as unsustainable because, with an operating deficit at this level, it means the current service level cannot be maintained without substantial and disruptive increases in rates. This adheres to the Commonwealth Government definition:

> *"One of the key requirements for sustainable government financial arrangements is a balanced budget over the medium to long term, given a reasonable degree of stability in the overall tax burden."*[17]

After adjusting operating surplus / (deficits) to account for the infrastructure backlog, Access Economics found that 83 Councils in WA are currently 'unsustainable' (Table 7).

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Table 7
Calculation of Adjusted Operating Surplus / (Deficit) Ratios
All WA Councils, 2004-05

	Actual operating surplus ($Million)	*less* nominal interest on backlog ($Million)	*plus* additional revenue capacity ($Million)	*equals* adjusted surplus / (deficit) ($Million)	*divided by* adjusted own-source revenue ($Million)	*equals* adjusted operating surplus / (deficit)
Metropolitan	$12.3	$24.3	$65.2	$53.2	$993.1	5.4%
Regional, with large towns	-$38.5	$46.1	$25.9	-$58.7	$348	-16.9%
Regional, without large towns	-$38	$49	$31.4	-$55.6	$196.3	-28.4%
Above-average growth	-$17.3	$31.7	$48.1	-$0.9	$581	-0.2%
Declining population	-$46.7	$55.2	$27.1	-$74.8	$276.2	-27.1%
Largest 25 per cent	-$13.2	$52.1	$76	$10.7	$1193.5	0.9%
Smallest 25 per cent	-$6.9	$11.9	$6.7	-$12.2	$52.8	-23.0%
All WA Councils	**-$64.2**	**$119.5**	**$122.5**	**-$61.1**	**$1537.4**	**-4.0%**

Source: Access Economics, 2006

Table 7 describes the operating surplus / (deficit) disparities that exist in the local government sector between the different categories of Councils. What is interesting is how the adjustments serve to exacerbate the operating deficits observed in rural and remote local governments. Regional communities have the largest infrastructure backlogs and also the least amount of additional revenue capacity when compared with metropolitan Councils. This may indicate that the rate base is insufficient to maintain the large road-networks of these regions.

Rates, as a taxation mechanism, work best when the beneficiaries of local social and economic infrastructure reside in the community. When local infrastructure is used by industries, such as mining or agriculture, which move through a local government, then the local community is providing an indirect subsidy.

CCI agrees with the comments made by the SSS Panel:

> *"Adopting proactive asset management will require a considerable change in policies and practice within the sector, supported by excellent community engagement of the choices available to the industry and better technique and tools applied to asset management, planning and funding."*[18]

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Finding: CCI believes that local government in Western Australia must embrace these changes. The current practice of delaying infrastructure maintenance to fund current expenditure is detrimental to the development of Western Australia and avoids the democratic governance of increasing general rates or the financial governance of increasing debt levels.

The disbursement of royalties from major projects that place considerable strain on local infrastructure needs to be assessed to ensure an equitable distribution and also an economic level of investment.

Financial Reporting

In examining local government finances in WA, Access Economics observed that there were a number of deficiencies in financial reporting standards that made an accurate assessment of local government finances difficult. In particular, difficulties were cited relating to the under-funding of depreciation, the outdated measurement of asset values and depreciation, poor asset management systems and policies, and the inadequate monitoring and reporting of a council's financial position and performance. This prompted Access Economics to say:

> *"Where financial governance is not well developed in councils, it is not surprising that there is a lack of understanding on the community's part of the true costs of current infrastructure and service commitments."*[19]

Finding: CCI believes that it is important for local government to have comparable financial reports on which communities and business can assess their effectiveness. As such, CCI endorses the recommendations made by the SSS Panel aimed at improving the consistency and quality of financial reporting within the local government sector.

Structural Reform

Structural reform in the form of amalgamation has been a key feature of local government reform in every state but Western Australia. The number of local governments in Australia has fallen 43 per cent between 1910 and 2004 whereas the number of local governments in WA has actually increased by almost three per cent over this time. In a sector without strong external competitive or governance pressures, structural reform has provided a strong impetus to improve efficiency. There are strong reasons to believe that the negative impacts of unsustainable local governments can be mitigated through concerted reform initiatives.

Local government in WA does not have the same external governance pressures as State or Federal Government. Unlike other spheres of government, local government does not face intense public scrutiny over its policy decisions. While State and Federal Government have high levels of voter turn-out, local government in WA tends to have around 30 per cent[20] of the electoral role vote in its elections. Additionally, the large number of Councils in the state means that the individual decisions of any one local government do not receive broad media attention. Nor does local government face competitive pressures. Unlike a private business, there is no competition for "customers" since rates have a statutory basis and is enforced by law, specifically the *Local Government Act 1995*.

There is a strong argument that enforced structural reform has prompted improvements in local government efficiency. The Commonwealth Department of Transport and Regional Services (DOTARS) 2005 annual report stated that:

> *'Larger councils have a more secure and adequate financial base; are better able to plan and to contribute to economic development; are more effective community advocates; and interact more effectively with government and business.'*
>
> *Since Commonwealth funding equates to around ten percent of council income, councils must 'deliver value-for-money services to local communities,' and because 'structural reform delivers economies of scale and permits councils to employ a wider range of professionals', council amalgamations will generate a greater range of services and improved quality of service.*

State governments across Australia have expressed concern over the operational efficiency of local governments resulting in a wave of structural reform and other initiatives implemented with the intention of creating a cost effective local government sector.

During the 1990s, South Australia, Tasmania and Victoria underwent episodes of forced local government amalgamations. More recently, restructuring under duress has occurred in New South Wales, and the Northern Territory, while Queensland replaced a collaborative process of structural reform with compulsory amalgamations designed to reduce the number of local government by 55 per cent. These different reform processes have resulted in a substantial decline in local governments in Australia. DOTARS (2005) state that:

> *'a key feature of Australian local government reform has been the use of council amalgamations as the primary policy tool in the search for more cost effective local services.' During 'the 80 years from Federation to 1991, the number of councils in Australia fell by over 20 per cent' and 'in the 13 years since 1991, council numbers have fallen by a further 27 per cent'.*

This year the Northern Territory announced that it will reduce the number of local governments from 63 to 13. This involves a major readjustment of regional and remote local government arrangements.

The Queensland government also announced major structural reform. It cited the failure of local governments to participate sufficiently in a voluntary reform process in its decision to reduce the number of local governments from 157 to as few as 70. The exact number is expected to be determined by September 2007.

Reform in Western Australia

While Western Australia has not experienced significant structural reform, with very few Councils undertaking voluntary amalgamation, there has been considerable reform in business activities. A survey of local governments in WA found that 92 per cent engaged in some form of resource sharing arrangements[21]. However, the authors of the report stated:

> *The authors believe that these models (for greater shared service provisions) are not widely adopted because of institutional resistance to change.*[22]

The authors of the Best Practice Report cited the following as being reasons that local government has not embraced structural reform:

- Lack of Resources
- Skill shortages
- Lack of Co-ordination
- Compliance Issues

- Lack of tangible benefits
- Financial capacity
- Geographical Location (i.e. remoteness)
- Increased bureaucracy
- Lack of access to new technology
- Poor levels of trust with State and Federal Governments
- Lack of trust (rivalry with neighbouring councils)
- Loss of Council's individual identity and autonomy
- Fear of Amalgamation

The SSS final report identified the following as potential benefits from structural reform:

> *"**Securing economies of scale and scope** – this is a useful argument for shared services, but not for structural reform as gains are usually only achieved in highly capital-intensive production processes and related corporate services. In the local government context a great deal of the "back-office" activity has the potential for significant cost savings provided service arrangements focus on standardised processes, appropriate service expectations and the best use of enabling technology. Other than where call centre-style services are offered to the public we see little only limited gains in prospect for "front office" services on a regional basis.*
>
> ***Better depth and capacity for skills** - larger local governments can employ a greater depth and range of technical and specialist staff on a full-time basis – others can only achieve this outcome through resource sharing and pool-style arrangements. The growing depth and complexity of the local government task is readily acknowledged with an inevitable consequence that economies based on capacity and skills seem likely to provide the key imperative for further structural change.*
>
> ***Consolidation to address administrative and compliance costs** - this argument contends that larger administrations allow local government to directly reduce the direct costs of administration and compliance costs. The Panel's view is that the compliance burden on local government is onerous. A preferred approach is to simply reengineer and reduce the compliance*

burden and determine whether the function is best performed on a regional, zonal or local basis."[23]

Finding: CCI agrees that there are substantial benefits that could be achieved by a more comprehensive and structured approach to delivering local government services that is not determined by vested interests. Based on research conducted by CCI, Western Australian business would benefit most from consolidation of local government planning regimes and through streamlining business approvals[24]. Given the widespread financial unsustainability of local governments in Western Australia, CCI believes it is important for local governments to adopt a more comprehensive review of its services to ensure that economies of scale and scope, as well as access to appropriate skills, be available to local government.

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Endnotes

[1] CCI, 2007, p. 4.

[2] WALGA, 2006, p. 6.

[3] SSS, 2006A, p. 32.

[4] WALGA, 2006, p. 6.

[5] SSS, 2006B.

[6] WALGA, *SSS Taskforce Bulletin One*, February 2007.

[7] SSS, 2006B, p. 15.

[8] Acton, 1997, p. 3–4.

[9] Department of Treasury and Finance, 2006.

[10] Access Economics, 2006, p. VIII.

[11] Oakerson, 1999.

[12] SSS, 2006A, p. 16.

[13] Local Government Advisory Board, 2006, p. XIX.

[14] Access Economics, 2006, p. 37.

[15] NSW Inquiry, 2006, p.282.

[16] Access Economics, 2006, p. 36.

[17] Commonwealth Government, 2002, p. 2.

[18] SSS, 2006B, p. 60.

[19] Access Economics, 2006, p. 66.

[20] Voter turnout for in person elections averaged 25.9% in 2001, 22.04% in 2003 and 20.28% in 2005 whereas postal elections averaged 38%, 35% and 37% voter-turnout respectively. Western Australian Electoral Commission, 2005.

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[21] Burow, Jorgensen and Associates, 2006.

[22] Burow, Jorgenson and Associates, 2006, p. 24.

[23] SSS, 2006B, p. 71.

[24] CCI, 2006.