Search Conference

STRENGTHENING LOCAL GOVERNMENT REVENUE

Background Paper

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Contents

1. Welcome

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 significant 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 local governments' financial performance and capacity. It then considers responses that may be warranted by all three spheres of government.

2. Background

There are 565 local governments in Australia.[1] This represents a reduction of 261 since 1991.[2] 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).[3] These smaller local governments are typically in rural and remote localities and often serve a verge large geographic area.

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 1990's and legislative requirements for local governments to follow such standards. These changes require

[1] ACELG website Fact Sheet 1
[2] 2007/08 Local Government National Report p.49
[3] ACELG 2012

governments to recognise infrastructure (eg roads, stormwater drains, buildings) as assets and depreciate them over their useful lives. These changes showed for the first time the total costs of service delivery by local governments inclusive of asset consumption; and

- 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 & expenses

Table 1 below shows aggregate revenue and operating (ie. 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 & expenses[4]

	2010-11	2010-11	Increase over 10 years
			2001-02 / 2010 - 11
GFS 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**		

Key observations:

- Revenue slightly exceeds operating expenses (and in fact has each year during this period);[5]
- Taxation revenue is the largest source of revenue; and

[4] Source: Australian Bureau of Statistics (2012) Government Finance Statistics, Australia, 2010-11: Table 1 Total Local General Government Operating Statement
[5] Revenue here includes capital revenue – see subsequent discussion

- Grant revenue has failed to keep pace with the increase in total operating expenses and tax revenue has increased at a greater rate.

3.2 Local government expenses by category

Table 2 below 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[6]

			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

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.[7]

[6] Source: ABS (2012) Government Finance Statistics, Australia, 2010-11: Table 4 Total Local General Government Expenses by Purpose
[7] For example transport and communications expenses represented 28% of total expenses in2001/02.

3.3 Local government balance sheet

Table 3 below 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[8]

			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**

Key observations:

- Almost all (92%) of the assets of local governments are of a non-financial nature;[9] and
- Local government liabilities (borrowings etc) are modest as a percentage of total assets (5%) and as a percentage of annual revenue (44%).[10] In fact the financial assets of the local government sector exceed its total liabilities. That is, the sector has negative net financial liabilities.[11]

3.4 Local government capital expenditure and depreciation

Table 4 below 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.

[8] Source: Australian Bureau of Statistics (2012) Government Finance Statistics, Australia, 2010-11: Table 3 Total Local General Government Balance Sheet
[9] 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 the SA Government has about three times as many assets relative to income as the Commonwealth.
[10] Based on revenue in Table 2.
[11] Net financial liabilities are total liabilities less financial assets

Table 4: Local Government capital expenditure and depreciation[12]

						Increase over 10 years
	2001-2	2002-03	2008-09	2009-10	2010-11	2001/2-2010/11
	$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	9,792	4,536	3,410	390

Key observations:

- Local governments are investing in new non-financial assets at a rate in excess of the recorded annual consumption of existing non-financial assets.[13] [14]

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.[15] 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);[16]
- 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 problem 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; and
- 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

[12] Source: Australian Bureau of Statistics (2012) Government Finance Statistics, Australia, 2010-11: Table 1 Total Local General Government Operating Statement & Table 2 Total Local Government Cash Flow Statement
[13] This was true in each year during this 10 year period
[14] This includes investment in both new additional assets and renewal, replacement and upgrading of existing assets.
[15] Capital revenue includes both money and physical assets 'donated' by another party.
[16] 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.

than is required or preferred and the responsible authority doesn't believe it has the financial capacity to renewal 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 (ie 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; and
- 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?[17]

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.

3.5 Local government revenue sources by jurisdiction

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

Table 5: Local government revenue sources by jurisdiction, 2008-09[18]

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**

[17] 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.
[18] Source: 2008/09 Local Government National Report

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 that is undertaken in many localities by local government authorities.

3.6 Local government expenses by purpose

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

Table 6: Local government expenses by purpose, 2010-11[19]

	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 & 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**

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, 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 have regard to the sources of revenue of all. Table 7 below shows Australian local government revenue by category and jurisdiction in 2010/11.

[19] Source: ABS Cat No. 5512.0 - Government Finance Statistics, Australia 2010-11

Table 7. Taxation Revenue % share by sphere of government and source of revenue 2010-11[20]

	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 & services	22.9	2.9	-	25.7
Taxes on use of goods & performance activities	0.2	2.5	-	2.7
Total	**80.5**	**16.2**	**3.5**	**100.0**

Key observations

- The overwhelming share of total taxation revenue is raised by Commonwealth and the majority of this is raised via taxes on income;[21] [22]
- Local governments raise a very modest share of total taxation revenue; and
- The states generate more revenue from property taxes than do local governments.[23]

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

Table 8 below 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[24]

	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%

[20] Source: ABS Cat. No. 5506.0 – Taxation Revenue Australia, 2010-11
[21] Taxes on income include tax raised on the incomes of both businesses and individuals
[22] The Goods and Services Tax is raised by the Commonwealth and therefore treated as Federal revenue but is distributed to the states and territories
[23] State property taxes include land tax and tax on property transactions (stamp duty)
[24] ABS Cat. No. 5506.0 Taxation Revenue Australia

	Federal	State	Local
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%

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 General Financial Crisis (GFC).

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 1960's.[25]

It needs to be borne in mind that taxation revenues collected by the Commonwealth and the states are far more volatile than that of local governments. They 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 revenue it doesn't spend much of it. There is significant vertical fiscal imbalance (VFI) between the three spheres of government as shown in Table 9 below.

[25] Access Economics 2004

Table 9: Taxes Raised and Spent, by Level of Government, 2002 03[26]

	Federal	State	Local
Total taxation raised (A)	81.7%	15.3%	3.0%
Total tax-funded own-purpose expenses (B)	40.3%	55.2%	4.5%
Degree of VFI (=A/B)	2.03	0.27	0.71

Key observations

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

4. Grants to local governments

Table 1 shows that in 2010/11 local governments received $3.376B in current grants and subsidies. It is a modest part (about 10%) of the sector's total revenue. Collectively most of the revenue local governments receive are 'own source'. There are some constraints on this quantum, for example

- some fees applied by local governments are set or capped by state governments; and
- New South Wales local governments are limited in rate increases they can levy.[27]

Nevertheless local governments in the main have considerable discretion regarding the quantum of revenue they raise.

The range of grants received varies widely between local governments. In part this is because the range 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:

- Financial Assistance Grants (FAGs) provided by the Commonwealth (technically via the states through their Local Government Grants Commissions). In 2008/09 this program provided $2.341 billion (71% of total current grants and subsidies).[28] 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.[29] The ongoing availability of these grants is relatively secure as their provision is enshrined in legislation that also provides for

[26] Source: Access Economics 2004
[27] 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.
[28] This amount was inflated because of an advance payment (5 quarterly payments were made instead of four) as a stimulus response by the Commonwealth to the GFC. For example in 2010/11 an amount of $2.082 billion was paid (4 quarterly payments). In 2011/12 5 quarterly payments were also made as a further stimulus measure. In a future year it is possible that only 2 quarterly payments may be made.
[29] See Hancock.

annual per capita and CPI adjustment. The grants have general purpose and local roads components but councils have full discretion as to how they spend these funds, and

- The Commonwealth's Roads to Recovery Program ($350M in 2010/11) 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.

Other grant 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 in many instances sought by local governments too).

5. 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.[30]

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 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.[31]

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 to cost-shifting per se and reviewed a wide range of local government financial issues.

Ongoing concerns within local government regarding the sector's financial capacity, driven in part by the Hawker Report but also the failure to secure increased grant funding and the reluctance of many local government to generate increased tax revenue (or restrictions on so doing or criticisms by state governments or citizens when they did so) led to 'local government financial sustainability' Inquiries

[30] Officially the Committee's report is titled, *"Rates and Taxes: A Fair Share for Responsible Local Government"*
[31] Part of the problem 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.

in all jurisdictions and nationally. These Inquiries were generally undertaken on behalf of the local government sector but by consulting firms and respected persons with a high degree of autonomy.

The various inquiries confirmed that in all jurisdictions there were significant improvements needed in local government financial management and performance.[32] 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/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 there was justification for more support from other spheres of government but concluded more so that generally local governments could and should do far more to improve their own financial performance.

In particular the inquiries highlighted the importance for the sector of:

- Using accrual accounting rather than cash accounting for budgeting and other financial decision-making;[33]
- Preparing long-term financial plans (LTFPs) based on affordable and responsible service level and revenue raising decisions; and
- Preparing long-term asset management plans (AMPs) that ensured monies were available for asset maintenance and renewal as required.

The Inquiries also highlighted the inadequacy in many instances of the existing local government financial management regulatory frameworks which emphasised short-term cashflow 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, eg 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 the means by which a significant part of these support programs have been funded.[34]

Old habits and perceptions die hard and there is still much to be done before local governments Australia-wide universally have relevant regulatory environments, guidance and skills to achieve systemic high level financial decision-making relevant to their circumstances. Nevertheless

[32] ACELG 2011 provides an overview and key findings from each of the Inquiries and reference details for the full reports.
[33] 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.
[34] 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.

significant progress has been made by the local government sector in improving its financial performance and capacity. For example the first Financial Sustainability Inquiry was undertaken in South Australia in 2005. It followed from an earlier study reporting an asset management expenditure needs in 2001 which concluded that South Australian local governments would need within 10 years to spend 3 times as much per annum (in real terms) on asset renewal as they then were.[35] For the past 3 years South Australian local governments have:

- Undertaken asset renewal expenditure at three and a half times the levels of 10 years ago in real terms; and at the same time
- Improved annual financial performance from a collective $100 million operating deficit to an operating breakeven result.

Similar trend improvements are occurring in other states. As predicted in the various Inquiries it is clear that many local governments are capable of progressively improving their own financial performance. It is also clear though as the Inquiries concluded, that many smaller rural and regional councils will find it much harder and, in many cases, impossible to be financially sustainable without additional financial support.

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.[36]

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 (but not excessive) level. Its research though 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 ALGA and the LGA of SA. It did not disagree with the its overall 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.[37]

6. Is more financial support for the sector warranted and achievable?

Most 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:

[35] The report produced for the Local Government Association of South Australia was titled, "A Wealth of Opportunities".
[36] It's report is titled, "Assessing Local Government Revenue Raising Capacity"
[37] Access Economics 2008

- grants as a share of local government revenue have declined over time;[38]
- 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; and
- 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.

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.[39]

Regardless of any justification that exists it may be hard for the sector to achieve material net additional financial support. The states have a worse VFI situation and generally are in a worse financial position (particularly post GFC) than their local government sectors. Realistically in the current foreseeable circumstances it is difficult to envisage most state governments wishing to provide significant additional funding to local governments that didn't require commensurate additional expenditure.[40] Whilst the Commonwealth is in a much sounder position than the states it doesn't 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 previous projected forecasts. There are always likely to be higher priorities for it for discretionary expenditure than supporting a sector that legally is the responsibility of the states.

The Commonwealth has already indicated that it intends that the terms of reference for the forthcoming review of the basis of distribution of FAGs be framed on the basis of no overall real per capita increase beyond existing provisions. That is not to say that some improvements in aggregate grant revenue shouldn't be sought or is not achievable. Any increases though in the base level of ongoing grants are likely to be modest. However, it may be possible to achieve improvement in the FAGs/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 that funds were to be applied in a manner broadly consistent with AMP projections.

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

[38] See Table 1.
[39] See eg Access Economics 2004, Hawker, the various Financial Sustainability Inquiries, Access Economics 2004, Local Government Rates Inquiry Panel, SA Centre for Economic Studies 2002
[40] 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?

increases in taxes are not only not an option on capacity to pay grounds, they would make little overall impact. 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 aren't 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 monies. The obvious area, both because of the magnitude of the pool of funds and the fact that the grants are untied, is the Commonwealth FAGs. Currently in accord with the Local Government (Financial Assistance) Act 1995 and associated National Principles the available general purpose pool is:

- distributed on an equal per capita basis across jurisdictions; and
- distributed 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.[41]

It is noteworthy that whilst the Act 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 report*, '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 future given:

- that there appears to be a significant proportion of financially challenged local governments in all jurisdictions; and
- 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 warrant 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; and
- the fact that it would not have had a material favourable impact for those local governments with greatest needs.[42]

Since the 2001 review Local Government Grants Commissions have in many instances 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/capita grant.[43] It is therefore likely that relaxing the minimum entitlement (eg from the equivalent per capita amount of

[41] The general purpose pool represents approximately 70% of the total pool of funds.
[42] The 2001 Report (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%.
[43] For example between 1996/97 and 2006/07 the number increased from 45 (representing 15% of the population) to 87 (representing 33% of the population). (DOTARS 2007). Most of this increase is likely to have occurred post 2001 and it is probable that the number is higher still now.

30% of the pool to say 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 methodology for those local governments with greatest need. FAGs typically represents a much higher share of total operating income of 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 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; and
- They are likely to have the capacity to generate offsetting additional revenue from higher property taxes to the extent that this may be is required.[44]

All recent studies that have commented on this issue have favoured abolition or reduction in the minimum grant.[45]

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

7. The case for higher levels of rating

Although not perhaps the preferred choice for them, increasing own source revenue (most notably therefore taxation revenue) is likely to be (at least in part) an appropriate policy option for many local governments. It is one they control.[46]

More importantly it is likely to be appropriate. The Productivity Commission concluded that many local governments have the capacity to raise rates. It and various other studies have concluded that property taxes are generally an appropriate revenue source to fund much of the cost of local government services.[47]

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[44] The Productivity Commission report 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.
[45] See eg Hawker, Productivity Commission and Henry.
[46] Except in NSW where there remain significant constraints. Sansom 2012 found that during the period 1995/96 – 203/04 rate increases in NSW averaged about half the rate of increase of other mainland states.
[47] See eg SA Centre for Economic Studies 2002. The New Zealand Local Government Rates Inquiry Panel's report also confirmed the appropriateness of property taxes to fund much of the cost of public goods provided

Local governments have been somewhat reluctant to make greater use of their property taxing powers. They often for example have reduced their tax rate in response to increases in aggregate property values in order to raise no more than their annual net cashflow requirements.[48]

Part of the reluctance to utilise property taxes to generate more revenue is the uncertainty within local governments and their communities as to whether council rates are a tax or a fee for service. Many see it as more the latter than the former. This needs to change if the sector is to effectively and appropriately utilise this revenue source. The New Zealand (NZ) Local Government Rates Inquiry Panel's report and the Henry Review into Australia's taxation systems both clearly concluded that local government rates should be viewed as a tax that should be used to fund public goods provided by local government and that local government should also effectively utilise fees and charges to better recover cost of goods that are more private in character.[49] The Australian Centre for Excellence of Local Government (ACELG) 2012 suggests local governments need to do more to promote acceptance of 'council rates' as a tax. It suggests a change in name, eg to 'community tax' might help in this regard.

A common criticism of property taxes is that they are often not perceived to correlate well with capacity to pay and in particular disadvantage property owners who are asset rich and income poor. The SA Centre for Economic Studies (2004) suggests there is likely to be reasonable (but far from perfect) correlation between housing (capital) values and lifetime incomes of owners.

Australian communities intuitively perceive that taxes should be raised on income and property taxes are unpopular. There would undoubtedly be political challenges in generating materially more revenue from property taxes. Many local governments are likely to lack the political will and technical property tax decision-making expertise to willingly and effectively embrace such an option.

The South Australian experience post the South Australian Financial Sustainability Inquiry does, however, suggest that with a comprehensive framework in place it is possible to achieve modest annual real increases in rate revenue that become material over the medium term without significant community backlash. Factors that have helped to achieve this have included:

- A legislative framework that requires local governments to have regard to financial sustainability considerations and longer-term needs in their annual budgeting and rating decisions;
- Various initiatives to improve financial understanding amongst both council members and officers;
- Reviews of rating systems by many councils to try to better align the impact of rating decisions with capacity to pay considerations of particular classes of ratepayers; and
- The State Government generally resisting criticising property tax decisions of local governments.

Work undertaken by Access Economics (2010) and Comrie et al (2011) suggests that there is scope to improve rating legislation and practices (including property valuation practices) throughout

by local governments. It recommended that local governments make better and more equitable use of their broad rating powers.

[48] This is true even for local governments that have significant accrual accounting operating deficits and in fact legislative frameworks and guidance material have traditionally encouraged such an approach.

[49] In 2007 A report, 'Funding Local Government' was prepared reviewing New Zealand local government rating.

Australia. This would require a better appreciation by both legislators and practitioners of the merits of property tax rating and how to maximise realisation of these strengths and minimise any downsides in practical application.

It is appropriate that legislation provide a degree of choice in rating methodologies to enable local governments to best cater for characteristics of their communities. Whether local governments also should be able to choose the property valuation base upon which they levy the tax rate is less clear. Some jurisdictions mandate a particular basis and others provide choice. Capital, land and annual values (or similar) are all widely used. Land value (or site or unimproved value) is more economically efficient, simpler to administer and is likely to better match benefits accruing to property from local government services. Capital value (and annual value) is likely to better reflect capacity to pay. Henry argues in favour of land value. Access Economics too prefers land value but considers that capital value with a significant proportion of total revenue being generated from a fixed charge may also be reasonable in many instances. The NZ Inquiry favoured use of capital values.

The frequency of re-valuation currently varies significantly between jurisdictions. Regardless of the valuation base, valuation data needs to be reliable (or at least valuation relativities between properties need to be reasonably reliable). This reliability can be found wanting under current valuation arrangements, particularly in periods of rapid movement in market property values. Addressing these concerns would help give more confidence to local governments to make better use of property taxes.

The Henry Review advocates states also generate more revenue from property taxes by broadening the land tax base to offset its recommended less reliance on (ideally elimination of) stamp duty on property transfers. Stamp duty is an extremely inefficient tax. If it were replaced with a broadly based land tax it would mean that the states would be effectively competing with their local government sectors to raise revenue from the same tax base. In a practical political sense this is likely to reduce the perceived capacity of local governments to raise revenue from this source.

The Henry Review also raised the possibility of administrative efficiency gains through the states and their local governments sharing one database and one notice being issued for both local government property taxes and state land tax. This would in practice require use of land value for local government rating purposes if savings were to be maximised and confusion reduced. In practice there would likely be considerable practical and political obstacles to the implementation of such a proposal.

It is hard to see the major property tax related reforms proposed by Henry being embraced in the immediate future. The recommendations though may at least help encourage review of local government rating frameworks within jurisdictions. Certainly there is scope for legislative related improvements to be made. These could for example include actions that lead to:

- More frequent/reliable property valuation data;
- Use of fixed charges in lieu of minimums;
- Clear guidance and constraints on the use of rate differential factors;
- Provision of deferral schemes for those with limited capacity to pay (eg asset rich/income poor); and

- More widespread use of ceilings to phase in increases for individual ratepayers who would otherwise experience a much larger increase in rates payable in a period than other ratepayers on average as a result of a large relative increase in property values.

8. Other options

8.1 Other revenue sources

Both the Henry and NZ reviews emphasised that local governments should make effective use of opportunities to charge fees that generally recover the full cost of services that have predominantly 'private goods' type character. Services with material costs appropriate for user-pays charging include water supply and wastewater disposal. In most instances these services already attract (or are progressing to implementation of) full user-pays pricing. An area where there is material opportunity for application of fee for service charging is for provision of household waste and recyclables collection.

It is hard to see significant opportunity for other widespread and material additional revenue sources. The NZ Review proposed an increase in the existing local authority petrol tax but there is likely to be little appetite for such an initiative here.

8.2 Review of expenditure needs

The focus of this paper has been on revenue-raising. Consideration of options to address financial challenges by any individual or entity should always however 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 helping 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, rates of increase in employee related costs and asset rationalisation are all areas warranting more consideration.

8.3 Better use of borrowings

Borrowings are not a source of revenue and over the long-run expenditure cannot exceed income. Borrowings do however allow short-term mismatches between revenue and outlays (eg for peaks in capital expenditure) to be accommodated and off-setting revenue to be raised over time. The various Financial Sustainability Inquiries highlighted the aversion of local governments to the use of debt and the often poor treasury management practices of local governments.[50]

Many councils perceive 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, for example to address urgent asset renewal expenditure needs.[51]

9. Conclusions

Although commonly perceived otherwise, overall the local government sector is in at least reasonable financial shape and many local governments are taking positive actions to improve their financial performance.

Most local governments generate a majority of revenue from their own sources with property taxes being the most significant. Property taxes are a highly appropriate revenue source to fund public goods which typically account for the majority of local government expenditure.

Property taxes are not popular. Various actions are needed to improve legislative frameworks and guidance in order for the sector to optimally utilise this revenue source. Even if this were to occur there would remain a significant number of mainly smaller rural local governments that need additional financial support from other spheres of government.

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 time relative to the increase in their own taxation revenue and as percentage of the nation's GDP. This is despite a significant increase in the roles of local governments during this period.

A sound case 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 Commonwealth and most states.

It may be possible to materially improve the financial capacity of disadvantaged and financially challenged councils by reviewing the basis of distribution of Commonwealth FAGs and redirecting some of the pool from local governments that are in a sound financial position. Many are likely to have the capacity if need be to generate more own source revenue. This is a matter that should be carefully considered in the Commonwealth's forthcoming FAGs review.

[50] In fairness both of these are still often encouraged by regulators of and advisors to local governments.
[51] Many local governments still base their borrowing and lending practices on arrangements that were more appropriate in an era of cash accounting.

Local government financial performance improvement needs to consider more than just use of property taxes and grant funding. Revenue from user charges, use of debt, service levels and opportunities for efficiency improvements all warrant more focus.

Tax and financial reform is never easy for any sphere of government. All too often these matters get put in the too hard basket. Local government tax reform and ongoing financial management improvement will require commitment and actions by all three spheres of government.

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ABOUT ACELG

ACELG is a unique consortium of universities and professional bodies that have a strong commitment to the advancement of local government. The consortium is led by the University of Technology Sydney's Centre for Local Government, and includes the University of Canberra, the Australia and New Zealand School of Government, Local Government Managers Australia and the Institute of Public Works Engineering Australia. In addition, the Centre works with program partners to provide support in specialist areas and extend the Centre's national reach. These include Charles Darwin University and Edith Cowan University.

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