



INTERIM SUBMISSION

SENATE SELECT COMMITTEE INQUIRY

**STATE GOVERNMENT
FINANCIAL MANAGEMENT**

MARCH 2008

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EXECUTIVE SUMMARY

The Commonwealth government is responsible for collecting over 82% of total tax revenue. The States collect just 15% of tax revenue and Local Governments 3% of tax revenue. However, State and Local governments are responsible for the majority of total public expenditure. The efficiency and effectiveness of financial management of each sphere of government, and the relationships between them are important in delivering high quality and equitable service provision to the Australian community.

Inadequate infrastructure is currently a constraint to economic growth in Australia. While much attention has and will continue to be focused on issues such as land transport, communications and ports, attention also needs to focus on community infrastructure, vital to ensure people are attracted to live and work where there is strong demand for labour.

Financial Assistance Grants and Special Purpose Payments are important in assisting local governments, particularly in regional and remote areas, deliver basic services to residents and businesses in their jurisdictions. However, the emphasis on short term program funding and inadequate or inappropriate indexing of payments limits the ability of local governments to plan for the medium term and co-operatively with other spheres of government. Six recommendations are identified to improve the ability of Federal, State and Local Governments to operate more effectively in delivering services to the community. The **Recommendations** are:

1. The adequacy of Financial Assistance Grants provided by the Commonwealth to Local Government is reviewed and appropriate escalation factors be used to adjust for changes in the cost of service provision over time.
2. In the longer term, Commonwealth transfers should give local government access to a revenue stream that grows in line with the economy and community expectations for infrastructure provision and service delivery. The Australian Local Government Association is seeking general purpose funding from the Commonwealth of at least 1% of Commonwealth taxation revenue net of GST.
3. More effective policy coordination between Federal, State and Local Governments is required to achieve alignment of investment priorities to maximise welfare outcomes for the community as a whole.
4. Partnership agreements between Federal or State and Local Governments for the delivery of services on an on-going basis should be developed rather than continued reliance on specific grants which have uncertain continuity of funding. Partnership agreements negotiated should include appropriate adjustments for cost changes over time and have administrative arrangements commensurate with the scale of the program.
5. Financial contributions to major infrastructure investments should be made by each sphere of government according to the financial returns accrued by that sphere of government.
6. Studies of infrastructure requirements to support growth of the Australian economy must consider the life cycle cost of those investments, which in many cases is several times the initial construction cost. Renewal of existing infrastructure which has reached the end of its economic life should be considered alongside and given equal weighting to the construction of new infrastructure.

ABOUT WALGA

The Western Australian Local Government Association (WALGA) is the peak organisation and united voice of Local Government in Western Australia. The Association is an independent, membership-based group representing and supporting the work and interests of all 140 Local Governments in Western Australia as well as the Councils on Christmas and Cocos (Keeling) Islands.

The Association provides an essential voice for almost 1,300 elected members, over 11,000 employees and almost 2 million constituents of Local Governments in Western Australia. The Association also provides professional advice and offers services that deliver financial benefits to the Local Governments and the communities they serve.

This Interim Submission on behalf of the Local Government sector has been prepared with limited consultation due to the tight time frames provided by the Senate Committee since this inquiry was established on 14 February 2008.

1.0 TERMS OF REFERENCE

The Terms of Reference to this Senate Inquiry are to report upon Commonwealth and state and territory fiscal relations and state and territory government financial management, including:

- a. Commonwealth funding to the states and territories – historic, current and projected;
- b. the cash and fiscal budgetary positions of state and territory governments – historic, current and projected;
- c. the level of debt of state/territory government businesses and utilities – historic, current and projected;
- d. the level of borrowing by state/territory governments – historic, current and projected;
- e. an examination of state/territory net government debt and its projected level – historic, current and projected;
- f. the reasons for any government debt including an analysis of the level and efficiency of revenue and spending;
- g. the level of investment in infrastructure and state-owned utilities by state and territory governments;
- h. the effect of dividends paid by state-owned utilities on their ability to invest;
- i. present and future ownership structures of current and former state-owned utilities and the impact of ownership on investment capacity; and
- j. the effect of investment by state-owned utilities on Australia's capacity constraints.

While these terms of reference primarily refer to the financial relationships between the Commonwealth and the States, Local Government is critically important in the provision of much of the infrastructure central to overcoming capacity constraints within the Australian economy. Local Governments rely primarily on Rates, Fees and other charges to fund their service delivery activities. However, they do receive important

funding from the Commonwealth (directly and via payments through the States) and from State Governments and hence optimal fiscal relationships between the three spheres of government are critical to achieving effective outcomes.

2.0 BACKGROUND

The Australian taxation system results in the Commonwealth Government collecting over 82% of total tax revenue¹ but responsible for around 54% of own purpose spending. In contrast, the states collect about 15% of taxation revenue but account for 40% of own purpose outlays². Local Governments collect approximately 3% of total taxation revenue³. Part of the taxation revenue collected by the Commonwealth is redistributed to State and local governments (primarily via the States) in order to deliver services to their communities. The efficiency of these payments provided to other spheres of government, by both the Commonwealth and States is important in delivering high quality and equitable service provision to the community.

In recent years there has been extensive focus on the provision of economic infrastructure and the constraints to the Australian economy imposed by infrastructure bottlenecks in the economy. Local Governments have an important role to play in the provision of regional and local infrastructure. However, State and Federal governments also have a responsibility in this area, particularly where there are spill over effects outside of the local government area (which is the case in most local government investments) and / or synergies from local governments operating together or in conjunction with State and Federal governments. This is clearly the case in many of the key areas of activity for local governments including roads, housing, planning and climate change mitigation and adaption.

Local Governments in Western Australia (and other States and Territories) are critically aware of their responsibilities in delivering sustainable growth to improve the quality of life for current and future generations. To this end, a number of studies and reports have been prepared on the structural and functional changes required to ensure sustainable delivery of local government services. These reports are relevant to the terms of reference of this inquiry and are provided as attachments to this submission:

- ***Local Government Finances in Western Australia***. Access Economics June 2006
- ***In Your Hands: Shaping the Future of Local Government in Western Australia*** Aug 2006

3.0 FINANCIAL ASSISTANCE GRANTS

Financial Assistance Grants (FAG's) are provided by the Commonwealth via the States and are an important source of funding for Local Governments, particularly in rural and remote areas of Australia. Local Governments are able to utilise FAG's for any

¹ Australian Bureau of Statistics 2007, Taxation Revenue Cat No 5506.0

² Warren, N. 2006 Benchmarking Australia's Intergovernmental Fiscal Arrangements, Final Report to the NSW Treasury.
http://www.treasury.nsw.gov.au/data/assets/pdf_file/0006/5793/fin-bench-rep.pdf

³ Productivity Commission 2007 Assessing Local Government Revenue Raising Capacity Draft Report

combination of operating and capital expenditure which best meets the needs of their communities. The Commonwealth allocation of funding to local government extends back to at least 1974/75.

Since 1991/92 FAG's have combined both Equalisation Funding and Road Funding. Although paid together and administered through the State Grants Commission processes, they are discussed separately here in order to better understand historical trends in the data.

3.1 Equalisation Funding

Funding provided by the Commonwealth to Local Governments in Western Australia over the past 20 years is summarised in Figure 1. In nominal terms funding has increased from \$59.2m in 1987/88 to \$115.7m 2006/07.

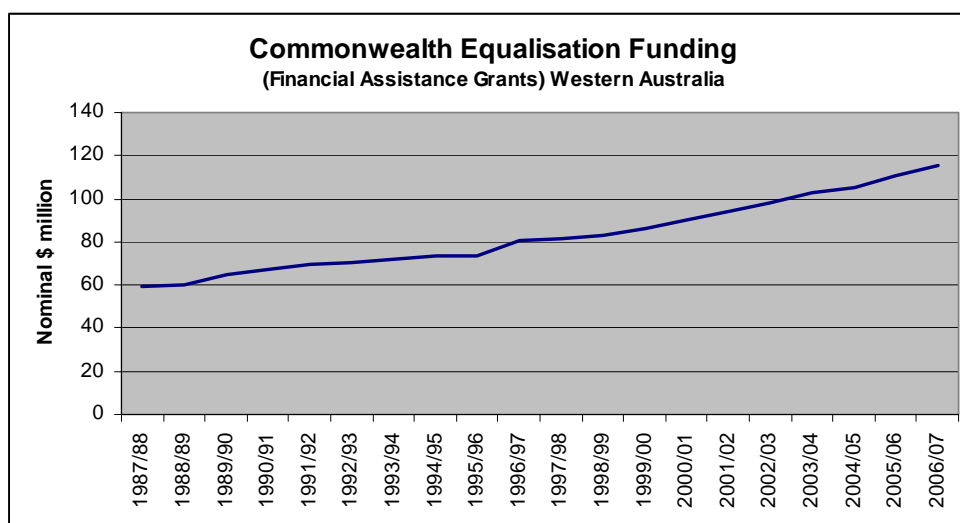


Figure 1: Financial Assistance Grants to West Australian Local Governments in nominal terms.

However, when converted to constant 2005/06 dollar values (using NIF Implicit Price Deflator for Final Consumption Expenditure of General State and Local Government⁴), in real terms funding from the Commonwealth has increased by 3.1% over the period, which is significantly less than the rate of growth in the population or the economy as a whole (Figure 2). On a per person basis Commonwealth funding to local governments in Western Australia has fallen by 25% from \$69 per person to \$52 per person over the period. Expressed as a proportion of total Commonwealth tax income or Gross State Product, the decline in Commonwealth funding to local government in Western Australia is even more significant.

⁴ Australian Bureau of Statistics 2007 Modellers Database Cat No 1364.0.15.003
Note very similar results will be achieved using Non-farm GDP Implicit Price Deflator

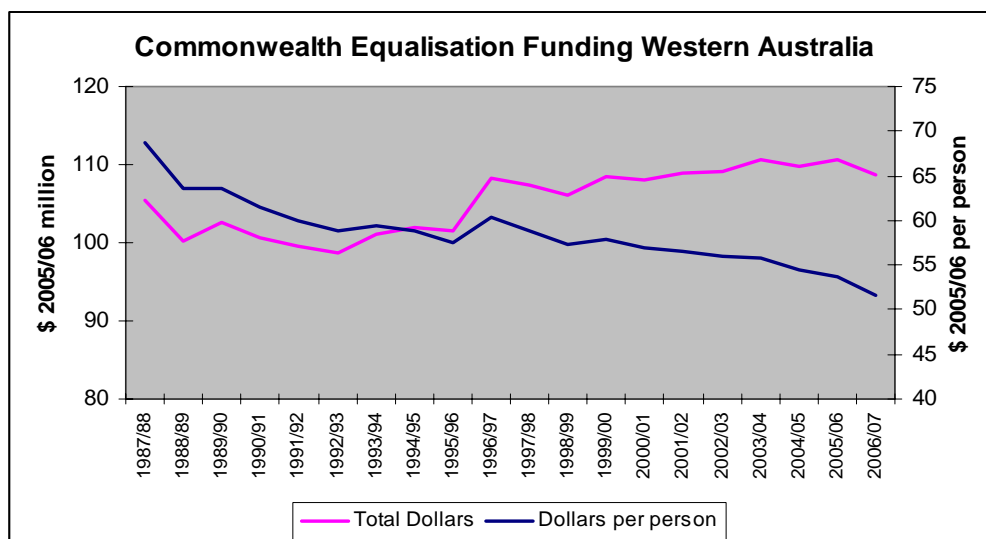


Figure 2: Commonwealth Equalisation Funding to Local Governments in Western Australia in constant dollars (left hand axis) and constant dollars per person (right hand axis)⁵.

If constant per capita funding had been maintained since 1987/88, in 2006/07 Commonwealth Equalisation Funding to Western Australia would have been approximately \$37 million (33%) higher than the \$108.6 million received. Over the past 20 years, failure of Commonwealth grant funding to local governments in Western Australia to be adequately adjusted for population and cost increases has resulted in a cumulative funding shortfall of some \$389 million or 18%. This is a significant factor in the accumulation of an estimated infrastructure renewal backlog in Western Australia of approximately \$1.75 billion ⁶(which accumulated over more than 20 years).

The State Grants Commissions are required to observe the National Principles relating to grants allocation to individual local governments identified in the *Local Government (Financial Assistance) Act 1995*. The Horizontal Equalisation principle requires that each local government in a jurisdiction is able to function, by reasonable effort, at a standard not lower than the average standard of other local governments in that State. It takes account of differences in the expenditure requirement and revenue-raising capacity of local governments⁷. The application of horizontal fiscal equalisation leads to larger general purpose grants per person for local governments with relatively smaller rates bases and disadvantage in terms of the relative costs of delivering services. However, it is well recognised that (after allocating minimum grants) the general purpose grants pool is insufficient to meet the full amount of the assessed need. Consequently standards of local government service delivery do vary and are generally below average in rural and remote areas, which are also home to most major resource projects in Western Australia.

⁵ Source: WA Local Government Grants Commission 2006 Annual Report

Australian Bureau of Statistics 2007 Australian Demographic Statistics Cat No 3101.0

⁶ Access Economics 2006 Local Government Finances in Western Australia

⁷ DOTARS 2006, Local Government National Report: 2004-05 Report on the Operation of the 'Local Government (Financial Assistance) Act 1995, Canberra.

Below-average level of general service provision in these areas has the potential to hinder economic development, particularly because it is more difficult for resource developers and supporting businesses to attract and retain skilled staff who may be reluctant to accept the lower standards of social and community services that exist in some areas of regional Western Australia.

Recommendation

The adequacy of Financial Assistance Grants provided by the Commonwealth to Local Government be reviewed and appropriate escalation factors be used to adjust for changes in the cost of service provision over time.

In the longer term Commonwealth transfers should give local government access to a revenue stream that grows in line with the economy and community expectations for infrastructure provision and services delivery. On behalf of the sector, the Australian Local Government Association is seeking general purpose funding from the Commonwealth of at least 1% of Commonwealth taxation revenue net of GST.

3.2 Roads Funding

Local Governments are responsible for 72% of the road network in Western Australia with a replacement value of \$14.6 billion. Roads are the largest single asset class managed by local governments. Expenditure by Western Australian local governments on roads in 2005/06 was \$412.4 million. This included \$274.3 million on road maintenance, which was \$120.1 million less than that estimated to be required to maintain this network at its current condition⁸.

The Federal Government provides approximately 30% of total Local Road funding in WA, with the majority provided by local governments. Introduction and extension of the Roads to Recovery and Federal Blackspot Programs has been vital in lessening the extent of the renewal backlog to provide effective land transport infrastructure. Over the ten years prior to 2001/02, identified Local Road Funding provided by the Commonwealth to Local Governments in Western Australia averaged approximately \$78 million per annum in real terms⁹.

In the six years since 2001/02, Federal funding for Local Roads has averaged \$126.7m per year in 2005/06 dollars, but is again trending downwards in real, per person terms (Figure 3).

⁸ WALGA 2007 Report on Local Government Road Assets and Expenditure 2005 - 2006

⁹ Bureau of Transport and Regional Economics 1989 Road Construction Price Indexes: 1977-78 to 1987 - 88 Information Paper 32, AGPS Canberra

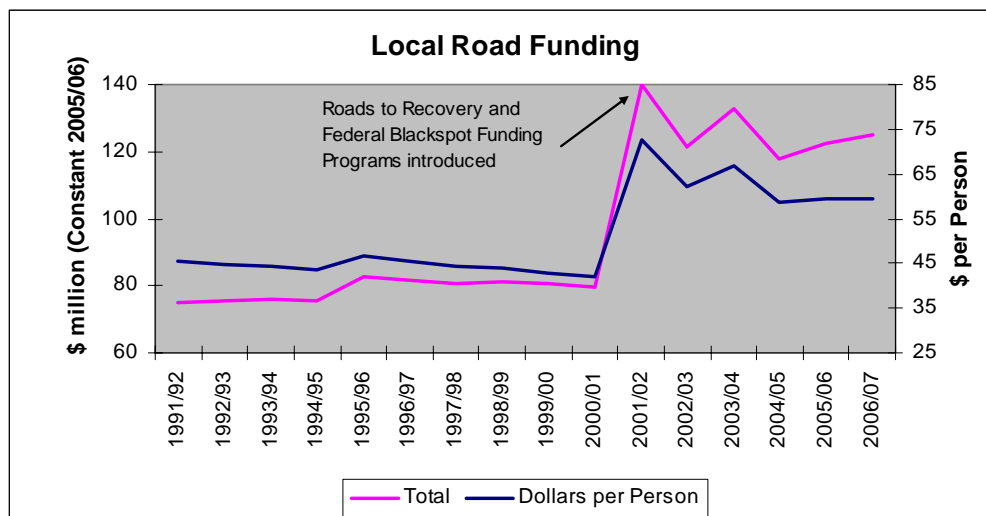


Figure 3: Commonwealth Local Roads Funding to Local Governments in Western Australia in constant dollars (left hand axis) and constant dollars per person (right hand axis).

Funding programs for major infrastructure such as roads need to be established in such a way as to ensure on-going adequacy of funding to achieve desired outcomes, making appropriate adjustments for increases in cost and demand over time.

While resource developers and the Western Australian Government are making significant investments in upgrading roads to enable major resource projects such as the BHP-Billiton Ravensthorpe Nickel Project and iron ore projects in the mid-West region to proceed, responsibility for renewing and upgrading supporting local roads falls to local governments which only indirectly benefit from these export focussed developments.

Recommendation

More effective policy coordination between Federal, State and Local Governments is required to achieve alignment of investment priorities to maximise welfare outcomes for the community as a whole.

4.0 DIRECT COMMONWEALTH FUNDING TO LOCAL GOVERNMENTS

Nationally local governments receive approximately \$0.5 billion per year in Specific Purpose Payments, primarily for the delivery of services on behalf of the Commonwealth such as the Home and Community Care program. Local governments are generally well positioned to deliver these types of programs on behalf of the Commonwealth Government, but remain concerned about:

- Potential “cost shifting” if funding for a successful and popular program is discontinued or inadequately adjusted for changes in costs over time;
- Administrative burden if the accounting requirements are excessive compared to the quantum of funding provided.

Recommendation

Partnership agreements between Federal or State and Local Governments for the delivery of services on an on-going basis should be developed rather than continued reliance on specific grants which have uncertain continuity of funding. Partnership agreements negotiated should include appropriate adjustments for cost changes over time and have administrative arrangements commensurate with the scale of the program.

5.0 STATE INFRASTRUCTURE STRATEGY

A State Infrastructure Strategy has been developed, combining the interests and expertise of eight state government departments and a reference group comprising major industries and sectors (including Local Government) in Western Australia.

The State Infrastructure Strategy White Paper is expected to be published in late March 2008. The process seeks to take a structured and objective view of the infrastructure investment priorities. If successful, this will lessen the temptation to allow short term (sometimes political) expediency to influence long term infrastructure decision-making.

Local Governments (and State Governments) would be better able to fund investments where a large proportion of the benefits accrue outside their jurisdiction if financial relationships between the spheres of government enabled an equitable sharing of costs and benefits. It is likely that in the absence of such arrangements optimal decisions from a national welfare perspective will not be made.

The Australian, and to a lesser extent the State Governments are the major beneficiaries of economic growth fuelled largely by resource-based developments. Local governments typically receive little direct financial benefit from these developments (many of which are covered by State Agreements which place restrictive conditions around rates revenue from these projects), but local residents are faced with significantly increased capital and operating costs.

Recommendation

Financial contributions to major infrastructure investments should be made by each sphere of government according to the financial returns accrued by that sphere of government.

6.0 STATE GOVERNMENT FUNDING FOR LOCAL GOVERNMENT INFRASTRUCTURE

Local Governments receive funding from the West Australian state government under a wide range of programs such as the Community Sport and Recreation Facilities Fund, and funding for roads as a hypothecated share of vehicle licence fees.

An agreement between the West Australian State Government and local government provides a proportion of vehicle licence fees to local governments to deliver transport and road infrastructure renewal. This agreement will deliver over \$108 million for local road funding in 2007/08. Importantly it provides a model for long term funding agreements between spheres of government which provides increased certainty of funding and enables more efficient and effective planning to be completed. This type of funding arrangement should be considered for a range of government services delivered in partnership between spheres of government, as an effective alternative to short term grant funding.

7.0 LOCAL GOVERNMENT DEBT FUNDING

Debt is not a major source of funding for capital projects undertaken by Local Governments in Western Australia. The net debt of WA Local Governments as at June 2006 was -\$773 million (ie a net surplus)¹⁰. There is, however, significant variation between local governments in their use of debt.

Rather than incurring debt in order to finance operating deficits, many West Australian local governments rely on capital contributions (such as the proceeds of asset sales), or inadequately fund depreciation and renewal of existing assets (essentially consuming existing capital) in order to generate sufficient cash to meet operating requirements.

8.0 FUNDING GAP

Detailed studies by local governments in most Australian states and at a national level have highlighted that currently there is inadequate investment by local governments in infrastructure renewal, to maintain the required service levels. In other words, the cost of the fixed assets being consumed by current users is not being paid for by current users. This is at least in part due to the broadening of local government responsibilities beyond the traditional services to property, without a corresponding broadening of the revenue base. Grants and transfers from other spheres of government, only partly meet the shortfall. The Australian Local Government Association estimate that nationally the backlog of infrastructure renewal expenditure is of the order of \$20 billion. This backlog will impact on the performance of the Australian economy in diverse ways including; increased costs to business due to higher transport costs from traffic congestion and poor quality roads; and inability to attract and retain skilled workers in rural and remote areas due to low community service levels and costs from delays in planning approvals.

¹⁰ Australian Bureau of Statistics 2007 Government Finance Statistics Cat No 5512.0

Recommendation

Studies of infrastructure requirements to support growth of the Australian economy must consider the life cycle cost of those investments, which in many cases is several times the initial construction cost. Renewal of existing infrastructure which has reached the end of its economic life should be considered alongside and given equal weighting to the construction of new infrastructure.

9.0 CONCLUSIONS

Local government is dependent on a narrow tax base (property rates), in competition with State and Territory governments, and is under-funded to meet the requirements for infrastructure along with the service expectations of other spheres of government and the community.

In order to address this issue in a financially sustainable way local government needs to share more equally in the broad tax revenue of the nation.

Funding to local government from other spheres of government needs to be indexed consistently and appropriately to ensure at least maintenance of real value per capita over time, reflecting the aspirations of the community for long term improvement in quality of life.

Future inter-government agreements concerning services, infrastructure and taxation should be conducted on a tri-partite basis between the Commonwealth, the States and Territories and Local Government.