

IN OUR HANDS

STRENGTHENING LOCAL GOVERNMENT REVENUE FOR THE 21ST CENTURY

Working Paper

February 2013

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EXECUTIVE SUMMARY

There is wide variation in the financial performance and capacity of Australian local governments. Most are in at least a satisfactory financial position or have the capacity to be so over the medium-term through reasonable and responsible financial decision-making. Some others, often with large geographic areas and small population bases, need additional financial support.

A case exists for greater levels of financial support for the sector from other spheres of government. Such an outcome is unlikely to be materially realised in the near- to medium-term given the other priorities and projected financial outlooks of the Commonwealth and most states and the Northern Territory. As a result, improved future financial performance will, for most councils, depend to a large degree on their own decision-making. This will involve a variety of factors but improving financial understanding and expertise at both officer and elected levels, and better long-term planning, are key. For example, councils often have more capacity than they appreciate to address perceived asset renewal needs and increased service level preferences.

In many cases, financial improvement would necessitate consciously and gradually reviewing service levels relative to community affordability and preferences, and/or increasing own-source revenues, and seeking to improve efficiency. In many instances there is a need to improve financial strategy settings and in particular for councils to make greater use of borrowings and adopt better treasury management practices. There is scope for other spheres of government to assist in these regards by ensuring their own policy settings and local government legislative frameworks support better local government financial performance.

Property taxes are an appropriate prime revenue source for local governments and generating more rate revenue is likely to be both warranted and feasible for many councils. In order to be able to successfully do so councils need to ensure that the structure of their rating strategy reasonably meets sound tax design criteria principles and the circumstances of their communities. There is already reasonable flexibility in rating-related legislation in most jurisdictions but in some cases further refinements and additional guidance would assist councils to make better rating decisions. Scope also exists for many councils to generate additional revenue from user charges for services that are of primarily a private good character.

Not all councils that need more revenue have the capacity to generate it from their own-sources. If more grant funds are not likely to become available then consideration needs to be given to allocating a greater share of the existing grant fund pools to councils that have less capacity to assist themselves. A reduction in the minimum per capita general purpose financial assistance grant is an option that could help achieve this outcome.

Good progress has been made by the sector on improving financial performance in recent years but more needs to be done, and not just by individual councils. Further collaborative, collective activity is required within the local government sector and with other spheres of government to strengthen the financial capabilities of local governments. Strengthening revenues is a key component for many councils but by no means the only one.

PREAMBLE

The development of this Working Paper, *In Our Hands: Strengthening Local Government Revenue for the 21st Century*, has been a collaborative venture between the Australian Centre of Excellence for Local Government (ACELG) and its partners in local government, federal and state agencies, universities, and consulting firms. Our aim is to strengthen local government revenues in the medium to long term by drawing together available information and research to develop a sound evidence base and fresh ideas that can inform discussions taking place in policy circles around Australia.

This paper builds on ACELG's Working Paper No. 4, *Unfinished Business? A decade of inquiries into Australian Local Government*, which was released in 2011. The need for further research on questions relating to the strength and sustainability of local government revenues has been recognised for some time. The research brief included consideration of the following questions:

- What do we know about the sustainability of local government revenue to date?
- Is the revenue base adequate and appropriate?
- Are rates being effectively utilised?
- Where the revenue base is inadequate, what are the best options for local government to increase and sustain own-source revenue to meet current and future needs?
- How can we sustain smaller rural and remote councils through increased external support?
- What have we learned about how increased and sustained revenue for local government is achieved with least political fallout?

This paper has been prepared with input from agencies with local government responsibilities and peak local government associations in all Australian jurisdictions, as well as academics, consultants, and others with a known interest in local government finances. A substantial amount of material was provided to, and reviewed by, the author.

A Background Paper was published in August 2012. It analysed and synthesised recent major papers and reports on the issues involved and provided an overview and assessment of their findings and implications. This Background Paper was the focus of a Search Conference of interested participants held in Melbourne in August. Findings from the conference and feedback from stakeholders helped inform preparation of a draft Working Paper that was released in November 2012. The draft was considered at a subsequent academic review workshop held in Sydney in December 2012.

This paper takes account of feedback on the draft Working Paper and incorporates material included in the Background Paper. It has been written for practitioners. This includes council members and officers working in local government who have strategic financial decision-making responsibility, local government peak bodies that provide guidance to councils, and agencies with local government program administration and monitoring of performance and legislative framework responsibilities.

All opinions expressed in the paper are those of the author and do not necessarily reflect the views of individuals and organisations that were consulted in its preparation. It is stressed that comments made by the author throughout the paper regarding, for example, the financial circumstances and capability of local governments and the needs and opportunities for improvement in the financial performance of local governments are of necessity general in nature. They may be of more applicability to certain

councils and jurisdictions than others. There are a large number of local governments in Australia. Their size and operating environments vary widely. There are also variations between jurisdictions in legislative frameworks and the nature of programs that have been established to support local government financial decision-making.

In a paper of this nature there is always more that could have been considered and discussed but it is hoped that it includes relevant content that stimulates the financial thinking of all councils and that it also encourages further research and writing on the subject of local government revenues. Both ACELG and the author will be well satisfied if anyone who believe their own council's or the local government sector's financial capacity and capability needs further strengthening is able to help achieve this on a sustainable basis through alternative approaches to those suggested within this paper.

Appreciation is extended to the many people and organisations who contributed through participation in the Search Conference, Academic Review or through the many written submissions and responses to draft papers during the development of this paper. A list of contributors can be found in the Acknowledgements section at the end of this paper.

1. INTRODUCTION

Over the past decade or so there has been considerable attention given to the state of Australian local governments' finances, the capacity of local governments to fund reasonable and appropriate service levels, why local governments may have financial challenges, and what if anything should be done about these matters.

There have been a number of comprehensive reports on these topics. Some have been commissioned by local government representative bodies at the state or national level and some have been initiated by the states and the Commonwealth. There has also been a major review of Australia's overall systems of taxation.

This paper explores the key themes and findings for local government of these reviews and draws on related research. To put this in context, it first provides contextual background and analyses the local government sector's financial performance and capacity. It considers the likelihood of additional funding support for local government from other spheres of government and the feasibility, merit and means of the local government sector and different categories of councils generating additional own-source revenue.

2. BACKGROUND

There are 565 local governments in Australia (ACELG 2012). This represents a reduction of 261 since 1991 (Australian Government Department of Infrastructure, Transport, Regional Development and Local Government 2010, p.49). While many urban councils serve populations of 100,000 persons or more, there are also many serving very low populations – about 200 serve populations of less than and often much less than 10,000 (Sansom 2012). These smaller local governments are typically in rural and remote localities and often serve very large geographic areas.

A number of factors have spurred increased interest in local governments' financial performance and capacity this century, including:

- Claims by the local government sector that communities and other spheres of government are expecting them to undertake a much broader range of responsibilities than historically has been the case and that their revenues have not kept pace with expenditure requirements.
- The demands and implications of demographic change. Many local governments in urban and coastal locations have experienced rapid rates of development and population growth resulting in additional infrastructure needs and service level pressures. At the same time many rural and regional communities have experienced population and/or income loss that has exacerbated the financial challenges of their local governments.
- Increasing recognition that local government assets are aging and concern that renewal expenditure is not occurring at the rate necessary to maintain service levels from existing assets. This follows changes in Australian Accounting Standards in the 1990s and legislative requirements for local governments to follow such standards. These changes require governments to recognise infrastructure (for example roads, stormwater drains, buildings) as assets and their gradual consumption as an annual expense (depreciation) over their useful lives. These changes showed for the first time the total costs of service delivery by local governments inclusive of asset consumption.
- Political agitation as a result of property price booms and local governments' rating policies that can create volatility in rates payable by many ratepayers (although not necessarily commensurate increases in local government revenue).

3. LOCAL GOVERNMENTS' FINANCIAL PERFORMANCE AND CAPACITY

3.1 Local government revenue and expenses

Table 1 shows aggregate revenue and operating (that is, not capital) expenses for Australian local governments and the percentage change in revenue and expenses by type over the past 10 years.

Table 1 Local government revenue and expenses

	2010-11	2010-11	Increase over 10 years
			2001-02 – 2010-11
GFS^a Revenue	\$m	%	%
Taxation revenue	12,408	37	84
Current grants and subsidies	3,376	10	51
Sales of goods and services	8,466	25	50
Interest income	1,192	4	222
Other	8,060	24	179
Total	33,503	100	87
less			
GFS Expenses	\$m	%	%
Gross operating expenses			
Depreciation	5,794	20	59
Employee expenses	10,891	37	89
Other operating expenses	11,447	39	72
GFS other	1,192	4	113
Total	29,323	100	77
equals			
GFS Net Operating Balance	4,180		

^a GFS is an abbreviation of the words 'Government Financial Statistics'. GFS is a reporting format used to enable standardised financial reporting by governments in Australia.

Source: Australian Bureau of Statistics (ABS) 2012, *Government Finance Statistics*, Australia, 2010-11: Table 339 Total Local General Government Operating Statement. File '55120DO019_201011'.

Key observations:

- Revenue slightly exceeds operating expenses (and in fact has each year during this period).¹
- Taxation revenue is the largest source of revenue.
- Grant revenue has failed to keep pace with the increase in total operating expenses while tax and other revenue has increased at a greater rate.

¹ Revenue here includes capital revenue – see subsequent discussion in Section 3.4.

3.2 Local government expenses by category

Table 2 shows aggregate expenses by category for Australian local governments and the percentage change for all items over the past 10 years.

Table 2 Local government expenses by category 2010-11

	Increase over 10 years		
	2010-11	2010-11	2001-02 / 2010-11
	\$m	%	%
General public services	5,611	19	93
Social security and welfare	1,684	6	87
Housing and community amenities	6,451	22	72
Recreation and culture	4,359	15	99
Transport and communications	6,640	23	43
Other economic affairs	1,016	3	73
other	3,559	12	117
Total	29,323	100	77

Source: Australian Bureau of Statistics (ABS) 2012, *Government Finance Statistics*, Australia, 2010-11: Table 339 Total Local General Government Operating Statement. File '55120D0019_201011'.

Key observations:

- The major expenditure category is transport and communications (roads, bridges, footpaths etc.) but the rate of nominal increase in expenditure over the past 10 years for this category has been less than for all others.²

² For example, transport and communications expenses represented 28% of total expenses in 2001-02.

3.3 Local government balance sheet

Table 3 shows the aggregated balance sheets of Australian local governments and the percentage change for all items over the past 10 years.

Table 3 Local government balance sheet 30 June 2011

	Increase over 10 years		
	2010-11	2010-11	2001-02 / 2010-11
Assets	\$m	%	%
Financial Assets	27,333	8	179
Non-financial Assets	300,935	92	95
Total	328,268	100	100
Liabilities	14,905	100	65
Net Worth	313,364	100	102

Source: ABS 2012, *Government Finance Statistics*, Australia, 2010-11: Table 3 Total Local General Government Balance Sheet.

Key observations:

- Almost all (92%) of the assets of local governments are of a non-financial nature.³
- Local government liabilities (borrowings etc.) are modest as a percentage of total assets (5%) and as a percentage of total annual revenue (44%).⁴ In fact, the financial assets of the local government sector exceed its total liabilities. That is, the sector has negative net financial liabilities.⁵

³ These non-financial assets are overwhelmingly land and fixed assets (infrastructure). Local government service delivery is far more asset intensive than other spheres of government and depreciation makes up a far higher proportion of local governments' operating expenses. For example, research undertaken by the Local Government Association of South Australia suggests that SA councils have approximately three times as many assets relative to income as the SA Government, and that the SA Government has about three times as many assets relative to income as the Commonwealth.

⁴ Based on revenue in Table 1.

⁵ Net financial liabilities are total liabilities less financial assets.

3.4 Local government capital expenditure and depreciation

Table 4 shows annual capital expenditure and consumption of capital assets (depreciation) by Australian local governments in service delivery and the percentage change for all items over the past 10 years.

Table 4 Local Government capital expenditure and depreciation

						Increase over 10 years
	2001-2	2002-03	2008-09	2009-10	2010-11	2001-02 / 2010-11
	\$m	\$m	\$m	\$m	\$m	%
Purchases of new non-financial assets	4,349	4,694	9,147	10,124	9,204	112
Depreciation	3,653	3,762	5,355	5,588	5,794	59
Difference	696	932	3,792	4,536	3,410	390

Source: ABS 2012, *Government Finance Statistics*, Australia, 2010-11: Table 3 Total Local General Government Balance Sheet.

Key observations:

- Local governments are investing in the acquisition of non-financial assets at a rate in excess of the recorded annual consumption of existing non-financial assets.⁶

The data presented in the tables above does not suggest that this is a sphere of government in financial crisis. However, caution is needed in interpreting this financial information, in particular because:

- Revenue listed in Table 1 includes capital revenue (it is included in, and likely to be the majority of, the amount shown as ‘Other’). Capital revenue is income received specifically for new or upgraded assets.⁷ That is, in a practical sense it does not offset existing operating expenses and instead its receipt will add to such expenses in future periods through associated depreciation, operations and maintenance.⁸
- Most local government assets (primarily infrastructure) are long-lived and not traded in markets. There is therefore more uncertainty as to their fair value for accounting purposes than for the assets of many other entities. This issue is exacerbated because in at least some jurisdictions local governments have not regularly re-valued assets to take account of relevant factors including, for example, price movements. Asset lives and rates of consumption are often also difficult to predict. These factors collectively give rise to some uncertainty as to the reliability of local governments’ reported depreciation expenses.

⁶ This was true in each year during this 10 year period. ‘Purchases of new non-financial assets’ include investment in both new additional assets and renewal, replacement, and upgrade of existing assets.

⁷ Capital revenue includes both money and physical assets ‘donated’ by another party.

⁸ It is generally accepted that a key indicator of local governments’ financial performance is their financial operating result (the difference between income and expenses net of capital revenues) over the medium-term. Generally speaking, local governments are likely to be able to maintain financial sustainability if they can maintain an underlying operating surplus on average over time.

- A wide range of studies have suggested that many local governments have significant asset renewal backlogs. Asset renewal backlogs arise where service levels from aged assets are less than is required or preferred and the responsible authority doesn't believe it has the financial capacity to renew such assets. The financial information listed in the above tables does not disclose or have regard for such backlogs.

On the other hand:

- It is likely that operating revenues (that is, revenue net of capital revenue) in aggregate for the sector and for many councils is approximately equal to (or only moderately less than) operating expenses.
- Depreciation expenses as a percentage of total expenses have been falling in many jurisdictions as asset related valuation and rate of consumption information has improved.
- The level of outstanding borrowings of local governments, having regard to both the extent of their holdings of long-lived infrastructure assets and annual revenue, is extraordinarily low. If there really are significant asset renewal backlogs, why don't local governments simply use existing financial assets or borrow to address this need?⁹

Having regard to the relative magnitude of depreciation expenses and capital revenues it is likely that overall the local government sector is in reasonable financial shape and has the capacity to raise additional debt if needed.

⁹ The aggregate operating result for the sector implies that many local governments would be able to service such borrowings without either the need to raise significant additional revenue or even if no additional revenue was raised then without material adverse impact on their operating result.

3.5 Local government revenue sources by jurisdiction

The financial activity of local governments varies somewhat between jurisdictions. Table 5 shows Australian local government revenue sources by jurisdiction in 2008-09.

Table 5 Local government revenue sources by jurisdiction, 2008-09

Revenue source		NSW	Vic.	Qld	WA	SA	Tas.	NT	Total
Taxation	\$m	3,041	2,928	2,393	1,220	956	263	74	10,874
	%	33.6	43.7	27.0	41.3	55.2	32.7	17.1	35.6
Grants & subsidies	\$m	1,104	740	698	342	185	111	134	3,314
	%	12.2	11.0	7.9	11.6	10.7	13.8	31.0	10.9
Sales of goods & services	\$m	2,844	1,178	3,314	615	284	302	79	8,617
	%	31.4	17.6	37.5	20.8	16.4	37.6	18.3	28.2
Interest	\$m	320	98	181	109	25	27	9	769
	%	3.5	1.5	2.0	3.7	1.4	3.4	2.1	2.5
Other	\$m	1,746	1,761	2,262	669	283	101	135	6,957
	%	19.3	26.3	25.6	22.6	16.3	12.6	31.3	22.8
Total	\$m	9,055	6,705	8,848	2,954	1,733	804	431	30,531
	%	100	100	100	100	100	100	100	100

Source: Jenkins et al. 2009.

Key observations:

- The most significant difference between jurisdictions is in the area of 'Sales of Goods and Services'. A major factor here is that in some states water supply and wastewater treatment and disposal is a function undertaken in many localities by local government authorities.

3.6 Local government expenses by purpose

Table 6 shows Australian local government expenses by category and jurisdiction in 2010-11.

Table 6 Local government expenses by purpose, 2010-11

	NSW	Vic	Qld	SA	WA	Tas	NT	Total
General public services	18%	13%	27%	14%	13%	17%	37%	19%
Social security and welfare	4%	15%	1%	5%	5%	4%	5%	6%
Housing and community amenities	26%	22%	20%	22%	18%	21%	19%	22%
Recreation and culture	13%	18%	11%	19%	23%	17%	11%	15%
Transport & communications	19%	18%	30%	19%	26%	30%	10%	23%
Other	20%	14%	11%	21%	16%	12%	18%	16%
Total (\$m)	9,088	6,544	7,997	1,753	2,890	603	449	29,323

Source: ABS Cat No. 5512.0 - *Government Finance Statistics*, Australia 2010-11. Tables 331 – 337 Local General Government Expenses.

While there are some differences between jurisdictions, what is far more significant is the difference in financial performance, position and capacity of local governments within all jurisdictions. The size and capacity to generate own-source revenue and expenditure needs and costs varies significantly between local governments across the sector. These issues and their implications are discussed later in this paper.

3.7 Taxation revenue share by sphere of government and source of revenue

Any review of revenue-raising by the local government sector and its financial relationship with other spheres of government needs to consider the sources of revenue of all jurisdictions. Table 7 shows Australian local government revenue by category and jurisdiction in 2010-11.

Table 7 Taxation Revenue % share by sphere of government and source of revenue 2010-11

	Federal	State	Local	Total
	%	%	%	%
Taxes on income	57.3	-	-	57.3
Employers payroll taxes	0.1	5.1	-	5.0
Taxes on property	-	5.8	3.5	9.3
Taxes on provision of goods and services	22.9	2.9	-	25.7
Taxes on use of goods and performance activities	0.2	2.5	-	2.7
Total	80.5	16.2	3.5	100.0

Source: ABS Cat. No. 5506.0 – *Taxation Revenue Australia*, 2010-11.

Key observations:

- The overwhelming share of total taxation revenue is raised by the Commonwealth and the majority of this is raised through taxes on income.¹⁰
- Local governments raise a very modest share of total taxation revenue.
- The states generate more revenue from property taxes than do local governments.¹¹

¹⁰ Taxes on income include tax raised on the incomes of both businesses and individuals. The Goods and Services Tax is raised by the Commonwealth and therefore treated as Federal revenue, but is distributed in full to the states and territories.

¹¹ State property taxes include land tax and tax on property transactions (stamp duty).

3.8 Share of total taxation revenue by sphere of government over time

Table 8 sets out the share of total taxation revenue collected by all three spheres of government over the past twenty years.

Table 8 Percentage share of total taxation revenue by sphere of government over time

	Federal	State	Local
1990-91	79.1%	17.4%	3.6%
1991-92	76.9%	19.2%	3.9%
1992-93	76.1%	20.0%	4.0%
1993-94	75.4%	20.9%	3.9%
1994-95	76.7%	19.9%	3.6%
1995-96	77.1%	19.6%	3.5%
1996-97	77.2%	19.6%	3.4%
1997-98	77.4%	19.4%	3.4%
1998-99	77.2%	19.4%	3.6%
1999-2000	77.8%	19.3%	3.1%
2000-01	81.9%	15.2%	3.0%
2001-02	81.7%	15.3%	3.1%
2002-03	81.8%	15.3%	3.0%
2003-04	81.5%	15.7%	3.0%
2004-05	82.3%	15.0%	2.9%
2005-06	82.4%	14.9%	2.9%
2006-07	81.9%	15.3%	2.9%
2007-08	82.0%	15.3%	2.9%
2008-09	82.0%	14.9%	3.2%
2009-10	80.3%	16.4%	3.5%
2010-11	80.5%	16.2%	3.5%

Source: ABS Cat. No. 5506.0 – *Taxation Revenue Australia*.

Key observations:

- Local governments' share of total taxation revenue has remained modest throughout this period and had been declining further until recently. The turnaround is primarily a reflection of the relative decline in revenue of other spheres of government as a result of a slowdown in economic activity post the Global Financial Crisis (GFC).¹²

¹² The GFC in 2008-09 severely and adversely impacted on the taxation revenue of the Commonwealth and states in that year and their aggregate revenues are in fact still below trend. It is likely that over time Commonwealth and state taxation revenues will improve and local governments' share of total taxation revenue will resume its trend decline.

Further to Table 8 above, local governments' share of total taxation revenue has in fact been declining steadily on a trend line basis since at least the 1960s (Access Economics 2004).

It needs to be borne in mind that taxation revenues collected by the Commonwealth and the states are far more volatile than those of local governments. The former are influenced to a large degree by changes in the level of economic activity. This is true even for states' revenue from property taxes, the majority of which is associated with stamp duty on property transactions.

3.9 Vertical fiscal imbalance in Australia

Whilst the Commonwealth collects most of the taxation and other revenue generated by governments in Australia, it doesn't spend the majority of it. There is significant vertical fiscal imbalance (VFI) between the three spheres of government as shown in Table 9 below.

Table 9 Revenue raised and spent, by level of government, 2010-11¹³

	Federal	State	Local
Total own-source revenue raised (A)	70.3%	23.2%	6.5%
Total own-purpose expenses (B)	53.5%	40.4%	6.1%
Degree of VFI (=A/B)	1.323	0.57	1.06

Source: ABS Cat No. 55120D0001_201011.

Key observations:

- The states generate less own-source revenues relative to their expenses than do local governments, and their expenditure programs and services are much more dependent on monies from other spheres of government (in their case the Commonwealth).

¹³ Calculated net of transfers between spheres of government. Expenses include depreciation but not net acquisition of non-financial assets. Total own-source revenue includes capital revenue. If it was possible to identify and net out this component, it is likely this would have only a very minor overall impact on relative vertical fiscal imbalance between the spheres of government (Access Economics 2004).

4. REVIEWS OF LOCAL GOVERNMENT FINANCES

In 2002, following lobbying from the local government sector the Commonwealth initiated (through a Parliamentary committee process) an inquiry into local governments' financial capacity and 'cost-shifting' to the sector. The committee was chaired by David Hawker MP, and it became known as the Hawker Inquiry and its report is commonly referred to as the Hawker Report.¹⁴

The local government sector had become increasingly concerned regarding its financial challenges. Local governments' roles and responsibilities had broadened over time and the sector perceived that other spheres of government were 'cost-shifting' onto local government. The sector was not opposed to a broader role but was seeking financial protection in any such arrangements (and increased Financial Assistance Grants; FAGs). Local governments were also beginning to better recognise that they were likely to need to undertake substantial increases in asset renewal in future.

The Hawker Inquiry found that cost-shifting had occurred but it also recognised that in some instances local governments had agreed to undertake additional roles (and often actively sought to do so in response to availability of grant funding programs) without taking full account of the longer-term financial implications.¹⁵

The Hawker Report led to the development of an Intergovernmental Agreement designed to limit cost-shifting to local governments. The Committee in its report didn't restrict itself only to issues of cost-shifting but also reviewed a wide range of local government financial issues.

Ongoing concerns within local government regarding the sector's financial capacity led to 'local government financial sustainability' inquiries in all jurisdictions and nationally. These concerns were driven in part by the findings of the Hawker Report that included the failure to secure increased grant funding and the reluctance of many local governments to generate increased tax revenue (or restrictions on so doing, or criticisms by state governments or citizens when they did so). These inquiries were generally initiated by local government but undertaken by consulting firms and respected persons with a high degree of autonomy.

The various inquiries confirmed that in all jurisdictions there were significant opportunities for improvement in local government financial management and performance.¹⁶ The reports suggested that many local governments did indeed have financial sustainability challenges. Typically in all jurisdictions it was suggested that 25% or more of local governments were 'financially unsustainable' under existing policy settings. These local governments were overwhelmingly ones with small populations (low own-source revenue base) and typically in rural localities and with large geographic areas to serve (higher costs per capita).

Many people within the local government sector would not have been surprised by these conclusions and in fact had anticipated that these reviews would validate their arguments for more financial support from other spheres of government. The inquiries confirmed that there was justification for more support from

¹⁴ Officially, the Committee's report is titled, 'Rates and Taxes: A Fair Share for Responsible Local Government'.

¹⁵ Part of the issue is that in practice there is often not clear delineation (or at least community understanding) of the respective roles and responsibilities of each sphere of government. If there is community concern regarding a problem, or preference for a service, that is not being adequately responded to by other spheres, local governments (being more accessible) are often under considerable pressure to address the matter.

¹⁶ ACELG (2011) provides an overview and key findings from each of the Inquiries and reference details for the full reports.

other spheres of government but concluded more so that in general local governments could and should do far more to improve their own financial performance.

In particular, the inquiries highlighted the importance for the sector to:

- Use accrual accounting rather than cash accounting to assess the cost of service provision and revenue raising needs (and, as a result, recognise depreciation as a legitimate expense and not just a book entry that can be ignored);¹⁷
- Prepare long-term financial plans (LTFPs) based on affordable and responsible service level and revenue raising decisions.
- Prepare long-term asset management plans (AMPs) that ensure monies are available for asset maintenance and renewal as required.
- Become more willing to make greater use of debt when warranted.

The inquiries also highlighted the inadequacy in many instances of the existing local government financial management regulatory frameworks that emphasised short-term cash flow stewardship considerations in decision-making. They were catalysts for significant action in most jurisdictions. In most states there have been subsequent legislative reforms that have required local governments to give focus to the longer term in their decision-making, for example by requiring the preparation of LTFPs and AMPs. There has also been a raft of guidance material and training programs developed. The Commonwealth's Local Government Reform Fund has provided a key means by which a significant part of these support programs have been funded.¹⁸

As part of its response to the Hawker Inquiry, the Commonwealth asked the Productivity Commission to undertake an inquiry into the revenue raising capacity of local government. The Productivity Commission completed its report in 2008.¹⁹

The Productivity Commission noted that the ratio of the local government sector's taxation revenue appeared to have remained relatively constant over the period 1990-91 – 2005-06 as a percentage of household disposable income but had declined by about 10% as a proportion of the nation's Gross Domestic Product (GDP).

It concluded that local governments in many rural areas were already taxing their communities at a reasonable (not excessive) level. However, its research led it to conclude that urban communities typically had the capacity to pay higher levels of local government taxes.

Access Economics reviewed the Productivity Commission's report on behalf of the Australian Local Government Association (ALGA) and the Local Government Association of South Australia (LGASA). It did not disagree with the report's general conclusions. However, it considered that the Productivity Commission over-stated the financial capacity of the sector by not having sufficient regard to its asset renewal needs and the obligations associated with capital revenues (Access Economics 2008).

¹⁷ Accrual accounting recognises consumption of assets as an expense whereas cash accounting recognises acquisition and renewal of assets as a cost. Although accrual accounting is used for annual financial reporting, many local governments still base budgets and other financial decisions on cash accounting concepts. This is not discouraged by legislative frameworks or supporting guidance material that still exists in many jurisdictions. Depreciation (that is, asset consumption) represented approximately 20% of total operating expenses of the local government sector in 2010-11. See Table 1.

¹⁸ An example is the preparation through ACELG/IPWEA of guidelines to assist local governments to prepare long-term financial plans and preparation and delivery of associated training programs (see ACELG & IPWEA 2012).

¹⁹ Its report is titled, 'Assessing Local Government Revenue Raising Capacity'.

5. GRANTS TO LOCAL GOVERNMENTS

Table 1 shows that in 2010-11 local governments received \$3.376 billion in current grants and subsidies. It is a modest part (about 10%) of the sector's total revenue.

The range and quantum of grants received varies widely between local governments. In part this is because the number and value of programs vary between jurisdictions and also because many require application by local governments or have eligibility criteria that restricts access.

The most significant universal sources of local government grants are:

- FAGs provided by the Commonwealth, technically via the states through their Local Government Grants Commissions (\$2.1 billion in 2010-11)
- the Commonwealth's Roads to Recovery Program (\$350 million in 2010-11).

Other grants programs provided by the Commonwealth and states and available to local governments tend to be for specific purposes and typically require additional expenditure by local governments. They are effectively subsidies to induce local governments to provide services and achieve policy outcomes sought by other spheres of government (and presumably favoured by local governments in most instances).

FAGs represent by far the most significant universal source of grants to local governments. Although it is only a modest share of total local government GFS (government financial statistics) revenue (6.2% in 2010-11), it can represent 50% or more of the total revenue of small remote councils with limited own-source revenue raising capacity and high expenditure disadvantages.²⁰

This source of funding was first made available in 1973 to both raise the financial capacity of all local governments and to improve horizontal fiscal equalisation between local governments (see Hancock 2004). The ongoing availability of these grants is relatively secure as their provision is enshrined in legislation that also provides for annual per capita and consumer price index adjustment. The grants have general purpose (\$1.48 billion in 2008-09) and local roads (\$657 million in 2008-09) components but councils have full discretion as to how they spend these funds (DRALGAS 2012).

Currently, in accordance with the Commonwealth Parliament's *Local Government (Financial Assistance) Act 1995* and the National Principles developed in accordance with that Act (see Section 6) for the purpose of allocation of grants, the available general purpose pool is distributed:

- i. on an equal per capita basis across jurisdictions
- ii. within jurisdictions based on each local government receiving at least the amount it would have received if 30% of the jurisdictional pool were distributed on a per capita basis.

²⁰ The Productivity Commission (2008, p. 33) noted that 20% of councils Australia-wide, representing only 1% of all residents, are dependent on grants for 48% or more of their total revenue. Grants made on the basis of horizontal fiscal equalisation attempt to compensate governments for revenue raising and expenditure disadvantages relative to the average of other comparable governments (for example states or local governments). Grants that were sufficient to achieve full horizontal fiscal equalisation would thus ensure that each government had the capacity to provide services at the overall average level assuming average levels of efficiency.

The local roads component is distributed across jurisdictions on a fixed percentage share basis. The National Principles require funds available to each jurisdiction to be distributed to local governments on the basis of relative need having regard to road lengths and usage.

The Commonwealth's Roads to Recovery Program is the largest 'tied' program that provides grants to all councils (\$350 million in 2010-11). The program was first introduced in 2001-02. It is subject to the budget processes but has always been extended since inception. Available funds are required to be used for transport related expenditure but may be spent on additional new assets and replacement, renewal, and maintenance of existing assets.

The Commonwealth announced in 2012 that the program will be extended to 2018-19. It is generally considered to have been a successful program with available monies well spent.

6. IS MORE FINANCIAL SUPPORT FOR THE SECTOR WARRANTED AND ACHIEVABLE?

Many people in local government argue strongly that the sector needs and warrants significant additional financial support from other spheres of government. This is understandable given that:

- grants as a share of local government revenue have declined over time²¹
- there is no doubt that local governments' roles have expanded
- communities typically want all spheres of government to do more for them (and are often not supportive of paying higher taxes to fund such increases)
- there is much greater awareness within local government of the long-run cost of its infrastructure related services and responsibilities and the need to balance revenue and expenditure provision
- given the size of the sector compared with the other spheres of government, it would be possible to materially improve local government's revenues with a very modest negative impact on the Commonwealth's and/or the states' budgets.

It also perhaps implies, given that grants are a much smaller share of total revenue than is own-source revenue, that the local government sector may lack the confidence and willingness to act as a relatively independent sphere of government in control of its own destiny.

Various studies have concluded that there are sound public finance theory reasons why other spheres of government should contribute general funding support to local government at higher levels than is currently the case.²² These arguments include that other spheres of government have a much broader range of taxation powers that enable equitable and cost-effective generation of revenue.

Regardless of the justification, it may be hard for the sector to secure material net additional financial support. The Commonwealth and states are faced with growing annual expenditure obligations and demands driven by demographic trends, rising health care costs, and proposed additional welfare and education-related expenditure programs. The annual rate of increase in costs for their existing policy obligations is likely to be far higher than that of local governments.²³ At the same time, their increase in taxation growth in recent years and current forward projections are less than previously forecast.

The states have much less capacity to collect own-source revenue relative to their expenditure responsibilities compared with associated local government sectors.²⁴ Realistically, in the foreseeable circumstances it is difficult to envisage most state governments wishing to provide significant additional funding to local governments that do not require commensurate additional expenditure.²⁵ Whilst the

²¹ See Table 1.

²² See for example: South Australian Centre for Economic Studies 2002; Hawker 2003 (the various Financial Sustainability Inquiries); Access Economics 2004; Local Government Rates Inquiry Panel 2007.

²³ Since a much lower proportion of local governments expenses are associated with health and welfare services or correlated with the demographic aging of the population.

²⁴ See for example Table 9. See also Henry 2010, Section G2.

²⁵ Why, for example, would a state government prefer to increase local government rate rebates for pensioners rather than, say, increase electricity bill concessions for this same class of citizen?

Commonwealth is in a much sounder position than the states, it does not have the capacity that it did in a pre-GFC environment, both because of new major one-off and ongoing expenditure programs and declines in revenue relative to previously projected forecasts. For the Commonwealth, there are always likely to be higher priorities for discretionary expenditure than supporting a sector that legally is the responsibility of the states.

The Commonwealth recently announced a review of the basis of distribution of FAGs and in doing so made clear that it will not be considering a real per capita increase in the quantum of funds beyond existing provisions (Swan 2012). That is not to say that some improvements in aggregate grant revenue should not be sought or may not be achievable. However, any increases in the base level of ongoing grants in the foreseeable future are likely to be modest. It may be possible to achieve improvement in the FAGs per capita escalation factor or indexation of future Roads to Recovery grants. The Commonwealth may see merit in providing additional funding under the Roads to Recovery Program if it was satisfied that this would facilitate further performance improvement – for example if recipient local governments had reliable, financially responsible AMPs in place and if funds were to be applied in a manner broadly consistent with AMP projections.

If the local government sector wishes to successfully argue for additional grants from other spheres of government it should also be prepared to strongly advocate for increases in existing taxes and/or for additional taxes to be raised by these other spheres of government, or else nominate areas for expenditure reduction. There is no ‘magic pudding’. Other spheres of governments’ forward projections show little capacity for additional expenditure without additional revenue or reductions in expenditure elsewhere.

It may be easier to generate additional tied grants over time compared with untied grants. Other spheres of government offer tied grants to help achieve their own policy objectives. Councils need to carefully consider all relevant factors before accepting such grants. Too often councils make applications for tied grant funding programs without fully considering all relevant factors. These include, for example: whether the project or service is one that is appropriate for local government to provide; what its strategic priority is compared with other alternatives; what is the whole of life cost; what is its affordability relative to the council’s financial capacity; and will the service continue beyond the period for which grant funding is available?

Even if many local governments could and should better utilise their own-source revenue capacities, this cannot be the answer for all and, in particular, for many small rural ones. Many of these generate only a minor share of their total revenue from their own sources. In many instances substantial increases in taxes are not an option on capacity to pay grounds. Such action would also make little overall impact where rate revenue is a small share of total operating revenue and total operating expenses significantly exceed total operating revenue. These local governments need more financial support if they are to provide a reasonable (but nevertheless modest) level of services on an ongoing financially sustainable basis.

Even if other spheres of government are not willing or able to provide more funding in aggregate to the local government sector, there does appear to be a case for redistribution and more effective targeting of existing grant pools. The obvious area, both because of the magnitude of available funds and the fact that the grants are untied, is the Commonwealth FAGs.

It is noteworthy that whilst the Commonwealth's *Local Government (Financial Assistance) Act 1995* requires available funds to be distributed within jurisdictions generally on horizontal fiscal equalisation (HFE) grounds, this is not how they are allocated across jurisdictions. If they were it is possible that pools available across jurisdictions would vary significantly from current arrangements. This issue was examined in the Commonwealth Grants Commission's 2001 report, titled *Review of the Operation of the Local Government (Financial Assistance) Act 1995*. That review did not recommend any change in distribution across jurisdictions. It is hard to see changes in this regard being made in the future given:

- that there appears to be a significant proportion of financially challenged local governments in all jurisdictions
- the politics potentially associated with material changes in the pool of funds available to individual jurisdictions.

The issue of relaxing the 30% basis of calculating the minimum per capita grant does, however, warrants further consideration. It was considered as part of the 2001 review but rejected then because of:

- the Act's intent to raise the financial capacity of *all* local governments
- the fact that it would not have had a material favourable impact, on average, for those local governments eligible for more than the minimum grant.²⁶

Since the 2001 review, Local Government Grants Commissions in many jurisdictions have refined their methodologies to improve HFE to take advantage of improved data and knowledge. This has led to a significantly higher number of local governments being on the minimum per capita grant.²⁷ It is therefore likely that relaxing the minimum entitlement (for example from the equivalent per capita amount of 30% of the pool to 15%) would now deliver a greater increase to local governments eligible for an amount in excess of the per capita minimum than was the case in 2001.

In any event, what is important is the impact of such a change in the grant allocation methodology for those local governments with the greatest need. FAGs typically represent a much higher share of total operating income for such councils. Whatever the average increase in the quantum received for a non-minimum grant council, the change would almost certainly have a much larger positive impact (relative to total income) for those that are currently the most financially challenged and have little capacity to materially increase own-source revenue. If modelling revealed that this was not the case, it may suggest that further review of grant distribution methodologies within jurisdictions is warranted.

It is also likely that many (probably the overwhelming majority) of councils that would incur a reduction in funding from a reduced minimum grant would not be materially adversely impacted, both because:

- FAGs are likely to be a relatively small part of their total revenue

²⁶ The Commonwealth Grants Commission Report (2001, p. 22) suggests that a reduction in the minimum grant from a 30% to 10% basis would have only increased the average grant to non-minimum grant councils by 6%.

²⁷ For example, between 1998-99 and 2008-09 the number increased from 60 of 720 councils (representing 22% of the population) to 91 of 565 councils (representing 34% of the population). See Australian Government Department of Regional Australia, Local Government Arts and Sport 2012.

- they are likely to have the capacity to generate offsetting additional revenue from higher property taxes to the extent that this may be required.²⁸

All recent studies that have commented on this issue have favoured abolition or reduction in the minimum grant.²⁹ The review of FAGs recently announced by the Commonwealth will reconsider this issue. The terms of reference specifically include assessment of the:

- impact of the Minimum Grant principle on the intrastate distribution of FAGs
- relative need of local governments in each state and territory with a particular focus on those that service regional and remote communities (Swan 2012).

Given the findings of the various financial sustainability inquiries, it is hard to see how relaxing the minimum grant criteria could not but materially benefit those local governments with the greatest financial challenges.

²⁸ The Productivity Commission report (2008) noted that relaxing the minimum per capita grant would generally and consequentially lead to a narrowing in the gap in own source revenue raising effort between smaller rural and larger urban local governments.

²⁹ See for example: Hawker 2003; Productivity Commission 2008; Henry 2010.

7. FINANCIAL FRAMEWORKS AND STRATEGIES

For many councils, financial issues are, to a large degree, either ones of perception or ones that can be substantially addressed through improved financial decision-making at the local level. Many councils are in at least a reasonable financial position or can be with incremental adjustments in their revenue-raising and their service level and expenditure outlay decisions over time.

Any assessment of the financial performance and position of a council and the sector collectively needs to have regard to the fact that councils are 'asset-intensive' in their means of service provision. Many local government services come from long-lived infrastructure that require increasing levels of maintenance as it ages and eventually requires renewal or replacement. Many councils traditionally focus on short-run (for example annual) cash costs when making their revenue-raising and expenditure/service level decisions. As a result, they have often been unprepared for increased asset management expenditure needs when required.

Generally speaking, if a local government can achieve a small operating surplus on average over time it should be able to maintain service levels in the future, including renewing and replacing assets as required. The desirability of basing revenue and service level decisions on achieving a small ongoing underlying operating surplus is now widely accepted within the local government sector (but not yet universally), and by agencies responsible for regulating local governments in all jurisdictions.³⁰

In 2008, led by the Local Government Ministerial Council and prompted by the outcomes of various local government financial sustainability inquiries, all jurisdictions committed to National Frameworks to achieve major improvements in local government financial management processes and practices. Very substantial work has been undertaken in all jurisdictions based on the findings of the financial sustainability inquiries to enhance financial planning and decision-making processes, prepare supporting guidance material, and provide training tailored for both officers and council members.

For example, the first Financial Sustainability Inquiry was undertaken in South Australia in 2005. It followed from an earlier study reporting on asset management expenditure needs in 2001 which concluded that within ten years South Australian local governments would need to spend three times as much per annum (in real terms) on asset renewal as they then were (see Burns, Hope & Roorda 2001). For the past three years, South Australian local governments have:

- undertaken asset renewal expenditure at three and a half times the levels of ten years ago in real terms
- improved annual financial performance from a collective \$100 million operating deficit in 1999/2000 to an operating breakeven result.

Similar trend improvements are occurring in other states too. Nevertheless, considerable ongoing work will be required before local governments Australia-wide have relevant regulatory environments, guidance and skills to practice sound financial decision-making relevant to their circumstances. For example, in some jurisdictions there is still not a legislated requirement for councils to prepare long-term financial plans or asset management plans.

³⁰ For further discussion regarding the value of basing decisions in local government on the operating surplus see for example: IPWEA 2009, Section 2; ACELG & IPWEA 2012, Sections 5, 7.2, 7.3.

In at least one jurisdiction councils are not yet required to have re-valued infrastructure assets thereby reflecting current day values in their calculated annual depreciation expenses.³¹ The basis of valuing assets and measuring depreciation can be quite variable between councils. There are differences in accounting treatment of capital revenues between jurisdictions that impact on the calculated operating result. There are material differences in reported primary financial indicators, their basis of calculation, and suggested appropriate targets for them between jurisdictions. It is likely to be some time yet before there is consensus regarding optimal approaches to these matters and therefore an even longer period before they become embedded and influence decision-making by local governments. Until these issues are addressed, it is likely that many local governments will continue to:

- i. *Maintain a preference for undertaking capital outlays on new additional assets without giving due consideration to the implications for their capacity to renew or replace existing assets when it is optimal to do so.* In fairness to councils, such decisions are often encouraged by community feedback and by conditions of many grant programs offered by other spheres of government which provide grants for acquisition of new additional assets but not replacement assets.
- ii. *Perceive that the sector generally does not have the capacity to address claimed asset renewal needs.* The reality is, however, that those that have been achieving satisfactory ongoing underlying operating results generally have considerable capacity to undertake warranted asset renewal activity without material increases in revenue or adverse impact on ongoing achievement of an appropriate operating result target.³² This is also true of councils that have the ability to incrementally generate more revenue (or reduce expenses) to achieve a satisfactory operating result. In each instance this would require them to either utilise existing financial assets or raise additional borrowings to finance such outlays. Councils typically are uncomfortable with the idea of taking such a course and consequently often prefer not to materially address so called asset renewal backlogs unless additional grant funding is received.
- iii. *Base their financial strategies on operating environment factors that may be of more relevance for financial decisions in the business world, or for community clubs or individuals, than those of a sphere of government with a large stock of long-lived depreciable assets and relatively secure ongoing sources of income.*
- iv. *Maintain a tendency to base annual revenue raising and expenditure outlay decisions on balancing cash inflows and outflows for the year, regardless of:*
 - the operating result that it generates
 - whether those inflows and outflows are of a capital or operating nature
 - whether capital outlays are for new additional assets, or renewal or replacement of existing assets
 - the impact on future budgets or the whole of life net cost of asset acquisition decisions.

³¹ Western Australian councils have been given until 2014-15 to recognise all assets at fair value.

³² Operating expenses associated with a replacement asset are likely to be similar to that of the asset that was replaced taking into account depreciation, maintenance, and financing expenses.

- v. *Lack good data for determining revenue-raising and service level affordability decisions.* For example, data used for preparing asset management plans, (such as determining estimates of asset renewal requirements, costs and timing) is often to varying degrees at odds with valuation and useful life information in asset registers used for preparing financial reports.

Sound financial understanding does not in itself generate more revenue or reduce expenses. Nevertheless, without it councils cannot commit to, or implement, strategies that deliver financial sustainability. Strengthening local government revenue-raising by itself will not necessarily solve councils' problems. More revenue will inevitably generate demands for more and higher levels of services (and acquisition of associated additional assets). Councils need the skills and frameworks that assist them to objectively and equitably balance revenue-raising with affordable preferred service levels that are efficiently delivered.³³

Agencies responsible for local government and local government peak bodies can do more to build on progress that has been made to date. There is scope for legislation, regulation and guidance material to be improved to capitalise on technical developments over the last few years and to take account of councils' current states of progress. Guidance material that exists within jurisdictions varies in comprehensiveness and, in some instances, approach. There is considerable potential for the sharing of information, materials and learning experiences between jurisdictions.

IPWEA's Australian Infrastructure Financial Management Guidelines (AIFMG) were developed with input and review from representatives of agencies responsible for local government and local government peak bodies nationwide. So too was ACELG/IPWEA's Long-term Financial Planning Practice Note. However, it has been more challenging to achieve national commitment to promoting consistent national financial practices. For example, jurisdictions have made little progress in determining and implementing reporting by councils on a small set of nationally consistent financial indicators.³⁴

Audit practices also vary widely between jurisdictions. Some but not all require councils to establish audit committees tasked with reviewing their council's financial governance and risk management systems and performance. In some states (Queensland, Tasmania and Victoria) their Auditor-General is responsible for external financial audits of councils and in other states councils appoint their own auditors. In the case of the latter, it is not unusual for different external auditors to have markedly differing opinions regarding what are required, sound and appropriate financial practices. In some (for example New South Wales and Victoria) but not all jurisdictions, the Auditor-General undertakes performance reviews on issues across the local government sector. Any action to review opportunities to improve local government financial capability and performance across jurisdictions should give consideration as to whether and how improvement in auditing regimes could assist. In many instances a strong, effective audit regime is a better, less burdensome alternative to increased oversight and regulation, and can help defend against calls for such responses.

³³ IPWEA is currently preparing a Practice Note to assist councils develop and articulate preferred affordable service levels. It is expected to be available in 2013.

³⁴ Agencies responsible for local government in each jurisdiction meet at least annually through what is known as the 'National Local Government Financial Management Forum'. That forum agreed in 2010 to work to achieve the goal of having councils report on a common, small, core set of financial indicators. General consensus was subsequently reached on applying four indicators but no jurisdiction has yet implemented such a reporting requirement by its councils.

8. RATES AND PROPERTY TAXES

8.1 Introduction

In reality, if a council believes it needs additional income then, in the case of most local governments, it is likely to best achieve this from its own sources of revenue. As highlighted in Section 5, while some councils are highly dependent on grants for a significant share of their total revenue, most councils collect the majority of their revenue from their own taxing decisions and from charging for particular services. There are, however, some constraints on this quantum, for example:

- some fees applied by local governments are set or capped by state governments, or are constrained by National Competition Policy obligations
- New South Wales local governments are limited in rate increases they can levy³⁵
- there are legal constraints and practical limitations on the generation of rate revenue by shire councils in the Northern Territory.³⁶

Nevertheless, local governments in the main have considerable discretion regarding the quantum of revenue they raise. They are required to consciously and explicitly determine rating levels each year as part of their budget-setting processes. This decision takes into account various factors including community preferred service levels, estimates of revenue for the period from other sources, and the entity's financial circumstances.

Taxation revenue (all from property taxes) represented 37% of councils' total GFS revenue in 2010-11.³⁷ In recent years, councils in most jurisdictions have been striving to increase rate revenue. This has been prompted in large part by the findings and recommendations of the various financial sustainability inquiries. In the period 2005-06 to 2010-11, for example, council taxation revenue increased by 42%.³⁸ This is well in excess of national income increases over this period. These increases have caused backlash in some localities and an understandable reluctance by councils to make greater use of this revenue source. In other localities, however, real material increases in rates have been accepted without significant adverse reaction. Factors likely to have contributed to differing responses include how well a council has:

- reflected community service level preferences in its expenditure decisions
- been able to adequately convey the need for rate increases
- structured its rating decisions to have regard to benefits received and capacity to pay of particular classes of ratepayers and other relevant tax design factors.

Many councils would ultimately be stronger financially and more confident that their expenditure decisions reflected community preferences if they relied to a greater extent on their taxation revenue raising powers. In order to do so, however, there is a need in many cases to improve understanding of rating theory in order to ensure that rating decisions are reasonable and defensible. There is sometimes

³⁵ Sansom (2012) found that during the period 1995-96 – 2003-04, rate increases in NSW averaged about half the rate of increase of other mainland states. A process exists under which local governments may be granted approval for a higher increase than the cap if they can demonstrate this is warranted to equitably meet costs of community preferred and required service levels.

³⁶ The NT Department of Local Government has indicated that rate revenue represents less than 10% of total revenue of NT shire councils.

³⁷ Refer Table 1.

³⁸ Source: ABS 2012, Government Finance Statistics: Table 349.

a perception within local government that council rates are a 19th century revenue raising measure that is not well suited to the needs of local governments and the circumstances of ratepayers in the 21st century. Such misconceptions need to be overcome if local governments are to equitably and effectively utilise this revenue source to a greater extent. Local government rating related legislation also warrants review in many jurisdictions. These issues are explored further in the remainder of this Section.

8.2 Overview of taxation theory considerations in the context of council rates

Various authors such as Stiglitz (2000, p. 458) and Dollery, Crase and Johnson (2006, p. 80) describe desirable characteristics of tax systems. Henry (2010, Overview p. 17) emphasises five:

- i. equity
- ii. efficiency
- iii. simplicity
- iv. sustainability
- v. policy consistency.

Equity considerations need to have regard to both benefits received and capacity to pay (Abelson 2006, p. 3). 'Efficiency' refers to economic efficiency considerations (distortionary impacts on decisions). 'Simplicity' refers to how readily a tax is administered and understood. 'Sustainability' refers to revenue raising durability. Finally, 'policy consistency' refers to whether discretionary components or applications of a tax undermine its overall objectives.

Henry (2010, Detailed Analysis p. 258-9) suggests that land value taxes are a sound and stable revenue base for local governments and that council rates are relatively simple, efficient and fair.³⁹ Other authors, for example Dollery et al. (2006, p. 88) and the South Australian Centre for Economic Studies (SACES 2002), also support property taxes as a prime revenue source for local governments. In New Zealand, where local governments have similar roles and legislative frameworks, Shand (2007, p. 168) concluded after an extensive analysis of alternative options that *'there is no better alternative to rates as a principal source of local government revenue'*.

It is generally accepted that income is the best indicator of capacity to pay (see SACES 2002, p.38-9) but councils cannot rate based on incomes. SACES concluded that residential property values may have reasonably good correlation with lifetime income, and subsequently undertook research on this topic without being able to find strong evidence to support this conclusion (SACES 2004) – nevertheless did it not resile from the claim.

Shand (2007, p. 126-7) showed that a strong degree of correlation existed in New Zealand between unimproved site values (USV) of properties and owners' incomes, and an even higher correlation between capital improved values (CIV) and incomes.⁴⁰

³⁹ For detailed consideration of Henry's review and its possible implications for local government, see Passant & McLaren 2011.

⁴⁰ There are three main property valuation bases used in Australia. They are known by various different names and have slightly different basis of determination in different jurisdictions. For convenience this paper assigns them three generic names: capital improved value ("CIV"), unimproved site value ("USV"), and annual rental value ("ARV"). USV reflects the

While it may often be that there will be correlations between site and capital values of residential properties, this will not always follow.⁴¹ This correlation may also be less applicable for commercial, industrial and primary production properties. Abelson (2006, p. 5) and Access Economics (2010, p. 31) both argue that capital value is likely to be a better indicator of capacity to pay than site value.

Taxing decisions should also have regard to benefits received. The CIV of a property will incorporate allowance for the value of the site (the difference effectively being the current value of the built improvements on the site). SACES (2002) and Access Economics (2010, p. 6) note that USV will be influenced by the quality and quantity of municipal services in the vicinity.

In general, a property that enjoys a high level of local government services will have a higher USV (and therefore a higher CIV) compared with one where these facilities do not exist (or are less accessible) but is equal in all other respects. The CIV of a property net of the USV is largely unaffected by the extent of available municipal services. USV therefore better reflects the relative value of local government services compared with CIV. However, it is important to recognise that relative property values (both USV and CIV) are also influenced by a wide range of other factors. In fact, in many instances the extent of readily accessible local government services may be a relatively small factor in influencing both.

USV better accommodates benefit principle considerations. It is also more efficient since it does not penalise (through higher taxes) development of the site – although Comrie, Smirl and Sody (2011, p. 17) note that this impact on decision-making is not likely to be material in the majority of cases.

Arguably, neither USV nor CIV has particular advantages relative to the other valuation methods based on simplicity, sustainability or policy consistency grounds, although USV is easier and therefore cheaper to determine. Some authors favour USV (see for example: Henry 2010, p. 689; Musgrave & Musgrave 1982, p. 480) while others favour CIV (see for example: Shand 2007, p. 127). Access Economics (2010, p. 47-9) suggest that the preferred method will depend on trade-off choices between principles of capacity to pay and benefits received.

Property values, whether calculated based on CIV or USV, are not perfect indicators of either relative capacity to pay or relative municipal service-type benefits received. It therefore makes sense for the amount that any individual ratepayer pays not to be determined solely by the value of their property. This can be achieved for example by use of a fixed charge. The Local Government Association of South Australia (LGASA 2012, Attachment 3, p. 3) suggests that a rating system based on use of a fixed charge to collect a significant share of revenue and capital values would provide a reasonable balance between benefit and capacity to pay considerations.

There seems to be no strong argument in the literature for the use of differential rates.⁴² Comrie et al. (2011, p. 13) suggest differentials may be appropriate to apply where particular classes of property impose higher costs on the council/community or where their owners have greater capacity to pay. However, these factors are often difficult to objectively assess and leave determination of relative differentials subject to the political power of different classes of ratepayers. In New Zealand, Shand

'land' value only of a property, i.e. its worth net of any built improvements. CIV takes account of all improvements to a site and thus should approximate a property's market value. ARV is based on an estimate of the annual rental worth of a property and has regard to the existence of structures and other improvements made to it.

⁴¹ See for example Access Economics' (2010) study into nature site and capital value of residential properties in Darwin.

⁴² The application of 'differential rates' involves levying a different rate in the dollar on differing classes of properties (for example differing uses of land). Use of differential rates results in properties of a different class but with the same assessed value being levied with different amounts payable.

(2007) recommended the abolition of the option of council use of differential rating, noting that business differentials had historically been set in an arbitrary fashion (2007, p. 131). Henry (2010, p. 258) also urges caution in the use of differentials.

One of the few criticisms of local government rates in the literature is that they can adversely impact on those who are asset rich and income poor (Dollery et al. 2006, p. 88). The suggested policy response is not to relieve such ratepayers of the obligation of the payment of this tax and therefore require others (who may have more current income but less overall wealth) to pay more, but rather by allowing such ratepayers to defer payment (for example for a principal place of residence until a change of ownership), which would be more equitable for all ratepayers and need not have any cost for a council.⁴³

8.3 Rating legislative frameworks

Comrie et al. (2011) analysed local government rating legislation in all Australian jurisdictions. They noted that only in South Australia does the *Local Government Act* make clear that council rates are a tax. This at least provides some guidance for councils in setting rates. It is clear, for example, that the South Australian Parliament intended that rates not be interpreted or applied as a form of utility charge as they are often perceived to be by those ratepayers who object to property values influencing the relative amount payable by individual ratepayers.

No jurisdictions specifically require councils to have regard to taxation principles in determining their rating structures. New South Wales stipulates that the imposition of rates by councils should be fair and Victoria emphasises that the imposition of rates and charges should be equitable.⁴⁴

Comrie et al. (2011, p. 1) suggested that 'Appropriate and explicit regard to clearly articulated principles would lead to better policy decision-making and improved community acceptance of rating outcomes'. Therefore, such an approach would potentially also give councils the confidence to draw more heavily on their property tax base where this was warranted. In terms of the key features of local government rating framework and legislation across jurisdictions, they noted the following issues:

i. *Variable valuation bases*

There is wide disparity regarding valuation bases used for rating between jurisdictions. USV is mandated in New South Wales and Queensland. In Western Australia, ARV is required to be used within the Perth metropolitan area and USV elsewhere. There is choice between all three bases in the other jurisdictions but in the Northern Territory only USV data is available. In two of the others (South Australia and Victoria) councils overwhelmingly favour CIV, and in Tasmania all choose ARV.

ii. *Variable use of fixed charges and minimum rates*

All jurisdictions allow the use of a fixed charge and/or a minimum rate to generate a share of rate revenue. A fixed charge, where utilised, is levied against all properties thus reducing the influence that relative property values have on determining relative amounts payable between different ratepayers. A minimum rate applies only to properties with a value below a particular threshold. The relative amount payable for properties above that threshold is therefore determined solely by property values.

⁴³ See for example: Shand 2007, p. 127; SACES 2004.

⁴⁴ NSW *Local Government Act* s8(1) and Victorian *Local Government Act* s3C(2)(f).

Victoria prescribes the option of using a fixed charge but not a minimum rate. Queensland and Western Australia allow different minimum rates for different land uses or in different localities but not a fixed charge. South Australia and Tasmania allow use of a minimum or a fixed charge but not both, New South Wales allows use of both a minimum and a fixed charge, and the Northern Territory allows use of both different minimums and different fixed charges in different localities. Some jurisdictions put limits on the proportion of revenue that may be generated by a fixed charge or minimum rate and others do not.

Comrie et al. (2011) argue that a fixed charge is likely to be a superior policy choice compared to a minimum rate, in particular when CIV or ARV is being used as a valuation base.⁴⁵

iii. *Variable use of differential rating*

All jurisdictions allow differential rating based on land use but the range of categories varies. Most also allow differentiation by location. Only Victoria and Western Australia impose limits on the rate of differentiation between property categories. None have provided guidance on the application of differential rating but this is currently under consideration in Victoria.

Data is not available for all jurisdictions in terms of the extent of use of differential rating by councils. In SA, for example, most councils utilise differential rates and typically apply higher differentials for commercial/industrial properties and lower ones for primary production properties, although this is not always the case.⁴⁶ Arguments made by councils for the use of differential rates may tend to be inconsistent with tax theory considerations. For example they often revolve around one or more of the following:

- a) *Accessibility to services* (for example, a lower rate for rural properties or properties outside of townships). It is likely that any material difference in relative access to council services is already factored into property values. It is not a factor warranting consideration in determining differential rates.
- b) *The perceived tax deductibility of council rates for owners of commercial and industrial properties as a reason to apply a higher differential rate to such properties.* At the same time, many councils also set lower rates for primary production properties that are also used for generating taxable income. The reality is that councils do not know the tax status of ratepayers in different classes. Many residential properties are also owned by landlords who rent them out and claim a tax deduction for rates paid, yet councils usually charge a lower differential rate on residential properties. The obligations of various classes of ratepayers to pay other taxes (or not) should not be a factor relevant to the setting of council rates.
- c) *Attempts to equalise the quantum payable (or achieve some other targeted relativity in amounts payable) or the percentage increase in amount payable between different classes of ratepayers and thus reduce or negate the influence of relative property values (or relative movements in property values).* This undermines the consideration

⁴⁵ Generally speaking, ARV will be more closely correlated with CIV than with USV. In fact in many circumstances ARV is assessed as a fixed percentage of CIV.

⁴⁶ In a few councils primary production properties incur a higher differential rate compared with residential/township properties.

of relative capacity to pay in determining the amount payable by various classes of ratepayers.

Rating legislation needs to offer some degree of flexibility to councils in their rating decisions. The character of communities, composition of property stock and range of council services varies between councils and should be considered in a rating system design. The extent of choice currently available within jurisdictions and variability between jurisdictions does detract from simplicity and consistency. It also leaves councils vulnerable to lobbying from sectional interests to tailor their rating systems to the advantage of particular ratepayer groups. Therefore, while flexibility can enhance rating decision equity, it needs to be balanced in the context of other taxation policy considerations.

8.4 Valuation frequency

A factor influencing a council's choice of rating system structure and detail is the reliability of available property valuation data. The valuation frequency varies between and within jurisdictions as follows:

- annually in South Australia and the Brisbane metropolitan area
- every 2 years in Victoria
- every 2 to 3 years for provincial coastal areas of Queensland, and every 5 years for western regions of the state
- every 3 years in the Northern Territory
- every 3 years in Perth, and every 3 to 5 years in other parts of Western Australia
- every 3 to 4 years in NSW
- every 6 years in Tasmania.

Even with annual revaluations it is not possible to keep valuations up to date in times of property booms. This issue obviously becomes more severe with less frequent revaluation periods. What matters for rating purposes is not so much whether absolute values are reasonably reliable, as whether *relative* valuations between properties are reliable. Ratepayers will not complain if the assessed value of their property is less than they perceive market value to be. Nevertheless, they could still be paying more than the share intended by the rating structure if other properties are under-valued by a larger factor.

Valuations are undertaken by or through contractors engaged by the Valuer-General's Office in each state (and the Australian Valuation Office in the Northern Territory) – or audited by same. Councils often express concern regarding the reliability of valuation data that they use for rating. In some instances they use differentials to attempt to compensate but this can generate further issues, as noted above.

Perceived inconsistencies and deficiencies in assessed property valuations will need to be resolved in order to give councils confidence to make greater use of property taxes. Where improvements are found to be warranted, it is likely that solutions will involve significant additional costs (for example, if they involve more regular revaluation cycles, additional field inspections and more sophisticated database systems).⁴⁷

⁴⁷ See for example: Access Economics 2010a; Access Economics 2010b.

8.5 Threats and opportunities

Delays by local governments in making more extensive use of their property tax powers simply invite other spheres of government to make more use of this tax base. This is already happening incrementally, and as a result local governments risk being 'crowded out' from greater use of property taxes. In recent years many state governments have introduced fire and emergency services and natural resource management levies which have the effect of being additional property taxes. Indeed, in some instances these are collected via council rates notices. These actions implicitly discourage councils that may wish to generate additional rate revenue from doing so.

Henry (2010) emphasised that in the global environment, governments should seek to rely less on taxing mobile bases like income and make better use of property taxes. He suggested that states should remove the exemption of the principal place of residence of property owners from their land tax regimes and to offset this by abolishing stamp duty on property transfer transactions.⁴⁸ Introducing a land tax on the principal place of residence would be a difficult political 'sell' to electorates. Nevertheless, most states are under severe financial pressure and need to generate more revenue. A broadening of the application of land tax may well be part of a wide-ranging package of taxation reforms in future. In fact, the ACT Government in 2012 announced its intention to do so, and has taken initial steps to do exactly this (ACT Government 2012).

The Henry Review (2010) also suggested that if the states were to levy a land tax across all properties, then administrative savings could be realised if request for payment was included (but separately disclosed) on the same notice as the request for payment of council rates. Such an initiative would erode tax raising transparency and accountability and be unpopular with whichever sphere of government issued the notice. Even if state governments were to do so, the initiative would still discourage councils from seeking to generate more rate revenue.

Henry also recommended in the interests of simplicity and consistency, that a single common valuation basis be used for generating council rates.⁴⁹ He had in mind USV. Regardless of which base was chosen, there would be significant practical and political issues to overcome. Most local governments are likely to prefer the current arrangements that apply in their jurisdiction or would seek more choice, not less. Any change in the valuation base would necessarily result in many ratepayers paying more and others paying less even if no more revenue were raised. There would be issues, too, for the states where some would no doubt prefer to continue to use different valuation bases for collecting different property related taxes.⁵⁰

Some jurisdictions don't currently collect CIV data and there would be a significant additional one-off cost and higher ongoing costs to establish and maintain such a database. It is likely, therefore, that if there were to be a national basis for levying council rates it would need to be USV. It is hard to envisage the achievement of a uniform national valuation basis for levying council rates unless it occurred as part of a package of major national taxation reforms that involved substantial overall long-run benefits for local government and, more particularly (given their relative scale), for other spheres of government too.

⁴⁸ It is universally acknowledged in public finance literature that stamp duty on property transfers is a poor tax on a wide variety of grounds. See for example Henry 2010, Section C2-3. The Northern Territory Government does not currently impose a land tax.

⁴⁹ Mangioni & Warren (2012) also discuss the merits of, and argue for a nationally consistent valuation base for, levying council rates.

⁵⁰ Land tax is generally levied on USV but some states use CIV as the base to levy wastewater charges, emergency services levies, and natural resource management levies.

8.6 Council rate concessions and exemptions

Given that council rates are a tax, it is appropriate that some concessions be available for disadvantaged ratepayers. However, it needs to be borne in mind that local government rates represent only 3.5% of total tax revenue by all Australian governments. Other spheres of government are far better placed to achieve effective income redistribution because they have both more income and a broader base of taxpayers across which to equalise than do individual councils.

In all jurisdictions, there are mandated concessional arrangements applying to rates payable on the principal place of residence of aged pensioners. The cost of these concessions are usually (but not always) met by the state or territory. Before offering additional discretionary rebates and exemptions to aged pensioners or other classes of ratepayers, councils should give careful consideration to longer-term precedent and financial and equity considerations. Rate deferral arrangements (even long-term) for ratepayers with capacity to pay constraints (for example retirees on limited incomes) can be structured to have negligible or no cost to other ratepayers.

There are occasional calls to allow councils to levy rates on properties owned by the Commonwealth and state governments. Those making such calls need to bear in mind that local governments enjoy exemptions from many taxes levied by other spheres of government – such as income tax on business activities and, in at least some jurisdictions, payroll taxes. Self (see Commonwealth of Australia 1985, p. 361)⁵¹ noted that if the Commonwealth was required to pay council rates and councils were required to pay all Commonwealth taxes, some councils – typically with central business districts – would be better off but overall the sector would be worse off. Any review of exemptions from council rates by other spheres of government, including any related commercial businesses, is likely to best be undertaken as part of broad national taxation review discussions. There is no indication that such discussions are likely in the near future.

8.7 Optimal Rating system?

There is no single best rating system. Any system will inevitably involve trade-offs of taxation policy considerations, the weightings of which may legitimately vary between councils and over time. Comrie et al. (2011, p. 20) suggested the following as a guide:

‘Should the ability to pay principle be paramount?’ If so, then CIV should be the preferred valuation method and valuations should be frequently updated. Consideration could also be given to application of differential rates where there is reason to believe this would enhance capacity to pay. Councils also need to consider other principles and in any event CIV is far from a perfect indicator of capacity to pay. For both of these reasons when using CIV a significant proportion of rate revenue should also be generated in most circumstances from a fixed charge and other specific user rates and charges where services provided so warrant.

‘Should the benefit principle be paramount?’ If so, then a Council should utilise a full range of service charges, separate rates where appropriate, and recover costs wherever possible using fees and charges. USV is a better indicator of benefits received than CIV but nevertheless a far from reliable guide. A fixed charge should be applied to ameliorate the impact of using USV to the extent that it is not a reliable indicator of benefits received and capacity to pay. In some instances USV may be a

⁵¹ The Commonwealth of Australia’s National Inquiry into Local Government Finance Report is commonly known as the Self Inquiry Report. The Inquiry was chaired by Professor Peter Self.

reasonable indicator of both capacity to pay and benefits received and in these circumstances a fixed charge would offer no additional policy advantages.

‘Should the principle of simplicity be paramount?’ If so, then USV should be the preferred valuation method, but the case would still exist for use also of a fixed charge and other specific user rates and charges.

‘Should the principle of policy consistency be paramount?’ If so, then many of the options and discretions available to Councils should be removed, in favour of a legislated consistent approach.’

8.8 Summarising comments

Some councils will need to (and should in the future) make greater use of their rate revenue raising powers. They and many of the councils that do not need, or have limited capacity, to raise more rate revenue, would benefit from having clearer understanding of sound property tax rating principles and how they can best be applied in their circumstances. Such knowledge would by itself, however, be insufficient. Councils that need to generate more rate revenue need to be able to clearly and persuasively make such a case to their communities, and be able to demonstrate not only why the quantum is needed, but why the strategy to levy this amount, in particular across various classes of ratepayers, is appropriate.

There is no perfect system of taxation and all decisions must necessarily involve trade-offs. It also needs to be recognised that policy decision change is often difficult, particularly where it is apparent that some stakeholders will be made worse off and there is not a groundswell of support for change. Local government itself needs to argue the case for change.

Property rates are the local government sector’s prime means of own-source income. It is important that this revenue stream is well managed, but not just to ensure adequate funding. Soundly-based, transparent and defensible taxation policies and decisions are hallmarks that enhance the status of, and respect for, governments by their citizens.

9. USER CHARGES

Henry (2010, p. 690) argues that councils should raise revenue in two main ways: from taxes for services with public goods type characteristics (i.e. services that are generally non-excludable and non-rival in consumption); and from user charges for private goods (those that are generally excludable and rival in consumption). Others also support this approach (see for example SACES 2002, p. 27; Abelson 2006, p. 7; Shand 2007, p. 128).

It is common for councils that provide water supply and wastewater disposal/treatment services to charge separately for such services while other services that have predominantly private good characteristics are funded by way of general rates. A good example is kerbside waste and recyclables collection services provided by councils. In all jurisdictions, provision exists for councils to apply a separate rate or charge for such services. This often occurs where a council applies the service in some localities (such as townships) and not others (such as out of town areas). There is no reason why councils that currently do not apply a service charge for waste collection services should not do so, even where it provides the same service to all properties. It would improve transparency and accountability. It also would potentially make it easier to generate additional overall revenue.

Councils should try to help communities understand that they provide a range of public goods (roads and related services generally being the most significant) that their general property taxes pay for and charge users for services that have more of a private good characteristic wherever possible.⁵² They would get better informed feedback from their communities about service level preferences and their perceived value if they did so.

Where councils do provide significant private good type services they should generally seek to recover the full additional costs of provision of the service from recipients. Where there are sound reasons why such a course is not appropriate, councils should have clear internally consistent policies regarding why and in what circumstances concessions will be provided. These reasons may include capacity to pay considerations or the perceived indirect social benefits from encouraging usage. Increased reliance on user charging of citizens for service provision and of sporting and community groups that use local government provided facilities needs to be tempered with implications for access to, and use of, services. Where concessions are provided, these should be objectively determined and transparently applied in the form of explicit subsidies.

Charging for kerbside waste and recyclables collection services probably represents the most significant widespread opportunity for councils to increase the application of user-pays pricing. Other areas, however, should also be considered, such as use of recreation and sport facilities, as services provided through these facilities have characteristics more of a private or 'club' good than a public good.⁵³

Shand (2007) proposed an increase in the local authority petrol tax that exists in New Zealand. In Australia, neither councils nor the states have the power to levy petrol taxes and there is unlikely to be support from the Commonwealth to increase fuel taxes and hypothecate such revenue to local governments. Operating expenses associated with local roads represent a high proportion of councils' total costs and in at least some instances a significant share of that cost is generated from other than

⁵² Sansom (2012) suggests that local governments need to do more to promote acceptance of 'council rates' as a tax. He suggests a change in name, for example to 'community tax', might assist in this regard.

⁵³ For discussion re public, club, merit and private goods and the pricing of local government services, see for example: Henry 2010, Section E1; Russell & Macmillan 1992, Chapter 6; South Australian Centre for Economic Studies 2002.

local ratepayers (for example heavy vehicles owned outside of the district driven on rural councils' roads).⁵⁴ The Commonwealth would no doubt argue it already provides substantial road related funding to local governments.⁵⁵ A case nevertheless can be mounted that local governments should receive some revenue directly from road users.⁵⁶ Henry (2010, p. 696) considered the issue of road-use charging and suggested that local governments stood to gain significant additional revenue from the advocated urban congestion charging and mass distance location pricing for heavy vehicles.⁵⁷ Passant and McLaren (2011, Section 3.4) highlight that such reforms or similar are not likely to be quickly realised or, even if they were, to bring about significant additional revenue for many councils. This is because a large proportion of total freight haulage occurs on roads that are not the responsibility of local governments. It is possible, however, that some councils with large lengths of road that are key freight routes could receive relatively significant revenue from such an initiative.

Opportunities to better utilise user-pays pricing of services and facilities will vary between councils. For example, inner-city councils may have opportunities that are not available to others to charge for car-parking on local roads. Wherever demand for a service or facility that offers primarily private benefits to recipients exceeds available supply, pricing should be considered.

Legislative provisions in most jurisdictions generally, albeit with some restrictions, allow councils to recover costs of a broad range of services by way of either a 'per user' or 'per unit used' charge, or a user rate (that is, the revenue raising measure is based on property value). An equal 'per user' or 'per unit' charge is generally likely to be more appropriate but if the service benefits some properties noticeably more than others, a user rate may be warranted.

As with any proposed increase in rate revenue, a substantial increase in user charges or user rates may generate adverse reaction from service users. Councils need to ensure that not only such decisions are well thought through but that they are able and willing to justify and defend them and, where warranted, subsequently make refinements based on objective consideration of any feedback. However, they should not resile from applying user rates and charges just because they may generate adverse reaction. The reality is that if councils cannot generate sufficient operating revenue from provision of private good type services to offset operating expenses, then users will either need to be cross-subsidised from ratepayers generally or service levels may not be maintainable at user-preferred levels in future.

⁵⁴ In each Australian jurisdiction roads are classified as either local roads (which are the responsibility of local governments) or main or arterial roads (which are the responsibility of the states and Northern Territory).

⁵⁵ For example, Local Roads Financial Assistance Grants and Roads to Recovery Program Grants.

⁵⁶ Or at least heavy vehicle road users since it is generally accepted that passenger vehicle use contributes very little to the wear of roads.

⁵⁷ Those reforms are described in Henry (2010, Section E3).

10. ROLE AND USE OF DEBT

Raising a loan (generally referred to as a 'borrowing' throughout this paper in accordance with GFS conventions) does not generate revenue. As such, the topic is only briefly discussed in this paper. Raising a borrowing merely allows timing mismatches between income and expenditure to be overcome. In the long-run, all expenditure needs to be offset by income.

If a council can achieve a small operating surplus on average, over time it should generally also be able to accommodate optimal asset renewal as required without the need for additional borrowings.⁵⁸ However, unless it generated large ongoing operating surpluses it would still need to raise additional borrowings as a consequence of purchasing additional assets.⁵⁹ Regrettably, and at least in part because of a short-term and cash-accounting focus in investment decision-making, this is not widely appreciated in local government. As a result, councils that prefer to acquire or construct new additional assets and keep debt levels low find that they have limited capacity to undertake warranted and cost-effective asset renewal activity.

In addition, councils with high rates of development growth that necessitate them financing upgrade and expansion of their infrastructure networks often are reluctant to use (or perceive that they are constrained from using) debt at appropriate levels for this purpose. They instead reduce other service levels to finance these investments from operating revenue or delay provision of warranted infrastructure. Providing that long-run revenue exceeds long run costs there is no reason why debt should not be used if needed to overcome timing imbalances between expenditure outlays and revenue inflows.

Low debt levels are often implicitly or explicitly encouraged in guidance material issued to councils by consultants, regulating agencies and auditors. As a consequence, many councils perceive that they have significant financial challenges when in fact these challenges are over-stated and could be overcome to a large degree by greater and more flexible use of debt in terms of how and when they borrow.⁶⁰

As highlighted in Table 3, debt levels of Australian local governments are extraordinarily low. In fact, Australia-wide the sector had almost twice as many financial assets as at 30 June 2011 (\$27.3 billion) as it had total liabilities (\$14.9 billion). Over the 10 year period to June 2011, total liabilities grew by 65% whereas total assets grew by 100%. As at 30 Jun 2011, total liabilities were just 4.5% of the value of assets local governments control and are responsible for managing, and 44% of their 2010-11 GFS revenue.⁶¹

Councils should aim not for low levels of debt per se but for responsible use of debt that helps deliver cost-effective and inter-generationally equitable service levels.

⁵⁸ Some borrowings may be required for short periods to accommodate renewal peaks or premature asset failure but generally not on average over the longer-term.

⁵⁹ If a local government was generating large ongoing operating surpluses, this may call into question the inter-generational equity of its taxing and pricing decisions.

⁶⁰ For further discussion on these issues, see: IPWEA 2009, Sections 5.6, 5.7; ACELG & IPWEA 2012, Section 8.

⁶¹ See Tables 1 and 3.

Local governments in all jurisdictions have access to flexible and cost-effective borrowing arrangements. There is no scarcity of available, competitively priced debt financing. What is needed is better understanding of whether it is appropriate to make greater use of debt and for better treasury management practices to reduce net interest costs and risks. To assist in this regard, ACELG is proposing early in 2013 to prepare a Working Paper on the role and use of debt by local governments in Australia. It is expected that the Working Paper will consider various factors such as:

- i. the current extent of local governments' use of debt
- ii. existing legislative frameworks and guidance material that influence decisions and attitudes regarding use of debt
- iii. whether local governments should be encouraged to make greater use of debt (and if so what constraints may be appropriate)
- iv. whether the mix of types of borrowings raised by councils is optimal.⁶²

The Commonwealth has recently released a report commissioned by the Department of Regional Australia, Local Government, Arts and Sport prepared for it by Ernst and Young titled, 'Strong foundations for sustainable local infrastructure'. That report considers and makes recommendations with regard to the funding and financing of infrastructure acquisition by local governments. It highlights that many councils have a 'fear of debt' (Ernst & Young 2012, p. 27). The Commonwealth is now liaising with the local government sector regarding possible responses to the report's recommendations. This report and follow up work offers the potential to assist councils improve their use and management of borrowings and better understand the merits, and potential for use, of other asset financing mechanisms.

⁶² Most local governments when they borrow usually do so at fixed interest rates for fixed terms with regular specified repayments required throughout the term. Many councils have both borrowings and substantial lendings (monies invested). This increases net financing costs and increases their exposure to interest rate risk volatility.

11. REVIEW OF EXPENDITURE NEEDS

The focus of this paper has been on revenue-raising. However, consideration of options to address financial challenges by any individual or entity should always include reviewing expenditure needs and preferences. This includes local governments. Modifying the scope and timing of expenditure proposals is likely to be an appropriate component of a financial performance improvement strategy for many local governments. Recent initiatives to require or encourage long-term financial planning are assisting in this regard.

Many local governments that claim that they cannot afford to undertake asset renewal expenditure have at the same time been spending considerable monies on discretionary new additional assets. This may be a perfectly rational and preferred decision but it does call into question the criteria under which renewal works not undertaken can be legitimately defined as 'backlog' that the council does not have the capacity to address.

In practice, individuals often have expenditure preferences in excess of available income. Governments are no different and ultimately choices have to be made.

Expenditure can be reduced by not only doing less but also by providing the same level of services more efficiently. Any local government related debate concerning revenue and expenditure also needs to consider opportunities for productivity improvement and efficiency gain. This needs to include more than utilising technological improvements and 'working smarter'. Difficult issues like amalgamations, resource-sharing, outsourcing, ongoing rates of increase in staff related costs and asset rationalisation are all areas warranting more consideration.

12. CONCLUSIONS

Although often perceived otherwise, overall the Australian local government sector is collectively in at least reasonable financial shape. Many local governments have in recent years taken positive actions to improve their financial performance.

Not all councils need to generate more revenue in order to be able to sustain existing or preferred service levels. Many have more capacity to address perceived asset management backlogs and more effectively and equitably serve their citizens than they realise. What are often needed are more sophisticated financial understanding, planning and strategies. Local government is a sphere of government that has significant own-source revenue raising power and a cost base that is driven to a large extent by provision of service through long-lived assets. Greater and better use of debt is likely to be a significant part of the appropriate mix of strategies for many councils.

A large proportion of councils that do need to generate more revenue to maintain reasonable and appropriate service levels have the capacity to incrementally do so over time. They may however need stronger encouragement to rise to this challenge and guidance as to how best to do so.

Local governments in Australia generate only a very small proportion of total taxation revenue and are responsible for a similar but slightly larger share of total government expenditure. The level of financial support provided to local governments from other spheres of government has declined over the past decade relative to the increase in councils' own-source revenue and the roles (and operating expenses) of local governments over this period.

A case certainly exists for additional untied financial grant support to the sector. A material increase in such support is likely to be hard to realise in the immediate future given the existing budget positions and forward projections of the other spheres of government.

The states and Northern Territory are responsible for the nation's systems of local government. They and the local government sector itself need to determine whether local government is a sphere of government that should be expected to manage in future without ongoing substantial aggregate additional financial support. If so, legislative frameworks, supportive guidance and political relations need to very clearly recognise this. The alternative is for the sector to argue (and in many cases actually believe) that responsibility for its financial challenges and their answers rest with other spheres of government. Such an approach is unlikely to offer ready or sustainable solutions.

Most local governments generate a majority of revenue from their own-sources, with property taxes being the most significant. Property taxes remain a highly appropriate prime revenue source for local government. There seems no reason why the sector shouldn't generate more revenue where needed from this tax base. Indeed, it is probable that if it does not seek to do so, then over time it is likely that other spheres of government will.

It is easy to frame taxes as unpopular, property taxes especially. Legislative improvements, including greater consistency between jurisdictions, and better understanding and application of taxation policy principles would assist councils make greater and more defensible use of property taxes. Many councils also have scope to increase user charges.

Even with increases in property tax levels there would remain a significant number of mainly rural local governments with large land areas and small population bases that need additional financial support from other spheres of government. Own-source revenue can represent a minor share of total revenue of such councils and their financial challenges are beyond what they reasonably have capacity to address.

It may be possible to materially improve the financial and service level sustainability of the most financially disadvantaged councils by reviewing the basis of distribution of Commonwealth FAGs. This would necessitate redirecting some of the pool from local governments that are, or could readily be, in a sound financial position through their own decisions.

Regardless of whether more grant funds were to be made available for the local government sector collectively or there was a redistribution of existing pools to better equalise financial capacity, this would not necessarily in itself secure the beneficiary councils' future financial sustainability. They would also need to maintain sound ongoing financial and service level planning and decision-making. Without this, there is a real risk that councils that receive additional grants will commit to acquisition of additional assets and new or increased service levels that cannot be sustained in the longer term.

All councils including those that have capacity to raise more revenue need to equally consider whether expense reductions through efficiency improvements and service level reviews may be at least part of the answer to both their own financial challenges and to delivering optimal value to their citizens and ratepayers.

Tax and financial reform is never easy for any sphere of government. All too often these matters get put in the 'too hard basket'. The strengthening of local government revenue raising and ongoing financial management improvement by the sector will require commitment and actions by all three spheres of government.

13. NEXT STEPS

This paper has been written with the intent of stimulating thought and action by practitioners at an individual council and local government sectoral level, and also in agencies in other spheres of government with local government related responsibilities. Collaborative, collective activity is required if further meaningful national and jurisdictional progress is to be made. It is suggested that jurisdictional peak local government associations and agencies with local government responsibilities together explore opportunities for strengthening local government revenue and financial capacity in the current context, and take account of the significant but varying legislative, guidance, and practice improvements that have occurred in different environments in recent years. For example, this could involve establishing:

- i. A national working party with representatives from local government and agencies responsible for regulating local governments in all jurisdictions, as well as persons with relevant academic/technical expertise to consider:
 - a. Existing rating and charging legislative frameworks in all jurisdictions and whether improvements could be made and a greater degree of beneficial harmonisation could be achieved between jurisdictions
 - b. Existing available rating guidance material and whether revisions or additional material are warranted to assist councils to better understand and apply sound taxation and user charging policy principles in their rating and charging decisions, and to be able to better communicate the rationale for these decisions
- ii. A second national working party with representatives from local government and agencies responsible for regulating local governments in all jurisdictions as well as persons with relevant academic/technical expertise to consider:
 - a. Existing legislative provisions directing financial strategy setting by councils and whether improvements could be made and a greater degree of beneficial harmonisation could be achieved between jurisdictions
 - b. Existing guidance material supporting inter-generationally equitable financial and service level planning and decision-making by councils, and whether there is potential for greater nationally consistent approaches and merit in developing further nationally applicable material
 - c. Training and support programs that exist in all jurisdictions to support local government council members and officers in their revenue-raising and overall financial management responsibilities to evaluate opportunities for improvement.

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