
5 Comparisons of revenue-raising capacity

Key points

- Fiscal capacity, as measured by communities' aggregate incomes, differs significantly across classes of local government. Capital city councils have the highest fiscal capacities and urban fringe councils the lowest, on average.
 - These averages mask considerable variation within classes of councils. Though remote councils have relatively high fiscal capacities on average, many have fiscal capacities that are below the national average, for example.
- Revenue-raising effort (the extent to which a council draws on its fiscal capacity), also differs across classes of local governments. Urban developed and urban fringe councils tend to draw lightly on their fiscal capacity. Urban regional, rural and remote councils draw relatively heavily on their fiscal capacity.
- The factors that have the greatest bearing on the own-source revenue per person raised by local governments include:
 - the after-tax income of their communities (personal and business)
 - key attributes driving expenditure (such as the length of the local road network, the number of properties served, whether water and sewerage services are supplied, and whether the council is experiencing rapid population growth or decline).
- Communities with larger populations tend to raise less own-source revenue per person because they are able to achieve economies of scale in the delivery of some services.
- Each local government, when benchmarked against all others adjusting for differences in key characteristics, is assessed to have some potential to raise additional own-source revenue. An indicative estimate is that, on average, own-source revenue could be raised by about 12 per cent, or about \$140 per person.
 - This would increase local government cost recovery from own-source revenue from 76 to 87 per cent, on average across Australia, assuming no matching increase in expenditure.
- However, the majority of rural and remote local governments would remain highly dependent on Australian and State government grants.
- Although this analysis indicates that councils have an assessed capacity to raise additional own-source revenue, this does *not* imply that local governments *should* increase their revenue-raising effort.

A key task for this study is to examine the revenue-raising capacity of local governments across their various classes, and the factors affecting their capacity to raise revenue. A conceptual framework was developed in chapter 4. In this chapter, a review of some of the factors that might influence the revenue raised by local governments is presented. Empirical estimates of the extent to which those factors affect revenue-raising capacity and the scope for councils to raise *additional* own-source revenue are also presented.

One of the factors affecting the revenue-raising capacity of a local government is its fiscal capacity. Evidence is presented on the fiscal capacities of local governments, as measured by the aggregate income of their local communities, in section 5.1.

However, aggregate income is only one of a number of factors that influence the revenue actually raised by local governments to fund services. In section 5.2, comparisons of the revenue-raising effort across local governments suggest that factors other than income are also important.

A statistical analysis is undertaken to investigate the potential influence of a range of factors that might explain the levels of revenue raised by different local governments. A review of possible factors is presented in section 5.3. The statistical analysis of these factors is presented in section 5.4.

The analysis of the factors on their own does not indicate whether councils have the potential to raise *additional* revenue, given their particular circumstances. To examine this matter, the statistical analysis of revenue raised is extended. An index is calculated for each local government that measures the extent to which it is able to raise additional own-source revenue. Each council's index is derived by comparing the local council's own-source revenue with that of all other councils, after adjusting for systematic differences due to a range of factors including the classes of local governments. The results are presented in section 5.5.

The financial implications of a hypothetical increase in own-source revenue are provided in section 5.6. This analysis is presented for illustrative purposes only. It does not imply that local governments *should* increase their own-source revenue or that their communities would support them doing so.

Before proceeding, there is a note of caution required about the analysis presented in this chapter. In order to undertake the analysis, the Commission has pooled the best available data from a variety of sources. However, the data do have limitations, as outlined in chapter 3 and appendix C. Data were not available for all local governments and, in a number of cases, there were limitations in the available data. This has meant that a number of local governments were excluded from the data set.

Many of these were remote local governments.¹ In applying the framework and statistical techniques, many assumptions were required. Given this, the results should be interpreted as indicative, not definitive.

5.1 Fiscal capacity

One factor affecting the ability of a local government to raise revenue is its fiscal capacity. The best indicator of fiscal capacity is the aggregate after-tax income of the local community, as explained in chapter 4. As a community's income increases so does the fiscal capacity of its local government.

As also stated in chapter 4, the indicator of the income of a community should be broadly defined. It is broader than normal definitions of personal income, in that it ideally includes all income that is actually or potentially available to the community. It includes personal income, retained corporate earnings, unrealised capital gains and imputed returns on assets (including from home ownership).

In practice, measures of fiscal capacity are not published at the local government level. Gross product (value added), for example, would provide a comprehensive, though not complete, indicator of the income generated in a local area as it is a measure of profits, wages and salaries. Although a measure of gross product is available at the national level (as gross domestic product) and state level (as gross state product), it is not available at the local government level (Bureau of Transport and Regional Economics [BTRE] 2005).

In the absence of such measures, it is necessary to estimate the aggregate income of each local government area. For the purpose of this study, an indicator of income is constructed using information about the aggregate taxable personal income, the imputed return from the ownership of dwellings and the gross operating surplus (GOS) of businesses in each local government area.²

¹ The full data set covers 3330 observations covering 666 local government bodies over five years (appendix C). After excluding unreliable observations, the final data set comprises about 2872 observations representing about 573 councils although not all local governments are represented in every year. (The exact number of observations and councils reported in this study varies according to the different types of analyses undertaken.) About 40 per cent of the local governments excluded from the analyses were remote. Other local governments for which reliable data were not available were small urban fringe and small urban regional councils (appendix C).

² GOS is equal to the income of incorporated enterprises less their operating expenses (including wages and salaries), but not depreciation, interest and company income taxes.

Personal incomes

The Commission's estimate of after-tax personal income is equal to the aggregate taxable income (ATI) based on Australian Tax Office (ATO) data from personal income tax returns), plus an estimate of the return from the ownership of dwellings (as reported by the Australian Bureau of Statistics [ABS]) less personal income taxes. Taxes are deducted for both actual income and imputed income. According to the BTRE³ (2005, p.2), real ATI:

... is an undifferentiated aggregate of all the income accruing to taxpayers from any source. It therefore includes income derived from salary and wages, net [unincorporated] business income, distributions from partnerships or trusts, interest and dividends, eligible termination payments, some government pensions and allowances, superannuation payments and reportable fringe benefit amounts less any allowable deductions ... [It] does not include the income of individuals who earned below the tax-free threshold, either positive or negative. Also, [undistributed] taxable income for companies, [and] funds ... is *not* included.

According to the ABS, the return from the ownership of dwellings is defined to include the rental income from the ownership of dwellings (actual rent in the case of the rental properties and imputed rent in the case of owner-occupied housing), less operating expenses (ABS 2000).⁴

The Commission's estimate of personal income based on ATI has several limitations. First, ATI omits welfare payments, except for cases where such payments are reported to the ATO in personal tax returns. Second, it excludes the incomes of those persons earning below the tax-free threshold, who are not required to lodge tax returns. Third, it omits unrealised capital gains from the ownership of assets. Fourth, it excludes the retained earnings of superannuation funds. Finally, although dividends paid to shareholders are counted in personal incomes, it excludes undistributed incomes (retained profits) of incorporated businesses.

The Commission's estimate of after-tax personal income as a result is only an approximation. Personal income is likely to be underestimated in low income communities (such as those with a high level of welfare dependence). Personal income might also be underestimated in more affluent local government areas because of the exclusion of unrealised capital gains and of retained income from companies and superannuation funds.

³ Now the Bureau of Infrastructure, Transport and Regional Economics (BITRE).

⁴ Expenses include council rates, building insurance, repairs and maintenance, consumption of financial services (such as accountants and financial advisers) and the payment of commissions to real estate agents for the management of rental properties (ABS 2000).

Business incomes

ATO statistics on the taxation of businesses do not provide reliable estimates of the geographic distribution of the income of corporations that operate in more than one locality. This is because financial and taxation accounts, for some circumstances, are reported for the group as a whole according to the legal structural arrangements. Reporting arrangements may not correspond with the physical operations of the business.

Consequently, the Commission has sought to construct some other indicator of business income using ABS estimates of GOS. The business income of a local government area is estimated to be equal to the GOS of its industries, after tax. Estimates of GOS are available for each industry in each State. Since the ATO also provides data on the total business income tax paid by different industries, it is possible to estimate an amount of corporate income tax to be deducted from the ABS estimates of GOS.

The ABS 2001 and 2006 Censuses provide data on the place of work (by local government area) of employees in each industry. Using this information, it was possible to apportion the after corporate-tax GOS of each industry in each State to a local government area. However, a shortcoming of this measure is that there is some double-counting between the dividends received by householders and estimates of GOS, though this amount is likely to be small.⁵ The Commission's method for deriving this measure of business income by local government area is outlined in appendix C.

The indicator of fiscal capacity for each local government area is estimated to be the sum of the disposable personal income (after income tax) plus the business income (after corporate tax) of the area. The data are reported on a per person basis to remove differences that reflect population size.

Total community fiscal capacity

The fiscal capacities of local governments, for the period between 2000-01 and 2004-05, are shown in table 5.1. The median council has a fiscal capacity of about \$20 700 per person. There is a large range in the fiscal capacities of local governments. The council ranked at the 20th percentile (that is, ranked at the top of the lowest twenty per cent) has a fiscal capacity of less than \$16 300 per person.

⁵ At a national level, gross dividends account for about 3 per cent of personal income.

The council ranked at the 80th percentile has a fiscal capacity greater than \$29 000 per person.⁶

One factor potentially contributing to the observed variation in total income is under reporting of the personal income in communities with a high degree of welfare dependency. As noted, personal taxable income does not include many welfare payments — many individuals on welfare do not lodge tax returns. However, as also noted, income (comprehensively measured), might also be underestimated in more affluent communities.

Another factor contributing to the variation in total income is the concentration of business income in particular local government areas. The very high estimate of total income for the City of Perth reflects its head office role for many mining and energy companies (table 5.1). Given that GOS is allocated to local government areas in accordance with each industry's employment, (a substantial) part of the mining industry's income was allocated to Perth, for example, rather than the location in which the mining and extraction took place.

Table 5.1 Distribution of the average fiscal capacity of local governments
2000-01 to 2004-05, dollars per person^{a, b}

<i>Local governments ranked in order of total income</i>	<i>Personal income^c</i>	<i>Business income</i>	<i>Total income^d</i>
<i>Decile and mean</i>			
Lowest	2 096	2 538	4 634
10 per cent	9 218	5 197	14 415
20 per cent	8 980	7 259	16 239
30 per cent	8 385	9 454	17 839
40 per cent	8 878	10 284	19 162
50 per cent (median)	16 058	4 723	20 781
60 per cent	13 298	9 227	22 524
70 per cent	14 463	10 567	25 030
80 per cent	10 184	19 298	29 483
90 per cent	7 094	31 988	39 083
Highest ^e	22 001	438 162	460 163
Mean ^f	12 837	15 213	28 050

^a Based on a sample of 2784 observations representing 602 councils over five years. Data were not available for all councils for all years. ^b The base year is 2005-06, adjusted using the ABS non-farm GDP deflator. ^c Care must be exercised when interpreting personal income because of its estimation. ^d Totals might not add due to rounding. ^e The maximum per person business income is in Perth, reflecting both large business income and relatively small residential population. ^f The average is calculated across councils and does not reflect the average across the Australian population.

Source: Productivity Commission estimates.

⁶ The ranking of local governments is based on their total income. The rankings of personal income, business income and total income are therefore not independent.

Income might also vary over time. The fiscal capacities of some local governments would be expected to be cyclical in nature. Rural local governments, for example, are dependent on their community's agricultural income. Given the relatively short time period, it is not evident by how much the estimates of fiscal capacities in rural areas are below or above their long-term average fiscal capacities.

Fiscal capacity differs across classes of councils. The average fiscal capacities of classes of local governments (based on the Commission's aggregated version of the Australian Classification of Local Governments [ACLG] as explained in appendix D) are shown in table 5.2. The per person estimates are based on the residential population of each council and the estimates of total income are the average for each class.

Capital city councils have the highest fiscal capacities as a group. This is due to their roles as centres of economic activity. With the exception of Brisbane, Darwin and Hobart, the high fiscal capacities are also due to their relatively small residential populations. The number of residents in the City of Perth in 2001, for example, was less than one-twelfth of the number of persons reported to be working in the city. Therefore, care must be exercised when interpreting the per person estimates of fiscal capacity of capital city councils.

Table 5.2 Distribution of average fiscal capacity, by class of local government

2000-01 to 2004-05, dollars per person^{a, b, c}

	<i>Personal income</i>	<i>Business income</i>	<i>Total income</i>
Capital city	18 488	98 307	116 795
Urban developed	17 715	7 069	24 783
Urban fringe	13 013	5 072	18 085
Urban regional	12 359	10 163	22 522
Rural	11 774	12 730	24 504
Remote	11 009	54 411	65 420
All councils	12 837	15 213	28 050

^a The estimates of total, personal and business income are an average for that class. They are calculated across councils and do not reflect the average across the Australian population. ^b Based on a sample of 2784 observations representing 602 councils over five years. Data were not available for all councils for all years.

^c The base year is 2005-06, adjusted using the ABS non-farm GDP deflator.

Source: Productivity Commission estimates.

The relatively high level of business income reported for remote councils also reflects both the nature of economic activity and relatively small residential populations. A number of remote councils had significant mining and energy businesses in their area. As a result, 12 remote councils had average business incomes above the average of all councils of \$54 000 per person. The remaining 39 remote councils had average business incomes less than the average of all councils.

Business income was smallest in the urban developed and urban fringe councils. This reflects the relatively lower economic activity in these suburbs.

Care should be exercised when interpreting the fiscal capacity estimates of councils. Many councils might be restricted from accessing part of their reported fiscal capacity. The Pilbara Regional Council (sub. DR76) argued that under the *Local Government Act 1995* (WA), councils are restricted in the value they can place on the unimproved capital value of mining land and the level of rates that may be applied to different area ranges (s. 6.3). Moreover, the fiscal capacity of some councils might be understated because of the exclusion of the income of day visitors. For example, inner metropolitan councils (such as central business districts and councils in coastal areas) can access the income of day visitors through other revenue instruments such as car parking fees.

FINDING 5.1

Fiscal capacity, as measured by a community's total after-tax income per person, differs across classes of local governments. There is considerable variation both between classes of local governments and within classes of local governments. Capital city and some remote local governments have very high fiscal capacities because of the concentration of business income and their relatively small resident populations.

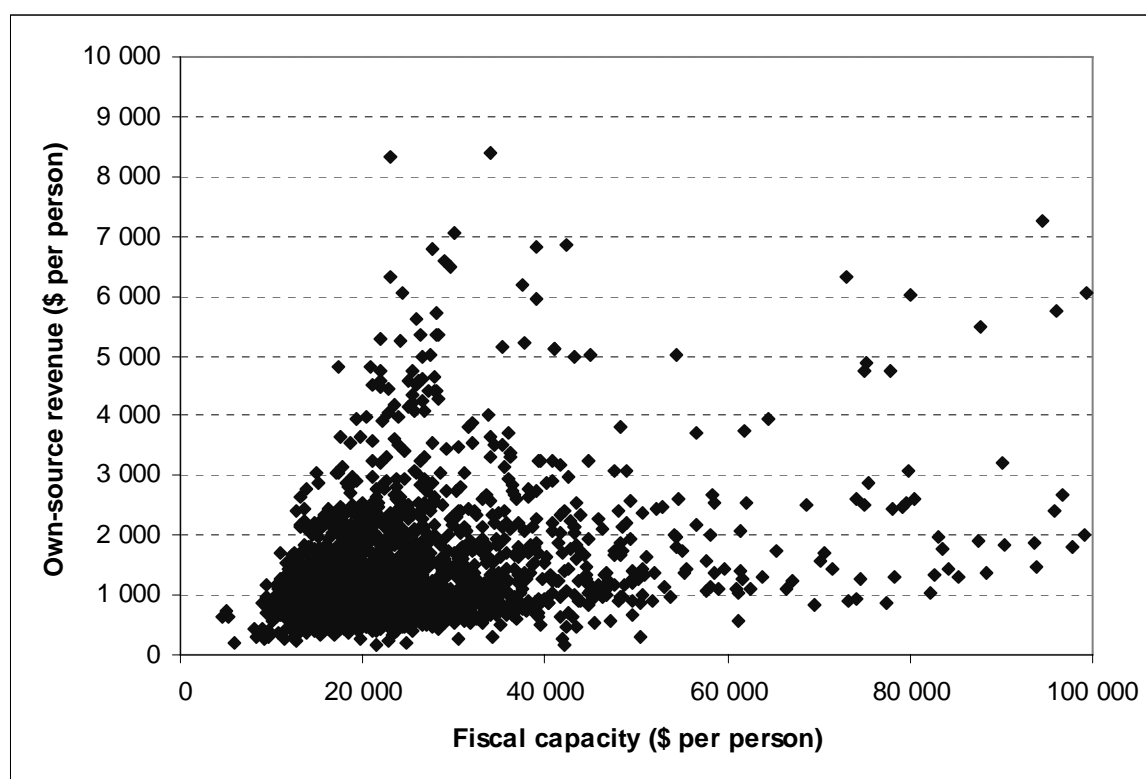
5.2 Revenue-raising effort

As outlined in chapter 3, there is considerable variation in the own-source revenue raised by councils. To gain insights into the efforts of local governments to raise revenue, it is useful to examine the relationship between own-source revenue raised by local governments and their fiscal capacity. This relationship is illustrated in figure 5.1.

It is difficult to draw conclusions about the link between the revenue raised by councils and their fiscal capacity from figure 5.1. The amount of revenue raised by local governments appears to increase with the community's fiscal capacity. However, given there are significant differences in the own-source revenue of councils that share similar fiscal capacities, other factors clearly are also contributing to the differences in revenue raised across councils. This is particularly evident for councils with fiscal capacities of between \$10 000 and \$40 000 per person, though it is also the case for the entire range of fiscal capacities per person.⁷

⁷ Some of this variation is likely to be attributable to measurement error.

Figure 5.1 **Own-source revenue versus fiscal capacity**
2000-01 to 2004-05, dollars per person^{a, b}



^a Based on a sample of 2784 observations representing 602 councils over five years. Data were not available for all councils for all years. ^b The base year is 2005-06, adjusted using the ABS non-farm GDP deflator.

Source: ABS unpublished; ATO unpublished; State grants commissions unpublished; Productivity Commission estimates.

One way to account for the effect of income on the amount of revenue raised is to express own-source revenue as a ratio to fiscal capacity. Revenue-raising effort, defined as own-source revenue divided by income, is a widely used indicator of *relative* revenue-raising effort (Barro 2002; Bird, Martinez-Vazquez and Torgler 2004; Davoodi and Grigorian 2007; Leuthold 1991; Piancastelli 2001; Teera and Hudson 2004).

The distribution of revenue-raising effort for councils across Australia and for classes of local government is shown in table 5.3. There are significant differences in revenue-raising effort, both between and within classes of councils. Nationally, the median level is about 4.9 per cent of income. The range in effort for the 30th to 70th percentile council is from 3.6 to 6.5 per cent of income.

The unweighted mean is the average across councils of each ACLG class. The weighted mean is the average across the *populations* of each ACLG class. Weighting averages by population provides an indication of the average

revenue-raising effort of the populations in each ACLG class. The weighted average revenue-raising effort is highest for urban regional (5.8 per cent), rural (6.0 per cent) and remote councils (6.4 per cent). These estimates are significantly higher than the national average of 4.5 per cent.

Table 5.3 Distribution of revenue-raising effort
2000-01 to 2004-05^{a, b}

<i>Decile and mean</i>	<i>All councils</i>	<i>Capital city</i>	<i>Urban developed</i>	<i>Urban fringe</i>	<i>Urban regional</i>	<i>Rural</i>	<i>Remote</i>
Minimum	0.3	1.3	1.6	1.6	0.7	0.5	0.3
10 per cent	2.4	1.8	2.1	2.6	2.7	3.0	1.1
20 per cent	3.0	2.3	2.3	3.0	3.5	3.8	1.6
30 per cent	3.6	3.1	2.6	3.2	4.1	4.4	2.5
40 per cent	4.1	3.6	2.7	3.5	4.5	5.1	4.0
50 per cent (median)	4.9	4.1	2.9	3.8	5.2	5.7	6.3
60 per cent	5.7	4.9	3.1	4.4	5.9	6.4	9.0
70 per cent	6.5	5.4	3.3	5.0	6.5	7.3	10.9
80 per cent	7.7	6.0	3.6	5.7	7.2	8.7	15.7
90 per cent	10.1	6.4	4.2	6.9	8.5	10.7	20.3
Maximum ^c	36.2	7.6	6.5	11.2	16.6	27.5	36.2
Mean (unweighted) ^d	5.8	4.2	3.1	4.4	5.4	6.4	8.7
Mean (weighted) ^e	4.5	5.2	3.1	4.1	5.8	6.0	6.4

^a Revenue-raising effort is own-source revenue (total revenue less grants) divided by fiscal capacity (after-tax income). ^b Based on a sample of 2784 observations representing 602 councils over five years. Data were not available for all councils for all years. ^c Care must be taken when interpreting the revenue-raising efforts of urban regional, rural and remote local governments. The relatively large estimates may reflect the underestimation of fiscal capacities in those areas. It might also reflect additional non-traditional services provided by local governments. ^d Average is calculated across local governments and is not weighted for relative population size. ^e Average is weighted for population size.

Source: ABS unpublished; ATO unpublished; State grants commissions unpublished; Productivity Commission estimates.

The wide variation in the distributions of revenue-raising effort within each class indicates that other factors are affecting the revenue-raising efforts. There are a number of possible explanations why some councils have higher revenue-raising efforts than others. It is possible that the local governments with above average revenue-raising effort are those with above-average costs, or below-average community incomes, or both. These and other factors are explored in the next section.

Revenue-raising effort, a measure of how much own-source revenue a local government raises relative to its income base, varies significantly within and between classes of local governments. Capital city, urban regional, rural and remote local governments have the highest average revenue-raising efforts, when adjusted for population size.

5.3 Factors affecting revenue raised by local governments

One of the key tasks for the Commission is to examine the factors that affect the revenue raising of local governments. A local government's own-source revenue raising is determined by community decisions about the desired levels and standards of service. The preferred way to explain differences in revenue raised between local government areas is to estimate the effects of all factors likely to influence the demands of each local community. As noted in chapter 4, it is difficult to estimate the demands for local public goods because the prices of many local government services are not observable.

In this study, local government own-source revenue is assumed to reflect how much the community is prepared to pay for services. How much a community is prepared to pay is in turn reflected by the attributes of a local community (such as its population size and income) and the services provided by its council. Local government services (such as, the number of kilometres of roads provided by local governments, and the number of properties serviced by the local government) can be thought of as key 'cost-drivers' of local government expenditure.

The Commission has drawn on evidence in submissions and reviewed a number of international and Australian studies to identify factors that might affect a local government's revenue raising. A number of factors identified in this study are similar to those used by State grants commissions (see for example, VGC 2007).

Not all the factors identified in submissions and other studies were included in the statistical analysis. This is because data were not available for some of the factors. Where data were available, many were not considered statistically significant when included in the estimation. Some data were only available for some years. Other data were only available for some States and Territories.

Since reliable data were not available for all the possible factors, it was necessary to rely on proxy indicators to represent the underlying factors that cannot be directly measured. For example, a variable representing the State in which the local

government is located (for example, measuring ‘1’ if in New South Wales and ‘0’ if not) can be used to test the extent to which there are other state-wide influences on the revenue raised by local governments. This might arise from differences in policies, or in legislative and regulatory arrangements (chapter 6).

Income of the community

As discussed earlier, a significant factor that affects the capacity of a local government to raise revenue is the income of its community. Communities with higher incomes per person are likely to spend more on local government services than communities with lower incomes per person, albeit probably at a diminishing rate as income increases.

Several participants to this study argued that income is an important determinant of the revenue-raising capacity of local governments (for example, Australian Chief Executive Officers Group, sub.18). The Local Government Association of Queensland (sub. 11, p. 26) stated:

The revenue-raising capacity is likely to be directly related to the economic performance of an area, so revenue-raising capacity will vary significantly from location to location, even in what might appear to be similar communities ([in terms of] population and geographic dispersion).

Local government services

The type and level of services provided by local governments are likely to be important determinants of the actual revenue raised by local governments. Higher levels of service provision have higher expenditure and, therefore, higher revenue requirements. Some local government services for which data were readily available include:

- *Kilometres of local roads per person* — local roads represent a major area of expenditure for councils. A physical indicator of the level of road provision is the kilometres of local roads per person in the local government area. This indicator does not account for the quality of roads (such as whether they are sealed or unsealed or the standard of the road surface), or differences in the cost of provision for reasons of geology and topography.
- *Number of properties per person* — other core activities of local governments include the provision of waste collection, footpaths and building regulations. A physical indicator associated with property services is the number of properties per person serviced and rated in the local government area.
- *Water and sewerage services* — in New South Wales, Queensland and

Tasmania, many local governments are required to provide water and sewerage services. It has not been possible to measure reliably the level of these services for each council. In the regression analysis reported later, a proxy variable is used instead, which takes a value of '1' if the local government provides water and sewerage and '0' if not.

Other factors affecting the costs of local government services

A feature of local government services is that many exhibit some elements of fixed costs. This implies that some local governments can experience economies of scale in the provision of particular services. Even though the total expenditure might increase with the level of services, it is possible that per person expenditure (and hence revenue required per person) might decrease with the level of service, depending on whether economies of scale are present. The Municipal Association of Victoria (sub. 22), for example, noted that both populations and population densities could influence the average costs of local governments.

It might also be the case that there are minimum scales of operation before local governments are able to provide some services. The Department of Transport and Regional Services (sub. 38, p. 19) stated:

Councils with low populations generally do not have the revenue base or economies of scale to deliver the range of services a larger organisation can provide. ... The experience in Victoria suggests that a population of at least 50 000 people may be required to create a viable local government.

To test the extent to which scale economies or economies of density are present, two factors are considered:

- *Population size* — as the residential population of a local government area increases, so does the need to service that community. If there are scale economies present, the unit cost (and therefore the own-source revenue per person) would be expected to decline with increases in population.
- *Population density* — analogous to population size, an increase in the population density of a local government area is expected to be inversely related to its unit costs.

Another factor that might affect the costs of local government service provision over time is the population growth of the community. The Western Australian Local Government Association (sub. 51) argued that rapid population growth and decline provided substantial challenges to local governments to fund infrastructure maintenance and investment. In the absence of borrowing for future infrastructure, communities experiencing rapid population growth may find the costs imposed on

current ratepayers are high. For example, high costs associated with new infrastructure investment required to accommodate the increasing population. Similarly, communities experiencing rapidly declining populations will find it more costly per person maintaining relatively extensive infrastructure assets.

State and class of local government

The State in which the local government is located can potentially affect its ability to raise revenue. There are a number of possible reasons for this. One factor might reflect the legislative and regulatory arrangements in which the local government operates. Regulatory arrangements that are restrictive might dampen revenue raised. Another reason is that there might be other state-wide influences or neighbourhood effects. It is possible that other State government policies or economic trends might be influencing the revenue raised by local governments.

Finally, the own-source revenue raised by local governments could be influenced by factors associated with the local government's geographic location. One reason is that remote communities have higher per person operating costs than non-remote. Another reason is that remote local governments find it more difficult to attract and retain staff than do non-remote. The Local Government Association of the Northern Territory (sub. 46), for example, stated that it recruited 30 chief executive officers in 2005-06. One council had 15 chief executive officers over eight years.

Several authors and participants to this study also argued that local governments are sometimes motivated to supply services that are not met by the private sector or other spheres of government (LGASA sub. 53; LGMA sub. 61). The South Australian Financial Sustainability Review Board (FSRB) (2005, p. 60) said:

Councils can also feel pressured by the community to pick up service gaps left by Commonwealth and State Governments.

The withdrawal of services by the State Government from regional South Australia has been a major source of cost shifting for country councils. Councils are also challenged with the fact that they see themselves as the last resort for the community to receive government support.

Including an ACLG class variable might serve as a proxy for differences in both service mixes and costs between classes of local governments.

Other factors

Participants to this study and several authors have identified that sociodemographic factors might also influence the ability of local governments to raise revenue.

Mullins (2004) and Shadbegian (1999), for example, considered the effect of different age cohorts on the level of revenue raised by local governments, given that they had differing effects on local government expenditures.

Sociodemographic factors (such as the age distribution, unemployment levels and Indigenous composition of the population) could have two possible influences on the revenue raised by local governments. First, sociodemographic groups may have different preferences and, therefore, may make demands on local governments for particular services. ALGA (2004), for example, noted that ageing communities place demands on local government for social and activity support services, meals programs, in home support, respite and allied health services. These in turn lead to higher levels of expenditure and revenue.

Conversely, some sociodemographic groups might restrain local government revenue raising. In particular, some age cohorts (such as residents with young families and residents on fixed incomes) are thought to be particularly sensitive to the prospect of local government rate increases. As a result, the ability of local governments to raise own-source revenue might be influenced by the effect that rate increases would be likely to have on particular groups (Bentley 1973; Inner South Metropolitan Mayors Forum, sub. DR87).

5.4 Analytical results

To investigate which factors best explain the differences in the revenue raised by different local governments, the Commission undertook a multivariate regression analysis using the stochastic frontier analysis technique. A detailed description of this technique is provided in appendix C.

Like any multivariate regression analysis, stochastic frontier analysis allows for statistical relationships to be established between the dependent variable and the independent variables. This is the subject of this section.

Stochastic frontier analysis simultaneously enables determination of the scope for each local government to raise *additional* revenue after controlling for:

- explicitly identified factors influencing revenue raised per person
- random variations across councils reflecting
 - the effect of random events, that might include measurement error in the variables and other random factors that affect revenue raised per person across councils, for example, droughts

- the combined effects of other omitted factors, many of which are not amenable to quantification. These might include local preferences and attitudes towards local governments.

The results of this second part of the stochastic frontier analysis are reported in section 5.5.

Table 5.4 Regression results of the stochastic frontier analysis

<i>Independent variables</i>	<i>Model 1 Dependent variable is: Log of own-source revenue per person (broad)^a</i>	<i>Model 2 Dependent variable is: Log of own-source revenue per person (narrow)^b</i>
Characteristics		
Log of personal income per person	0.309 ^c	0.275 ^c
Log of business income per person	0.089 ^c	0.108 ^c
Log of roads per person	0.079 ^c	0.078 ^c
Log of properties per person	0.084 ^c	0.072 ^c
Water (categorical variable)	0.237 ^c	0.219 ^c
Log of residential population	-0.125 ^c	-0.145 ^c
Population growth rate squared	0.009 ^c	0.004 ^c
State^f		
New South Wales	0.168 ^c	0.169 ^c
Queensland	0.110 ^c	0.154 ^c
South Australia	-0.147 ^c	-0.094 ^c
Western Australia	-0.096 ^c	-0.078 ^c
Tasmania	-0.075 ^d	..
Northern Territory	-0.711 ^c	-0.714 ^c
ACLG class^g		
Capital city	0.845 ^c	0.964 ^c
Urban fringe	..	-0.103 ^c
Urban regional	0.074 ^e	..
Rural agricultural	-0.2217 ^c	-0.290 ^c
Remote	..	-0.069 ^e
Constant	4.225 ^c	4.527 ^c
Number of observations	2854	2854
Number of councils ^h	604	604
Log likelihood	-758.133	-646.463

^a Defined as total revenue less grants. ^b Defined as total revenue less grants, dividends, interest, and capital contributions. ^c Significant at less than the 0.1 per cent level. ^d Significant at the 5 per cent level. ^e Significant at the 10 per cent level. ^f The reference state captured in the constant term is Victoria. ^g The reference ACLG class captured in the constant term is urban developed. ^h Not all councils are represented in all years. .. Not significant at 10 per cent level or below.

Source: ABS unpublished; ATO unpublished; State grants commissions unpublished; Productivity Commission estimates.

A number of models describing the effects of factors on own-source revenue per person were estimated. They reflect different assumptions about which sources of revenue local governments should be assessed against and the factors that might account for the differences (heterogeneity) across councils. The results of two models are presented here. In the first, own-source revenue is broadly defined to be equal to total revenue less grants. In the second model, own-source revenue is narrowly defined to be equal to total revenue less grants, interest, dividends and capital contributions. Some summary results of these analyses are in table 5.4. A more detailed summary of the results and sensitivity analyses are reported in appendix C. For both models, the estimated parameter values appear plausible and have the anticipated signs, given prior expectations.

Own-source revenue per person increases with both per person personal income and business incomes. An interpretation of this result is that as each after-tax source of income increases, the community prefers to spend proportionally less of it on local government services (chapter 4). The coefficient on business income is smaller than that of personal income, suggesting that a local government's revenue stream is inelastic (that is, less sensitive) to changes in business income than from changes in personal income.

In terms of local government services, own-source revenue per person also increases with the length of roads per person. This suggests that as the length of roads (in per person terms) increases, so do the per person costs of maintaining them. Similarly, own-source revenue per person increases with the number of rateable properties per person, reflecting higher services and expenditure needs. Some councils are required to supply water and sewerage services. As expected, the revenue raised by councils supplying water and sewerage services is higher.

In terms of other factors that might influence the costs of local government services, own-source revenue per person decreases with the size of the population, which suggests economies of scale. Population density, however, was not found to be statistically significant. Population density was not strongly correlated with own-source revenue, but was correlated with population level. This suggests that communities that benefit from economies of scale also benefit from economies of density. Population growth was found to be positively correlated with own-source revenue. This confirms the view that communities experiencing rapid population growth or decline are also those likely to be raising more own-source revenue per person.

There are also differences in the level of revenue raised by councils between States. The reference state for comparisons is Victoria. Councils in New South Wales and Queensland on average tend to raise more revenue than councils in Victoria.

Councils in South Australia, Western Australia and the Northern Territory raise less than in Victoria.

There are also differences in the level of revenue raised by councils between ACLG classes. The reference ACLG class for comparison is urban developed. Capital city, and to some extent urban regional councils, tend to raise more own-source revenue per person than urban developed councils. This most likely reflects the higher per person (resident) costs of servicing those areas and, in the case of capital cities, the number of visitors to the area. Rural councils raise less than urban developed (after taking account of other factors such as roads, population and income). This suggests that rural communities on average make fewer demands of their councils than do urban developed councils.

FINDING 5.3

An empirical assessment indicates that local government own-source revenue raised per person:

- *increases with personal and business incomes per person of the community*
- *increases with the length of roads, the number of properties rated and served, and whether water and sewerage services are provided*
- *increases in communities experiencing population growth*
- *decreases with population size.*

There are also differences between jurisdictions and classes of local governments.

5.5 The scope to raise additional own-source revenue

The statistical analysis in the preceding section focuses on identifying the factors influencing the revenue *actually* raised by local governments. Such an analysis can be used to predict the revenue that an average council raises, given its values for the variables specified in the regression equation and the estimated parameters. However, it cannot provide insights into whether it might be possible for councils to raise more revenue, if they so choose. That is, it does not reveal information about their potential to raise *additional* revenue.

The next step is to identify the extent to which local governments have scope to raise additional own-source revenue. It needs to be stated at the outset that the purpose of such an analysis is not to suggest that councils *should* raise additional revenue. Clearly, it is the responsibility of councils and their local communities to choose the appropriate level of revenue to be raised.

The method used here to identify any potential to raise additional revenue is to

compare (that is, to benchmark) the own-source revenue raising of local governments. There are a number of techniques that allow for such benchmarking. One well known technique is data envelopment analysis. Ordinary least squares regression (as used by Teera and Hudson 2004) is another. The scope for a local government to raise additional revenue is based on how the local government compares to a frontier determined by the ‘best practice’ local governments (in the case of data envelopment analysis), or the average performance of all councils (in the case of ordinary least squares regression). However, both are unsuitable for the purposes of this study since they overestimate the scope to raise additional revenue by incorporating measurement error in the estimates of revenue-raising potential (appendix C). As noted in chapter 3, measurement error is a particular problem for this study.

Another challenge posed for this study is the high level of diversity among local governments, as noted in chapter 2. Local governments vary significantly in the services they provide, the communities they support, and the regulatory and geographic environments in which they operate. Such diversity introduces a high degree of heterogeneity into local government data.

Stochastic frontier analysis is the Commission’s preferred method to make comparisons across local governments. It takes account of the factors that explain council revenue raising, the random influences (such as measurement error) and the heterogeneity across local governments. It is able to distinguish between measurement error and heterogeneity as well as what is thought to be the underlying scope to raise additional revenue. A detailed discussion of how these effects are separately handled within stochastic frontier analysis is provided in appendix C.

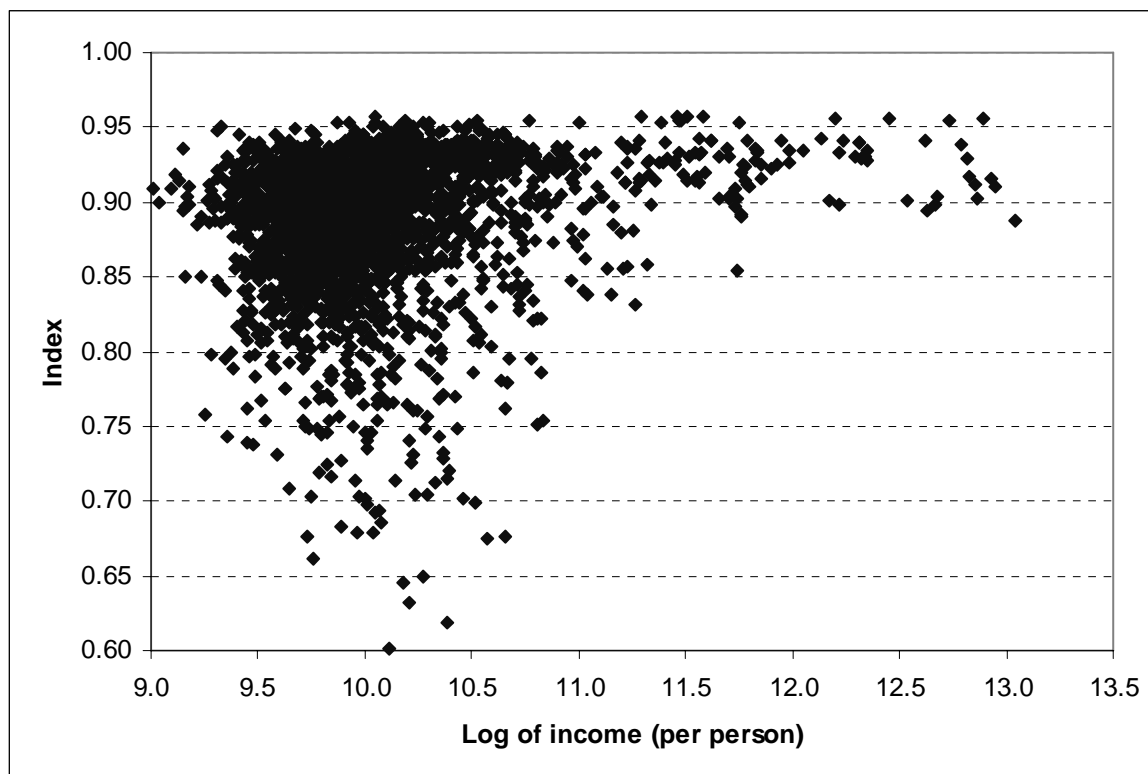
Compared with alternative methods, stochastic frontier analysis yields more conservative estimates of the relative potential of local governments to raise additional revenue. This is because the estimated potential to raise additional revenue is determined after controlling for the identified factors, random events and heterogeneity of data.

Invariably, the index of how much revenue each council is raising relative to its potential revenue will be less than unity. If a local government has an index of 0.8, it is raising 80 per cent of the revenue that it potentially could raise as assessed against its hypothetical benchmark. It is rare for any council to be ranked 1.00 using this analysis, since each council’s frontier is uniquely determined using *all* the observations in the sample rather than a few outliers. Put simply, even councils with the highest indices of relative revenue raising can increase their revenue raising.

The estimated indices of the relative potential to raise additional own-source revenue (based on the first model in table 5.4) are shown in figure 5.2. Most local

governments have indices between 0.75 and 0.95. There are a number of councils with lower values, mainly between 0.6 and 0.75. Most councils are clustered between incomes of \$13 000 and \$36 000 per person.

Figure 5.2 Estimates of each local government’s own-source revenue relative to its potential own-source revenue, by income 2000-01 to 2004-05^{a, b}



^a The index is defined as the current own-source revenue divided by the potential own-source revenue. ^b Log of 9 is equivalent to about \$8000, log of 9.5 is about \$13 000, log of 10 about \$22 000, log of 10.5 about \$36 000, and log of 11 about \$59 000 and log of 12 about \$160 000.

Source: ABS unpublished; ATO unpublished; State grants commissions unpublished; Productivity Commission estimates.

A summary of the indices by class of council is presented in table 5.5. Across all councils, the (unweighted) average index is 0.88. This means that, on average, Australian councils are raising about 889 per cent of what they hypothetically could raise. On average, councils have an assessed scope to raise an additional 12 per cent of own-source revenue.

There is considerable variation in mean and median indices between classes of councils. The urban councils are assessed to have greater scope to raise additional own-source revenue than do non-urban councils. The councils with the greatest scope to raise additional revenue are capital city (unweighted average index of

0.85), urban developed councils (0.84) and urban fringe (0.85). Rural (0.90) and remote (0.92) councils have the least scope to raise additional revenue (table 5.5).

Table 5.5 Distribution of each local government's own-source revenue relative to its potential own-source revenue, by class of local government

2000-01 to 2004-05, per cent^a

<i>Decile and mean</i>	<i>All councils</i>	<i>Capital city^b</i>	<i>Urban developed</i>	<i>Urban fringe</i>	<i>Urban regional</i>	<i>Rural</i>	<i>Remote</i>
Lowest	0.56	0.75	0.56	0.67	0.60	0.67	0.84
10 per cent	0.83	0.77	0.75	0.78	0.83	0.87	0.90
20 per cent	0.86	0.78	0.80	0.82	0.85	0.88	0.91
30 per cent	0.87	0.80	0.83	0.83	0.86	0.89	0.91
40 per cent	0.89	0.82	0.85	0.85	0.87	0.90	0.92
50 per cent (median)	0.89	0.85	0.86	0.85	0.88	0.91	0.93
60 per cent	0.90	0.87	0.87	0.86	0.89	0.91	0.93
70 per cent	0.91	0.89	0.88	0.88	0.89	0.92	0.94
80 per cent	0.92	0.91	0.89	0.89	0.90	0.92	0.94
90 per cent	0.93	0.93	0.91	0.91	0.91	0.93	0.95
Highest	0.95	0.94	0.93	0.94	0.94	0.94	0.95
Mean (unweighted) ^c	0.88	0.85	0.84	0.85	0.87	0.90	0.92
Mean (weighted) ^d	0.86	0.81	0.85	0.86	0.88	0.89	0.91

^a Based on a sample of 2784 observations representing 602 councils over five years. Data were not available for all councils for all years. ^b There are 33 observations representing seven capital city councils over five years. One capital city was not represented for one year. ^c Average not weighted by relative population share. ^d Average weighted by relative population share.

Source: ABS unpublished; ATO unpublished; State grants commissions unpublished; Productivity Commission estimates.

FINDING 5.4

A sophisticated benchmarking analysis of the relative potential of local governments to increase their own-source revenue suggests that, on average, councils are raising about 88 per cent of their hypothetical benchmarks. Whether a council can realise its assessed potential to raise additional revenue will depend on its individual circumstances. (The scope for raising additional revenue should not be taken to imply that local governments should increase the revenue they raise.)

To put this result into perspective, the dollar equivalents are presented in table 5.6. The average hypothetical potential to raise additional *total* revenue per person is about \$140. There are differences between classes of councils in the potential to increase total revenue. The average increase ranges between \$120 and \$140 per person for several types of councils to about \$500 per person for capital city councils.

Table 5.6 Estimates of the average potential to increase total revenue, by class of local government

2000-01 to 2004-05, per person^{a, b}

<i>Local governments by ACLG class</i>	<i>Number of observations</i>	<i>Number of councils^c</i>	<i>Actual total revenue</i>	<i>Potential total revenue</i>	<i>Average increase in total revenue</i>
			\$	\$	\$
Capital city	33	7	4 251	4 751	500
Urban developed	394	87	829	955	126
Urban fringe	219	48	905	1 029	123
Urban regional	506	111	1 317	1 453	135
Rural	1 409	298	2 367	2 502	135
Remote ^d	223	51	6 642	6 837	194
All councils	2 784	602	2 208	2 350	142

^a Average not weighted by relative population share. ^b The base year is 2005-06, adjusted using the ABS non-farm GDP deflator. ^c Not all councils are represented in all years. ^d Care must be exercised due to the quality of data for remote local governments.

Source: ABS unpublished; ATO unpublished; State grants commissions unpublished; Productivity Commission estimates.

Care needs to be exercised when interpreting the results for capital city and remote councils. Melbourne, Adelaide and Perth have relatively small residential populations and very high own-source revenue per person. Even though the analysis suggests that these cities have less scope to raise additional own-source revenue in percentage terms when compared to other capital cities, they nonetheless have the potential to raise large amounts of additional revenue in total. Moreover, the estimate that capital city councils can raise an additional \$500 per person is an unweighted average — that is, it is an average taken across all the capital city councils irrespective of population size — the same weight is given to, for example, Brisbane City Council and Darwin City Council.

Care also needs to be exercised when interpreting the results for remote councils, as the average increase in total revenue may not be reflective of all remote councils. The estimated average increase in total revenue reflects the scope for larger remote councils to collect additional revenue from rural and mining businesses as distinct from residents. This is because 173 of 400 observations for remote councils were removed from the database data quality reasons (appendix C). Most of these were smaller councils, many of which are Indigenous. Moreover, it is likely that the estimates of fiscal capacity for the most affluent remote councils are over estimated, given the practice of exempting all or part of mining leases from paying rates in some jurisdictions.

5.6 Financial impacts of increased revenue raising

One of the issues prompting this study relates to the financial sustainability and financial performance of local governments. The terms of reference, however, do not ask the Commission to examine the extent to which local governments are, or could, become financially sustainable. Notwithstanding this, there will be some financial impacts on local governments, should they choose to raise the additional own-source revenue which the Commission's analysis suggests they might be able to raise.

To provide some insights into how material the scope is for local governments to raise additional revenue on local government finances, the Commission has simulated the effect of a hypothetical increase in own-source revenue on the:

- revenue-raising effort of each council
- cost recovery from own-source revenue of each council.

Revenue-raising effort was defined in section 5.2. Cost recovery from own-source revenue is defined to be equal to own-source revenue (broadly defined) divided by total expenditure. This indicator is not a measure of the real cost recovery or financial viability of local governments because it does not include:

- costs from any outstanding infrastructure renewals and maintenance
- grants that would contribute to the total cost recovery of local governments.

Further, in this exercise it is assumed that:

- expenditure and grants are held constant and there are no changes to costs from raising additional revenue
- increases in prices of goods and services do not yield smaller than expected increases in revenue (residents might respond to price increases by reducing their consumption of those goods and services).

The Commission undertook sensitivity analyses of the effects of increasing own-source revenue based on projections using alternative models of own-source revenue raising (such as model 2 in table 5.4). These results are presented in appendix C.

The distributions of the indices of cost recovery from own-source revenue for all councils and for classes of councils, are shown in table 5.7. Councils are required to set rates, fees and charges after taking into account budgeted costs and grants received from other spheres of government. Consequently, most councils have cost-recovery ratios (as defined here) of less than unity, and some at around 0.5.

Table 5.7 Distribution of the ratio of cost recovery from own-source revenue, by class of local government

2000-01 to 2004-05, ratio^{a, b}

<i>Decile and mean</i>	<i>All councils</i>	<i>Capital city^c</i>	<i>Urban developed</i>	<i>Urban fringe</i>	<i>Urban regional</i>	<i>Rural</i>	<i>Remote</i>
Lowest	0.07	0.76	0.61	0.50	0.47	0.15	0.07
10 per cent	0.46	0.82	0.78	0.73	0.61	0.43	0.24
20 per cent	0.55	0.88	0.83	0.82	0.70	0.50	0.35
25 per cent	0.58	0.91	0.85	0.83	0.74	0.52	0.38
30 per cent	0.62	0.95	0.86	0.86	0.78	0.56	0.41
40 per cent	0.70	1.02	0.89	0.89	0.83	0.60	0.48
50 per cent (median)	0.77	1.05	0.93	0.94	0.86	0.65	0.51
60 per cent	0.83	1.13	0.96	0.98	0.91	0.71	0.55
70 per cent	0.89	1.18	0.99	1.02	0.97	0.77	0.59
75 per cent	0.92	1.19	1.01	1.05	0.99	0.80	0.63
80 per cent	0.96	1.22	1.03	1.07	1.03	0.83	0.68
90 per cent	1.06	1.29	1.09	1.18	1.11	0.93	0.80
Highest	1.80	1.35	1.67	1.80	1.55	1.69	1.26
Mean ^d	0.76	1.06	0.94	0.96	0.87	0.68	0.52

^a Cost recovery from own-source revenue is defined as total revenue less current and capital grants all divided by total expenditure. ^b Based on a sample of 2784 observations representing 602 councils over five years. Data were not available for all councils for all years. ^c There are 34 observations representing seven capital city councils over five years. One capital city was not represented for one year. ^d Average not weighted by relative population share.

Source: ABS unpublished; ATO unpublished; State grants commissions unpublished; Productivity Commission estimates.

As expected, there are differences in the ratios across the groups of councils (table 5.7). Remote councils have the lowest ratios and are highly dependent on grants, as are many rural councils, though to a lesser extent. Capital city councils have the highest ratios followed by urban fringe, urban developed and urban regional.

The impact of a hypothetical increase in own-source revenue (of the magnitudes described in table 5.5) on the revenue-raising effort of councils is illustrated in table 5.8. The average increase in own-source revenue would lead to a rise in the average revenue-raising effort across all councils from 5.8 per cent of fiscal capacity to 6.4 per cent. For urban developed councils, the revenue-raising effort would increase, on average, from 3.1 per cent of income to 3.6 per cent. The revenue-raising effort of remote councils would increase from 8.7 per cent to 9.3 per cent (table 5.8).

As noted earlier, the unweighted averages do not provide an indication of the incidence of revenue-raising effort across the population. If there are significant differences in the population size of local governments, then taking account of

these, would provide an indication of the overall revenue-raising effort across the population. It is estimated that the weighted average revenue-raising effort would increase from 4.5 to 5.1 per cent, on average. Similarly, the average revenue-raising effort in remote councils would increase from 6.4 to 6.9 per cent (table 5.8).

Table 5.8 Effect of a hypothetical increase in own-source revenue raised on revenue-raising effort, by class of local government
22000-01 to 2004-05, per cent^a

<i>Local governments by ACLG class</i>	<i>Revenue-raising effort not adjusted for population</i>			<i>Revenue-raising effort adjusted for population</i>	
	<i>Actual mean</i>	<i>Hypothetical mean</i>	<i>Hypothetical distribution^b</i>	<i>Actual mean</i>	<i>Hypothetical mean</i>
Capital city	4.2	4.9	2.8–6.8	5.2	6.4
Urban developed	3.1	3.6	3.0–4.0	3.1	3.6
Urban fringe	4.4	5.1	3.6–6.2	4.1	4.7
Urban regional	5.4	6.2	4.3–7.7	5.8	6.5
Rural	6.4	7.0	4.6–8.5	6.0	6.6
Remote	8.7	9.3	2.2–13.0	6.4	6.9
All councils	5.8	6.4	3.8–7.8	4.5	5.1

^a Based on a sample of 2784 observations representing 602 councils. Not all councils are represented in all years. ^b This is the distribution of the middle 50 per cent (inter-quartile range) of observations around the median hypothetical revenue-raising effort.

Source: ABS unpublished; ATO unpublished; State grants commissions unpublished; Productivity Commission estimates.

The impact of the hypothetical increase in own-source revenue on the cost recovery from own-source revenue and grant dependency of councils is illustrated in table 5.9. Overall, cost recovery would increase from 0.76 to 0.87 for the unweighted case. The average cost-recovery ratio of capital city councils would increase from 1.06 to 1.25. At the other end, the average cost recovery for remote councils would increase from 0.52 to 0.56. Similarly, the cost recovery of rural councils would increase from 0.68 to 0.75, on average. About 87 per cent (about 250) of rural and 95 per cent (about 48) of remote councils would remain dependent on grants, even if they adopted the assessed increases in own-source revenue raising. About 27 per cent of urban developed, 36 per cent of urban fringe, and 50 per cent of urban regional councils would also remain dependent on grants.

Even though the average business income in remote councils is high (table 5.2), many remote councils would still remain dependent on grants. The relatively high average business income of remote councils is likely due to a small number of councils with mining activities. Even after accounting for a number of Indigenous councils which have been removed from the dataset, there still remains a relatively large number of remote councils that do not have mining activities.

Table 5.9 Impact of a hypothetical increase in own-source revenue on cost recovery from own-source revenue, by class of local government

2000-01 to 2004-05^{a, b}

Local governments by ACLG class	Cost recovery not weighted by population share				Cost recovery weighted by population share	
	Actual	Potential	Hypothetical distribution ^c	Share of councils remaining grant dependent	Actual	Potential
	Ratio	Ratio	Ratio	Per cent	Ratio	Ratio
Capital city	1.06	1.25	1.13–1.34	–	1.01	1.23
Urban developed	0.94	1.11	0.99–1.20	27	0.94	1.10
Urban fringe	0.96	1.12	0.99–1.21	26	1.00	1.16
Urban regional	0.87	0.99	0.84–1.13	50	0.95	1.08
Rural	0.68	0.75	0.58–0.89	87	0.74	0.83
Remote	0.52	0.56	0.41–0.68	95	0.56	0.61
All councils	0.76	0.87	0.64–1.06	67	0.94	1.09

^a Cost recovery from own-source revenue is defined as total revenue less grants, divided by total expenditure.

^b Based on a sample of 2784 observations representing 602 councils over five years. Not all councils are represented in all years. ^c This is the range of the middle 50 per cent (inter-quartile range) of observations around the median hypothetical cost-recovery ratio.

Source: ABS unpublished; ATO unpublished; State grants commissions unpublished; Productivity Commission estimates.

Weighting by population size gives a slightly different perspective of the effect of raising additional own-source revenue. Across all local governments, cost recovery from own-source revenue would increase from 0.94 to 1.09. For urban developed communities, the ratio would increase from 1.01 to 1.23. For remote communities, the increase would be from 0.56 to 0.61. It is also possible to consider the effect of population sizes on the extent to which local governments remain dependent on grants. On average, about 34 per cent of the population resides in local governments that would remain dependent on grants, assuming that each local government increased its own-source revenue by the assessed amount (appendix C).

As a generalisation, all councils have some potential to raise additional revenue. For urban councils, a modest increase in own-source revenue has a material effect on their cost recovery and grant dependency. For rural and remote councils the situation is different. Increases in own-source revenue would increase their already relatively high levels of revenue-raising effort. However, given their relatively high expenditure in per person terms, such increases would still leave them substantially dependent on grants, at current levels of expenditure.

A number of councils, particularly in capital city and urban developed areas, have the means to recover additional revenue from their communities sufficient to cover their expenditure without relying on grants. However, a significant number of councils, particularly in rural (87 per cent) and remote (95 per cent) areas would remain dependent on grants from other spheres of government to meet their current expenditure. Some councils would remain highly dependent on grants.

5.7 Policy implications

The ability to recover expenditure is not, however, the same as being financially sustainable. Cost recovery from own-source revenue is defined using the ABS government finance statistics definitions of revenue and expenditure items. These items are reported in current terms. As noted, the definition of cost recovery from own-source revenue used in this study makes no reference to a local government's future liabilities, such those associated with infrastructure renewal, where adequate provision has not been made to cover these.

The Commission's findings are broadly consistent with the findings in other studies (for example, PwC 2006; Access Economics 2005, 2006a, 2006b and 2007) relating to the financial sustainability of local governments. PwC reported that the 'majority of larger metropolitan councils are generally viable or have the ability to self-effect an improvement in financial sustainability', whereas, 'rural remote and rural agricultural have more pronounced viability problems' (PwC 2006, p. 113).

Depending on the extent of the projected growth in the expenditure on renewing and maintaining infrastructure assets, the estimates presented in table 5.9 might over state the true cost-recovery position of local governments (Local Government Association of South Australia, sub. DR86).

In 2004-05, the Commonwealth and the States distributed over \$3.6 billion in grants to local governments of which almost 30 per cent (or \$50 per person) was Commonwealth general purpose grants (table 2.3). Even though the largest recipients of grants (capital and current) were councils in urban fringe, urban regional, rural and remote areas, grants were distributed to all types of local governments — including capital city and urban developed (table 3.7).

A number of participants have questioned the appropriateness of the existing arrangements for distributing Commonwealth general purpose grants. Participants to this study have identified that the existing arrangements fail to meet the objective

of full fiscal equalisation. The WA Department of Treasury and the WA Department of Local Government and Regional Development (sub. 65, p. 21) said that full equalisation was not achievable because of:

... the quantum of FAGs [financial assistance grants] and the minimum grant condition. This particularly impacts on the financial capacity of local governments in regional and remote areas of Western Australia. To achieve full equalisation there would need to be an increase in the FAG pool and no minimum grant.

The WA Department of Local Government and Regional Development argued eliminating the minimum grant component of general purpose grants could significantly increase the allocation of funding to rural and remote councils. In a case study, the department showed that the removal of the minimum grant from the City of Stirling in Western Australia (a minimum grant council) would reduce its total revenue by 2.6 per cent. In contrast, the removal of the minimum grant would increase the total revenue of Halls Creek by almost 7.8 per cent (sub. DR89).

Other participants have called for a more substantial reform of the grants allocation process. The City of Mandurah (sub. DR73, p. 4), for example, argued that the Commonwealth Grants Commission:

... should introduce a ‘national distribution’ model, providing general purpose grants directly to local governments (bypassing the States), based on their relative ‘need’ (horizontal equalisation), rather than on their State’s population.

The issue of the appropriateness of the current distribution of financial assistance grants is beyond the scope of the Commission’s terms of reference. To the extent that full equalisation remains a policy objective of the Australian Government there is a case for more work in this area.

FINDING 5.6

Given the differences in the scope to raise additional revenue across different classes of councils, there is a case to review the provision of Australian Government general purpose grants to local governments.