

THE CASE FOR INCREASED FUNDING FOR LOCAL GOVERNMENT

An assessment prepared for the

City of Port Phillip

by



Canberra
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EXECUTIVE SUMMARY

This paper has been commissioned by the City of Port Phillip and prepared by Access Economics.

It deals with certain funding-related issues arising in the context of the House of Representatives Standing Committee on Economics, Finance and Public Administration's current local government inquiry (hereafter referred to as "the Inquiry"). The Inquiry was called by the Commonwealth Minister for Regional Services, Territories and Local Government, who requested that the Committee inquire into:

"...cost shifting onto local government by state governments and the financial position of local government".

Our focus is on the following two (of six) items nominated for examination in the Inquiry's terms of reference:

2. *Current funding arrangements for local government, including allocation of funding from other levels of government and utilisation of alternative funding sources by local government.*
3. *The capacity of local government to meet existing obligations and to take on an enhanced role in developing opportunities at a regional level including opportunities for councils to work with other councils and pool funding to achieve regional outcomes."*

There are strong grounds, both theoretical and practical, for increased financial assistance grants (FAGs) to play a major role in addressing the worsening *vertical fiscal imbalance* (VFI) evident between the Commonwealth and the lower tiers of government in Australia.

Fundamentally, mismatches between taxation collected centrally at the Commonwealth level and the Commonwealth's own spending responsibilities require the Commonwealth to distribute the surplus revenues it collects back to those levels of government with deficient revenue sources (State and Local) in the form of revenue sharing grants.

This case has been strengthened by recent changes in Commonwealth-State financial relations as a consequence of the move to a goods and services tax (GST). Given limits on the alternatives, it is hard to deny that the Commonwealth should be addressing the local sector's need, along the lines it acknowledged with respect to the State sector, to:

"...have access to a secure and growing source of revenue and the capacity in the medium to long term to allocate additional funding for services..."¹

The main alternatives to increased FAGs identified in this paper are as follows:

- the local sector cuts back its expenditure on unfunded mandates imposed by higher levels of government;
- the Commonwealth facilitates changes to State policies on exemptions, concessions, rate capping and the like; and
- the States and the Commonwealth allow an increase in local government revenue, initially by allocating 'tax on tax' revenue associated with the GST to the local government sector and, over time, by amending the relevant intergovernmental agreement to eliminate such tax effects, making room for an offsetting increase in local government rates on residential property.

As long as the Commonwealth continues to balk at (preferable) measures aimed at reducing VFI *at its source*, there is a clear case for additional local government FAGs.

¹ Commonwealth Treasurer, p.16

The main options for increasing FAGs are either:

- a change to the escalation factor (from one based on estimates of population growth and CPI increases, to one based on growth in Commonwealth tax collections) – which would have the effect of locking in the current FAGs proportion of Commonwealth tax collections; or
- a fixed (say 1%) share of total Commonwealth taxation revenue; or
- adoption of a real-terms per capita betterment factor (so allowing for a nominated growth in service levels per head of population).

Whichever option is pursued, there is no denying that:

“... the funding arrangements for local government need to be sufficiently flexible to meet the changing needs of councils and communities in the future.”²

² DOTARS, July 2002, p.15.

1. Introduction

1.1. House of Representatives Inquiry into Local Government and Cost Shifting

This paper deals with certain funding-related issues arising in the context of the House of Representatives Standing Committee on Economics, Finance and Public Administration's current local government inquiry (hereafter referred to as "the Inquiry"). The Inquiry was called by the Commonwealth Minister for Regional Services, Territories and Local Government, who requested that the Committee inquire into:

"...cost shifting onto local government by state governments and the financial position of local government".

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While item 3 deals with "capacity" in its widest sense, the focus on this item here is solely on financial capacity, thereby tying in with item 2.

Our discussion also:

- focuses on the local government sector consolidated across the States (hereafter "the local sector"), and so does not provide information either for an individual Council or on a State-by-State basis; and
- does not directly address issues associated with the allocation of local government grants, financial assistance grants between (and within) States, and so does not address matters related to horizontal fiscal equalisation (HFE).

Against this background, this paper provides an assessment of the views put at the Commonwealth and State levels that run counter to those generally put by Local Government, as evident in the submissions already provided to the Inquiry.

The remainder of this chapter briefly summarises – without comment – the key views at the Commonwealth, State and Local Government levels relating to current funding arrangements and the local sector's capacity to meet its obligations. Later chapters provide an assessment of the main opposing arguments.

1.2. Local government's views

1.2.1. City of Port Phillip's views

In its submission to the Inquiry, the City of Port Phillip's fundamental position on funding matters was expressed as follows:

"The overall percentage of tax revenues allocated to Local Government is grossly inadequate."³

Two broad sets of reasons were given in support of this view. First, on the expenditure side:

³ City of Port Phillip, p.1.

"...Local Government continually struggles with impacts from the service and legislative requirements from other levels of government coupled with the corresponding increase in community expectation."⁴

Secondly, as to the local sector's own sources of funding:

"Councils do not have access to any substantial growth revenues and correspondingly at times have to reduce the level of services offered in line with budgetary constraints. For a number of years, rates were frozen and/or capped by State legislation that further exacerbated this [funding deficiency] issue. Generally recent rate increases have been in line with CPI rises however Local Government expenses are increasing at a faster rate more in line with adjusted average weekly earnings increases."⁵

1.2.2. Municipal Association of Victoria's (MAV) views

In its submission to the Inquiry, the MAV's conclusions with regard to current funding arrangements and the local sector's capacity to meet its growing obligations were as follows:

"Local government has a limited capacity to meet its service obligations.

The Commonwealth, and to a lesser extent the State, do have the revenue capacity to better support local government.

Local government raises revenue from its own sources, primarily property tax, but is increasingly reliant on Commonwealth and State funding for specific service provision.

There is a range of important constraints on local government revenue. Property tax has a limited growth potential due to limitations related to land development and existing uses.

Grants from other levels of Government are also subject to constraints. The quantum of these grants grows in line with price increases while at the same time local government's costs are growing in line with wage pressures. Over time this has eroded the effectiveness of grants as a source of revenue while increasing the financial pressures on local government.

If local government is to continue providing infrastructure and services to the community, then it must have access to a form of financial support that provides a pool of funds that grow as required. This capacity is the result of the Commonwealth having access to a taxation system built on growth through income and consumption taxes."⁶

1.2.3. Australian Local Government Association's (ALGA) views

In its submission to the Inquiry, the ALGA has argued that the local sector's general financial capacity must be enhanced for it to undertake the new roles, functions and powers taken on as a result of policy choice, increased community expectations, devolution and prescription through legislation and regulations by other levels of government.

"There is clear evidence that local government does not have a sufficient revenue base a) to maintain or meet increasing community demand for human services, and at the same time b) adequately maintain and replace their traditional forms of infrastructure."⁷

In support, the ALGA has argued that:

⁴ City of Port Phillip, p.1.

⁵ City of Port Phillip, p.2.

⁶ MAV, p.7.

⁷ ALGA, p.5.

"...through the intergovernmental forum, COAG, negotiations should take place to ensure local government has access to a proportion of the GST monies. Such would be the first step towards addressing structural Vertical Fiscal Imbalance. This is also a pertinent point in light of the declining State Specific Purpose Payments (SPPs) flowing to local government over the last decade and a half.

Both Commonwealth and State and Territory Governments (through access to the GST) have access to tax bases that currently exhibit high levels of real growth, and will continue to do so into the future. Stable growing revenue bases are critical to the efficient and effective operation of each sphere of Government including local government.

Alternatively, steps should be immediately taken to set the level of FAGs at an appropriate level of total Commonwealth Taxation Revenue (incl GST) or Gross Domestic Product in order to assist local government in addressing financial inequities resulting from Vertical Fiscal Imbalance."⁸

1.3. Commonwealth's views

The views put about local government funding at the other levels of government contrast in many important respects to the views held by local government itself (as summarised above). Most telling is the Commonwealth Minister's caveat in the Inquiry's terms of reference, that:

"The Inquiry is to be conducted on the basis that the outcomes will be budget neutral for the Commonwealth".

Hence, the Inquiry is premised on the notion that, whatever local government's financial position, the solution lies at the local or State – but not Commonwealth – levels.

Likewise, the focus of the Inquiry's terms of reference on 'cost shifting' reflects the Commonwealth view as to a primary pressure on local government's financial capacity to be the failure of State governments:

"...to ensure there are sufficient funds or increased access to revenue to cover the imposition of functions and/or costs onto local government for which the state government is normally regarded as responsible."⁹

In its submission to the Inquiry, the Commonwealth Department of Transport and Regional Services (DOTARS) stated that it saw merits in the Commonwealth Grants Commission's (CGC) suggested responses to cost shifting, namely:

"...where the source of the financial pressure on local government is as a result of a discretionary action by the council itself, it would appear to us to be appropriate for that to be funded by the council from its own revenue sources. However, where the source of the financial pressure is as a result of changing policies or actions from other spheres of government and these actions impose extra costs and functions on the local government, we consider greater financial assistance could be appropriate.

Financial assistance [from the States] could also be appropriate where those actions reduce the revenue capacity of local government – for example, through actions such as rate pegging, fee capping or the granting of rates and concessions, which is occurring in a number of States".¹⁰

As to local government's funding mix since the Commonwealth first started providing direct funding in the 1970s, DOTARS has suggested that:

⁸ ALGA, p.5.

⁹ As reflected in DOTARS's proposed definition of cost shifting (DOTARS, July 2002, p.42).

¹⁰ DOTARS, September 2002, p.42.

"The share of revenue going from state governments to local government has declined. This, combined with the limitations many councils face in increasing their own source revenue through controls such as rate capping, has placed an increasing focus on revenue from the Commonwealth to support local government activities in many areas. This has been recognised by the Commonwealth in the development of the Roads to Recovery program whereby additional roads funds are paid directly by the Commonwealth to local government."¹¹

"Although the amount of State assistance has increased in real terms since 1974-75, its rate of increase (0.4 per cent per annum in real terms) is about one-tenth of the rate of increase of local government own-source revenue (4 per cent per annum in real terms). Its decline in importance is almost exactly matched by the increase in importance of Commonwealth transfers."¹²

Beside increased funding by the States, the other options canvassed in DOTARS submission were as follows:

"...there is scope to rationalise the roles and responsibilities between the three levels of government, but there will always be some complexity about defining roles.

...Local government must also consider how to make better use of its existing resources in order to provide better quality services to its communities.

...In the face of growing expenditure demands and restrictions on revenue raising, local government is increasingly under pressure to search for new or expanded revenue sources beyond grants, rates, and user charges. Possible own-revenue sources include borrowings; additional user pays/charges; developer contributions; asset sales; other investment income; and entrepreneurialism including public-private partnerships."¹³

Finally, DOTARS suggested that:

"In assessing local government's financial capacity, relevant issues are that:

- *Local government has maintained its share of revenue from its own sources, despite providing an increasing range of services; and*
- *Its overall debt levels have declined over recent years.*

On average, the local government sector continued to be in a sound financial situation in 2000-01... Indeed in 2000, for the first time since records commenced in 1993, total cash, deposits and lending exceeded gross debt. The position was even healthier in 2001.

...Given that interest rates have been at historically low levels in recent years, this suggests that there is capacity for local government to respond to financial pressures from within existing resources."¹⁴

1.4. States' views

Only the South Australian, Western Australian and Queensland Governments have made submissions to the Inquiry that address the overall funding issue.

The Queensland submission probably reflected the view of most States:

"The financial position of local government in Australia is an important topic. The Queensland Government is concerned the current Inquiry will not do justice to the issue, and is greatly concerned it was not consulted about the appropriate process for a meaningful Inquiry into the financial position of local government..."

¹¹ DOTARS, September 2002, p.41.

¹² DOTARS, July 2002, p.24.

¹³ DOTARS, July 2002, p.25.

¹⁴ DOTARS, July 2002, p.30.

It is not possible to examine levels of State funding for local government in isolation from consideration of levels of Commonwealth funding to the States. Vertical fiscal imbalance occurs in all federations. In Australia, only the Commonwealth has a capacity to raise revenue in excess of its expenditure requirements. Both State and local governments have expenditure responsibilities in excess of revenue raising capacity. The level of financial transfers between the Commonwealth and States, and cost shifting by the Commonwealth to the States impacts on States' capacity to provide additional assistance to local government

The Queensland Government strongly urges that the terms of reference be widened to include Commonwealth cost shifting onto States, and that a broader inquiry be undertaken by an independent body.

The Commonwealth Government is responsible for the provision of general financial assistance grants to local government. Yet the terms of reference require the Inquiry to be conducted on the basis that the outcomes will be budget neutral for the Commonwealth. This is unacceptable. The Commonwealth Government similarly protected itself when it drafted the terms of reference for the Commonwealth Grants Commission (CGC) Review of the Local Government (Financial Assistance) Act 1995. The quantum of Commonwealth Government financial assistance grants for local government was expressly excluded from the terms of reference. In its report, the CGC noted that many participants said the financial assistance grants were the most important aspects of local government funding."¹⁵

Only the SA submission went into the issues in more detail, first stressing that:

"There are significant pressures on the funds available to both Local Government and State Government for the delivery of services, and this is likely to increase in the future. In recognition of this pressure, the real amount of untied grants distributed to both local and state government needs to be increased."¹⁶

In particular, the State's view was that:

"... to date the financial pressure [on local government as well as State government] is due to a reduction in grants rather than increased costs.

... the future is likely to see spiralling demand for services, putting cost pressure on the operations of not only Local Government but also State Government where the majority of service delivery to communities occurs."¹⁷

The SA Government suggested that a key implication of the CGC's recent review was that:

"...it is essentially demand for new services along with declines in grant funding rather than cost shifting per se that is creating financial pressure for Local Government."¹⁸

The SA Government stressed that:

"Over recent years the States have become increasingly concerned at the decline in their share of national tax revenues, particularly in light of increasing expenditure requirements and limited State tax bases."¹⁹

¹⁵ Queensland Government, pp.1-2.

¹⁶ South Australian Government, p.20.

¹⁷ South Australian Government, pp.13-14.

¹⁸ South Australian Government, p.13.

¹⁹ South Australian Government, p.2.

Even though introduction of the GST is predicted to eventually make the States better off, with GST revenues expected to outstrip the guaranteed minimum amount (i.e. funding paid to States to ensure they are no worse off under the new arrangements) for all States by 2007-08, it is the SA Government's view that:

"...the new arrangements up till now have not, however, improved the budget position of South Australia or any other State.

If the Commonwealth maintains its current level of funding from sources other than the GST, the States' share of national revenue will, at best, remain unchanged... There will be no windfall gain to the States from the GST revenue; it will simply allow the States' revenue base to grow at around the same rate as that of the Commonwealth. It follows that the Commonwealth will continue to have a significant role in ensuring that States are adequately funded to provide services.

... financial resources available to state and local government have been generally reducing relative to the size of the economy, and to the underlying level of taxation revenue.

The proportion of centrally collected funds that has been distributed to state and local government for delivery of services has consistently fallen over two decades."²⁰

The SA Government also suggested that are strong theoretical arguments supporting:

"...a large component of service delivery being undertaken by the state and local spheres of government with revenue being collected more centrally. There should, therefore, be an adequate allocation of grants from higher levels to lower levels of government as the options for taxes at the local level are limited."²¹

The SA Government indicated that a key issue facing Local Government is that since the mid-1980s there has been a steady decline in grants as a share of Gross State Product (GSP). A research report was cited indicating that:

- " • ...The Commonwealth is the major source of grants for Local Government in South Australia, providing 85% of Local Government grants.*
- There has been a corresponding increase in "own" taxation by Local Government in the state, to match the decline in grants*
- There has also been an increase in "sales" or user charges by Local Government– but this has in part brought it back to levels of early 1980's."²²*

The SA Government did, however, direct some parting shots at the local sector:

"... there is room and theoretical argument for extra user charges (maybe in areas of road use charges and use charges for environmental resources, with an over reliance on rates as a source of revenue)..."

... in the absence of adequate grant funding, Council rates may be at least as good a general tax as other alternatives.

...Budget outcomes in the Local Government sector in South Australia over the last 5 or 6 years have averaged an approximately zero net borrowing, something the State Government has as its fiscal target for the future."²³

²⁰ South Australian Government, pp.3-4.

²¹ South Australian Government, p.9.

²² South Australian Government, p.12.

²³ South Australian Government, pp.13-14.

1.5. Key differences of view

The above survey of views at the Commonwealth, State and Local Government levels reveal a number of key differences relating to current funding arrangements and the local sector's capacity to meet its obligations, namely:

- whether the local sector's finances – currently or prospectively – are under stress;
- the extent to which local government has scope to control its spending within limits set by its available financial capacity;
- the extent to which local government has scope to increase revenue-raising effort from its existing own sources (taxes and user charges);
- whether the States have a capacity to increase (SPP) funding to local government;
- whether vertical fiscal imbalance implies that the Commonwealth should bear the main burden in ensuring local government revenues keep pace with centrally collected (i.e., national) taxation; and
- whether extended tax powers (or a reallocation of expenditure responsibilities) is preferable to increased revenue sharing grants to offset vertical fiscal imbalance between local government and the other levels of government in Australia.

The following chapters provide our assessment of the main opposing arguments.

2. Are the Local Sector's Finances Under Stress?

Before anything is likely to be done to increase the quantum of grants paid to the local sector by other levels of government, it is necessary to provide evidence that the local sector's finances are under some pressure relative to other levels of government.

2.1. Commonwealth views

There are views at the Commonwealth level that the local sector already has sufficient financial resources to meet its legitimate needs – so that local governments have access to resources that could be used to offset grants (especially Commonwealth grants).

In particular, DOTARS suggested that:

"In assessing local government's financial capacity, relevant issues are that:

- *Local government has maintained its share of revenue from its own sources, despite providing an increasing range of services; and*
- *Its overall debt levels have declined over recent years.*

On average, the local government sector continued to be in a sound financial situation in 2000-01... Indeed in 2000, for the first time since records commenced in 1993, total cash, deposits and lending exceeded gross debt. The position was even healthier in 2001.

...Given that interest rates have been at historically low levels in recent years, this suggests that there is capacity for local government to respond to financial pressures from within existing resources".²⁴

2.2. State views

Likewise, the SA Government has suggested that:

"Budget outcomes in the Local Government sector in South Australia over the last 5 or 6 years have averaged an approximately zero net borrowing, something the State Government has as its fiscal target for the future."²⁵

2.3. Comparative analysis

What is the actual picture?

Table 2.3.1 provides the latest ABS figures for the 2000-01 year for the respective general government (i.e., tax supported) sectors. To enable a comparison between the levels of government, all the \$ million figures have been expressed as a proportion of the total expenses for the respective level of government.

²⁴ DOTARS, July 2002, p.30.

²⁵ South Australian Government, p.14.

Table 2.3.1: General Government Finances, by Level of Government, 2000-01
Total Expenses = 100%

Percentage	C'wealth	All States	Victoria	Local Sector
Revenue	102.7	102.0	105.4	107.6
<i>less</i> Total expenses	100.0	100.0	100.0	100.0
equals Net operating surplus(+)/deficit(-)	2.7	2.0	5.4	7.6
<i>plus</i> Depreciation	0.8	4.8	3.6	22.5
<i>plus</i> Disposals of non-financial assets	1.3	0.7	0.7	3.5
<i>equals</i> Internal sources of capital financing	4.8	7.5	9.6	33.6
<i>less</i> Acquisition of non-financial assets	1.5	8.7	7.0	31.4
equals Net lending(+)/borrowing(-)	3.3	-1.2	2.6	2.2
Gross debt	45.6	35.7	29.8	35.2
<i>less</i> Cash and deposits	0.6	5.5	4.1	13.5
<i>less</i> Other 'marketable' financial assets	24.5	27.9	16.1	28.9
equals Net debt	20.5	2.3	9.6	-7.2
plus Other debt-like liabilities	48.1	58.2	64.2	10.2
<i>less</i> Other non-equity liabilities (net)	0.5	-1.6	2.2	-1.2
<i>less</i> Equity investments	29.1	121.2	111.3	3.8
equals Net financial liabilities(+)/worth(-)	39.9	-62.3	-35.3	-2.0
<i>less</i> Non-financial assets	18.9	198.2	159.0	936.3
equals Net liabilities(+)/worth(-)	21.0	-260.4	-194.3	-938.3

Source: Australian Bureau of Statistics

There is no denying these statistics show that the local sector's:

- net operating surplus (at 7.6% of total expenses) is the strongest among the levels of government, well above the 2.0% figure for the States;
- net lending (or *negative* net borrowing) at 2.2% of total expenses, while less than for the Commonwealth, is at a more comfortable level than the States' (positive) net borrowing of 1.2%; and
- negative net debt position (i.e., a net creditor position) contrasts with the (positive) net indebtedness of the other levels of government, particularly the Commonwealth.

Superficially, this is interpreted by some as enough evidence that the local sector's finances are not under any particular stress, and that the sector has the resources to absorb a greater reliance on borrowing. However, as discussed below, that interpretation fails to take into consideration some major differences between the levels of government, as revealed in Table 2.3.1.²⁶

²⁶ Another significant set of considerations, not canvassed here, is the fact that the numbers in Table 2.3.1 aggregate the position over 700 local councils in Australia, and so represents the *average* picture. The fact is that financial performance and position shown for the local sector in the Table does not apply to all councils. Moreover, the absence of full fiscal equalisation between these councils means that those councils in a poorer financial position (unlike a State in such a position) reflect genuine cost disabilities and below-average taxable capacities (which are equalised across the States at the State but not local level) as well as policy choices and inefficiencies.

2.3.1. Comparison with Commonwealth

First, the Commonwealth's fiscal activities are quite different in nature from those of the lower levels of government in Australia, for at least three quite different reasons:

- As a national government, it is primarily responsible for fiscal policy. In the short run, fiscal policy is concerned with the extent to which budgetary changes lead to over- or under-stimulation of the economy and can work through the operation of automatic stabilisers. In the medium term, the concern shifts to the impact of fiscal changes on the national saving rate of the economy.²⁷
- An 'asset' missing from the Commonwealth's measured balance sheet is its superior ability to impose taxes and other compulsory levies on households, financial institutions and corporate enterprises – without any reciprocal obligation on the government concerned.²⁸
- The functions of the Commonwealth mean its capital spending is relatively low (only 1½% of total expenses, compared with almost 10% and over 30% for the State and local sectors, respectively).

These circumstances combine to explain why the Commonwealth's motives for borrowing are quite different to those of sub-national levels of government. For this reason alone, it is inappropriate to directly compare the financial performance of the local sector with that of the Commonwealth. Much of the Commonwealth's borrowing is cyclical in nature, or reflects policy decisions to arbitrage against its strong creditworthiness position (by borrowing, and then investing the proceeds of such borrowings in financial – rather than non-financial – assets). Unlike the Commonwealth, the State and local sectors have relatively significant 'capital' revenue elements to their income as measured by the ABS (including in the form of capital grants).

2.3.2. Comparison with the States

The comparison between the State and local sectors is more valid – and instructive. These two sectors are both primarily involved in the provision of public goods and services (as opposed to having macroeconomic or redistribution functions), their taxation powers are both quite limited, and they both have substantial capital works roles.

Both sectors' apparently strong net worth positions are largely illusory, however, reflecting the high valuation placed on non-financial assets such as schools and roads which would be hard to realise. For this reason, the comparison of their respective net worth is of little use.²⁹

Focusing on the net debt positions of the two sectors can also be misleading. Our view is that a comparison of each sector's net financial liabilities (*negative* net financial worth) is of most use. Net debt and net financial liabilities differ mainly because the latter includes both:

- unfunded employee entitlements (including unfunded superannuation benefits) as measured by the present value of the difference between the projected primary expenditure and revenue (at current contribution rates) on such entitlements; and
- equity invested in public financial and trading corporations.

In these regards, while the two sectors' relative gross debt (i.e., borrowings) are on a par:

²⁷ In addition, only national governments have access to monetary policy instruments, which have in the past been used to amortise public debt through inflation and exchange rate appreciation.

²⁸ The main 'liability' missing is the value of the Commonwealth's future benefit and transfer payment commitments. For these reasons, the Commonwealth's measured balance sheet may be less useful in indicating policy sustainability than typically the case for sub-national governments. In fact, the Commonwealth's implicit assets and liabilities represented by the streams of future tax revenues and of future benefits and transfer payments may well dwarf the measured financial assets and liabilities in a government's balance sheet.

²⁹ Similarly, the comparison between each sector's capital structures (as indicated by the debt to assets ratio) is of little merit.

-
- the State sector's unfunded superannuation (and other debt-like) liabilities – and superannuation assets held on-balance sheet – are quite large relative to those for the local sector; and
 - the local sector's equity investments (in public corporations) – which are a source of financial flexibility, and loan security – are insignificant relative to those of the States.

Related to this line of argument, we consider the most useful measure for comparing the State and local sectors' annual financial performance to be the net lending/borrowing measure, rather than the net operating surplus measure. Net lending is the contribution made by a government's annual transactions to its net financial liabilities position, whereas the net operating surplus is the contribution made by annual transactions to net worth. Moreover, comparisons between the State and local sectors' net operating surpluses are also affected by a relatively larger 'capital' revenue component in the local sector's income as measured by the ABS (including in the form of capital grants).

Inspection of Table 2.3.1 indicates the local sector's relative net financial worth (*negative* net financial liabilities) position to be less comfortable than that for the States on average (and Victoria in particular). When this is combined with the fact that the local sector's relative capital spending is four times larger than the States' (and the relative value of the non-financial assets on the local sector's balance sheet is nearly five times larger), it is not surprising (indeed prudent) that, compared with the States, the local sector:

- exhibits a larger net operating surplus (to internally generate sources of capital financing);
- is a net lender (unlike the States which are net borrowers on average, although Victoria was a larger net lender in 2000-01); and
- has cash balances which are nearly three times larger than the State's on average.

Therefore, an appreciation of the differences between the State and local sectors means first impressions from the usual key indicators (net operating surplus and net debt) are misleading.

2.3.3. *Scope for additional borrowing?*

Borrowing to fund capital spending therefore typically is not a common practice for local governments across Australia.³⁰

Among other things, the long-run decline in borrowing reflects the pressure from State governments for the local sector to further reduce debt, with many local councils as a consequence adopting "zero debt" objectives as part of their financial planning. For the most part, the local sector runs large net operating surpluses in order to internally fund capital spending.

While borrowing for capital expenditures is a legitimate and economically sound strategy for local governments to follow, there may be limited scope for additional net borrowing by the local sector. Local government experiences difficulty in charging for the infrastructure services it provides, with the local sector's capital expenditure on such key things as roads and bridges not generating a revenue stream to service debt that is easily offset by the sector's ability to impose property rates. In addition, the relatively small size of many local councils means that debt management costs are higher when councils borrow than can be achieved by centralised borrowing at the Commonwealth and State levels.

Nor do low current borrowing levels necessarily mean that a borrowing requirement isn't a real prospect. If anything, an erosion of the local sector's net lending position over time is likely if recent trends persist. This pattern reflects a squeezing of the local sector's net operating surplus over time, suggesting the local sector may have to increasingly rely on borrowing if revenue and spending policies are to remain unchanged.

³⁰ Difference in the resort to borrowing can be observed between the local sector in different States. For example, borrowing is more common in Queensland, where local government has broader responsibilities necessitating higher capital expenditure.

Such a strategy may not be viable given limits on the ability of the local sector to borrow, as well as limited revenue raising options from many of its assets. Such constraints on borrowing might instead lead to a reduction in services in order to keep budgets in balance.

3. Is There a Case for Moderating Local Government Expenditure?

Even if there is pressure building up on the local sector's finances, what role could be played by reducing the sector's level of spending?

3.1. Commonwealth views

In its submission to the Inquiry, DOTARS indicated its agreement with the view that:

*"... where the source of the financial pressure on local government is as a result of a discretionary action by the council itself, it would appear to us to be appropriate for that to be funded by the council from its own revenue sources. However, where the source of the financial pressure is as a result of changing policies or actions from other spheres of government and these actions impose extra costs and functions on the local government, we consider greater financial assistance could be appropriate."*³¹

Moreover, elsewhere in its submission DOTARS indicated that:

"...All spheres of government face these kinds of challenges [to provide a wider range of services; to improve their service delivery] to some extent. However, it is arguable that local government experiences greater direct pressure than the other spheres, due to its proximity to communities. Accordingly, the onus remains on local government to respond as efficiently and effectively as possible to the changing circumstances in which it operates."

*...Local government must also consider how to make better use of its existing resources in order to provide better quality services to its communities."*³²

3.2. State views

The SA Government indicated that local government was:

*"...currently significantly under-funding infrastructure renewal. This has led to a call ... for efficiency gains by Councils through better asset management as well as for an improved revenue base for Local Government so that expenditure on infrastructure renewal and replacement can be increased."*³³

3.3. Operating expenses

Observing the trend in the local sector's operating spending as a percentage of GDP over the last two decades is complicated by the break in the series resulting from the introduction by the Australian Bureau of Statistics of accrual reporting in 1998-99. A suitable time series is only available using the old 'cash' format, covering the period through to 1997-98.

³¹ DOTARS, September 2002, p.42.

³² DOTARS, September 2002, pp.8,53.

³³ South Australian Government, p.14.

Table 3.3.1: Operating Spending as a % of GDP, Local Sector

By major function	1977-78	1982-83	1987-88	1992-93	1997-98
General public services	0.17%	0.26%	0.25%	0.28%	0.17%
Education, health & public order & safety	0.08%	0.09%	0.07%	0.07%	0.08%
Social security and welfare	0.03%	0.04%	0.06%	0.09%	0.10%
Housing and community amenities	0.10%	0.17%	0.14%	0.14%	0.20%
Recreation and culture	0.19%	0.22%	0.21%	0.21%	0.25%
Transport and communications	0.26%	0.25%	0.22%	0.27%	0.20%
Other	0.03%	0.02%	0.01%	0.01%	0.02%
TOTAL	0.86%	1.05%	0.98%	1.07%	1.03%

Source: Australian Bureau of Statistics

Table 3.3.1 shows little trend change in local sector operating spending as a share of GDP over the last couple of decades, although some change is evident in the composition of such spending, particularly in the five years to 1997-98. In that time, there has been less emphasis on general public services and transport and communication (dominated by spending on roads), with growth in spending on social security and welfare, as well as housing and community amenities.

Evident therefore is an expansion of services beyond those traditionally delivered by the local sector. For example, the average rate of growth in per capita operating spending on social security and welfare by the local sector has been more than twice that of CPI growth over the past decade.

There is strong *prima facie* evidence that this pattern reflects increased community demand for essential services. Local councils are increasingly taking on responsibility for social functions, such as addressing alcohol and drug problems, community safety issues and improved planning and accessible transport. Local government is also playing an increasingly regulatory role, not least of which is in the areas of development and planning, public health and environmental management.

Local government has also extended its activities in the delivery of a variety of community services funded fully or partly by other tiers of government. Such programs have usually involved specific purpose payments (SPPs) and often require a financial contribution from local government as one of the conditions of funding. Sometimes, local councils have contributed to the successful delivery of new services only to find external funding subsequently withdrawn.³⁴

Expenditure reviews would be most justified with regard to any unfunded mandates from other tiers of government. In these circumstances, local government is confronted with the choice of continuing to fund the activity in total or wearing the political costs of ceasing the activity. These are very difficult choices.

It is not apparent that other levels of government would wish local government to cease such activities. Shifting expenditure responsibilities away from the local sector may not be economically efficient. As already noted, service delivery is most appropriate/efficient where services are provided by the sphere of government most closely related to those who most directly benefit from – and can most directly pay for – those services.

³⁴ For example, one major area of increasing responsibility is management of the environment. Since the inception of the Natural Heritage Trust, local government has been progressively drawn towards on-ground action for conservation of the environment. This Commonwealth scheme to fund environmental activities has bolstered community involvement and, to a degree, local government involvement in environmental issues. Following the Trust's closure, the pool of money for the environment will no longer exist, but the landcare and bushcare community groups formed to undertake conservation activities will still remain, as does the community concern for the environment.

3.4. Capital expenditure

Table 3.4.1 shows the local sector's capital spending as a percentage of GDP, again just for the years in which the cash series is available.

Table 3.4.1: Capital Spending as a % of GDP, Local Sector

By major function	1977-78	1982-83	1987-88	1992-93	1997-98
General public services	0.26%	0.04%	0.04%	0.07%	0.08%
Education, health & public order & safety	0.01%	0.01%	0.01%	0.00%	0.01%
Social security and welfare	0.01%	0.01%	0.01%	0.01%	0.02%
Housing and community amenities	0.07%	0.08%	0.08%	0.07%	0.07%
Recreation and culture	0.10%	0.11%	0.11%	0.10%	0.08%
Transport and communications	0.44%	0.38%	0.32%	0.23%	0.23%
Other	0.01%	0.02%	0.01%	0.01%	0.01%
TOTAL	0.90%	0.65%	0.59%	0.49%	0.49%

Source: Australian Bureau of Statistics

Table 3.4.1 shows that transport and communications (notably roads) remains the dominant capital spending area, although such spending has clearly fallen as a share of GDP over time. Capital spending as a share of GDP for other functions has been reasonably constant.

In general, there are two types of capital spending:

- spending on 'replacement', involving investment in replacing old assets aimed at maintaining existing service levels; and
- spending on 'growth', involving investment in new assets and aimed at increasing (augmenting) service capability.

On the basis that depreciation expense provides an indication of the need for replacement capital spending, Table 3.4.2 shows the local sector's capital spending as a ratio of depreciation expense since 1998-99 (the only years for which GFS data on depreciation expense is available). Depreciation expense measures the amount of capital stock used up, so a ratio of less than 100% means that the local sector's capital stock is not being maintained. Only where capital spending exceeds depreciation may there be evidence of investment in additional infrastructure as well as in the rehabilitation of existing assets.

Table 3.4.2: Capital Spending relative to Depreciation Expense, by Level of Government

	1998-99	1999-00	2000-01
Commonwealth	219.7%	175.7%	179.9%
All States and Territories	190.3%	178.9%	181.8%
Victoria	214.4%	198.7%	197.1%
Local sector	152.7%	143.7%	139.6%

Source: Australian Bureau of Statistics

Table 3.4.2 shows marked differences in capital spending across the levels of government. In particular, the local sector exhibits the lowest amount of capital spending for 'growth' purposes.

For particular functions (especially roads), there is evidence that capital spending may indeed be insufficient for replacement purposes (so that service standards are deteriorating). For example:

"...the Victorian Auditor-General [has found] that over the past five years renewal spending on local roads was deficient by between \$1.4b to \$2.75b."³⁵

A recent study of the South Australian local sector by that State's Local Government Association³⁶ found that, on average, the annual rate of deterioration of the local road network in the State was three times more than the level of expenditure on replacement/rehabilitation.

3.5. Conclusion

There appears to be limited scope for cutting into local sector spending.

As DOTARS acknowledged :

"...local government's role has expanded and changed significantly over the past few decades. Local government is shifting its focus from hard infrastructure provision to a greater relative importance on spending on social services such as health, welfare, safety and community amenities. ...[It] is delivering a wide range of welfare and social services and has a greater regulatory role than its traditional 'roads, rates and rubbish' image. Given this, the question now is the capacity of local government to deliver. Its capacity to provide quality services has a direct bearing on most Australians' standard of living."³⁷

³⁵ MAV, p.3.

³⁶ South Australian Local Government Association.

³⁷ DOTARS, September, pp.40-41.

4. Is There a Case for Greater Use of Own-source Revenues?

If there is little scope to cut local sector spending (and, indeed, some underspending is suggested), what role could instead be played at the local sector level by increased revenue effort?

4.1. Commonwealth views

Underlying the Commonwealth position appears to be a view (at the Treasury level in particular) that the local sector should be more self-sufficient, and not become over reliant for funding on other tiers of government.

4.2. State views

The SA Government is more specific, suggesting that:

"... there is room and theoretical argument for extra user charges (maybe in areas of road use charges and user charges for environmental resources, with an over reliance on rates as a source of revenue)..."

... in the absence of adequate grant funding, Council rates may be at least as good a general tax as other alternatives."³⁸

4.3. Types of own-source revenues

Table 4.3.1 shows the local sector's own-source revenues by major item as a percentage of GDP by level of government.

**Table 4.3.1: Own-source Revenues as a % of GDP, by Level of Government
2000-01**

% of GSP	Taxation revenue	Sales of goods and services	Other income
Commonwealth	26.1%	0.6%	1.0%
All States and Territories	4.9%	1.4%	1.9%
Victoria	5.0%	1.6%	1.1%
Local sector	1.0%	0.8%	0.3%

Source: Australian Bureau of Statistics

Note: GSP is used for the States, while GDP is used for Australia as a whole.

Taxation is the largest component of the local sector's own-source revenues, a component which has been growing steadily with local economies over time. Revenue received from sales of goods and services ("user charges") is also considerable. Other income comprises current revenue items such as fees and fines, as well as capital revenue items such as local government capital levies and grants from private bodies for capital works e.g., capital contributions to road construction.

4.4. Increased reliance on local government rates?

Rates are the local sector's sole source of taxation. Rates typically account for between 40% to 50% of operating revenue. The rate in the dollar and the consequent revenue is set as a balancing item in order to manage the annual total rate payment faced by ratepayers.

³⁸ South Australian Government, pp.13-14.

The local sector's taxation effort has kept pace with economic growth remarkably well over time, hovering at or just over 1% of GDP since the early 1980s.

Since 1974-75 (when FAGs were introduced), the average annual increase in rate collections across Australia has been 9%. This compares with annual taxation revenue growth of 10% by the Commonwealth and 10% by the States in that time. This would suggest that the taxation effort being made by the local sector has been largely consistent with the efforts of the other levels of government.

The present system of local rates is a relatively efficient tax base for local government, based on Access Economics' modelling:

- rates are almost as efficient, overall, as State payroll taxes or taxes on gambling;³⁹ and
- residential rates can be justified both in terms of charges for property-related local government services, as well as shoring up the consumption tax base by effectively including rentals (including imputed rental from owner-occupied dwellings) in the consumption tax base.⁴⁰

The attractions of this source of revenue are increased because the tax base is easily attributable to each local government area.

However, whether local rates are a 'growth tax' is more debateable:

- unless valuations for rating purposes are smoothed, there is a risk of substantial tax base volatility; and
- growth tax claims will vary substantially across different local government areas as population and economic pressures vary by region.

Moreover, there are currently some inefficiencies in the application of local government rates:

- All councils offer rate concessions and exemptions, usually sanctioned (expected) by State governments. While the wording of State legislation in relation to rate remissions for groups such as pensioners varies, all States provide for the apparent reduced cash flow capacity of groups in the community such as pensioners. Moreover, these concessions and exemptions are often not well targeted. The States meet the cost of pensioner concessions to varying extents.
- New South Wales has rate capping legislation. Rate capping has negative implications for revenue stability and planning. Relating rate pegging to CPI movements in particular reinforces the relative decline in the local sector's revenue-raising capacity and share of taxation revenues compared to Commonwealth and State governments. Rate capping – and the equivalent criticism that often occurs in States other than New South Wales of rate increases – is inconsistent with the call for local governments to become more financially secure and to develop broader sources of revenue. It also rewards poor management and promotes inefficiency because, if anything, local councils are encouraged to increase rates by the full extent of the allowed limit irrespective of need.

4.5. Additional user charges?

Table 4.5.1 shows user charges (revenue received from sales of goods and services and from fees and fines) as a share of operating spending (including allowance for depreciation of assets). This provides an indication of each sector's "cost recovery ratios".

³⁹ This is especially the case with respect to residential rates, but less so regarding rate on commercial property as the latter entail taxes on business inputs (which are generally undesirable and inefficient – indeed, the logic of the GST included the point that the GST would greatly reduce taxes on business inputs).

⁴⁰ This last argument is only a rough justification because new housing is already subject to GST: the justification is stronger in relation to the stock of housing in place before the GST was introduced on 1 July 2000 (which benefits, on sale, from a windfall gain as the market includes an allowance for GST in its price).

Table 4.5.1: Revenue from User Charges as a % of Operating Spending, by Level of Government

	1998-99	1999-00	2000-01
Commonwealth	2.4%	1.9%	2.2%
All States and Territories	10.1%	9.8%	9.6%
Victoria	13.2%	12.7%	12.4%
Local sector	31.1%	34.6%	34.5%

Source: Australian Bureau of Statistics

Local government is heavily reliant on user charges for its operation, recovering over one-third of its operating expenses in this form.

As shown in Table 4.5.1, the local sector's cost recovery ratio is much higher than those for the Commonwealth and State sectors. In the main, this reflects considerable variation in the responsibilities of the different levels of government, with the local sector in a much better position to recover costs for the services it delivers. It may also suggest that there are limits on the extent to which local government can increase its cost recovery efforts.

User charges for the local sector have also increased over time. Wider adoption of "user pays" pricing of services under Australia's microeconomic reform program has seen a higher share of local sector revenues coming from fees and charges, with many services operating on a self-funding basis independent of local sector taxation revenues.

There may also be a role for environmental charges and the like. As a general principle, local councils are in a position to adopt a "polluter-pays" position on all environmental services which may involve local councils in remedial management of environmental damage, or where environmental degradation is regarded as a significant local issue. Environmental levies could include the introduction of stormwater charges based on the quantity and quality of stormwater discharged from urban developments (encouraging recycling as well as environmental protection). Other potential areas for environmental levies are refuse dump fees, tree clearing levies, charges for erosion protection and charges on developers for construction site pollution of surrounding areas.

There are often political (and other) limits to cost recovery within local government. User charges are sometimes criticised because they may exclude some community members from using them (or ration their use), although this can be offset by payments made to enable concessional pricing to meet community service obligations. Also, if full costs can be recovered, including allowance for capital, then such activities might best be left to the private sector.

4.6. Conclusion

Annual increases in rates across Australia have been around 9% since the mid-1970s. This is broadly consistent with the taxation effort of both the Commonwealth and the States over the same period.

There is already a high level of reliance on user charges by the local sector. User charges often raise equity considerations that must be considered at all levels of government.

5. Is There a Case for Greater State Funding?

If there is little scope for an increase in the local sector's revenue effort from its existing own-source revenue, what role could be played by increased SPPs from the States?

5.1. Commonwealth views

The Commonwealth holds the views that:

- as the local sector comes within the legislative ambit of the States, State governments should be responsible for funding the local sector; and
- with State sector finances having been given a boost by the GST arrangements, the States now have a greater capacity to provide additional funding to the local sector (among other things).

As to local government's funding mix since the Commonwealth first started providing direct funding in the 1970s, DOTARS has suggested that:

"Although the amount of State assistance has increased in real terms since 1974–75, its rate of increase (0.4 per cent per annum in real terms) is about one-tenth of the rate of increase of local government own-source revenue (4 per cent per annum in real terms). Its decline in importance is almost exactly matched by the increase in importance of Commonwealth transfers."⁴¹

In this way, the Commonwealth is echoing the argument put by the ALGA that:

"The failure of State SPPs to maintain parity with the growth rate of local government own source revenue, or even Commonwealth payments to local government, represents a significant transfer of responsibility to local government from States."⁴²

5.2. State views

The States' view is that they do not currently have the resources to increase funding to local government in preference over other programs (such as health, education, law and order).

In particular, the SA Government has stressed that:

"Over recent years the States have become increasingly concerned at the decline in their share of national tax revenues, particularly in light of increasing expenditure requirements and limited State tax bases."⁴³

Even though introduction of the GST is predicted to eventually make the States better off, with GST revenues expected to outstrip the guaranteed minimum amount (i.e., funding paid to States to ensure they are no worse off under the new arrangements) for all States by 2007-08:

"...the new arrangements up till now have not, however, improved the budget position of South Australia or any other State.

If the Commonwealth maintains its current level of funding from sources other than the GST, the States' share of national revenue will, at best, remain unchanged... There will be no windfall gain to

⁴¹ DOTARS, July 2002, p.24.

⁴² ALGA, p.14.

⁴³ South Australian Government, p.2.

*the States from the GST revenue; it will simply allow the States' revenue base to grow at around the same rate as that of the Commonwealth."*⁴⁴

5.3. Current role of States

States do not generally provide untied financial assistance to the local sector. Instead, assistance provided by the States is tied and provided in the form of SPPs.

As to States' national competition payments, only Queensland, Western Australia and Victoria pass on a portion of their payments to the local sector.

5.4. Local government sharing in States' GST windfall

One possible longer-term scenario could be for local government to be allocated a share of the GST revenue now flowing to the States.

In 1996, the National Commission of Audit recommended that:

*"Local government financial assistance grants should be integrated into revised State payments."*⁴⁵

Indeed, in the initial Inter-Governmental Agreement on the reform of Commonwealth-State financial relations associated with introduction of the GST signed on 9 April 1999, it was agreed that the Commonwealth would transfer responsibility for the payment of local government FAGs to the States. Moreover, in the context of the States being provided access to "a robust and growing tax base [the GST]", the Commonwealth merely sought to oblige the States to maintain local government FAGs in real per capita terms on an ongoing basis.

In the end, however, the Commonwealth retained responsibility for the payment of local government FAGs because of last-minute changes to the Inter-Governmental Agreement endorsed in June 1999. These changes were on account of the reduction in estimates of GST collections following the late exclusion of basic food and some other items from the GST base as a result of the deal between the Commonwealth Government and the Democrats.

Since 1 July 2000, States and Territories have been receiving the full (net) proceeds from the GST. Under the new system, FAGs are no longer paid by the Commonwealth to the States. While the rate and tax base are fixed, the GST has given the States access to a growth tax.

While some in the Commonwealth may suggest that the States could share their GST windfalls with the local sector, this overlooks the fact that the States will not have the capacity to do so in the foreseeable future. The costs to the States of the foregone revenue and new responsibilities associated with the new tax system will exceed the revenue from the GST for quite a number of years. This shortfall in GST revenue is to be met by the Commonwealth, with 'budget balancing assistance' ensuring that no State will be *worse off* under the new arrangements.

Figures released by the March 2002 Ministerial Council for Commonwealth-State Financial Relations indicate that Queensland may be the first to experience a windfall in 2003-04, followed a year later by Western Australia, Tasmania and the ACT. On official figuring, windfalls will not be being experienced by all States until 2007-08.

⁴⁴ South Australian Government, p.3.

⁴⁵ National Commission of Audit, p.78.

5.5. Conclusion

The State sector is a victim of inadequate Commonwealth funding levels just as much as the local sector. The Commonwealth cannot rely on the States to address funding issues affecting the local sector, unless or until it provides sufficient funding to the State sector for this purpose.

6. The Case for More Commonwealth Funding

If there is limited scope for the additional financial capacity necessary to meet the growing demands on the local sector to come from either the local sector or the State sector, should the major role be played by the Commonwealth?

6.1. Commonwealth views

The DOTARS submission canvasses the local sector's share of national taxation revenue, without once mentioning VFI explicitly:

"In Australia, each of the three levels of Government has its own revenue raising powers and expenditure responsibilities. In the CGC Review (CGC, 2001, Working Papers, p. 166) the CGC noted that:

- *The Commonwealth has the largest own-source revenues and own-purpose outlays, and local government the smallest;*
- *The Commonwealth's own-source revenue exceeds its own-purpose outlays; and*
- *The State and local governments' own-purpose outlays exceed their own-source revenue".⁴⁶*

Rather than acknowledge the implications of this VFI, the Commonwealth's position instead is that the share of local government revenue coming from the Commonwealth has been increasing. For example, DOTARS's submission to the Inquiry argued that:

"...since the introduction of the untied financial assistance in 1974, Commonwealth grants assistance has grown by around 10.8 per cent per annum on average, whereas the States' contributions have only grown around 6.6 per cent per annum on average."⁴⁷

6.2. State views

By contrast, the Queensland Government argued that:

"Vertical fiscal imbalance occurs in all federations. In Australia, only the Commonwealth has a capacity to raise revenue in excess of its expenditure requirements. Both State and local governments have expenditure responsibilities in excess of revenue raising capacity. The level of financial transfers between the Commonwealth and States, and cost shifting by the Commonwealth to the States, impacts on States' capacity to provide additional assistance to local government.

... the failure of the Commonwealth to increase the quantum of financial assistance grants to local government in line with growth in Commonwealth taxation revenue represents a systematic cost shifting by the Commonwealth onto local government."⁴⁸

In a similar vein, the SA Government concluded that:

"...financial resources available to state and local government have been generally reducing relative to the size of the economy, and to the underlying level of taxation revenue."⁴⁹

⁴⁶ DOTARS, July 2002, p.16.

⁴⁷ DOTARS, July 2002, p.22.

⁴⁸ Queensland Government, pp.1-2.

⁴⁹ South Australian Government, p.3.

6.3. What is VFI?

Intergovernmental financial relations in Australia are characterised by significant differences between the relative revenue-raising and expenditure responsibilities of the three tiers of government. VFI involves the mismatch of spending and taxing powers between levels of government.

Table 6.3.1 compares the proportion of taxes collected at the different levels of government in 2000-01 (the latest year for which actual data is available) and each level's proportion of tax-funded⁵⁰ own-purpose⁵¹ expenses.

Table 6.3.1: Taxes Raised and Spent, by Level of Government, 2000-01

	% of total taxation raised	% of total tax-funded own-purpose expenses	Ratio of % raised to % spent
Commonwealth	81.8%	60.2%	1.36
State	15.3%	34.7%	0.44
Local	3.0%	5.1%	0.59
TOTAL	100.0	100.0	

Source: Australian Bureau of Statistics

VFI is most apparent between Commonwealth and State levels of government. In 2000-01:

- the Commonwealth raised 82% of taxation Australia-wide, but was responsible for only 60% of total tax-funded own-purpose government expenses; and
- States raised 15% of taxation Australia-wide, but were responsible for 35% of total tax-funded own-purpose government expenses.

In the same year, the local sector raised 3.0% of taxation revenues and was responsible for spending 5.1% of total tax-funded own-purpose government expenses. All up, therefore, the local sector was responsible for raising just 60% of the tax revenues expended by that sector on its own-purpose activities. The remaining 40% was raised by the Commonwealth (and paid either directly to the local sector or passed through the States).

As Table 6.3.2 shows, differences in the relative revenue-raising ability of the levels of government have varied over time.

Table 6.3.2: Taxation by Level of Government

% of total taxes collected by:	1901-02	1929-30	1948-49	1964-65	1974-75	1985-86	1993-94	2000-01
Commonwealth	63.6	54.2	88.2	82.2	80.4	79.9	74.4	81.8
State	18.4	31.5	7.9	11.8	15.7	16.3	21.4	15.3
Local	17.9	14.3	3.9	6.0	3.9	3.8	4.2	3.0
<i>Total taxes as a % of GDP</i>	6.3	13.7	23.8	23.4	28.4	30.7	29.2	30.6

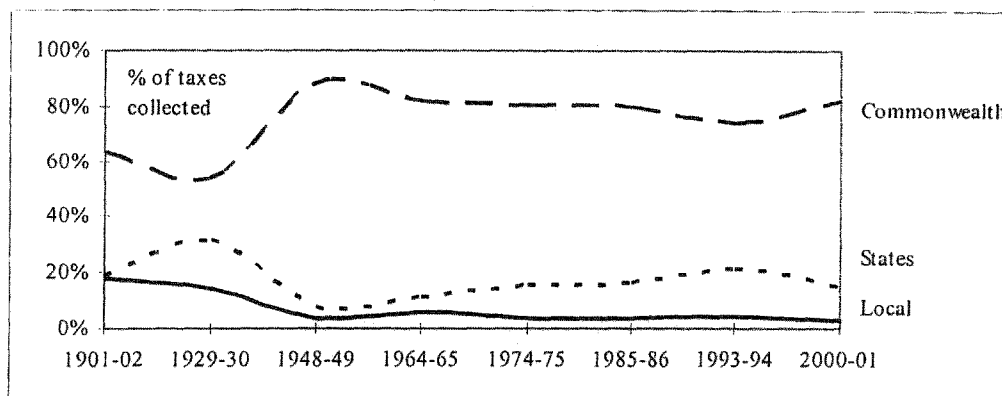
Source: Access Economics and Australian Bureau of Statistics

⁵⁰ Tax-funded expenses are total expenses excluding expenses funded from non-tax sources (e.g. user charges, interest income). As such, tax-funded expenses are expenses funded by either own-source taxes or grants from other levels of government.

⁵¹ Own-purpose expenses of a particular level of government are the total expenses of that level of government excluding the grants paid to other levels of government.

The proportion of total taxes collected by the different tiers of government since Federation is also illustrated in Chart 6.3.1 below.

Chart 6.3.1: Taxation by Level of Government



Source: Access Economics and Australian Bureau of Statistics

These mismatches require the level of government with excess revenue sources (the Commonwealth) to distribute its surplus revenues back to those levels of government with deficient revenue sources (State and Local) in the form of grants from the Commonwealth.

As Table 6.3.3 below shows, Commonwealth payments to local government (general purpose grants, identified local roads grants, specific purpose road grants and other specific purpose grants) account for 52% of all grants to local government. State grants (generally, specific purpose grants) represent the other 48%.

Table 6.3.3: Composition of Grants Received, Local Sector, 2000-01

\$ millions	FAGs	other grants (mostly SPPs)	Total
from Commonwealth	1,316.3	111.4	1,427.7
from States	-	1,320.7	1,320.7
TOTAL	1,316.3	1,432.1	2,748.4

Source: Access Economics

6.4. Implications of VFI

6.4.1. Role of FAGs

The role played by FAGs in the local sector is therefore clear evidence of VFI.

It should be noted, however, that FAGs (and any inadequacy in their levels) are not the *cause* of VFI. VFI is caused by the uneven distribution of taxing powers and expenditure functions. FAGs merely serve to offset – not reduce – VFI. As such, FAGs are a *symptom* of VFI. Only an evening up of the local sector's tax powers and expenditure responsibilities would reduce that sector's VFI problems.

6.4.2. What role SPPs?

Just under one-half of VFI grants at the local sector are provided in the form of FAGs, while the remainder is in the form of SPPs.

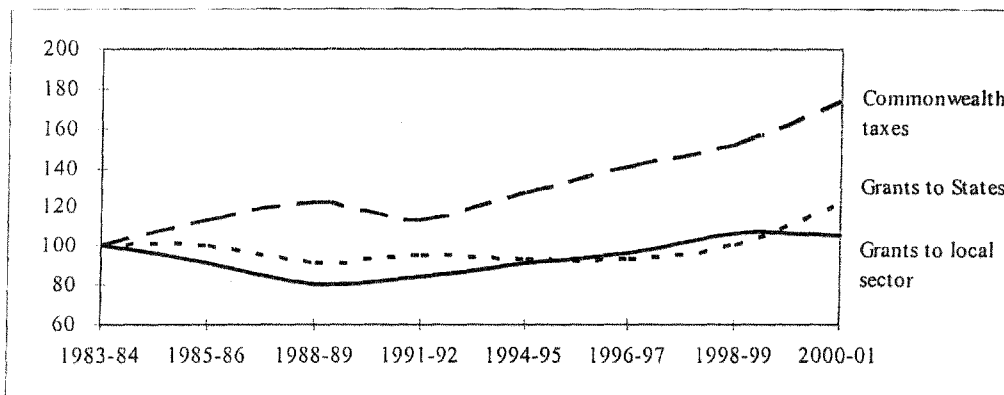
Only if SPPs genuinely reflect the donor government's priorities (with the local sector acting merely as an agent/provider) is attaching conditions to such grants warranted. If, on the other hand, the SPPs represent a donor government's attempts to influence priorities in areas outside the donor government's direct area of responsibility, SPPs can result in economic inefficiency or inappropriate service delivery. Service delivery is most appropriate/efficient where the types and level of services are determined by the sphere of government most closely related to those who most directly benefit from – and can most directly pay for – those services, taking due account of the existence of economies of scale in service provision, spillover effects and public good issues.

6.4.3. *Appropriate rate of growth in any tax sharing grants*

For those grants that are provided to address VFI, the taxes that are being shared in principle are being collected (in the Australian case) nationally. The allocation of tax sharing grants from higher levels to lower levels of government therefore should involve tax sharing grants growing at the same rate as tax collections centrally collected.

Chart 6.4.1 shows the relationship, since 1983-84, between taxes collected centrally by the Commonwealth on the one hand and (current and capital, general purposes and specific purpose) grants paid to the State and local sectors on the other.

**Chart 6.4.1: Per Capita Tax and Grant Revenues, Constant (2000-01) Prices
1983-84 = 100**



From Chart 6.4.1, it is clear that tax sharing grants – at both the State and local sector levels – have failed to keep pace with growth in centrally collected taxes. Between 1983-84 and 2000-01, when expressed in constant price per capita terms, Commonwealth tax collections have increased by 74% over the period while grants to the States by increased by 21% (much of this recently related to the GST arrangements) and by just 5% for the local sector.

Hence, the fact that local government FAGs may have been tracking the increase in population and prices in recent years is not sufficient. Tax sharing grants should grow at the same rate as Commonwealth estimates and projections for Commonwealth taxes (exclusive of GST) and GST revenues (collected by the Commonwealth on behalf of and paid to the States), not less quickly as in the case of FAGs to local government.

6.5. Conclusion

The position taken by the Commonwealth clearly overlooks VFI, and the role to be played by untied grants in addressing the symptoms of that imbalance (if not the causes).

7. Is There a Case for Extended Tax Powers?

Increasing FAGs is not the only possible response to VFI. In principle at least, eliminating (or reducing) VFI is better achieved by transferring sufficient tax power away from the level(s) of government with more taxes than spending (or by, alternatively, transferring expenditure responsibilities away from the level(s) of government with more expenditures than taxes).

This chapter discusses possible ways in which the financial needs of the local sector could be met by reducing the extent of VFI itself, especially:

- additional tax powers; and
- the sharing of tax powers.

7.1. Benefits of reducing VFI

Reliance on grants while VFI continues is not without its disadvantages.

7.1.1. Reduces duplication

VFI leads to duplication and higher operational costs. Where higher levels of government provide grants to particular areas, they generally require a say in the manner policy is administered (via SPPs). This generally results in additional bureaucratic structures and contributes to more difficult decision making. And when these higher levels of government have to cut spending, it is always easier to cut payments to the local sector rather than own-purpose spending, regardless of the relative merits of the programs involved.

7.1.2. Encourages benefits of federalism

While VFI remains, the options for tax competition at the local sector are minimal. Local governments lose a deal of their discretion to choose whether to adopt high tax/high spending policies, or low tax/low spending policies. That heavily curtails the type of competitive choices normally available to taxpayers in a federal system.

*"The typical economic conception of federalism emphasises its role in permitting diversity in decision-making where goods or services have spatially limited benefits, while retaining central control over functions where the benefits are essentially all-inclusive ('national')."*⁵²

The National Inquiry into Local Government Finance in 1985 concluded that, while seeing an important role for general purpose financial assistance for local government:

*"...local government should in the main raise its own revenue. Only then can it exercise responsible local choice."*⁵³

7.1.3. Reducing any mendicant attitude towards the Commonwealth

VFI also results in the wrong incentive structure.

The current system creates ambiguity as to which level of government is responsible for certain services and encourages buck passing – in both directions.

Recipient governments are encouraged to spend too much time and energy manoeuvring for a relatively greater share of the available grants from the Commonwealth.

⁵² Walsh, pp.6-7.

⁵³ National Inquiry into Local Government Finance, pp.358-9.

7.2. Additional (or exclusive) taxing powers

Maximum independence and efficiency is achieved where the local sector has guaranteed access to an exclusive tax base, and obtaining such exclusive access should be a key strategy for local government.

The most logical exclusive tax base for the local sector is local rates based on residential property.⁵⁴

Rates could be made a more attractive tax base for local government if:

- States were to abandon land taxation and leave residential property rates as a fully exclusive tax base for local government; and
- reciprocal taxation or similar arrangements led to State and Commonwealth governments paying property taxes on the same basis as private properties.

However, this option would involve the States solving the local sector's VFI problem by worsening their own.

7.3. Role for sharing tax bases

The degree of VFI in Australia has its attendant problems but, on the other hand:

- it enables pursuit of the advantages of a degree of centralised revenue raising – arising both from its part in macroeconomic management and from its economic and administrative efficiency; and
- it discourages revenue competition between local councils within, or between, States that could be detrimental in the absence of full HFE.

An alternative which retains some of the advantages of reducing VFI is shared access to tax bases by different levels of government. The local sector could seek guaranteed access to a tax base also utilised by another level of government.

The advantages of a strategy of shared access are:

- it would provide a broader and more diverse tax base;
- it could, if rates were locally set, encourage healthy competition among local councils, leading to greater efficiency in resource allocation; and
- it would provide for a closer link between the nature of services provided and the means of funding those services (petrol taxes and road maintenance, for example).

Tax sharing could take two forms:

- Local government could seek independent access to taxation, with the right to set levels of taxation locally. This would maximise flexibility, allow a good reflection of local priorities and preferences and the exercise of local choice, and provide adequate (although fluctuating) revenue bases for many local councils.
- Local government could have access to these tax bases but with uniform rates of taxation set across all local councils. While this reduces flexibility and local choice, it would avoid the effects of competitive "bidding down" of tax rates and provide a more sustainable revenue source (although still fluctuating with economic cycles).

On the down side, however, would be considerations like:

- the complexity that would be added, both in an administrative sense and in an already over-regulated part of tax (and economic activity); and

⁵⁴ The economic case for the local sector being given exclusive access to property and real estate taxes is explored in Neilson and Morton, pp.64-76, 93-95.

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- without broadly similar fiscal capacities among local councils, regional disparities within Australia might only be increased by the resultant competitive federalism.

7.4. Correcting an anomaly in the *New Tax System*

One option for sharing revenue would be to amend the Intergovernmental Agreement (IGA) to correct an anomaly in the way the *New Tax System* operates.

Specifically, the original IGA always envisaged that the interaction between remaining State taxes and the GST would eliminate 'tax on tax' problems. Following the deal between the Commonwealth Government and the Democrats, the application of the GST has seen this principle violated in two ways:

- Some State taxes form part of the tax base for the GST (e.g., fire services levy in those States retaining this very inefficient and unfair tax).
- The GST forms part of the tax base for other State taxes (e.g., stamp duties).
- As a result, in some cases, and in particular involving property (the potential tax base for local government), we now have 'tax on tax on tax' problems. For example, the fire services levy in Victoria is part of the tax base for GST, and both are part of the tax base for stamp duty on property insurance.

One option for augmenting local government revenue (which, in a way, is GST-related) has two parts:

- Initially, calculate the total revenue for each State attributable to 'tax on tax' effects associated with the introduction of the GST. For each State, allocate this revenue to the local government sector immediately.
- Over time, and ideally, amend the IGA to eliminate all 'tax on tax' effects associated with the GST, making room for a corresponding increase in revenue from local government rates.

7.5. Conclusion

Local government needs to press these issues.

By doing so, it would be seen to be working towards greater self-sufficiency while also contributing to simplification of the total tax system.

In reality, however, the MAV is likely to be correct in its view that:

"Restrictions on local government's income are not easily addressed without major reform of Australia's taxation and inter-governmental financial relations. The simpler solution is to increase the quantum of funds provided to local government."⁵⁵

Nevertheless, by indicating a preparedness to take on tax powers if offered, the failure of the other levels of government to agree would strengthen local government's advocacy of increased FAGs (albeit as a second best solution).

⁵⁵ MAV, p.15.

8. Access Economics' Conclusions

There are strong grounds, both theoretical and practical, for increased FAGs to play a major role in addressing the worsening VFI evident between the Commonwealth and the lower tiers of government in Australia.

Fundamentally, mismatches between taxation collected centrally at the Commonwealth level and the Commonwealth's own spending responsibilities require the Commonwealth to distribute the surplus revenues it collects back to those levels of government with deficient revenue sources (State and Local) in the form of revenue sharing grants.

This case has strengthened on account of recent changes in Commonwealth-State financial relations as a consequence of the move to a goods and service tax (GST). Given limits on the alternatives (discussed in earlier chapters), it is hard to deny that the Commonwealth should be addressing the local sector's need, along the lines it acknowledged with respect to the State sector, to:

*"...have access to a secure and growing source of revenue and the capacity in the medium to long term to allocate additional funding for services..."*⁵⁶

The main alternatives to increased FAGs identified in this paper are as follows:

- the local sector cuts back its expenditure on unfunded mandates imposed by higher levels of government;
- the Commonwealth facilitates changes to State policies on exemptions, concession, rate capping and the like; or
- the States and the Commonwealth allow an increase in local government revenue, initially by allocating 'tax on tax' revenue associated with the GST to the local government sector and, over time, by amending the IGA to eliminate such tax effects, making room for an offsetting increase in local government rates on residential property.

As long as the Commonwealth continues to balk at (preferable) measures aimed at reducing VFI *at its source*, there is a clear case for additional local government FAGs.

The main options for increasing FAGs are either:

- a change to the escalation factor (from one factor based on estimates of population growth and CPI increases, to one based on growth in Commonwealth tax collections) – which would have the effect of locking in the current FAGs proportion of Commonwealth tax collections); or
- a fixed share of total Commonwealth taxation revenue (with the ALGA, for example, advocating a fixed 1% share); or
- adoption of a real-terms per capita betterment factor (so allowing for a nominated growth in service levels per head of population).

⁵⁶ Commonwealth Treasurer, p.16.

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