

**Preliminary Submission to the House of Representatives**  
**Economic, Finance and Public Administration**  
**Committee Inquiry into Cost Shifting by State**  
**Governments to Local government**

July 2002

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## EXECUTIVE SUMMARY

As drafted the Terms of Reference for this Inquiry ultimately require the Committee to consider the following broad issues:

- The current roles and responsibilities of local government;
- The impact of cost shifting by other spheres of government onto local government;
- Appropriate recognition of the roles and responsibilities of local government; and
- The long term financing of local government.

All of these issues are interrelated, although they are separate and distinct policy areas. In addressing one, it should not be assumed that the others are automatically addressed.

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## OVERVIEW

Local government anchors the Australian system of government. Diverse sophisticated and complex, local government offers a range of services across the full spectrum of 'hard' and 'soft' infrastructure.

Initially focused upon basic infrastructure, 'local government' has evolved significantly over the past 150 years.

Despite this evolution, the constitutional, legislative and financial framework that support this, the third sphere of government has not kept pace. It is time for constitutional reform to better reflect the contemporary reality and the new roles, functions and powers of Australian local government. **(For further discussion see Chapter One)**

Some of these new roles, functions and powers have occurred as a result of policy choice, increased community expectations, devolution and prescription through legislation and regulations by other spheres of government. Regardless of the cause, local government's general financial capacity must be enhanced to undertake its expanded role.

At the outset, it must be acknowledged that local government has clearly demonstrated its preparedness to play its part in securing own source revenue. However, independent research suggests that own source revenue cannot be further expanded, it is now time for a joint approach and a re-examination of the distribution of taxation revenue.

It is clear that cost shifting over several decades has placed considerable pressure on local government finances. It has also resulted in a number of undesirable outcomes.

According to the Commonwealth Grants Commission this includes<sup>1</sup> '...declining levels of infrastructure maintenance and replacement, and increased levels of user charges'.

A base line indicator of the cost to local government resulting from cost shifting is the change in Specific Purpose Grants (SPPs) from States to local government overtime.

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<sup>1</sup> *Review of the Operation of the Local government (Financial Assistance) Act 1995*, 'Commonwealth Grants Commission June 2001

States do not pay General Purpose Grants (GPPs), and therefore SPPs are the only source of State funding to local government. Changes in the quantum, and the conditions under which they are paid have a significant impact on council budgets. Cost shifting from other sphere of government to local government can often be tracked back to service areas covered by SPPs.<sup>2</sup>

According to the Commonwealth Grants Commission the level of State SPPs has increased over time, but has fallen as a proportion of local government revenue. State SPPs have fallen as a proportion of local government revenue from 14.8% in 1974-75 to only 7.1% in 1997-98, or by over 50% over the past few decades.

During the period 1974-78 to 1997-98 average annual growth rates for sources of local government revenues were: Municipal rates 3%, User Charges 6.4%, Other 4.5%, Commonwealth 4.3% and State 0.4%.

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.

*This process has lead to a distortion of local government expenditure profile. 'Analysis of local government expenditure over the period 1961 – 62 to 1997 – 98 shows that the composition of services being provided by local government has changed markedly over the past 30 – 35 years. Local government is increasingly providing human services at the expense of tradition property - based services (particularly roads).*

*Some changes are the result of changing priorities of local government; others are imposed on them by other spheres of government. The general broadening of local government functions has implications for local government finances.”<sup>3</sup>*

The Commonwealth Grants Commission concluded, ‘... Local government is increasingly providing human services at the expense of tradition property - based services (particularly roads). This conclusion is confirmed by the State Local government Associations who also report that the cost of increased service provision have been met by delaying maintenance and replacement infrastructure activities.<sup>4</sup> **(For further discussion see Chapter 2)**

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<sup>2</sup> Under this analysis of SPPs no attempt has been made to separate capital and recurrent expenditure. To ascertain an accurate appreciation of the financial impact of changes to SPPs it is recommended that further work be done. For the purposes of this submission it is sufficient to notes that States grants for capital items do not make ongoing expenses such as provision for depreciation, and therefore is a source of cost transfer to local government over time.

<sup>3</sup> **Commonwealth Grants Commission**, *Review of the Operation of the Local government (Financial Assistance) Act 1995*, June 2001 page xiv

<sup>4</sup> A Wealth of Opportunities, 2001. Also see the Local government Association of South Australia, submission.

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

This consequent deterioration of the local roads asset was astutely recognised by the Commonwealth as a problem of national significance and which it has attempted to rectify through the introduction of the \$1.6 billion over four years *Roads to Recovery* program in 2001.

ALGA has long maintained that local government finances need to be addressed in a manner that provides for long term stability. However, it should be clearly understood that in addressing the broader issue of local government finances the issue of cost shifting itself is not addressed. **(For further discussion see Chapter Three)**

ALGA and local government believe that 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.

Since the introduction of the 'new taxation system' consideration has also been given to the need to establish FAGs on the basis of an appropriate share of total GST revenue providing that it is no less than the on-going real value of existing FAGs (June 2002).

It is sometimes often glibly argued by other spheres of government that the solution to the local government's financial needs lays in its own hands. Measures may include:

- Reducing expenditure;
- Increasing user of the existing local government rate base;
- Increased user charges;
- Significantly increase the taxation base, and
- Increased reliance on borrowing.

ALGA has commissioned its own research into these options. In summary this research indicates:

**Local government could consider reducing its expenditure.** Independent research suggests that there is prima facie evidence that local government expenditure is reflecting community demand.

**Local government could increase its existing local government rate base.** The ABS acknowledges that local government own source revenue (rates) is the largest component of local government finances, equating to 40% to 50%. Annual increases in rates across Australia has been around 9% since the mid 1970's. This is consistent with the taxation effort of both the Commonwealth and the States over the same. It should also be noted that some State governments are adverse to rate increases and have introduced practices such as 'rate pegging.'

**Increasing user charges.** Independent research sponsored by ALGA indicates that there is already a high level of reliance on user charges. Current estimates indicate that the average revenue from users as a percentage of operating spending is approximately 37%. This cost recovery ratio compares with the Commonwealth at a little over 4% and the States at 12%. User charges often raises equity considerations that must be considered at all levels of government.

**Significantly increase the taxation base.** As costs increase, local government must consider broadening the local taxation base beyond that of traditional property taxes.

**Increase reliance on borrowing.** Borrowing for capital expenditure is a legitimate and sound economic strategy, however much of local government's capital investment do not, and arguably are not, capable of generating sufficient revenue returns to service debt. Independent research indicates that an average interest cover of 3.9% for local government in Australia and indicates that local government has adequate cover of its interest expenses. However there is strong evidence to suggest that higher debt levels will not be a sustainable financing strategy. **(For further discussion see Chapter 4)**

Local government strongly believes that the solution to local government financial needs, and the secure provision of services to our communities is a joint solution involving a combination of strategies.

These and other issues may be discussed in other submissions to be forwarded to the Committee later in the Inquiry process.

**ALGA Secretariat  
July 2002**

## PREAMBLE

There are 698 councils across Australia, employing approximately 140,000 people, collecting \$6,002 million per year in rates and responsible for 639, 197 kilometres of road.

For the purposes of this submission a council means those councils currently incorporated in accordance with the Local Government Act within each State and thus full members of the State Local Government Association.<sup>5</sup>

The Australian Local Government Association (ALGA) is the peak body for local authorities across Australia. Representing 698 councils, shires and other local governing bodies, ALGA advocates on behalf of local institutions, the local communities they represent and the process through which they interact. Founded in 1947 by the six States, the Australian Local Government Association now represents all States and Territories and is a full member of the Council of Australian Governments (COAG).

Local government holds a very important place in the Australian system of government and is the mechanism through which local communities advocate and seek expression for commonly held views and aims.

Local government serves the community as:

- ◆ **A local representative government**, providing a voice for community aspirations and concerns;
- ◆ **A policy maker**, setting local agendas and priorities;
- ◆ **An advocate**, representing local communities to other spheres of government and various community based agencies;
- ◆ **A regulator**, in areas such as construction controls, public health and the environment;
- ◆ **A planner**, overseeing the development of local planning frameworks;
- ◆ **A co-ordinator**, ensuring integrated, effective and efficient service delivery to the local community;
- ◆ **A service deliverer**, providing social and physical infrastructure;
- ◆ **An agent**, providing services to the community on behalf of other spheres of government; and
- ◆ **An information broker**, between suppliers and consumers, across all spheres of government, business, community organisations and local residents.

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## CHAPTER ONE – ROLES, RESPONSIBILITIES AND RECOGNITION

*Local Government is the expression of Australia's community to community democracy.*

*The rights of citizens to the democratic pursuit of community values through elected Local Government must be protected in the Australian constitution.*

*The diversity of Local Government in its approaches to public policy is a reflection of the areas and communities it serves. It mirrors differences in history, geography, patterns of settlement, local economies and community values. Variations in the structure and activities of Local Government from place to place must therefore be expected and valued as a strength of the system of Government.*

*(2001 National Agenda for Australian Local Government)*

In 1901 the Commonwealth Constitution attempted to delineate the roles and responsibilities of the States and the Commonwealth. Since that time due to changing demographics and community expectations, it is clear that these roles and responsibilities as originally defined do not accord with the daily operations of the federation which involves a partnership between the three spheres of government.

Precisely defining the roles and responsibilities of local government in Australia is an extremely difficult task. In the last century we may have expected that legislation would have prescribed roles and responsibilities to local government, however in the modern federation the adoption of more contemporary approaches based on general competency powers, which have given Local government a much greater flexibility to undertake their role. .

The history of local government shows a complex set of inter-relationships and inter-dependence between the three spheres of government, which make up the Australian federation.

The local government experience in Australia significantly contrasts to the international experience. Within Australia, there is no one national, uniform system of local government; rather seven different systems have evolved.

The history of local government in the Australian colonies tells of a structure of government formed to predominantly facilitate service provision. In all States and the Northern Territory, local government grew from the concern of local communities, predominantly about local road construction and maintenance.

Most local councils were proactive local democratic initiatives that assumed control of their own futures, in the absence of direct support for local services from colonial administrations and Britain. Local citizens generally assumed it that locally provided services and facilities would become the responsibility of States governments (and later



the Commonwealth) commensurate with their respective revenue raising powers. Thus this history demonstrates the first signs of the tension that exists around the task of defining roles and responsibilities of local government and the States.

However, to limit the historical experience of local government to such a narrow focus would be to forget the significant role community based democratic structures played in fostering the federalism cause, particularly with regards to the Cowra Convention in 1890.

In 1901 the six colonies federated to form the Commonwealth of Australia. The governing document of the Commonwealth, is the *Constitution of Australia*. Within this document, a federal system of government was established.

Under the Constitution, the Federal Government's powers and responsibilities are formally set out. The responsibilities of States and Territories were to be taken as everything not allocated to the Commonwealth,<sup>6</sup> as well as those powers and responsibilities ascribed to the State Government under State constitutions.

Each of the State Constitutions contains a section relating to local government. In some states these sections are quite brief, merely acknowledging that a system of local government exists in the State and that the responsible Minister or Parliament has authority to suspend or dismiss a council. In other States, these constitution provisions are more far reaching and include statements as to their powers and responsibilities. However, even in these roles and responsibilities sections there is little convergence.

In each State the *Local government Act* outlines the roles, responsibilities, structure and governance model of local governing authorities in that State. Historically, *Local government Acts* were extremely prescriptive in regards to roles and responsibilities of Local government bodies, and arguably provided some clarity to their respective functions.

However, during the past decade almost every State has reviewed their local government legislation and moved towards a more flexible approach, basing their legislation upon the general principle of local government competencies. Thus, local government has a wide mandate to provide a range of services to its community. This coupled with the fact that local government often acts as a service provider for Federal and State Governments has further expanded the range of services beyond that which might have been considered to be 'traditional' local government services.

To reflect these and other relevant changes, local government strongly believes that there is an urgent need for constitutional reform.

A mature democracy should recognise and acknowledge the local democracy as an important part in a fully functioning federal system of government.

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<sup>6</sup> Including local government

## **CHAPTER TWO – THE NATURE OF COT SHIFTING AND DECLINE OF STATE SPECIFIC PURPOSE PAYMENTS**

From a local government perspective, cost shifting can be broadly said to occur when the burden of the cost of provision of a service are transferred to local government from another sphere of government without a supporting revenue stream. This can occur under a variety of circumstances.

The following table indicates the diversity of circumstances in which cost shifting to local government from has occurred. Each of these practices has placed significant cost pressures on council’s budgets.

In some instances, the transfer of the responsibility of the services is explicit, and direct. For example where councils working in partnership with other spheres of government agree to be a joint funder, and provider of a service, and yet are required to contribute high and higher levels of funding due to the failure of other partner to maintain an ongoing commitment to maintain a service at a particular level.

In other instances the cost shift is quite subtle. For example, where there is a demonstrable community need such as the provision of accessible transport infrastructure and other spheres of government fail to acknowledge a shared responsibility for this service leaving local government to pick up the tab.

Cost shifting occurs when, (but not exclusively limited to) circumstances where:

1. Local government is required to provide services that had been previously provided by the other spheres of government;
2. The requirement of other spheres of government to provide concessions and rebates and with no compensation payment.
3. Services are formally referred to, and/or are assigned to local government through legislative and other State and/or Commonwealth instruments;
4. Local government is required to be the sole provider of essential/important local services that clearly contribute to local, regional, state and national public good;
5. Local government is required to be the sole provider of new and innovative services that have no historical funding precedent.
6. Local government is required to ‘pick-up’ services as a result of the direct transfer of ‘ownership’ of infrastructure from another sphere of government.
7. The imposition of government policies that require local government to undertake costly compliance activity.
8. Failure to provide for indexation of fees and charges that local government is permitted to apply for services prescribed under state legislation or regulation.

**Table 1**

	<b>Types of cost shifting</b>	<b>Examples</b>
1	Local government is required to provide services that had been	The provision of aged and children’s services was initially funded through

	previously provided by the other spheres of government	Federal and State Governments initiatives (usually in the form of Specific Purpose Program (SPP) funding), albeit often requiring local government matching funding. Over time Commonwealth and State funding has been reduced in real terms. Funding has not been adequately indexed, or grown to meet increased demand that has resulted from population growth. To maintain/grow these important services in their local communities in line with demand, local governments have been forced to significantly increase their funding contributions, often at the expense of other services.
2	The requirement of other spheres of government to provide exemptions, concessions and rebates to pensioners, low income earners, disability support recipients amongst others, with no compensation payment.	States, and increasingly the Commonwealth, often require local government to provide exemptions, concessions and rebates to pensioners, low income earners, disability support recipients amongst others, with no compensation payment. These impose direct costs to local government as well as the cost of compliance and/or administration.
3	Services are formally referred to, and/or are assigned to Local government through legislative and other State and/or Commonwealth instruments	There are numerous examples where State and Commonwealth legislation and/ instrument require local government to undertake service provision, including regulatory functions. These cover such services as food inspection, enforcement of building and planning controls, environmental management functions etc. These requirements are not accompanied by funding and are a direct cost to local government. Under existing arrangements these costs can only be met by own source revenue or levying business. (The Commonwealth Grants Commission in their <i>Review of the Operation of the Local government (Financial Assistance) Act 1995, June 2001, identified this practice as 'raising the bar' and/or 'devolution'.</i> )
4	Local government is required to be the sole provider of	The provision of local services and infrastructure such as local and regional

	essential/important local services that clearly contribute to local, regional, state and national public good.	roads, environmental management services and community services are often essential/important activities that, when viewed from a whole-of-network perspective <sup>7</sup> provide significant local, regional, state and national public good. The provision of these services and infrastructure should not therefore be the sole responsibility of local government. They are clearly a collective responsibility and should be jointly funded by all spheres of government.
5	Local government is required to be the sole provider of new and innovative services that have no historical funding precedent	The provision new and innovative services and infrastructure such as telecommunications and information technology (IT) has emerged as a critical issue in all communities. The provision, for example to access to Internet services in rural communities is a major issue for and in many cases a major cost to local government. As there has not been a historical precedent for government funding of this new innovative service, it has fallen upon local government to be the provider of these local services. However, local government believes that this type of investment clearly contributes to state and national equity objectives, and should therefore not be the sole responsibility of local government.
6	Local government is required to 'pick-up' services as a result of the direct transfer of 'ownership' of infrastructure from another sphere of government	This type of cost shifting occurred, for example when 'Commonwealth Aerodromes' were transferred to local government, albeit with initial financial incentives. This transfer gave no consideration to the capacity of councils, particularly in remote and rural to sustain the new arrangements. The choice for councils appeared to be one of either accepting the opportunity or loosing the service to the community. Councils now are responsible for the funding of these facilities without the financial or administrative capacity to sustain these services.

<sup>7</sup> For example the national transport network or a national catchment management framework,

7	The imposition of government policies that require local government to undertake costly compliance activity.	The implementation of the National Competition Policy agreements was a significant and costly exercise for local government. These direct costs to local government were not compensated not supported in all states with an appropriate share of the national competition payments to States.
8	Failure to provide for indexation of fees and charges that local government is permitted to apply for services prescribed under state legislation or regulation	In some States, charges that local government may apply for the provision of some regulatory services are not indexed. As the real cost of the service has increased, the additional costs have been gradually been absorbed by local government.

### **COST SHIFTING FROM STATES TO LOCAL GOVERNMENT**

Due to the diversity of the circumstances in which cost shifting occurs, the complexity of accurately identifying all occurrences and the lack of adequate data, quantification of the full cost of cost shifting to local government is extremely difficult.

However, it is clear that cost shifting over several decades has places considerable pressure on local government finances. It has also resulted in a number of undesirable outcomes, including, according to the *Commonwealth Grants Commission*<sup>8</sup> ‘...declining levels of infrastructure maintenance and replacement, and increased levels of user charges’.

A base line indicator of the cost to local government resulting from cost shifting is the change in Specific Purpose Grants (SPPs) from States to local government overtime. States do not pay General Purpose Grants (GPP), and therefore SPPs are the only source of State funding to local government. Changes in the quantum, and the conditions under which they are paid have a significant impact on council budgets. Cost shifting from other sphere of government to local government can often be tracked back to service areas covered by SPPs.<sup>9</sup>

State governments have used SPPs for a number of purposes. These are:

- to fund programs that reflect their own priorities as a government, and
- a vehicle to influence the priorities of local government.

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<sup>8</sup> *Review of the Operation of the Local government (Financial Assistance) Act 1995*, ‘Commonwealth Grants Commission June 2001

<sup>9</sup> Under this analysis of SPPs no attempt has been made to separate capital and recurrent expenditure. To ascertain an accurate appreciation of the financial impact of changes to SPPs it is recommended that further work be done. For the purposes of this submission it is sufficient to notes that States grants for capital items do not make ongoing expenses such as provision for depreciation, and therefore is a source of cost transfer to local government over time.

In the first instance, where States decide to provide funding to local government to 'deliver' programs<sup>10</sup> that reflect their own priorities, it is reasonable to expect that States would provide full funding for these services. Failure to do so would be a direct cost shift. This is consistent with federal principles.

However, in most instances State SPPs have been used in the latter sense, where States have required matching funding, and/or other conditionality which causes local government to jointly fund these programs. The requirement that local government, in effect must use own resource for activities that may be considered to be outside of their normal purview, or their direct 'traditional' area of responsibility, has placed significant pressures on local government budgets. This is also a serious form of cost shifting; particularly if States decrease their contribution in real terms over time, and/or do not increase levels of funding to meet increased demand.

According to the Commonwealth Grants Commission the level of State SPPs has increased over time, but has fallen as a proportion of local government revenue. State SPPs have fallen as a proportion of local government revenue from 14.8% in 1974-75 to only 7.1% in 1997-98, or by over 50% over the past few decades.

Table 2 shows, that for the period 1974-78 to 1997-98 average annual growth rates for sources of local government revenues were: Municipal rates 3%, User Charges 6.4%, Other 4.5%, Commonwealth 4.3% and State 0.4%.

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.

This process has led to a distortion of local government expenditure profile.

*'Analysis of local government expenditure over the period 1961 – 62 to 1997 – 98 shows that the composition of services being provided by local government has changed markedly over the past 30 – 35 years. Local government is increasingly providing human services at the expense of tradition property - based services (particularly roads).*

*Some changes are the result of changing priorities of local government; others are imposed on them by other spheres of government. The general broadening of local government functions has implications for local government finances."<sup>11</sup>*

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<sup>10</sup> As an 'agent'

<sup>11</sup> **Commonwealth Grants Commission**, *Review of the Operation of the Local government (Financial Assistance) Act 1995*, June 2001 page xiv

## CHAPTER THREE - LOCAL GOVERNMENT FINANCES

Leaving aside (for the moment) the question of levels of services, total community demand for services and therefore the total level of local government revenue required, the following analysis provides an outline of the nature of local government expenditure over time by category of expenditure. Later in this section it is proposed to examine the levels of sources of local government revenue. This will be followed by a discussion of some possible remedies to the funding dilemma with which local government is confronted.

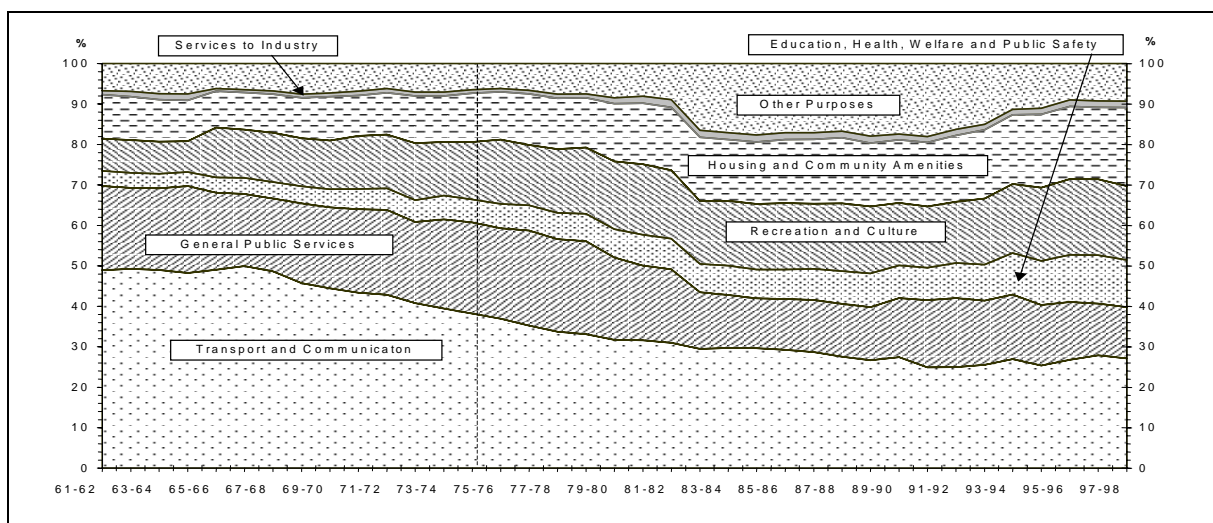
Table 2 and Chart 1 shows the level of local government expenditure by category from 1961–1998. The table shows a significant increase in expenditure on *Education Health, Welfare and Public Safety, Recreation and Culture and Housing and Community Amenities* as a proportion of total local government outlays. Correspondingly, it shows a significant decrease in expenditure as a proportion of total local government outlays in *Transport and General Public Services*.

**TABLE 2 LOCAL GOVERNMENT EXPENDITURE AT 1997–98 PRICES**

Year	Transport	General Public Services	Education Health, Welfare and Public Safety	Recreation and Culture	Housing and Community Amenities	Services to Industry	Other Purpose	Total
	\$m	\$m	\$m	\$m	\$m	\$m	\$m	\$m
1961–62	1 534	651	120	248	341	30	210	3 133
1973–74	1 899	1 060	281	639	545	49	338	4 810
1974–75	2 132	1 258	318	790	673	52	358	5 582
1997–98	3 275	1 539	1 403	2 217	2 348	188	1 121	12 090
Share of total outlays (%)								
1961–62	48.9	20.8	3.8	7.9	10.9	1.0	6.7	100.0
1973–74	39.5	22.0	5.8	13.3	11.3	1.0	7.0	100.0
1974–75	38.2	22.5	5.7	14.2	12.1	0.9	6.4	100.0
1997–98	27.1	12.7	11.6	18.3	19.4	1.6	9.3	100.0
Average annual growth (%)								
1961–62 to 1973–74	1.8	4.2	7.4	8.2	4.0	4.2	4.1	3.6
1974–75 to 1997–98	1.9	0.9	6.7	4.6	5.6	5.8	5.1	3.4
1961–62 to 1997–98	2.1	2.4	7.1	6.3	5.5	5.2	4.8	3.8

Source: Commonwealth Grants Commission – Review of the Operation of the Local government (Financial Assistance) Act 1995, June 2001

**CHART 1 COMPOSITION OF LOCAL GOVERNMENT EXPENDITURE, 1961-62 TO 1997-98**



Source: Commonwealth Grants Commission – Review of the Operation of the Local government (Financial Assistance) Act 1995, June 2001 page 54

Table 2 and Chart 1 demonstrate the severe financial constraints of local government. From their analysis of these figures the Commonwealth Grants Commission concluded, ‘... Local government is increasingly providing human services at the expense of tradition property - based services (particularly roads). This conclusion is confirmed by the State Local government Associations who also report that the cost of increased service provision have been met by delaying maintenance and replacement infrastructure activities.’<sup>12</sup>

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

The following is an analysis of local government revenue. This analysis shows that the rate of growth of state funding to local government is significantly less than local government own source revenue effort, including rates and user charges, and even less than that of the Commonwealth.

<sup>12</sup> A Wealth of Opportunities, 2001. Also see the Local government Association of South Australia, submission.



**TABLE 3 LOCAL GOVERNMENT REVENUE SOURCES 1974-75 TO 1997-98**

Year	Own-source Revenue			Transfers		Total Revenue
	Municipal Rates	User Charges	Other Revenue	Common-wealth	State	
1974-75	(\$m) 2 842	703	381	550	779	5 256
1997-98	(\$m) 5 620	2 947	1 052	1 443	848	11 911
Share of total revenue						
1974-75	(%) 54.1	13.4	7.2	10.5	14.8	100.0
1997-98	(%) 47.2	24.7	8.8	12.1	7.1	100.0
Average Annual growth						
1974-75 to 1997-98	(%) 3.0	6.4	4.5	4.3	0.4	3.6

*Source: Commonwealth Grants Commission – Review of the Operation of the Local government (Financial Assistance) Act 1995, June 2001*

Table 3 shows local government's relative revenue raising effort has risen since the introduction of Financial Assistance Grants (FAGs) in 1974-75. Municipal rates remain the sector's primary revenue source but its slow rate of growth has been a major constraint on local government's development. The rate of growth of municipal rates has slowed slightly over this period, but the slow growth in municipal rates has been offset by the fast growth in user charges.

From the above the Commonwealth Grants Commission concluded that local government is increasingly being drawn into new areas of service provision. It has responded by increasing rates and user charges and spending proportionally less on roads.

This consequent deterioration of the local roads asset was astutely recognised by the Commonwealth as a problem of national significance and which it has attempted to rectify through the introduction of the \$1.6 billion over four years *Roads to Recovery* program.

It has been constrained in what it can do because its primary revenue source (municipal rates) is a slow growth tax.

User charges have become an increasingly important source of revenue and are the local government's growth revenue. This has important implications from a political as well as a technical perspective. The extent to which local government can realistically be expected to continue to raise increasing amounts of revenue from user charges is not a secure strategy for sustainable development and service delivery for local communities. Given the introduction of the 'new Taxation System' including the Good and Services

Tax (GST), there is considerable ratepayers and tax payer concern about the total level of taxation, fees and charge that are raise by any sphere of government.

While State assistance to local government has increased in line with inflation, it has not grown as quickly as Commonwealth assistance to local government. This has led to a marked change in the pattern of local government funding since the introduction of FAGs. Since 1974–75, State assistance has grown at about one-tenth of the rate of local government own-source revenue. The contribution of State assistance to total local government revenue has declined in importance since 1974–75.

The level of assistance from the Commonwealth and State has declined slightly over the period. However, it is the Commonwealth rather than the State that provides the greater share of transfers to local government.

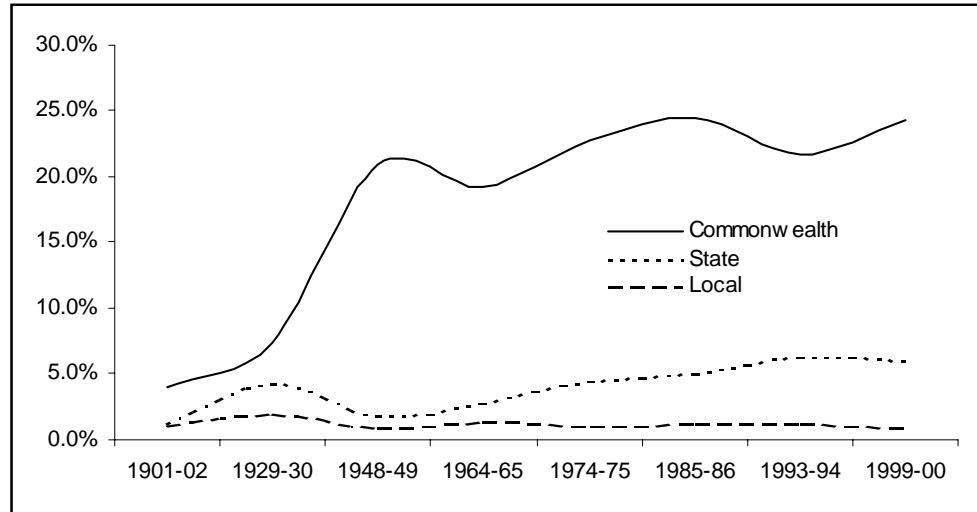
ALGA government believes that the Australian federal system of government requires fiscal equivalence, across all levels of government in order to operate appropriately. Each sphere of government should possess the resources to fund relevant actions across its own domain of responsibility.

ALGA argues that the functionality of Australia's federal system is retarded by a limited recognition of Local government as an integral part of the federation. This absence of recognition is most clearly expressed through the vertical fiscal imbalance and inequitable financial arrangements between the spheres of government.

Financial relations between the three spheres of government are characterised by significant differences in their relative revenue-raising and expenditure responsibilities. The mismatch of spending and taxing powers is known as Vertical Fiscal Imbalance (VFI).

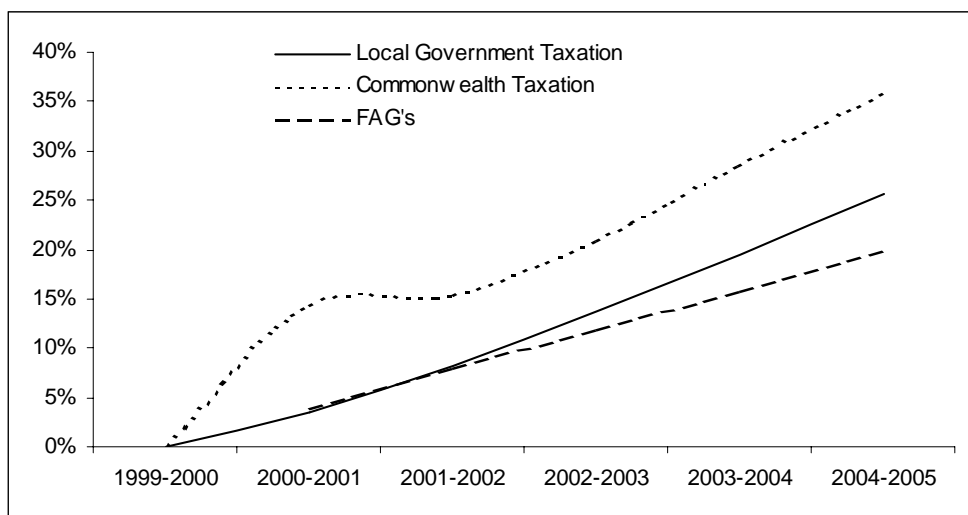
These mismatches require the Commonwealth with it's excess revenue sources to distribute its surplus revenues back to governments with deficient revenue sources (State and Local) in the form of General Purpose Payments (GPPs).

**CHART 2**  
**Taxation as a proportion of GDP by the spheres of Government**  
**1901/02 to 1999/00**



In 2000-01 the Commonwealth Government collected \$175 billion of taxation revenue, (including GST) which amounted to 27.1% of GDP. <sup>13</sup> By 2004-2005 this is expected to increase to \$207 billion. As Chart 3 shows the rate of growth in Commonwealth taxation revenue outstrips the growth in FAGs and Local government Taxation.

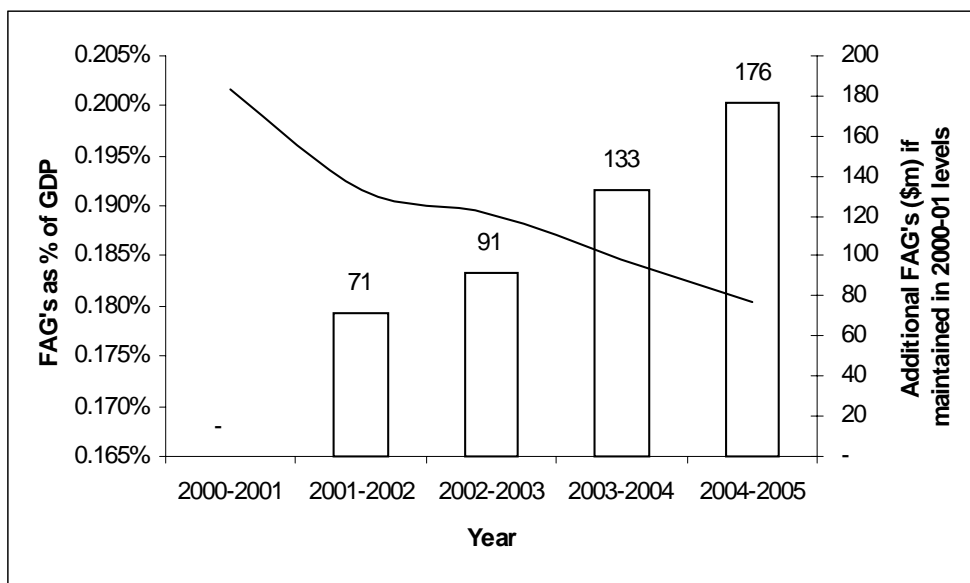
**CHART 3**  
**Commonwealth and Local government Taxation and Financial Assistance**  
**Grants Growth since 1999/00**



<sup>13</sup> 2000-2001 Outlook

FAGs have declined as a proportion of gross domestic product (GDP). In the absence of action by the Commonwealth to change the situation, this trend will continue and local government and their communities around Australia will suffer as shown in Chart 4.

**CHART 4**  
**FAGs as a % of GDP and the amount lost if they are not maintained at 2000-2001 levels (0.205%)**



Prior to 1974-75, the States were the primary revenue provider to local government. However, in 1974-75 the Whitlam Government introduced a system of untied financial assistance grants through the States to local government. Motivating this decision was the Commonwealth's desire to "make the third tier of government a genuine partner in the (Federal) system and to give local government access to the nation's finances."

This program of assistance has been maintained and extended by subsequent governments. The Local Government (Financial Assistance) Act 1995, is the most recent Act through which untied financial assistance is being provided to local government.

A primary objective of Financial Assistance Grants is to address the problems resulting from vertical fiscal imbalance (VFI). The extent, to which FAGs actually address VFI itself as opposed to the effects of VFI, is contested. It could be argued that in order to address structural VFI, each sphere of government must have access to their own growth based revenue stream, free from any constraint placed on it by other spheres of government. In order to ensure equity across councils, a relative need grant may then be applied to ensure consistency and equity across the nation.

Indexing FAGs via an escalation factor determined by the Treasurer on the basis of the level of inflation and demographic changes is a deficient manner to share the tax resources of the nation.

**CHART 2** Commonwealth – Local government Vertical Fiscal Imbalance 1961/62 to 2000/01

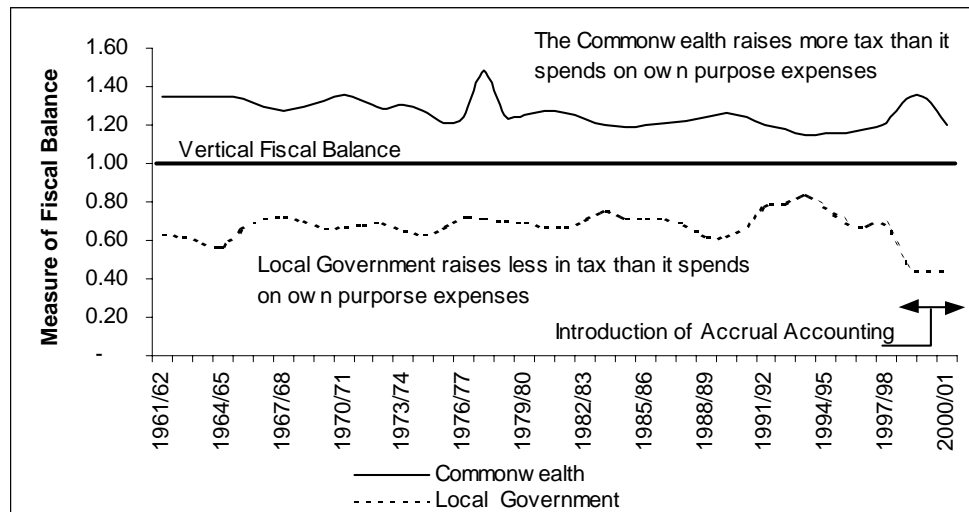


Chart 2 clearly illustrates the ongoing problem of VFI, which faces Local government.

Local government taxes are a stable revenue base, however, they do not grow at a rate displayed by other taxation regimes and they are constrained by other spheres government.<sup>14</sup> This kind of cost shifting significantly contributes to a worsening of the VFI occurring between the spheres of government.

<sup>14</sup> For example councils are expected by State governments to provide rebates and concessions for pensioners on their property rates. Councils are not duly compensated for this expense although by rights they should be entitled to attract community service obligation payments. The attractiveness of this arrangement to other spheres of government, is growing with the Commonwealth now looking to local government to provide rebates to those ratepayers who meet energy rating levels

## **CHAPTER FOUR - REMEDIES TO IMPROVE LOCAL GOVERNMENT'S REVENUE BASE**

ALGA has long maintained that local government finances need to be addressed in a manner that provides for long term stability. It should be understood that in addressing the issue of local government revenue and vertical fiscal imbalance, the issue of cost shifting itself is not addressed.

Cost shifting is a further distortion of local financing to that of vertical fiscal imbalance. Thus addressing VFI does not mean that the issue of cost shifting has automatically solved. Whilst the two issues are separate they are also interlinked, due to the longevity and embedded nature of cost shifting now within local government finances.

When the Commonwealth embarked on one of the largest tax reform agendas by any OECD economy, local government hoped that the GST agreement would settle the matter once and for all. However the 1999 GST agreement between the Commonwealth and the States, failed to address the issue of local government finances.

ALGA and local government believe that 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 VFI. This is also a pertinent point in light of the declining State Specific Purpose Payments 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 VFI.

Since the introduction of the 'new taxation system' consideration has also been given to the need to establish FAGs on the basis of an appropriate share of total GST revenue providing that it is no less than the on-going real value of existing FAGs (June 2002).

The extra funds provided via a methodology will:

- improve the ability to provide standard levels of service amongst all local governing bodies;
- improve the delivery of local services by local governing bodies;
- maintain and improve the level of infrastructure around Australia;
- repair environmental infrastructure across Australia; and
- improve community cohesion.

Chart 3 illustrates the manner in which the Commonwealth has increased its share of Australia's growing taxation base since Federation.

Financing this emerging gap will be problematic for local government it is faced with the choices of:

- cutting back on the provision of unfunded mandates imposed by the Commonwealth and the States (although some of these may be difficult as they are legislated and difficult to cut back);
- increasing rate collections above average (a basic shifting of the tax burden from the Commonwealth and States to local government); or
- increasing user charges (the level of cost recovery in local government is already quite high particularly when compared with other levels of Government and presents limited opportunities).

## OTHER OPTIONS

It is sometimes often glibly argued by other spheres of government that the solution to the local government's financial needs lays in its own hands. Measures may include:

- Reducing expenditure;
- Increasing user of the existing local government rate base;
- Increased user charges;
- Significantly increase the taxation base, and
- Increased reliance on borrowing.

ALGA has commissioned its own research into these options. In summary this research indicates:

<b>Measures</b>	<b>Comments</b>
Reducing expenditure	Independent research indicates that there is little scope to reduce local expenditure. There is prima facie evidence that local government expenditure is reflecting community demand. There is strong evidence of the need to increase expenditure on replacement and other local government/community assets. It is politically difficult given the level of community expectation. In addition, local government expenditure is in many cases meeting Commonwealth and State objectives as in the case of matching funding for SPPs.
Increasing use of the existing local	Independent research indicates that local

government rate base.	government own-source revenue has been growing steadily with local economies Own source taxation (rates) is the largest component of own source revenue, comprising between 40% and 50% of operating revenues. Annual average increases in rates across Australia has been around 9% since the mid 70s. This is consistent with the taxation effort of both the Commonwealth and States over the same time. It is also worth noting that some State governments are also adverse to local government increasing the rate base as demonstrated by practices such as ‘rate pegging’.
Increased user charges	ALGA independent research indicates that is already heavily reliant upon user charges. Current estimates indicate that the average revenue from user charges as a percentage of operating spending, are about 37%. This cost recovery ratio compares with the Commonwealth at a little over 4% and the States at 12%. There are clearly political and philosophical limits to the extent to which local government, as a sphere of government can push this practice. User charges often raises equity considerations that must be considered at all levels of the society.
Significantly increase the taxation base.	As costs increase for local government consideration must be given to significantly broadening the tax base of local government beyond that of the traditional ‘property’ tax.
Increased reliance on borrowing.	Borrowing for capital expenditure is a legitimate and sound economic strategy. However, much of local governments capital investment do not and arguably are not capable of generating sufficient revenue returns to service debt. Independent research suggests that average interest cover of 3.9% for local government in Australia and indicates that local government has adequate coverage of its interest expenses. However, there is strong evidence to suggest that higher debt levels



	is not a sustainable strategy for financing local government service provision.
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Local government strongly believes that the solution to local government financial needs, and the secure provision of services to our communities is a joint solution involving a combination of strategies. Local government has clearly demonstrated its preparedness to play its part in securing own source revenue. It is now time for a joint approach and a re-examination of the distribution of taxation revenue.

Local government believes that there is a substantial case for increased support from the Commonwealth as demonstrated above. Another option together with an increase in FAGs overall, is a reform of State Government assistance to local government. As previously mentioned, currently State Governments do not provide General Purpose Revenue to local government and would be highly desirable strategy to explore.

These and other issues may be discussed in other submissions to be forwarded to the Committee later in the Inquiry process.

**ALGA SECRETARIAT  
JULY 2002**