
8 Principles for revenue raising

Key points

- Through open and transparent processes, local governments can improve the well-being of their communities by:
 - ensuring financial sustainability
 - evaluating and setting priorities, including seeking community input
 - identifying core functions and ensuring recognition of full costs
 - undertaking functions effectively and efficiently.
- The implementation of appropriate principles for revenue raising can assist the effective operation of the decision-making processes of local governments.
- These principles can guide decisions about:
 - the appropriate structure of rates, including minimum rates, fixed charges, valuation methods and differential rating
 - the balance between rates, and fees and charges
 - setting fees and charges depending on the nature of the service and the users
 - making appropriate provision for refurbishment and replacement of assets.
- Practical application of such principles requires skills and resources.
- In addition to the current initiatives in a number of jurisdictions, some local governments will need further assistance in applying the principles.

The terms of reference for this study require the Commission to focus on assessing the revenue-raising capacity of councils. The Commission has presented evidence in chapter 5 that, when each council is compared to all others, adjusting for the key factors that explain differences between them, councils have some capacity to raise additional revenue. However, this does not imply that councils *should* exploit that capacity. This is a matter for their communities to decide.

Local government's revenue raising should be considered in the overarching context of promoting the well-being of its community as effectively and efficiently as possible. In accordance with its charter and operating principles, the Commission has sought to take a wider perspective than just focussing on the revenue-raising capacity of councils. In this chapter, a number of principles are set out which can help guide the revenue-raising decisions of local governments. The principles

provide a framework through which councils can discover whether they can and should increase (or potentially decrease) their own-source revenue and how this might best be achieved.

Conventional wisdom has it that the closeness of local governments to the people means that they are more likely to respond effectively to their residents' preferences than higher levels of government. Local government rates, fees and charges are highly visible from the perspective of local communities. If they are not convinced they are getting value for money, they are unlikely to be willing to:

- approve rate increases, through the political and decision-making processes of local governments
- pay fees and charges to use the services being offered.

On the other hand, local governments are making claims that their existing levels of revenue are inadequate to meet:

- increasing demands for services placed on them by their communities
- the costs of maintaining and upgrading infrastructure assets
- the costs of additional services being provided to their communities by councils on behalf of other spheres of government (chapter 2)
- rising input costs due to, for example, labour and skills shortages (Australian Chief Executive Officers Group, sub. 18).

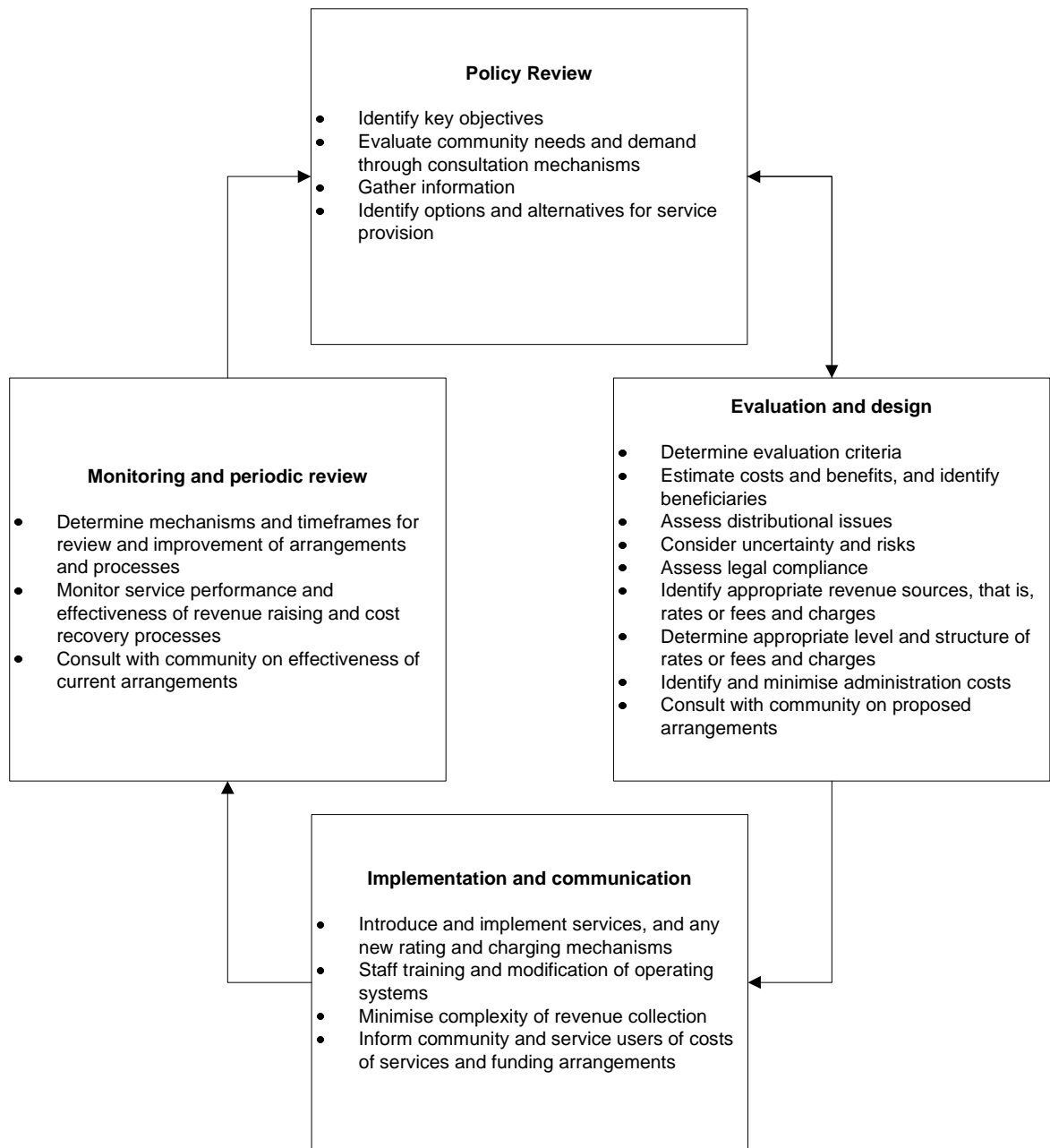
The system of local government is inherently a political one. As such, many considerations (social, political, institutional and governance) are as relevant as economic considerations. This means that there are invariably trade-offs between economic and other objectives, such as equity and administrative simplicity. Further, although the system might be an appropriate one to deliver local public goods and services, it can still have limitations, as alluded to in chapter 4.

The application of some economic principles can play a useful role in guiding the revenue-raising (and expenditure) decisions of local government. This is because the economic principles are consistent with, and indeed help support, the effective operation of the democratic and decision-making processes of local governments.

Overview of the local government decision-making process

In simple terms, a local government's revenue raising is determined through a process involving policy decisions, budgeting and cost recovery, as illustrated in figure 8.1. The various stages raise a number of issues which are explored in the discussion of revenue-raising principles through the remainder of the chapter.

Figure 8.1 Local government decision-making process



8.1 Principles to guide effective revenue raising

The principles set out below have been synthesised from a number of sources. In particular, they are based mainly on work published by Abelson (2003), Bailey (1999), Bird (1999), Groenewegen (1990), the Productivity Commission (2001) and the South Australian Centre for Economic Studies (2002). Use is also made of long established principles in the public finance and economics literature,

as well some of the principles outlined in the recent financial sustainability reports commissioned by several local government associations.

The principles set out in this chapter relate to:

- sustainable financial management
- evaluating and setting priorities
- core functions
- identifying costs of service delivery
- least cost of supply
- rate setting and pricing of services
- prudent borrowings for infrastructure
- responsibility and accountability
- openness and transparency
- providing services on behalf of other spheres of government.

Sustainable financial management

A key responsibility for councils is to conduct the business of local government in a financially sustainable manner. That is, the own-source revenue raised by councils, plus that received from grants, needs to be sufficient to cover the aggregate long-run costs of delivering the services provided on an accrual accounting basis. The aggregate cost to councils includes:

- operating expenses — such as labour, energy, materials and purchased services (including contracted-out services)
- depreciation on all long-lived assets — such as roads, buildings, pavements, bridges and water supply and drainage assets
- a return on the opportunity cost of holding assets — based on an appropriate rate of return on the investment in assets and appropriate valuation of assets that the council intends to operate over the long term
- taxes paid to other spheres of government, where applicable (for example, where councils undertake commercial operations).

The need to improve financial management systems and processes, particularly in regard to long-lived assets, was identified as a priority for councils to improve their

financial performance in recent financial sustainability reports.¹ Sustainable financial management requires the application of a multi-year framework to financial management, asset management and planning, and spending and revenue-raising decisions.

Accrual accounting requires that revenues and expenses be reported when they are incurred, rather than when a cash flow actually occurs. Under an accrual-based system, depreciation costs are included in the operating statement and employee entitlements are accounted for when accrued (for example, long service leave and superannuation accruals). Such an approach increases the accuracy in attributing costs to particular outputs or services that the council provides, thereby improving the information available to local government managers for their decision-making.

Evaluating and setting priorities

As noted elsewhere in this study, councils are facing increasing community pressure to expand the range of services provided. It is important that both the community and their council understand the costs of providing these services and how they are funded. The processes of identifying and making decisions about priorities are made more effective where:

- councils are aware of, and have regard to, the views of their communities about the priority areas for local government services
- councils heighten their communities' awareness of the benefits to them associated with the priority areas for services and discretionary expenditure
- councils heighten their communities' awareness of the short and long-term financial implications of potential service priorities and key decisions, including any trade-offs between priorities and risks associated with successfully delivering the services
- councils heighten their communities' awareness of the sources of revenue raised to pay for the priority areas for services.

¹ These reports are listed in chapter 1.

In the recent sustainability reports, it was suggested that councils might need to reassess their priorities. The establishment of long-term service plans has been identified as an action item for local governments. It has been suggested that councils should use service plans to set out:

- the services a council will provide
- how services will be delivered
- how services will be funded.

Rating and pricing principles, as discussed later, can help determine how to effectively raise the revenue required to pay for various types of goods and services provided by local governments. These principles extend to the provision of services on behalf of other spheres of government, either voluntarily or involuntarily.

Core functions

As noted in chapter 2, local governments have a variety of roles and functions and deliver a wide range of services. They are able to take on roles not precluded by other legislation and are designated as responsible authorities for the purpose of undertaking functions and providing services on behalf of other spheres of government. The main roles of local governments include governance and advocacy, planning and community development, regulation, provision of infrastructure and service delivery (DOTARS 2007).

A major function of local governments is the provision of goods and services that can be categorised as:

- public goods such as local roads, water drainage, local street lighting, parks and gardens
- natural monopoly goods and services, such as local roads and bridges
- services with associated externalities, such as some health, library and land use services.

There is general acceptance that it is appropriate for local governments to be providing these core types of services. The benefits are likely to accrue to the local community and the private sector is unlikely to provide the optimal level of these services.

Councils often choose to provide a broader range of services within their local government area. As noted in chapter 2, there has been a trend of local governments broadening the range of services they provide. Over time, councils have been increasing their involvement in areas of non-traditional social services, including health and welfare services, community housing, and recreational and sporting facilities. Some of these services appear more like those provided in private sector markets. In such situations, the case for provision by local government is less convincing.

However, where councils do engage in the provision of goods and services that resemble those of private sector markets, it is preferable for councils to approach service provision in a way that seeks to emulate that of private markets. In these situations, it is preferable to rely on user fees to recover the costs of providing these services and reveal the willingness to pay of users. Local governments should avoid under-charging for these services as it encourages over consumption and requires some subsidisation from other revenue sources. Moreover, the application of competitive neutrality principles requires that local governments aim to recover the full costs of significant business activities, including all direct costs of providing goods and services, rate and tax equivalent payments and a commercial rate of return on investments (appendix B).

Identifying costs of service delivery

Before a council can set its rates, fees and charges appropriately, it first needs to identify the costs of delivering its various goods and services. This information is essential in deciding how to set both the levels and the structures of rates and charges in an efficient manner, taking into account the distinction between private and public goods. Some definitions of the basic categories of costs are outlined in box 8.1.

Box 8.1 Cost definitions

Direct costs are costs that can be directly and unequivocally attributed to an activity or product. They include labour (and labour on-costs) and materials used to deliver products.

Indirect costs are costs that are not directly attributable to an activity or product and are often referred to as overheads, joint or common costs. They can include 'corporate service costs, such as those of the chief executive officer's salary, financial services, human resources, records management and information technology.

Capital costs comprise the user cost of capital and depreciation. The user cost of capital represents the opportunity cost of funds tied up in the capital used to deliver activities or products. It is the rate of return that must be earned to justify retaining the assets in the medium to long term. Depreciation reflects the decrease in the value of the asset over time, reflecting the decrease in its service life arising from wear and tear and obsolescence.

Fixed costs are costs that do not vary with the amount of activity or product. Rent and capital costs are usually fixed costs in the short run.

Variable costs vary with the volume of activity or product and typically include direct labour and materials.

Marginal costs is the change in total cost that arises when the quantity produced changes by one unit.

Source: CCNCO (1998).

Marginal and incremental cost

Conceptually, marginal cost provides the relevant basis for measuring the costs of an increase in supply of a service because it reflects the opportunity cost of extra units of resources required. A proxy for marginal cost is incremental cost. This is the increase in a local government's total cost attributable to the supply of a specific service. Marginal cost differs from average cost, which is the total cost of supplying a good divided by the number of units supplied. A distinction is made between short-run and long-run incremental cost. Long-run incremental cost includes operating and maintenance costs, incremental capital costs (that is, a return on the additional assets required) and incremental indirect costs (CCNCO 1998).

Long-run incremental cost is the appropriate measure of cost in situations where councils are committed to providing a service into the future (such as roads). Short-run incremental cost is preferred when a service could be discontinued or when there is excess capacity that will persist for some time.

Some costs incurred by councils are joint or common costs. These costs are not attributable to the incremental supply of services. In the case of local governments, where the beneficiaries of particular services are not easily identifiable, it is probably best to recover these through rates, for reasons explained later.

Capital costs

Pricing of services based only on direct costs without inclusion of all capital costs can result in distorted price signals. It can also lead to mis-specification of any inherent subsidy in providing a service (Carnegie and Baxter 2006). Asset management benefits from the inclusion of all relevant capital costs in the costs of a product or service. This creates an incentive to dispose of surplus assets and to use an efficient mix of assets (PC 2004).

Full capital costs include both the return on capital and depreciation (or appreciation). The first component reflects the opportunity cost of capital (the benefits of alternative uses of funds, such as retiring debt). The return on capital can be measured by applying an appropriate rate of return to the value of the asset. This can be achieved using a number of methods, including the application of a uniform rate of return across all local government services or, alternatively, using differentiated rates of return for various products and services to reflect differences in the risk profile of projects. There are trade-offs in terms of complexity and costs associated with systems and processes required to use various methods.

Depreciation costs are based on how the economic value of assets is reduced over time as they are used to provide services. Asset valuation methods can be cost-based (such as historic cost or replacement cost) or value-based (such as fair market value, net present value or optimal deprival value) or a combination of these methods. Again, there are trade-offs between the complexity and costs of implementing and using particular methods and the extent to which particular methods accurately estimate the future economic benefits of the asset, thereby encouraging its most efficient use. Historic cost accounting is usually relatively simple to administer, but only reflects asset values at a particular point in time. Such methods do not necessarily reflect the real opportunity costs of using assets. The appropriate asset valuation method will depend on asset characteristics; for example, whether the asset is short-lived or long-lived, or whether its market value changes significantly over time.

The rate of return establishes goals and benchmarks for performance assessment and provides a basis for making investment decisions (Abelson 2003). Accounting rates of return can provide an indication of the financial obligations of an entity but can have limitations for the purpose of performance assessment. Accounting profit

can be subject to strategic manipulation depending on the method used to revalue assets. The accounting rate of return is often poorly correlated with a market-based measure of return (SCNPMGTE 1996). An alternative, the economic rate of return, is a market-based measure of performance based on all relevant income, including both net cash flows and changes in capital value. It is measured as the income derived from an asset (including any change in its value) as a proportion of its market value at the start of the period. The economic rate of return provides an unbiased measure of performance that is comparable with the cost of capital and relevant to decision making.

The economic framework for assessing financial performance developed by the Steering Committee on National Performance Monitoring of Government Trading Enterprises (SCNPMGTE 1996) provides some guidance for local governments. The Committee also produced guidelines on accounting policy for valuation of assets using current valuation methods.

Least cost of supply

The revenue required to be raised by local governments should reflect the lowest achievable cost of supplying the services they provide. Councils need to search for ways to ensure that they are delivering services at lowest possible costs consistent with the desired quality and standard of service offered. Examining ways of reducing the internal operating costs of providing services is important. Benchmarking and efficiency studies can be useful tools in identifying the scope to reduce costs.

Councils might be able to improve the cost-effectiveness of providing services by entering into purchaser-provider arrangements with private sector suppliers and putting the provision of services out to competitive tender. Road construction and maintenance, and the operation of sports and leisure centres, are some common examples of where these arrangements have proven to be useful.

Commercial arrangements with private sector businesses and others for the provision of services should be in accordance with best practice in the private sector. Competitive tendering for the delivery of services should be undertaken for specialised work or for contracts that can be clearly specified and monitored (Abelson 2003).

Where there are potential scale and scope economies across councils, options for reducing costs include:

- shared service provision by creating separate entities (such as regional councils or special purpose joint venture corporations to provide services)

-
- administrative arrangements and agreements between councils, including joint purchasing
 - knowledge sharing, benchmarking and adopting best practices across councils
 - council amalgamations (PwC 2006).

Councils should make their local communities aware of the options that have scope to lower the cost of service delivery and improve the cost-effectiveness of service delivery, as well as their consequences for revenue raised by the council.

Rate setting and pricing of services

The appropriate setting of rates and prices for goods and services is essential for the efficient recovery of the costs of providing council services. Councils have a choice about using rates, or user fees and charges, to recover these costs. The principles outlined in this section provide a guide to the way that local governments should appropriately set both the structure and levels of their rates, fees and charges.

Generally, cost recovery can be regarded as an attempt to charge users more directly for the local government services they consume. By requiring a payment for services supplied, users recognise the costs of the resources involved and have an incentive to adjust their consumption in line with their willingness to pay.

For each main category of good or service provided, councils need to determine whether it is a public good, private good, or likely to result in some kind of externality. This is important for attributing costs to users (box 8.2). This determination helps to guide the extent to which the costs of providing services are recovered through rates, user fees and charges, or a combination of both.

The appropriate spatial allocation of asset costs depends on the extent to which infrastructure provides services to those in a particular location or development. Community infrastructure benefits a wide group (usually over a substantial period of time) and, therefore, might require allocation of costs across dispersed beneficiaries. If the beneficiaries are not easily identifiable there may be a case for funding from rates rather than from user charges. In the case where infrastructure costs are directly attributable to individual property owners it might be equitable to recover these costs via developer charges or contributions (which are usually capitalised in the value of the property) or via the fixed charge component of a multi-part tariff.

Box 8.2 Guidelines for attributing costs

The Wellington City Council (New Zealand) applies the following cost attribution rules to its services and activities:

- If a service (or activity) benefits identifiable individuals or groups the cost should be allocated to those individuals or groups (user pays), for example, swimming pools.
- If those that benefit directly cannot be identified or if those that benefit directly cannot be excluded from using the service, the costs should be allocated to the community (public good), for example, footpaths.
- If there are indirect or 'flow-on' benefits and those that receive these benefits cannot be identified, the costs should be allocated to the community (positive externality), for example, libraries.
- If the service prevents the negative effects of the actions of identifiable people the costs should be allocated to those people (polluter or exacerbator pays), for example, parking fines.
- If the service will benefit future generations, costs should be allocated to reflect the distribution of benefits over time (intergenerational equity), for example, where council capital expenditure is funded through borrowings.

Source: SACES (2002).

These principles are important for achieving efficiency in service delivery and revenue raising. They play a role in helping councils to coordinate the demand for, and supply of, the goods and services they provide. In this way, the principles help guide what councils do for their communities. By choosing the appropriate instrument (rates, fees or charges), councils can get a better indication of user's willingness to pay for services and minimise some of the economic distortions that can arise when an inappropriate instrument is used.

The pricing of local government services can have an impact on the roles and functions of government. If local governments provide products free of charge, users are likely to demand more than they would otherwise. As Bird (1976, p. 35) states:

An important advantage of pricing is thus to curb the demand for expanded public sector activities by making their real costs apparent to the prospective beneficiaries in a meaningful fashion. Correct pricing can alleviate ... the pressures to expand government. ... If beneficiaries are not willing to pay what the expansion of a service will cost, then it should not be expanded; if they are, it should be.

Getting the mix of revenue instruments right is a matter for each individual council. As pointed out by SACES (2002), most councils have the flexibility to change the balance of rates and user charges, if they choose to do so. There might be a case for

greater use of user charges or special rates. Where these user pays mechanisms are not used, the role of general rates in funding particular goods and services will be higher.

However, it needs to be borne in mind that economic efficiency is not the only criterion used when setting rates and prices. The other criteria commonly cited include equity, administrative simplicity, and transparency and accountability (Abelson 2006).

Equity implies an appropriate balance between the benefit and ability to pay principles. Equity considerations often result in prices for some services or user groups being subsidised, with the subsidy funded by higher prices charged for other services or groups, or from rates revenue. Where this is the case, correct identification and transparency in the level of the subsidy is important to enhance accountability and avoid poor pricing decisions.

Local governments might seek to minimise the transaction costs associated with imposing rates, fees and charges by making them easy to administer and understand and reasonably constant over time. Carnegie and Baxter (2006) consider that while price setting based on full costs is important, unduly complicated cost allocation processes to service delivery are more than likely to fail on the basis of the associated costs outweighing the benefits.

In practice, there are always trade-offs made in setting rates, user fees and charges. It might be reasonable for local governments to make trade-offs at a disaggregated level, that is, choices about funding individual services. However costs in aggregate need to be recovered in full.

Rates

Rates on land values are generally considered to be an efficient form of taxation in that they do not significantly distort economic activity and resource allocation — that is, choices about how to use the land. Even though rates can be levied on the capital improved value of land in some jurisdictions, and are therefore a tax (in part) on capital improvements, the general consensus is that the distortions and efficiency costs are small. For this reason, rates are seen as an efficient way to raise revenue for the provision of public goods and to raise revenue to subsidise services with externalities, or for other reasons, such as to achieve equity objectives.

Overall, property rates represent an attractive method of financing many forms of local government expenditure, partly because they are predictable and stable (Bailey 1999). Many local public goods cannot feasibly be financed using fees and charges because the cost of excluding non-paying users is prohibitive (for example,

users of local roads). As a result, rates represent an appropriate means of financing local public goods (excluding the annual charges elements which relate to specific services where beneficiaries are identifiable, such as rubbish collection).

For goods and services where positive externalities arise, rates can be used to partly subsidise the service. The extent of the subsidy should be guided by the assessed monetary value of the positive externality.

In practice, the distribution of the rates burden on ratepayers probably reflects a combination of the benefit principle and the ability to pay principle. Under the benefit principle, the rates burden would be allocated to ratepayers based on some notion of the benefits that are derived from the goods and services provided by local governments. Under the ability to pay principle, the rates burden would be based on some notion of the ability of ratepayers to pay, such as income. Rates setting might reflect a combination of both principles where, for example, it includes a minimum charge and an ad valorem component. In this case, the minimum charge would reflect the fact that all users benefit from a particular service and the ad valorem component would vary according to the ratepayers ability to pay (based on property values).

Local governments have capacity to set different rates in the dollar for different land uses and specific activities. Most local governments can use differential, separate, service or special rates, depending on what is permitted under State legislation. However, there might be scope to increase and improve the use of such mechanisms. The range of differential rates introduced by some Queensland councils are examples of targeted differential rates that are intended to recover more efficiently council costs as well increase revenue-raising capacity (box 8.3).

Box 8.3 Rating strategies of Queensland councils

The legislative framework in Queensland provides local governments with reasonably flexible powers in setting rates, particularly the use of differential and special rates.

The various rating strategies employed by some Queensland councils have enabled them to access better their revenue-raising capacity, through introducing innovative ways to categorise commercial and industrial rateable properties. Differential rates are determined in a manner that allows councils more efficiently to recover costs associated with properties and to ensure a more equitable distribution of rates. Some examples of rating strategies include:

- Residential single dwelling — categories are based on valuation ranges. This has enabled some councils to align better rates relative to the benefits obtained or costs imposed. This has reduced rates on higher-valued residential property, for example, canal frontage, where service levels or benefits do not increase at the same rate as the increase in land valuation.
- Residential units — categories are based on the height of the block of units (for example, greater or less than four levels). This has been used for high density units that have a high capital value relative to a low unimproved capital value and were previously paying only the minimum rate.
- Shopping centres — categories are based on gross floor area or the number of on-site car parks provided. The rationale for this is that some larger shopping centres built on the edge of towns have lower valuations than smaller centres closer to the central business district. Yet, these larger centres have greater impacts, for example, on traffic, roads and the environment. They also are the beneficiaries of the infrastructure required to address these impacts.
- Major industries — categories are based on the number of employees or other indicators of activity for large or noxious industries (for example, food processing, tanneries and sugar mills). These properties might be located on land with comparatively low value relative to the cost of providing council services to the site.
- Mining — categories based on bands of employment for mines with a relatively low valuation of mining leases, which tends to reflect the value of the land for rural uses.

Other examples of types of properties subject to differential rates include feedlots, intensive agriculture, major accommodation providers, power stations, and oil and gas processing plants.

Source: LGAQ (sub. 11).

Fees and charges

Fees and charges should be used as far as practical to raise revenue for the provision of goods and services that are not pure public goods. To the extent possible, the community should be given choices about the amount of local government services

they consume, based on the fees and charges for those services.

Efficient pricing ensures that goods and services provided by local governments are supplied to those that are willing to pay the opportunity cost of supply. In this way, the value that consumers attach to goods and services and the relative costs of production of suppliers are revealed.

There are various forms of price structures that can be used to achieve efficient pricing of goods and services, including:

- Multi-part tariffs — where a fixed charge is imposed in addition to a variable charge related to the amount of the good or service consumed. An example of this could be where a fixed charge is imposed for standard garbage collection services and a variable charge levied on additional waste collected over a threshold amount. Increasing (or decreasing) block-rate pricing is a form of multi-part tariffs. This consists of a flat or fixed charge combined with a volumetric rate that increases (or decreases) in various stages as consumption rises.
- Variable block pricing — this can include lower unit charges imposed on more frequent users or consumers of goods and services (for example, commuters, park visitors) or higher unit charges imposed during periods of peak demand or congestion (for example, recreational facilities such as swimming pools).

Pricing for private goods with positive externalities, such as various health and welfare services, involves taking external benefits into account in setting user charges. This requires estimating the size of the marginal external benefit provided by the service, and then setting the price equal to marginal cost less this external benefit (Bird 1999).² However, it is recognised that measuring external benefits, both conceptually and in monetary terms, can be challenging.

In a number of areas, local governments are statutory monopolies, so they have the potential to charge prices above competitive levels. An example could be that local governments have the sole responsibility for approving development applications in their area. Monopoly provision can lead to over-recovery of costs and the mis-allocation of resources. It could also create poor incentives for agencies to control their cost base. Investing in facilities of an unnecessarily high standard (sometimes called ‘gold plating’), or cost padding, might result (PC 2001). Local government monopolies should set prices as though they operate in a competitive market. Yet, in practice determining the level of such charges and implementing them is not straightforward. A number of approaches, such as State Governments’

² The marginal external benefit is defined as the value of the benefit to the community from supplying an additional unit of the good or service.

regulating council fees and charges, are sometimes used to prevent monopoly power from being exercised.

Compliance and administration costs

In applying the rate setting and pricing principles, the number of categories of rates and fees and charges would be determined, in part, by the size of the administration costs relative to the total cost of providing the service. This principle recognises that there is a trade-off between the benefits arising from efficient pricing and the costs associated with its implementation.

Tax systems should be as simple as possible to minimise assessment and collection costs not only for local governments but also for individual taxpayers (Groenewegen 1990). This includes minimising administration, enforcement and compliance costs. Although the costs to local governments of assessing and collecting rates revenue should, to the extent possible, be kept to a minimum, this can result in a trade-off between achieving equity and efficiency of rates on one hand, and administrative efficiency on the other.

Study participants have commented that the impracticality of revenue collections and administration costs, as well as a lack of reliable cost data, can preclude some councils from setting efficient prices (Australian Chief Executive Officers Group, sub. 18).

Prudent borrowings for infrastructure assets

If local governments decide to provide infrastructure assets, there are broadly two financing options available:

- ‘pay-as-you-go’ — funding out of current revenue or accumulated savings of councils
- capital market financing — based on borrowings or non-refundable capital contributions, such as developer charges (either in kind or as lump sum payments).

The preferred method for meeting the up-front costs of an infrastructure asset depends on the characteristics of the asset, that is, whether it has a short or long-life span or payback period (Ploeg 2006).

Borrowings, when undertaken prudently, are an appropriate means for local governments to finance long-lived infrastructure assets — the costs of which are often large or ‘lumpy’ and might be delayed in the absence of borrowing. The

servicing of debt through rates or user charges (where appropriate) enables the cost of the asset to be matched with the benefits from consumption of the services over the life of the asset, thereby promoting inter-generational equity. As noted by Dollery, Crase and Johnson (2006, p. 281):

This method ensures intergenerational equity, since those who benefit from the infrastructure contribute to its cost. Funding the asset with a one-off allocation from recurrent revenue means that it is paid for by current taxpayers, but provides a benefit to future taxpayers over the life of the asset.

The inter-temporal distribution of benefits across users and hence the inter-temporal allocation of costs can influence the timing of any infrastructure charges.

Infrastructure financing decisions require local governments to weigh up the benefits and costs of borrowing, including cost of capital and risks associated with infrastructure projects. The powers of local governments to borrow under State legislative and regulatory frameworks are outlined in appendix B.

Responsibility and accountability

Responsibility and accountability are important to linking the democratic and other participatory avenues available to local residents and businesses to the decision-making processes of local governments. It can help link the willingness of a community to pay for goods and services provided by their council to its revenue-raising and expenditure decisions. It also strengthens the incentives for councillors, council management and staff to use efficiently and effectively the resources available to them in the interests of the community they serve.

In general, the revenue-raising and expenditure decisions of local government are likely to be more effective if councillors and managers are held accountable and responsible for their decisions. This includes:

- policy decisions about the services that councils provide
- the expenditure on, and delivery of, services provided
- the way services are funded and paid for by the community.

As local governments are created under State constitutional powers, State Governments have a role in setting up the institutional and governance arrangements to ensure local governments carry out these responsibilities and accountabilities effectively.

Promoting responsibility and accountability can be achieved through:

- separating activities according to responsibilities (whereby councillors make

decisions about outcomes and funding these outcomes, and councillors and managers are held responsible for producing these outcomes)

- separating local government activities according to function (whereby there is clear identification and separation of the major activities of local government — revenue raising, purchasing of services, delivery of services and regulation)
- decentralising the provision of services within councils (whereby decision making is delegated as far as practical to those responsible for delivering services, thus shortening communication channels with the public and allowing councillors and council staff to be more informed about local preferences)
- implementing performance monitoring and independent audit processes, to facilitate public scrutiny of the performance of local government against objectives determined in consultation with the community (Abelson 2003).

Openness and transparency

Access to information can facilitate accountability. Open and transparent processes for decision making of councils are important. Such processes include making information openly available to people in the local community and seeking active participation by the community about choices regarding the services provided and how they are funded. Active consultation with the local community can be an important way of getting individuals and groups in the community to reveal their views about the services they want and their willingness to pay for them.

Local governments should have clearly defined objectives regarding their activities, programs and services, and these should be accompanied by quantifiable or measurable outcomes. Where local governments provide subsidies to consumers, these should be explicitly identified and costed and the sources of revenue to pay for them clearly identified (Abelson 2003). This improves transparency and allows the community to better assess the provision of subsidies by local governments.

In some of the recent financial sustainability reports, it has been suggested that establishing internal structures to provide for independent review of processes and decision making could assist councillors to be more accountable to ratepayers and the community.

Although accountability and transparency measures are part of an effective and democratic local government system, they are not costless. It has been estimated that such measures could potentially absorb some 2 per cent of revenue for some councils (SACES 2002).

Providing services on behalf of other spheres of government

Local governments are often involved in the provision of services on behalf of other spheres of government. Where appropriate, local governments should enter into purchaser-provider arrangements with other spheres of government. This occurs to some extent already. An example is concessions, whereby local governments provide rates concessions to particular groups in the community, such as pensioners. These are reimbursed by State Governments (in full in most jurisdictions but not in New South Wales).

Where local governments enter into the delivery of services on behalf of other spheres of government, the supply of these services should be delivered on commercial terms based on the incremental costs to the council. In situations where councils decide for their own reasons to provide subsidies for the delivery of their services, they should make the costs transparent and inform their communities about the purpose and amount of the subsidy, and how it is to be funded.

Some of the principles relevant to providing services on behalf of other spheres of government have been set out in the Inter-Governmental Agreement Establishing Principles to Guide Inter-Governmental Relations on Local Government Matters (Australian, State and Territory governments and ALGA 2006).

Effective interaction between local government and other spheres of government is important to ensure delivery of some essential services to the community. As commented by SACES (2002, p.18):

Such interaction is easiest where there is an agreed view about the respective roles of different levels of government and a willingness on the part of those levels of government to provide the resources required to carry out their own roles.

8.2 Application of the principles

The framework outlined in this chapter might raise practical challenges for some local governments. One particular issue is whether smaller regional and remote councils can practically implement the principles. Do the elected councillors and administrative staff have the skills required to implement the framework? Are the resources available to councils adequate for such a task? As noted by PricewaterhouseCoopers (2006, p. 5):

... individual councils have had mixed success in managing and funding community demands for more services whilst retaining a healthy financial position.

The principles discussed in this chapter can serve as a guide to assist and improve the decision making of local governments, particularly in the context of effective

revenue raising and financial sustainability. The emphasis in setting out the principles is about providing high-level guidance. This recognises that, in implementing these principles, councils and the communities they serve have to make practical decisions using incomplete information within the democratic framework in which councils operate. Councils and their communities invariably confront trade-offs and the principles are designed to provide guidance on how to improve the quality of decision making in this environment.

In practice, there are difficulties and complexities in applying the principles outlined. A number of these limitations have been discussed throughout the chapter. In implementing the principles outlined, councils need to take into account their own circumstances and the diversity of goods and services they provide.

Many councils are likely to be applying some of the principles outlined in this chapter already, to varying degrees. This is illustrated by the City of Boroondara's financial strategy principles which provide the framework for the development of the Council's long-term financial strategy and annual budget (sub. DR71). State government legislation governing the operation of local governments and associated administrative policies, procedures and processes often include, or implicitly have, some of these principles embedded within them. The NSW Government provides a council rating and revenue-raising manual and asset management planning guidelines to assist councils. The SA Government and the local government association signed an agreement in 2006 to improve consultation arrangements in order to better coordinate services and infrastructure and promote accountable government and transparent processes. Some examples of current local government initiatives are provided in box 8.4.

Box 8.4 Local government sector initiatives

There are many examples of current reforms and initiatives in the local government sector that reflect one or more of the principles discussed in this chapter.

The Systemic Sustainability Study (SSS) Taskforce was established through WALGA to engage with the local government sector and industry on consideration and implementation of the recommendations made by the SSS panel. The recommendations, among other things, encompass a range of best-practice reforms including:

- promoting local government roles as representing their community's interests and ensuring effective and efficient delivery of services and infrastructure
- increasing the focus by government and industry on new models for efficient service delivery at regional and zone levels
- strengthening financial and planning disciplines using a best-practice approach
- promoting local governments' use of output-based reporting frameworks to clearly enumerate the cost and benefits of local government services
- developing guidelines for debt funding of infrastructure and whole-of-life costing of assets.

The Best Value Policy implemented by the Victorian Government incorporates principles which promote accountability and responsiveness, regular community consultation on performance and efficient service delivery. A framework is currently being developed to promote better local governance and address councillor conduct.

In most States, joint purchasing arrangements and knowledge sharing are accessible to local governments. A number of local government associations — NSW LGSA and LGAQ for example — have established procurement service companies to achieve cost savings for local government through bulk supply arrangements and assist in promoting best practice in the procurement process. LG Infrastructure Services Queensland, a joint initiative of LGAQ and the Queensland Treasury Corporation, provides assistance to local governments in evaluating and delivering infrastructure in a cost effective manner.

The local government associations in most States provide workers compensation and public liability insurance services to councils as well as services related to industrial and workplace relations and occupational health and safety.

Source: Various local government associations, LGV (2008).

Some of the principles are alluded to in the recent sustainability reports. The reports highlight a number of deficiencies in the operation of some local governments and have identified potential areas for improvement, such as:

- establishing long-term service plans setting out what councils will provide and how services are to be delivered and funded

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- establishing internal structures that provide for independent review of processes and decision making to assist councillors to meet their accountability to ratepayers and the community
 - improving council efficiency and effectiveness — mainly by reducing costs through increased scale, outsourcing, shared service provision, financial management and asset management, and by embedding spending and revenue decisions in a multi-year framework against a background of long-term financial rules
 - generating additional resources from revenue measures, operational cost savings, reordering of spending priorities, asset leases and increased borrowings.

There may be a need for further assistance and guidance for some local governments from the State Governments and/or the local government associations, beyond that which currently takes place. Some examples of how this might be achieved are provided in box 8.5.

Box 8.5 Assistance for local governments

The Local Government Managers Association developed the good practice toolkit to identify and build capacity within local governments by sharing expertise as well as to minimise risk. The toolkit is a web-based program available to all local authorities in New South Wales that acts as a potential single source for all information required by councillors and staff. It includes information relating to good practice processes and quality assurance, benchmarking and legal compliance.

The Local Government Association of the Northern Territory (LGANT) aims to promote best practice and improve the efficiency and responsiveness of local governments by providing a range of administrative and technical services to its member councils. These services are provided through individual contracts with member councils or under contract with the Australian Government and/or the NT Government. They include:

- financial management and reporting
- information and communications technology
- human resources services
- administration of transport and infrastructure contracts (including management of the Roads to Recovery Program and other Australian and NT Government programs)
- elected member and staff training (to support best practice in governance, legal responsibilities, ethics and conduct).

Source: LGANT (2006), LGMA (2008).

The effectiveness of applying revenue-raising principles and frameworks on a nationally consistent basis might be improved if advocated through a national peak body or representative group. One such group is the Local Government and Planning Ministers' Council (LGPMC) established by the Council of Australian Governments. The LGPMC have endorsed a series of nationally consistent frameworks for each of the State and Territory Governments to apply in the context of their relationships with their local government sectors. The frameworks provide guidance on:

- assessing local government financial sustainability
- asset planning and management
- financial planning and reporting.

The wider and more rigorous application of the principles outlined in this chapter offers councils a way to determine more effectively which services local communities really want and value, and how much they are prepared to pay for them. In this way, local governments can more effectively promote the well-being of their communities.

FINDING 8.1

The application of a set of principles to guide revenue-raising and expenditure decisions of councils can assist them in improving the well-being of their communities.

FINDING 8.2

There is scope to utilise further the existing institutional arrangements between Australian and State Governments, local government associations and local governments to promote best practice in all aspects of revenue and expenditure decisions by local governments.