ACCESS ECONOMICS Pty Limited

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A Review of the Productivity Commission's Draft Research Report on *Assessing Local Government Revenue Raising Capacity*

Report by Access Economics Pty Limited for the

Australian Local Government Association

and

Local Government Association of SA

TABLE OF CONTENTS

Executive summary **iii**

1. Introduction **1**

1.1 Areas of agreement 1

1.2 Structure of remainder of our review 4

2. Implications for individual councils **5**

2.1 The relative potential to raise revenue 5

2.2 Financial impacts of increased revenue raising 9

3. Role of the Commonwealth government **15**

3.1 Vertical fiscal imbalance issues 16

3.2 Horizontal fiscal equalisation issues 17

4. Role of State governments **19**

4.1 Overview of PC's findings 19

4.2 Assessment of PC's findings 20

Appendix **23**

References **25**

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EXECUTIVE SUMMARY

From Access Economics' perspective, the PC's draft report clearly establishes that many **councils in Australia have some scope, at least in theory, to increase their revenue raising.**

And we agree too with the PC that **councils have access to efficient forms of revenue raising**, namely property rates and (when properly applied) user charges and developer charges.

Where we think **the PC has tried and failed** is in assessing both:

- the extent of councils' **potential to raise additional revenue**
- and the extent to which **such additional revenue seems sufficient** by itself to ensure the financial sustainability of local government.

The PC has not addressed the extent to which existing levels of spending (and so presently-observed best-in-class revenue raising effort) reflect what the community is willing to pay for in the way of local government services and infrastructure.

And the PC takes **no account of** future spending pressures on councils, particularly on the **maintenance and renewal of ageing infrastructure**. (It's also a pity that the PC's terms of reference preclude an examination of the capacity of councils to borrow or otherwise fund capital spending, with the PC's analysis focused on operating spending.)

Even within these constraints, the PC has overstated the potential to raise additional revenue were all councils to match the effort of best-in-class councils. Inclusion of variability across councils and over time in **capital contributions** and in **interest and other investment income** are the main culprits. Were these distortive influences removed, we think that the potential additional revenue available to councils based on the PC's benchmarking exercise may be up to one-half of that suggested by the PC.

On top of this, the PC misstates the likely impact of any potential additional revenue upon the financial performance of councils.

First, the **PC's treatment of capital contributions as indistinguishable from revenue from property rates and user charges** may be fine where such capital revenue is relatively insignificant (as may be the case in the finances of the Commonwealth and State governments). But failure to distinguish between operating and capital revenue is not so easily justified in the case of local government with its asset-intensive activities especially in the roads and stormwater drainage areas. The exclusion of these revenue items from the PC's analysis may well change the picture.

Secondly, **without justification the PC's framework presumes general purpose grants have no particular role** and that self-sufficiency should be targeted. To the contrary, such grants are a reflection of vertical fiscal imbalance and serve to achieve some important equity goals.

In fact, the **PC seems to have 'pulled its punches'** with regard to the roles and responsibilities of the other spheres of government.

The PC's analysis – even in its overstated form – clearly shows that many **rural and remote councils** would not be financially sustainable even if they lifted their rates, fees and charges to levels equivalent to the highest effort councils. This makes a persuasive case for the Commonwealth to improve both the level and the distribution of general purpose grants. And the PC should say so.

The PC's survey of State government legislation and regulation also shows that – rate capping in NSW aside – most of the States' restrictions on council revenue raising have little practical effect. While this may be the case currently, it is by no means certain that it will necessarily remain the case. Also, the PC makes little of the costs imposed on councils and the economy generally by such inefficient and ineffective regulation.

The PC has articulated principles of revenue raising to be adopted by individual councils. What is missing is an equivalent set of **principles to be followed by State governments when it comes to the regulation** of local government's revenue raising conduct and performance.

If its analysis isn't widened, we think there is a danger that the PC's policy prescriptions for councils (and the lack of them for the other spheres of government) are unlikely to **create the incentives** necessary in future if councils are to be encouraged to pursue efficient and equitable revenue raising policies.

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1. INTRODUCTION

The Australian Local Government Association together with the Local Government Association of South Australia have asked Access Economics to comment on the Productivity Commission's recent draft research report entitled *Assessing Local Government Revenue Raising Capacity*, hereafter referred to as the "PC's draft report".[1]

The views expressed in this report are those of Access Economics and are not necessarily endorsed by the ALGA or its constituent associations or by the LGASA or its constituent councils.

Access Economics' views are based on its economic credentials supplemented by the experience it has derived over recent years in analysing local government finances.

We have restricted our review to chapters 4-6 and 8 of the PC's draft report. In particular, we have not looked at the issues raised in chapter 7 dealing with the distributional impact of local government rates and charges.[2]

1.1 AREAS OF AGREEMENT

Overall, we agree with many of the PC's findings. The fact that we challenge the interpretation that could be placed on some of the PC's findings should not detract from our support for the general tenor of much in the PC's draft report.

Fiscal capacity and revenue-raising effort

As to the issue at the heart of the PC's draft report, the PC has got it right that the aggregate income of a community is the main indicator of the community's ability to pay for government services. The higher the aggregate income of a community (ability to pay), the higher is the fiscal capacity of its local government.

As income is a more appropriate indicator of a council's fiscal capacity than the rateable value of land, we agree that the approach taken by the PC is superior in principle to the approach to defining and measuring fiscal capacity used by State Grants Commissions (SGCs).

Given the data sources available, we see no reason to quibble with the indicator used by the PC of each council's fiscal capacity, namely the sum of the disposable (after-tax) personal income and the imputed after-tax income of businesses within a council's boundaries.

We therefore consider the PC's resultant findings on fiscal capacity and revenue-raising effort to be most instructive:

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[1] Productivity Commission 2007, *Assessing Local Government Revenue Raising Capacity*, Draft Research Report, Canberra.

[2] This also means we have not addressed aspect of the "affordability" question. The Shand Report defined affordability as "...the ability to pay without serious economic difficulty. Ability to pay rates requires consideration of:

- the cost of rates relative to income and also relative to wealth, to the extent that wealth can be converted into income
- having sufficient income to pay for rates without crowding out other critical expenditure
- ratepayers earning greater income as a result of council investment in infrastructure and services." (Shand Report (2007), p.185)

- **Fiscal capacity**, as measured by after-tax income per person, differs across classes of councils. Capital city and urban developed councils have fiscal capacities above the national average. Urban fringe, urban regional and rural councils have fiscal capacities at about or just below the national average. Remote councils have the lowest fiscal capacity. (Finding 5.1)
- **Revenue-raising effort**, as measured by how much own-source revenue a council raises relative to its income base, varies significantly within and between classes of councils. This suggests that factors other than income and the class of councils are affecting observed revenue-raising efforts. Urban developed, urban fringe and urban regional councils have the lowest average revenue-raising effort. Capital cities have above average revenue-raising effort. Rural and remote councils exhibit the highest revenue-raising effort. (Finding 5.2)
- Council own-source revenue raised per person *increases* with income per person of the local community, the grants received per person, the number of people working in the area, the length of roads and the number of properties rated and served and *decreases* with population size. There are also differences between States. (Finding 5.3)

Principles for revenue raising

In chapter 8, the PC's draft report also encapsulates important principles to guide the revenue-raising decisions of councils, reinforcing recommendations of earlier studies.[3]

The wider and more rigorous application of the principles outlined by the PC offers councils a way to determine more effectively which services local communities really want or value and how much they are prepared to pay for them. In this way, councils can more effectively promote the well-being of their communities. Without doubt, implementation of these principles would improve council decision making, particularly in the context of effective revenue raising and financial sustainability.

In our experience, many councils apply some of these principles, but to varying degrees. The diversity observed goes beyond that justified by the diversity of goods and services provided by councils across Australia.

Rates

Work we have undertaken elsewhere confirms that property rates are a relatively efficient way to raise revenue to finance the provision of public goods and the subsidisation of government services which exhibit externalities, supporting similar views expressed in the PC's draft report.

Our efficiency rankings of alternative tax sources are based on the ratio of the percentage change in real consumption to the percentage change in tax revenue that is induced by changing each tax in turn. The ranking primarily reflects a combination of:

- the differences in the elasticity of supply and demand in the relevant markets; and
- whether the taxes fall on businesses or households. Those that directly affect business tend to be less efficient since:
  - they have a proportionally larger impact on export industries which face very elastic demand; and

[3] PwC (2006), SA Inquiry (2005), NSW Inquiry (2006), WA Inquiry (2006) and Access Economics (2007).

- they have second-round impacts through their effect on the cost of capital and, thus, investment decisions and the accumulation of capital.

The more efficient taxes are those that apply to markets with relatively less elastic supply and demand. This is especially true for land-based taxes (including property rates) which, in effect, fall on the rental price of immovable land. Empirical studies of markets for land find very low elasticities of demand and, especially, supply. Consequently, these are attractive markets from the perspective of efficient taxation arrangements since quantities are not very responsive to changes in price (or taxes) and thus the taxes involve relatively small distortions.

Therefore, property rates are an attractive method of financing any local public goods that cannot feasibly be financed using fees and charges because the cost of excluding non-paying users is generally prohibitive (for example, 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 monetary value of the positive externality.

Rates setting can include both a minimum charge and an *ad valorem* component. In this case, the minimum charge can reflect the fact that all users benefit from a particular service and the *ad valorem* component can vary according to ratepayers' ability to pay (based on property values).

Fees and charges

There is also no disputing the PC's view that fees and charges should be used as far as practical to raise revenue for the provision of those goods and services that are not pure public goods.

When properly applied, user charges ensure that goods and services provided by councils 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.

When properly applied, developer charges are consistent with both efficiency and equity objectives. Efficiency is promoted by forcing developers to internalise the cost of additional infrastructure that is caused by the development. If this were not done, excessive levels of development would be expected. A corollary is that if developer charges exceed the cost imposed on existing communities by new developments, development would be discouraged. Developer charges are also equitable, because they avoid some sections of the community (those already living in a location) subsidising others (new residents). There are however clear limits on the extent to which councils can and should use developer charges. Councils should ensure that they reach those limits, because doing so is efficient and equitable. But there is no economic rationale for exceeding them.[4]

[4] see Shand Report (2007), pp.152-153.

1.2 STRUCTURE OF REMAINDER OF OUR REVIEW

Our disagreements with the PC's findings relate to other issues.

Chapter 2 takes a closer look at the implications of the PC's empirical work for the future revenue raising effort of individual councils. These implications are not all they seem to be.

Chapter 3 takes a closer look at the implication of the PC's empirical work for the Commonwealth government. We find the PC's analysis provides further support for increased general purpose grants to local government, especially in relation to rural and remote councils.

Chapter 4 provides some thoughts on legislative and regulatory constraints currently imposed on council revenue raising by State governments. We find that the main omission in the PC's analysis in this area is the absence of detail regarding the appropriate framework for State governments in their regulation of local government.

2. IMPLICATIONS FOR INDIVIDUAL COUNCILS

The focus of this chapter is on the implications of the PC's key findings for councils themselves. The following two chapters look at the implications also for the Commonwealth and State governments.

The PC has first examined fiscal capacity and revenue-raising effort. As already explained, broadly we have no problems with these parts of the PC's analysis *per se*.

Rather, our concerns relate to the PC's subsequent findings regarding the scope for and impact of increased revenue raising by individual councils.

These concerns all relate to the interpretations likely to be placed on the PC's main finding, namely that most councils have the capacity to increase their own-source revenue in the order of about 10%. A number of unjustified interpretations are likely, notwithstanding the PC's qualifications that:

> *...this analysis 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.*
>
> *...[and] the purpose of such an analysis is not to suggest that councils should raise additional revenue. As pointed out later, in chapter 8, it is the responsibility of the council, and its local community, to choose the appropriate level of revenue to be raised. (p.75)*

Notwithstanding these qualifications, if left stated as bluntly as in the draft report, invariably the PC's findings will be interpreted as implying that both:

- councils should consider increasing their own-source revenue effort by at least 10%
- and, if a council chooses not to do so, then its resultant financial performance is its own responsibility.

2.1 THE RELATIVE POTENTIAL TO RAISE REVENUE

Having quantified each council's fiscal capacity and revenue-raising effort, the PC turns to investigating the potential for individual councils to raise additional revenue.

In doing so, the PC has not addressed first order issues such as what the community wants a council to provide in the way of services and infrastructure, which may be higher or lower than the current level of provision. This gives rise to questions about whether institutional arrangements and political considerations lead to outcomes that fully reflect community preferences, and a range of other 'willingness to pay' questions.[5]

[5] "Ratepayer concerns may often reflect unwillingness, rather than inability, to pay based on dissatisfaction with perceived value for money from rates. ... Dissatisfaction with council decision making and lack of willingness to pay also appears to be linked to public dissatisfaction with consultation undertaken by local authorities." (Shand Report (2007), p.187)

Rather, for purposes of its analysis, the PC has limited itself to asking a more restricted question involving the extent to which councils have the capacity to finance their **existing** levels of spending.

Moreover, in part because of the prohibition in its terms of reference against looking at local government's capacity to borrow, the PC has also restricted itself to analysing the capacity of councils to finance their existing levels of **operating** spending. This excludes the question of (future) capital spending on infrastructure, and the associated issue as to whether any forthcoming surge in renewal/replacement requirements is within a council's existing revenue raising capacity.

PC's methodology and key findings

Based on existing levels of service, the PC has first undertaken what is in effect a benchmarking analysis of the relative potential to raise revenue. The PC has applied a technique known as **statistical frontier analysis**, which enables the determination of the relative potential for each council to raise additional revenue after controlling for explicitly identified factors influencing revenue raised per person and random variations across councils. In this way, the revenue raised by councils with similar attributes can be compared.

The PC's Table 5.4 (reproduced in part below) presents the results of its stochastic frontier regression analysis.

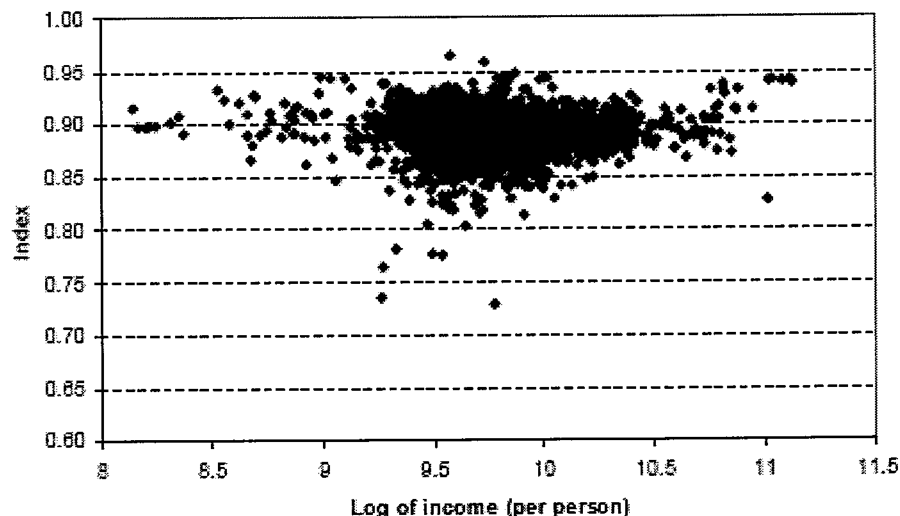
Independent variables	Model 1: Dependent variable is log of own-source revenue per person
Log of income per person	0.379[b]
Log of grants per person	0.182[b]
Log of residential population	-0.401[b]
Log of people employed in area	0.243[b]
Log of share of population Indigenous	0.003[b]
Log of roads	0.031[b]
Log of properties	0.083[b]
Water (categorical variable)	0.286[b]
New South Wales	0.064[b]
Queensland	..
South Australia	-0.222[b]
Western Australia	0.104[b]
Tasmania	..
Northern Territory	-0.445[b]
Constant[a]	3.100[b]
Number of observations	2,886

a The reference State captured in the constant term is Victoria.
b Significant at less than the 0.1% level.
.. Not significant at 10% level or below.

This statistical analysis of the factors influencing the revenue actually raised by different councils is used to predict the revenue that a council would raise, given its values for the variables specified in the regression equation and the estimated parameters. In this way, the PC derives indices of the *potential* to raise additional revenue. Typically, the relative potential index for an individual council is less than unity. For example, if a council has an index of 0.8, it is raising 80% of the revenue that it could potentially raise as assessed against its hypothetical benchmark. If, after allowing for these factors, a council raises less revenue than the hypothetical benchmark, this indicates that there is potential for a council to raise additional revenue.

The estimated indices of the relative potential to raise additional own-source revenue are shown in the PC's Figure 5.2 (reproduced below). Most councils have indices above 0.85. There are a few with relatively lower values, between 0.7 and 0.8. Significantly, as fiscal capacity (measured by per person income) increases, the PC has found that the average index appears to remain fairly constant.

Figure 5.2 **Estimates of the relative potential to increase own-source revenue, by income**
2000-01 to 2004-05



Based upon these indices, the PC finds that:[6]

> *On average, councils are raising almost 90 per cent of their potential, as defined in this analysis. That is, the average potential to raise additional own-source revenue appears to be in the order of about 10 per cent.. (p.77)*

The PC has therefore concluded that most councils have some capacity to increase their own-source revenue, with its indicative estimate being that, across Australia, own-source revenue could be raised by about 10% or by an average of about $167 per person.

Assessment of PC's analysis

It seems to us that the potential to raise additional revenue is in fact overstated by the PC.

Generally, we have no problem with the use of statistical frontier analysis to benchmark a council's revenue-raising effort. In fact, we acknowledge this approach is superior to the approach we applied in some of the sustainability studies which made only crude attempts to standardise for differences in characteristics and which generally applied below best-in-class revenue effort standards. By contrast, the PC's procedure is much more rigorous in taking into account the factors that may explain council revenue raising as well as other random influences, so ensuring that the revenue effort of councils with similar characteristics are being

[6] The PC also presented these results in terms of the average potential to raise additional *total* revenue per person (i.e., including grants). Although the effect of an increase in own-source revenue on total revenue is on average about 9% across Australia, it varies across classes of councils because the share of own-source revenue in total revenue differs across classes of councils.

compared. Moreover, the benchmarking is against best-in-class revenue effort, rather than average effort or minimum top quartile effort.

Nor do our criticisms relate to limitations in the data. We recognise that:

> *...the results should be interpreted as preliminary and merely indicative. The Commission will continue to work on issues relating to data and statistical analyses for the preparation of the final report. (p.61)*

Rather, we question some aspects of the PC's *application* of the frontier analysis. Our concerns are evidenced by the resultant finding that no council is on the revenue raising effort frontier. We think this is evidence that the PC's finding that councils possess a capacity to increase their own-source revenue by 10% may be overstated.

That none of the benchmarked entities end up on the frontier being measured – and all fall inside that frontier – can be regarded as an unexpected result of any frontier analysis. But this is the result thrown up by the PC's analysis.

All benchmarking exercises, however sophisticated, are based on targeting behaviour or performance exhibited by *observed* best-in-class behaviour or performance. They do not involve establishing standards that are in excess of any entity in the frontier-establishing sample of entities.

Technically, the PC's result where no council is observed to be at the effort frontier, that is with an index (in the PC's Figure 5.2) at or near 1.0, is most likely explained by individual councils being at the effort frontier in particular years only, but with none staying at the frontier for all four years involved (2000-01 to 2004-05) in the data set used in the PC's analysis.

The PC's result therefore indicates that some important explanatory variables may be missing.

The most likely explanation seems to be that the PC's result reflects inclusion in the effort calculation of revenue elements that are volatile for reasons not included in the PC's regression equation. This is the case in particular with regard to contributions revenue (both operating and capital). Year-on-year variations in contributions revenue do not necessarily reflect variations in council revenue raising effort, but the activity levels of other governments and developers in the years in question.

In addition, variability in interest revenue and perhaps other investment income generated by a council's holdings of financial assets and equity investments occurs mainly for reasons outside the control of councils (e.g., interest rate movements and changes in returns on other investments).[7]

Variations in these revenue items are unlikely to be explained by the factors included in the PC's regression equation.

To overcome these problems, we think the estimation of the revenue raising effort frontier needs to be undertaken in terms only of those elements of each council's own-purpose revenue that are predictable from year to year, and not volatile (which would exclude operating contributions and reimbursements, capital contributions and interest and other investment income). Specifically, what is perhaps required is a Model 3, sitting between the PC's existing

[7] Also at issue is the likelihood that high or increasing interest revenue reflects inefficient or surplus holdings of cash and investments rather than superior or best-practice revenue raising effort.

Models 1 and 2, with this new model including revenue from sales of goods and services as well as rates but excluding other revenue.

Also important could be the addition of other explanatory variables that have been shown by our studies to also be important in accounting for differences in council financial performance, notably growth differentials as measured by growth in population or property numbers.

Until these considerations are taken into account, it is possible that councils with effort indices at around 0.95 are practically on the effort frontier. This means that such councils do not have the capacity to increase their revenue raising. Furthermore, those councils that display effort indices of less than 0.95 may have the capacity to increase their own-source revenue on average by somewhat less than 10%.

2.2 FINANCIAL IMPACTS OF INCREASED REVENUE RAISING

PC's methodology and key findings

The PC has also chosen to simulate the impact of raising additional revenue on council financial performance. Specifically, the PC considered the impact of the increase in own-source revenue (required to emulate the own-source revenue raised by similar councils) on each council's **aggregate cost recovery.**

Using ABS government finance statistics (GFS), the PC has chosen to measure aggregate cost recovery by own-source revenue (total revenue *less* grants) divided by total expenditure.

The PC finds that most councils have aggregate cost recovery ratios of less than unity, and some much less. On average for councils across Australia between 2000-01 and 2004-05, the PC has found that own-source revenue recovered 84% of total expenditure. Typically, capital city, urban developed, urban fringe and urban regional councils have a higher than average cost recovery. Aggregate cost recovery is lowest among rural and remote councils.

Of most significance, the PC finds that aggregate cost recovery across all councils could potentially increase from 84% to 94% of total expenditure, assuming no matching increase in expenditure.[8]

> *For urban councils, a modest increase in own-source revenues substantially improves their cost recovery, making many councils financially independent (based on current levels of expenditure). For rural and remote councils the situation is different. The increase in own-source revenue would increase their already relatively high levels of revenue-raising effort. But since many rural and remote councils experience relatively high expenditures in per person terms, any increase in own-source revenues would still leave them substantially dependent on grants, at current levels of expenditure. (pp.82-83)*

Assessment of PC's analysis

We have two related concerns about this aspect of the PC's analysis. In summary, they involve us challenging both:

- the validity or usefulness of the 'aggregate' cost recovery indicator used by the PC
- the assumption that financial 'self-sufficiency' is necessarily desirable for all councils.

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[8] This is the mean result for councils expressed on a population unweighted basis. When adjusted for population differences, the mean aggregate cost recovery ratio is shown to increase from 98% to 109%.

Measuring degree of "cost recovery"

Overall, we think that the PC's analysis could be made much more pertinent if it adopted a measure of cost recovery in which:

- the numerator included relevant grants revenue as well as appropriate own-source revenue
- the denominator included only those expenditures intended to be funded by the revenues included in the numerator.

Measured on this basis, the target cost recovery ratio would indeed be a ratio of around 100% and the significance of the potential to raise additional revenue could be meaningfully assessed.

However, the PC's measure of "aggregate cost recovery" – own-source revenue (total revenue *less* grants) divided by total expenditure – is not particularly helpful.

Assuming that "total expenditure" for this purpose refers to total expenses (see Box 1), we are not concerned about the focus on operating expenditure. We think this inevitable when it comes to assessing current fiscal capacities. Distinguishing between current and capital spending, and between the financing of current spending through rates (the 'tax price' paid by current ratepayers) and the financing of capital spending through debt (to be serviced by tax prices paid by future ratepayers) is most important.[9]

Box 1: "Expenditure" or "Expenses"?

While most of the PC's explanations are in terms of "expenditure", we assume it means "expenses".

Expenses are explicitly referred to only in footnote (a) of Table 5.9. In all other similar tables and throughout the draft report's text, the reference is to "expenditure".

Expenditure can include capital expenditure as well as operating expenditure. Given the scope of the PC's analysis, inclusion of capital expenditure would not be appropriate.

While the final report could more carefully clarify this point, there are indirect indications in the draft report that capital expenditure is not included.

For example:

"The revenue raised by councils is driven by the need to fund expenditures (including depreciation), after netting out grants from other tiers of government." (p.42)

"Rural and remote councils have higher expenditure per person compared with urban councils. This is largely explained by ... rural and remote councils ... maintaining more kilometres of roads per person ...". (p.44)

Depreciation and maintenance are important asset-related expenses.

Nor do we question the exclusion from revenue of changes to balance sheet items that do not result from a transaction (e.g., revaluations which arise from price movements, including exchange rate and interest rate movements) or of the net proceeds of asset sales.

[9] As a general principle, operating expenses inclusive of a fair measure of annual depreciation represent the spending on outputs the consumption of which give rise to benefits derived wholly in the current period. Capital spending results in benefits beyond the current period. When the operating surplus appropriately measured is positive, own-source operating revenue (and associated grants) is more than sufficient to finance current operations. When the operating surplus is negative (indicating an operating deficit), own-source operating revenue (and associated grants) is insufficient to finance current operations.

But we do not consider that the PC – following the ABS – is using the appropriate treatment of capital grants and contributions.

In effect, the PC's aggregate cost recovery ratio can be shown to be equivalent to:

1 + a council's "net operating surplus/(deficit)" expressed as a % of its total expenses.

The **net operating surplus/(deficit)** concept being used here is an operating surplus/(deficit) measured *after* capital grants and contributions ("capital transfers" for short). A net operating deficit indicates that a shortfall has been incurred on current operations and that it is necessary to liquidate assets, incur liabilities or increase equity in order to finance those operations.

In the GFS system, capital transfers are classified as revenue because:

- they increase net worth
- and they are indistinguishable from current transfers in their effect on government operations and similar capital grants and subsidies from other governments.[10]

However, we regard the **operating surplus/(deficit) measure *before* capital transfers** to be the key analytical balance in relation to a council's annual operating financial performance. In contrast to the net operating surplus (and as explained below), the operating surplus/(deficit) measure *before* capital transfers:

- measures a council's annual net saving
- and recognises the distinctive role played by capital/developer contributions.

The ABS's net operating surplus concept is equal in concept to the national accounting balance of net saving *plus* capital transfers. Therefore, when measured *before* taking account of capital transfers, an operating surplus/(deficit) is equivalent to the 'net saving' aggregate in the National Accounts. Net dis-saving (i.e., when net saving is negative) indicates the portion of a council's costs incurred in the year in question that is being transferred to tomorrow's ratepayers rather than being met by today's ratepayers. Hence, the surplus/(deficit) measured *before* capital transfers sheds direct light on inter-generational equity considerations crucial for determining appropriate taxation levels.[11]

In the asset-intensive context of local government, and to ensure that developer contributions are efficiently and equitably applied, it is essential that capital/developer contributions are not regarded as substitutes for rates (tax) revenue. Local government is much more asset-intensive than the other spheres of government, so this issue is more important. Councils in Australia are responsible for the management of non-financial assets and infrastructure with an estimated current replacement value in excess of $300 billion, which is around 20% of all assets held by the non-financial public sector in Australia. This compares with the local government's share of operating spending (GFS expenses) in the non-financial public sector in Australia of around 5%.

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10 ABS, *Australian System of Government Finance Statistics: Concepts, Sources and Methods*, Chapter 2: Australian GFS framework, October 2003

11 Intergenerational equity is achieved when ratepayers today do not bear a disproportionate share of expenditure that benefits future generations and vice versa.

On this basis, it would be more informative if the PC used a cost recovery ratio measured using revenue *excluding* not only (relevant[12]) capital grants but also any capital contributions.

That is, it would be better if the PC used the following measure of cost recovery:

1 + a council's "operating surplus/(deficit) *before* capital transfers" expressed as a % of its total expenses.

In fact, the PC gives inadequate consideration to the appropriate temporal allocation of revenues and costs. The closest the PC comes to this issue is in its revenue principles, where it correctly states that:

> *A key responsibility for councils is to conduct the business of local government in a financially sustainable manner. That is, the aggregate 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. (p.147)*

The PC recognises that for this purpose the **aggregate cost** to councils generally includes:

- operating expenses — such as labour, energy, materials, purchased services (including contracted-out services)
- depreciation on all long-lived assets — such as roads, buildings, pavements, bridges, water supply and drainage assets
- and, where councils undertake commercial operations, taxes paid to other spheres of government and the return required 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.

Is self-sufficiency an appropriate target?

The PC's conceptual framework also seems to presuppose that grants do not have any necessary role in local government.

Is the absence of inter-governmental grants an efficient or equitable outcome?

The desirability of ensuring that sub-national spheres of government face a hard budget constraint does not preclude the national government providing financial support for activities carried out by those other governments.

In Australia, the reasons for the system of inter-governmental grants are two-fold:

- to offset the imbalance which exists between the revenue raising and expenditure responsibilities of the different spheres of government, with the *level* of general purpose grants aimed at offsetting what is known as **vertical fiscal imbalance** (VFI)
- to enable the pursuit of certain **equity** goals, with the *distribution* of general purpose grants serving explicit redistribution goals.

Among the three spheres of governments in Australia (Commonwealth, State and local government), each has its own revenue raising powers and expenditure responsibilities.

[12] We also advocate the treating of "capital" grants for renewals/replacement/rehabilitation purposes on an above-the-line basis, to the extent that such grants are intended to relieve ratepayers from fully funding depreciation. In the Australian context, such a split in capital grants data is only reported by SA councils.

The following Table compares the proportion of taxes collected at the different spheres of government in 2005-06 (the latest year for which full year actual data is available) and each sphere's proportion of tax-funded[13] own-purpose[14] expenses.

Taxes Raised and Spent, by Sphere of Government, 2005-06

Sphere of government:	% of total taxation raised (A)	% of total tax-funded own-purpose expenses (B)	Degree of VFI (= A/B)
Commonwealth	82.2%	59.8%	1.37
State	14.8%	36.2%	0.41
Local	3.0%	3.9%	0.76
TOTAL	**100.0%**	**100.0%**	

Source: Australian Bureau of Statistics, Cat No 5512.0; Commonwealth Budget Paper No. 3: Federal Financial Relations 2007-08

This Table confirms that:

- the Commonwealth's tax revenue exceeds (by about one-third) its tax-funded own-purpose expenses; and
- the State and local governments' tax-funded own-purpose expenses exceed (roughly doubles) their tax revenues.

The States and local government require additional revenue if they are to fulfil their functions. Fundamentally, mismatches between taxation collected centrally at the Commonwealth level and the Commonwealth's own spending responsibilities require the Commonwealth to provide (and preferably make room for) the States and local government with either:

- new revenue-raising powers; and/or failing that
- financial assistance in the form of **general purpose grants**.

Ideally, each sphere of government should finance its assigned functions with funds that it raises itself (the principle of 'fiscal equivalence').

However, there is a tension here with broader economic efficiency considerations which require:

- the national government to levy taxes:
  - on highly-mobile tax bases (to help avoid businesses and families moving between localities due to tax considerations)
  - on tax bases which are very uneven across localities so as to ensure fairness
  - on tax bases with cross-border externalities (such as pollution or greenhouse taxes or user charges for water rights)
- in contrast, sub-national governments to levy taxes on immobile tax bases.

Moreover, there are potentially significant economies of scale available in centralising tax collection. These arise not only from economies in tax administration, but also because, for example, the potential evasion and avoidance associated with mobility of tax bases when

[13] Tax-funded expenses are total expenses of the general government sector excluding expenses funded from non-tax sources (e.g. user charges, interest income). As such, tax-funded expenses are expenses funded by either own-source taxes or grants from other spheres of government.

[14] Own-purpose expenses of a particular sphere of government are the total expenses of that sphere excluding the grants it pays to the other spheres of government.

taxes are imposed and administered at lower spheres of government is reduced. This suggests that sub-national governments should delegate tax collection on their behalf to the national government.

In addition, when tax collection is centralised, there is also a tendency for sub-national governments to harmonise the requirements they place on businesses and families – that is, they agree to common definitions, common collection dates, and common reporting requirements. These all have the benefit of reducing the cost of compliance.

In brief then, the State and local spheres of government should have access to all tax bases that are not mobile or unevenly distributed or for which there are not significant economies of scale available in centralising tax collection, to the extent warranted by their own spending responsibilities.

The above discussion is a reminder that the longstanding consensus among economists in Australia is that it makes sense for most taxes to be raised at the Commonwealth sphere of government, with general purpose grants making up the gap arising because State and local spheres of government have responsibilities which invariably see them spend more than they tax.

Once a system of general purpose grants is in place to offset VFI, it also provides the basis for pursuing distributional (or equity) objectives. The distribution of general purpose grants seeks to affect the horizontal distribution of income, i.e., contribute to all Australians in similar economic circumstances being treated in a similar way. While in principle the concern is with the equitable treatment of individuals across localities, for practical reasons what is equalised are the capacities of sub-national governments.

For these various reasons, general purpose grants from other spheres of government, particularly the Commonwealth, have an important role to play in funding council expenditures in addition to own source revenue.

The PC should therefore consider changing the measurement of its cost recovery index to somehow include grants. Either they could be included in the measurement of the numerator of the cost recovery index or they could be netted off total expenses in the denominator. Either way, taking general purpose grants into account when assessing any impacts upon council financial performance would avoid the misconception that self-sufficiency is necessarily a valid fiscal target in its own right for councils. Rather, councils should be encouraged to target an operating surplus after taking into account relevant (operating) grants but before any capital transfers.

3. ROLE OF THE COMMONWEALTH GOVERNMENT

This chapter briefly considers the role to be played by increased general purpose funding particularly to rural and remote councils.

The PC's Table 2.3 (reproduced in part below) provided estimates of the level of all grants received by local government.

Grants[a] to local government from Commonwealth and State governments, 2004-05

Type of grant	NSW	Vic	Qld	SA	WA	Tas	NT	Total
General purpose grants ($M)	358	263	205	82	105	26	11	1,050
Identified local road grants[b] ($M)	137	98	89	26	72	25	11	458
SPP direct grants ($M)	90	78	54	22	43	10	7	305
State government grants ($M)	471	547	371	75	203	40	125	1,831
Total ($M)	**1,056**	**986**	**719**	**205**	**423**	**101**	**154**	**3,644**
Commonwealth grants per person ($/head)	87	88	89	84	110	127	146	91
State grants per person ($/head)	70	110	94	49	102	82	621	92

[a] includes current and capital grants [b] includes supplementary local government road funding for SA of $4 million

We recognise that these figures, notably as they relate to grants from State governments, may be subject to some error. In our own work in local government, we have confronted different reporting practices across the States. Different sources of such information have also proved difficult to reconcile. This is something which the States (and the Commonwealth) need to address.

Significant findings by the PC regarding the level and distribution of general purpose grants include:

> *Even if councils were to increase their own-source revenue by an average of about 10 per cent, a significant number of local governments, particularly rural (73 per cent) and remote (91 per cent), would remain dependent on grants from other levels of government to meet their current expenditure. (p.xxxv)*
>
> *...an increase in Australian and State government grants is correlated with an increase in own-source revenue. This might be due to an incentive for local governments to spend more than the grant amount of local government services. Alternatively, grants might be allocated to local governments that have higher expenditures and revenue requirements. (p.212)*
>
> *...The application of horizontal equalisation leads to larger general purpose grants per person for councils with relatively smaller rates bases and disadvantages in terms of the relative cost of*

delivering services. However, the total general purpose grants pool in each State is not sufficient to achieve full fiscal equalisation. (p.22)

These findings point to important limitations in the existing level and distribution of general purpose grants. It seems to us that the PC has 'pulled its punches' in this regard, by failing to draw out such implications for the Commonwealth government.

3.1 VERTICAL FISCAL IMBALANCE ISSUES

When introduced in 1974-75, Commonwealth funding of local government was an applications-based program. In 1976, income tax sharing arrangements were introduced. In 1985-86, tax sharing was replaced with the level of funding being capped and only allowed to increase by 2% more than inflation for that year. Funding was then maintained in real terms through to 1989-90.

In 1991-92, previously tied Commonwealth local road grants became untied and were paid to councils as an identified local road grants component of general purpose grants. Until 1993-94, general purpose grants continued to be maintained in real terms.

Apart from a reduction in 1996-97 associated with a budgetary savings exercise, general purpose grants to local government have been maintained in real *per capita* terms since then, rising annually in line with an escalation factor taking into account changes in population as well as inflation, as determined annually by the Commonwealth Treasurer. This reflects an escalation arrangement similar to that adopted for the States until State financial assistance grants were replaced by GST payments in 2000-01.[15]

In the long-term, our modelling has shown that a CPI-based real per capita escalator (combining CPI and population increases) will fail to keep pace with the national tax take let alone annual growth in nominal GDP.[16]

In principle, and *other things being equal*, general purpose grants paid to each sphere of government in Australia whose own-source revenues fall short of its own-purpose expenses should escalate in line with the national tax take *if* VFI is to remain fully offset. In practice, such a formulation would involve some circularity. For this reason, basing escalation arrangements on Commonwealth tax collections may be the best practical alternative.

Other things are not likely to be equal over time, however. In fact, any escalation factor applying to general purpose grants to local government based on the growth path of Commonwealth tax collections would need to be adjusted (up or down as the case may be) from time to time for both:

- any differences over time in the relative rates of growth of Commonwealth tax collections on the one hand and State and local tax collections (and so national tax collections) on the other; and
- any differences over time in the relative rates of growth of local sector expenses on the one hand and Commonwealth and State expenses on the other.

The first adjustment most likely would justify an escalation factor greater than the growth path of Commonwealth tax collections, because of the lower income elasticity of property rates compared with income and consumption taxes.

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[15] CGC (2001), pp.48-52.

[16] Access Economics (2004).

By contrast, the second adjustment could call for an escalation factor lower than the growth path of Commonwealth tax collections to the extent that the ageing of the population in prospect (for one) is likely to impact more on the types of services funded by the Commonwealth and the States (e.g., health) than local government. Offsetting this could be the increasing infrastructure maintenance and replacement challenge facing local government over the medium to long term.

3.2 HORIZONTAL FISCAL EQUALISATION ISSUES

The allocation of general purpose grants from the Commonwealth is influenced by **horizontal fiscal equalisation** (HFE) principles. HFE is about providing each government *within the same sphere of government* with the same financial capacity to provide services as every other government *within that sphere of government*.

The **interstate distribution** of general purpose grants has been a contentious issue for some time, with doubts existing that the *equal per capita* interstate allocation achieves HFE between each of the States' local government sectors. It presupposes, for example, that the distribution of rural and remote councils is broadly similar across States.

Also, as the PC has noted, the **intrastate allocation** of the general purpose grants prevents achievement of HFE between councils *within* each of the States' local government sectors.

Overall, the difficulty that many councils – especially rural and remote councils – would still face in recovering their costs even after lifting their revenue raising effort to best-in-class levels (as evidenced even after the PC's inclusion of capital revenue and its use of the aggregate cost recovery ratio) is *direct evidence* of inadequacies in the existing level and distribution of general purpose grants.

The relevant Commonwealth legislation itself recognises that full HFE is not being sought within each State, and that the Commonwealth's intentions in providing assistance under this purpose are to reduce but not eliminate the disadvantage faced by some councils.[17]

Because general purpose grants currently are not designed to provide sufficient assistance to meet all of the assessed needs of the disadvantaged councils, SGCs distribute the limited assistance available among the disadvantaged councils in their State by scaling back their equalisation assessments.[18]

Compounding this problem is the existing minimum grants requirement that each council must receive at least the amount it would have received if 30% of the funds made available to the State were distributed on a per capita basis. Minimum grants prevent full HFE being achieved because they:

- give some councils more assistance than HFE would warrant, thereby placing them in an above average financial position; and
- reduce the assistance available for HFE purposes, so that disadvantaged councils receive less assistance than HFE would warrant.[19]

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[17] CGC (2001), pp.15,18.

[18] Termed 'factoring down' by SGCs.

[19] The Hawker Committee (2003) concluded that "... the minimum grants should be abolished in line with equalisation principles but phased out over a period of three years. (Recommendation 16)." (para 6.94)

Having no minimum grant would not, however, be the same as a 'full' HFE outcome as this would require taking revenue from councils with a negative equalisation assessment and sharing it among the remaining councils. Such inter-council transfers are not feasible.

Hence eliminating the minimum grants component of the existing general purpose arrangement would not be sufficient.

If rural and remote councils in particular are to become financially sustainable, also required is a measured *increase* in the size of the general purpose grants pool so that revenue shortfalls experienced by these councils – even after they lift their revenue raising effort to best-of-group levels – can be addressed.

Without much needed improvement in arrangements regarding the level and distribution of general purpose grants to local government, rural and remote ratepayers are looking at tax burdens well in excess of their urban counterparts. Not only is this is contrary to notions of the equal treatment of equals (horizontal equity), it could be adding to the inequality in the distribution of income among individuals and households (vertical equity).

4. ROLE OF STATE GOVERNMENTS

This chapter looks in brief at the PC's analysis (in its chapter 6) of State government legislative and regulatory constraints on the level and structure of rates, fees, charges and contributions. The various State government restrictions on rating levels, structures, exemptions and concessions can have both economic efficiency and distributional effects.

4.1 OVERVIEW OF PC's FINDINGS

Constraints on rates

Property rates are the only tax instrument, and discretionary source of general revenue, available to councils.

Council rates often include a fixed minimum charge, which may be levied in addition to an *ad valorem* component. Rates may consist of general rates, separate or special rates.

In general terms, the PC's findings are as follows:

- State legislation has little effect on councils' ability to raise sufficient rates revenue to finance appropriately local government provision of public goods and services, with the flexibility of **differential rates and rating structures** providing councils with considerable ability to influence the distribution of the rates burden among ratepayers.
- **Rates exemptions** do not necessarily constrain aggregate revenue.
- Where **rates concessions** are not fully reimbursed, revenue forgone may be able to be offset by implementing rates increases for other ratepayers albeit with distributional impacts on the remaining rateable properties.
- **Rate pegging**, which refers to State government restrictions on the annual percentage increase in rates revenue, has dampened the revenue raised from rates in New South Wales relative to other States and there seems to have been little offset from non-rates revenue sources.
- *"...the overall impact on revenue raising of State government legislative and regulatory requirements is minimal in most jurisdictions because of the considerable flexibility in rating regimes and, to some extent, other offsets. Most constraints can be mitigated, at least to some extent, because they are either avoided or other types of revenue are raised." (p. 106)*

Constraints on fees and charges

In general terms, the PC's findings are as follows:

- While **fee and charge setting restrictions** operating in most jurisdictions can result in partial cost recovery, these do not appear to be a major constraint on revenue raising, both on fees and charges revenue and total revenue.
- The **capping of permit and licence fees** set by State governments can be ameliorated by generally liberal arrangements for setting other fees and charges, and rates, in most jurisdictions.

Constraints on developer contributions

Developer contributions involve either property developers being levied up-front for the cost of providing a service or infrastructure or developers otherwise being required either to construct infrastructure and transfer it to local government upon completion and/or to donate land to local government for facilities such as public open space and roads.

In general terms, the PC's findings are as follows:

- Councils in **some States do not have the authority** under State legislation to require developer contributions for some facilities.
- Unless prevented by legislation, **voluntary arrangements** could be made.
- Where this is the case, it suggests that **regulation of developer charges and contributions** is not a constraint on revenue-raising capacity to meet specific expenditure needs.
- The developer contributions component of local government revenue has grown considerably in recent times in most States.

4.2 ASSESSMENT OF PC's FINDINGS

While the PC's findings in this area individually are relatively uncontroversial, they risk missing the forest for the trees. They lack an overarching perspective.

Understatement of inefficiencies arising from current State regulation

The PC has documented a significant amount of State government legislation and regulation imposing or implying limits on the revenue raising of councils. The amount and extent of such limits varies significantly across the States.

The PC seems relatively relaxed about the legislative and regulatory limits in place. Nevertheless, as with all regulation, it comes at a cost to the community. At the very least, the PC should be advocating that such regulation be subject to the same periodic review as government regulation of the private sector.

Moreover, increased regulation is a constant threat to local government. For example, a cap on rates based on the Consumer Price Index (CPI) is always a possibility. Rate pegging has only recently been introduced in the Northern Territory. The PC should be guided by the Shand Report in NZ which, in the context of much higher recent annual increases in council rates & charges, concluded that introduction of rate capping (even self imposed rather than via regulation) was not supportable because it was:

> *...too blunt and intrusive an instrument to achieve restraint given the wide variety of financial situations and expenditure needs of different councils. It is difficult to define with precision, and is therefore capable of manipulation. ...Rather, the Panel considers all councils should be required to adopt clear and honestly measured financial targets, which would be reflected in [long-term business plans] and a three-year indicative budget. These targets would cover proposed increases in operating expenditures as well as rates. (Shand Report (2007), p.3)*

More generally, the PC would be remiss if it fails to recommend that any new types of regulation of local government revenue raising which are proposed in future by State governments be subject to the usual cost-benefit assessments.

Failure to identify regulatory principles

The PC's survey has found in effect that much current State regulation of local government is neither efficient nor effective.

Given these circumstances, and just as it has done for councils in the area of revenue raising, the PC has the opportunity to set out some principles to be observed by State government regulation of local government.

These principles could be based on the relatively fertile recent experience in New Zealand, where central government oversight of councils basically aims at empowering councils and in return puts in place associated consultation and accountability instruments.

In Australia, a coordinated national approach could be pursued through the Local Government Ministerial Council operating under the Council of Australian Governments.

In place of the raft of piecemeal – and generally inefficient and/or ineffective – regulatory arrangements currently in place, best practice would see State governments instead focussing first on making **legislative provision for community involvement in council decision making**, with the aim of enabling democratic local decision-making and action by, and on behalf of, communities. Communities can be better involved in decision making via the mandatory public notification of the release of defined proposals, such as a draft policy or a proposed annual plan or long-term business plan. Such proposals should be made publicly available, a set minimum period should be allowed for interested parties to make written submissions, and councillors should be required to deliberate publicly on such written submissions.

In this way, State legislation should focus in the main on improving the quality of decision making by councils. As shown in NZ, however, care is needed to avoid such statutory provisions being excessively detailed, complex and potentially confusing for the various parties involved (citizens, other stakeholders, and councils).

In addition, State legislation should concentrate on putting in place **mechanisms which ensure that councillors demonstrate accountability to ratepayers and the community**. Mechanisms recently canvassed in NZ could be considered. In the Australian context, this would involve a State government's regulation of local government (and its enable legislation) also making clear provisions for the following:

- The use of standardised policy templates and guidance for implementation, aimed at addressing poor understanding about the role of local government, its financial decision making, its funding mechanisms, the opportunities for public participation, and the accountability arrangements.
- Clear requirements for the long-term financial and asset management planning processes.
- Consistent and comparable reporting on proposed levels of rates and rate increases, to be achieved by way of a template, developed by local government in consultation with other stakeholders and to be operated as a guide to best practice. This template could set out:
  - total rates and individual components (general rates, special rates, user charges, and council-controlled fees and annual charges)
  - the real change in rates (that is, adjusted for inflation as measured by the State capital CPI)

  - the adjustment for increases in the number of rateable properties and other growth factors
  - the relative amounts and average rate borne by residential, business and rural ratepayers and how this has changed from the previous year.

  This would enable ratepayers and the community to better understand the rating system and the expenditures behind their rate payments, to assess the changes that are occurring in their council's rates, and to make comparisons with other councils.

- Consistency and clarity in rates assessment notices, with annual notices required to set out, for each ratepayer, how much will be allocated for particular activities or services. It should be clearly broken down into contributions to capital expenditures and operating expenditure. It could also incorporate the information on overall rating levels and rate increases set out above.
- The requirement that explicit and clear medium-term financial targets be developed and published by each council, with councils being required to adopt clear and honestly measured financial targets, covering at least the medium-term budgetary period. These targets should encompass changes in operating expenditures, as well as the level of rates and some measure of the level of debt in relation to assets. These should be developed as a best practice statement or template by local government in consultation with other stakeholders. Their achievement or otherwise should also be reported on in the audit report on the financial statements.
- Consistent and comparable annual reporting on performance, including benchmarking, based on a reporting template that meets the dual purpose of reporting on the funding of both operating and capital expenditures and which clarifies the relationship between accounting and funding issues.
- Monitoring and review of the overall performance of each council by the State department or office responsible for local government policy. Currently, however, these departments or offices generally lack adequate resources or capacity for developing:
  - good-quality information about the sector
  - guidance for citizens and communities about implementation of legislation
  - best practice guidance on implementation of local government legislation
  - monitoring and review of implementation of local government legislation.

  Certainly, outputs currently available publicly from these sources are very limited.

A significant opportunity would be lost were the PC to fail to advocate some of these guiding principles for State governments in its final report. The observance of such principles by the relevant State authorities – and the incentives thereby created for individual councils – will be a key determinant of whether councils in future pursue efficient and equitable revenue raising policies.

APPENDIX

SUMMARY OF PC RESULTS

The following table pulls together the main empirical findings by the PC across the adjusted ALGC classes of councils.

Item	period of observations	Capital city	Urban developed	Urban fringe	Urban regional	Rural	Remote	All councils
Total expenditure per person (Table 3.8)*	05-06	$1,887	$732	$720	$1,214	$1,800	$5,986	n.a.
Grants revenue per person (Table 3.7)*	05-06	$64	$61	$101	$169	$526	$2,902	$294
Own-source revenue per person (Table 3.3)*	05-06	$2,534	$688	$841	$1,120	$1,520	$2,822	$1,308
Rates revenue per person (Table 3.4)*	05-06	$1,179	$431	$383	$435	$587	$390	$490
Sales of goods and services revenue per person (Table 3.5)*	05-06	$851	$149	$166	$409	$447	$989	$374
Other revenue per person (Table 3.6)*	05-06	$440	$94	$198	$217	$338	$801	$311
Personal income per person (Table 5.2)*	00-01 to 04-05	$20,340	$18,552	$14,030	$13,205	$12,764	$12,747	$13,857
Business income per person (Table 5.2)*	00-01 to 04-05	$18,861	$4,985	$3,680	$3,904	$5,357	$3,598	$4,912
Total income per person (Table 5.2)*	00-01 to 04-05	$39,201	$23,537	$17,710	$17,109	$18,121	$16,345	$18,769
Actual revenue-raising effort (Table 5.3)*	00-01 to 04-05	6.8%	3.1%	4.0%	6.1%	8.0%	17.6%	6.6%
Actual revenue-raising effort (Table 5.8)**	00-01 to 04-05	8.6%	3.3%	4.8%	6.7%	9.5%	18.8%	8.4%
Hypothetical revenue raising effort (Table 5.8)**	00-01 to 04-05	9.3%	3.7%	5.3%	7.5%	10.7%	20.8%	9.3%
Hypothetical distribution (Table 5.8)**	00-01 to 04-05	5.4%-11.3%	2.8%-4.4%	3.5%-6.8%	5.5%-8.9%	6.6%-13.0%	11.9%-28.6%	4.9%-11.3%
Actual-to-potential own source revenue (Table 5.5)*	00-01 to 04-05	91.3%	88.9%	89.3%	89.4%	88.7%	89.6%	89.0%
Potential increase in total revenue per person (Table 5.6)*	00-01 to 04-05	8.4%	11.1%	10.3%	9.9%	9.1%	6.6%	9.4%
Actual aggregate cost recovery (Table 5.7)*	00-01 to 04-05	107%	95%	99%	92%	75%	60%	84%
Actual aggregate cost recovery ratio (Table 5.9)**	00-01 to 04-05	106%	96%	101%	92%	77%	61%	84%
Potential cost recovery ratio (Table 5.9)**	00-01 to 04-05	116%	107%	112%	103%	87%	68%	94%
Actual share of councils not recovering costs (Table 5.9)**	00-01 to 04-05	31%	67%	50%	65%	86%	95%	76%
Hypothetical share of councils not recovering costs (Table 5.9)**	00-01 to 04-05	17%	32%	27%	42%	73%	91%	58%

Source: PC (2007), table numbers as indicated * **median** value of councils within the class of councils **unweighted **mean** value of councils within the class of councils

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ACCESS ECONOMICS Pty Limited

March 2008

SA-Specific Issues Arising From the Productivity Commission's Draft Research Report on *Assessing Local Government Revenue Raising Capacity*

Report by Access Economics Pty Limited for the

Local Government Association of SA

TABLE OF CONTENTS

Foreword **iii**

1. Present and Future Infrastructure Challenges **1**

1.1 LGA's view 1

1.2 PC's treatment of the issues 1

1.3 Access Economics' analysis 2

2. "Single Tax" and "Tax Room" Issues **7**

2.1 LGA's views 7

2.2 PC's treatment of the issues 8

2.3 Access Economics' analysis 9

3. Developer Contributions **15**

3.1 LGA's view 15

3.2 PC's treatment of the issues 15

3.3 Access Economics' analysis 16

References **19**

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FOREWORD

Access Economics has separately commented on the Productivity Commission's recent draft research report entitled *Assessing Local Government Revenue Raising Capacity* from a national perspective.[1] That review was jointly commissioned by the Australian Local Government Association and the Local Government Association (LGA) of South Australia.

Separately, the LGA requested us to comment on the PC's analysis and findings where they may be of particular interest from a South Australian perspective. The LGA expressed interest in directions for further strategic analysis or actions by the LGA that could assist SA councils.

As to the issues of particular interest from a SA perspective, we have been guided by the LGA's July 2007 submission to PC.[2]

Chapter 1 takes a closer look at the importance of the infrastructure challenge facing local government;

Chapter 2 takes a closer look at issues related to the single-but-shared tax nature of council rates; and

Chapter 3 provides some thoughts on the role of developer contributions.

In each case we

- briefly outline the LGA's perspective;
- identify relevant responses in the PC's draft report; and
- provide our own assessment of the issues and the direction which future work might usefully take.

Topics not included in this report are: State government limitations on council fees and user charges, the role of (further) amendments to the *Local Government Act 1999* in order to improve local government financial management and control, and inter-governmental grants. In the time available, we have not been able to add to the views already expressed in our national perspective report.

Access Economics
March 2008

[1] Access Economics (2008).

[2] LGA (2007).

1. PRESENT AND FUTURE INFRASTRUCTURE CHALLENGES

One of the major functions of local government is its "engineering and infrastructure" function. This involves public works design, construction and maintenance of roads, bridges, footpaths and drainage; and waste collection and management.

1.1 LGA's VIEW

In its July 2007 submission to the PC, the LGA made the following set of arguments:

- Local government has extensive infrastructure asset holdings, which relative to its operating revenue are much greater than for either Commonwealth or State governments.
- While community pressure is to keep rates low and to spend on new assets, most councils are experiencing **increasing maintenance and renewal requirements** with regard to their existing assets. Assets acquired as a result of the large-scale housing development and rapid expansion of council areas that occurred in the 1960s, 1970s and early 1980s – many of which were funded by State or Commonwealth government subsidies – are now ageing.
- If asset maintenance and renewal does not take place as it is programmed, council services will decline in quality or will leave the next generation to face unacceptably high rates increases to avoid such an outcome.
- Councils currently have inadequate revenue to, among other things, fully fund maintenance and renewals requirements as they fall due and redress present infrastructure backlogs.

  > *Most Local Councils would need to double their renewal spending now and provide for much larger renewal spending in the next 10-15 years to gain significant ground on the backlog of infrastructure renewal or replacement. (LGA (2007), p.15)*

- The PC needs to make an assessment of the likely ongoing financial pressures facing local government including in the infrastructure area, taking particular account of:

  > *The profile of Local Government infrastructure, much of which was established in the 1960s and 1970s, [which is] facing peak replacement demands over the next 10 to 15 years...(LGA (2007), p.32)*

1.2 PC's TREATMENT OF THE ISSUES

In its draft report, the PC limited its analysis and findings to the following:

- Together, councils are responsible for management of an estimated $183 billion of non-financial assets and infrastructure.
- As to the **funding** of infrastructure, the following principles were proposed:

  > *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 may 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. (PC (2007), pp.153-154)

- As to appropriate **financing principles**, borrowing when undertaken prudently is an appropriate means for councils to finance long-lived infrastructure assets, the costs of which are often large or 'lumpy' and may 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. (PC (2007), p.152)

The PC did not deal with the following issues raised by the LGA:

- An examination of **existing levels of capital spending**. Instead, perhaps in part because of the prohibition in its terms of reference against looking at local government's capacity to borrow,[3] the PC restricted itself to analysing the capacity of councils to finance their existing levels of *operating* spending.
- **Likely future capital spending pressures**. It therefore did not address whether any forthcoming surge in renewal/replacement requirements is within a council's existing revenue raising capacity.

1.3 ACCESS ECONOMICS' ANALYSIS

In our national perspective report, we drew out the importance of the PC distinguishing between revenue from rates, fees and user charges on the one hand (generally own-source operating revenue) and capital transfers ("capital" grants and contributions, properly defined) on the other. In particular, we criticised the PC's treatment of capital contributions as indistinguishable from a council's own-source operating revenue.

We also acknowledged that the PC concentrated on local government's capacity to fund just its *operating* expenditure.

As a result, the PC has focused exclusively on operating issues largely to the neglect of capital ones. This is regrettable.

What seems to be required on local government's part is a clearer exposition – a restatement – of the integral nature of capital expenditure challenges to the sustainability of councils' long-term finances. Fundamentally, the issue is a financial one and not just an asset management issue.

In our experience, asset-related challenges – particularly as they relate to the renewal and rehabilitation (rather than the enhancement) of infrastructure networks – are not well understood at the Commonwealth and State spheres, including among these governments' economic and financial advisers.

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[3] Its terms of reference specified that, in undertaking the study, the PC was not to investigate the scope for councils to borrow. The PC indicated that it has interpreted this to mean:

"...that it should not report on, or imply, borrowing targets or rules of thumb about borrowing targets for local governments. However, borrowing could be a factor affecting revenue raising across councils, in terms of the structure and the level of rates, and fees and charges. This is particularly relevant to infrastructure services. Consequently, a broad consideration of borrowing is considered relevant to this study." (PC (2007), p.3)

Relative size of asset responsibilities

The PC has acknowledged that councils are responsible for an "estimated $183 billion of non-financial assets".[4] However, this amount only indicates the written down value of council assets, and is under-estimated at any rate as a result of many such assets being valued on an historical cost basis rather than at current (replacement) cost. In terms of these assets' full replacement value, and after adjustment onto a current value basis, we estimate that councils in Australia are responsible for the management of non-financial assets with an estimated current replacement value in excess of $300 billion.

The PC's $183 billion figure is also expressed in absolute terms only. More to the point, local government's non-financial assets represent around 20% of all assets held by the non-financial public sector in Australia. This compares with the local government's share of operating spending (GFS expenses) in the non-financial public sector in Australia of around 5%.

With regard to the general government (or tax-supported) sector only, annual depreciation charges are around 21% of total expenses for local government compared with just 4% for all spheres of government.

Clearly, local government in Australia is a much more capital intensive activity than are the Commonwealth and State spheres of government. Not surprisingly, with this comes a particular set of challenges that don't deserve to be overlooked or dismissed.

Types of capital expenditure, and financing requirements

Capital expenditure (or capex) refers to amounts expended on the purchase or construction of non-financial assets. **Maintenance expense**, by contrast, is the expenditure on existing assets which is periodically or regularly required to ensure that the council's existing assets achieve their economic life or period of service between renewal.

Capex is of three general types:

- **Enhancement capex** is the cost of expanding the service capacity of a council's non-financial assets beyond their current capacity. It usually involves extending or expanding the council's assets as the service requirements of its community grows.
- **Renewals capex** is the cost of restoring the condition (and service capacity) of a council's existing non-financial assets to 'as new' standard when such restoration falls due at the end of these assets' useful/economic lives, i.e., when an asset degrades to its intervention condition level, being the condition level at which a council's asset managers consider an asset should be renewed/replaced.[5]

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[4] Non-financial assets are a council's 'physical' or 'fixed' assets, and mean a council's land, buildings, roads, bridges, storm water & drainage network, equipment, furniture, fittings and the like.

[5] While depreciation is an annual expense, it is not a measure of the required renewals capex in any given year. Nor does it reflect the actual degradation of an asset as monitored by asset managers. In fact, for a single asset, straight-line accounting depreciation is likely to overstate the amount at which the asset degrades in the early years of its life and understate the amount by which it degrades the later years of its life.

Annual depreciation really serves a funding purpose. Straight-line depreciation serves to prompt asset owners to set enough money aside – on an inter-generationally equitable basis – for the eventual renewal of their existing assets. Were an asset degradation path instead used as a basis for annual depreciation charges, depreciation would be delayed (and consequently amassing funds for asset replacement would be delayed) until the assets showed wear and tear. By then it would be necessary to fund most of the renewals cost in a short time span, placing a disproportionate financial burden on future ratepayers.

- **Rehabilitation capex** is the cost of restoring the condition (and service capacity) of a council's existing non-financial assets as a result of past deferrals of maintenance and/or renewals. Rehabilitation capex means capital expenditure aimed specifically at reducing a council's existing maintenance and renewals backlogs.

Using this framework, an important distinction can be made between (present) infrastructure backlogs and (future) annual renewals gaps.

An **infrastructure backlog** is the estimated total cost of undertaking the maintenance and renewal that the council's asset managers had programmed to occur in previous years but which have not yet been carried out (due to a lack of finance or other reasons) and are still required to be done.

An infrastructure backlog generally involves:

- any *unplanned maintenance* necessary to return existing assets that have not reached their respective intervention condition levels back to their normal degradation path
- any *backlog maintenance* necessary to return existing assets that have prematurely degraded past their respective intervention condition levels at least back to their normal degradation path
- and any *backlog renewal* necessary to replace those assets that have reached or exceeded their respective intervention condition levels after having been in service for at least their expected lives, and so bringing these particular existing assets back to 'as new' service potential.

An asset's degradation path is the sloping curve depicting the rate at which the asset's condition (and service capacity) is expected to degrade with age assuming normal wear and tear combined with routine maintenance and regular upkeep. Degradation will happen more quickly if an asset is subject to more use and less maintenance than was originally intended.

A present infrastructure backlog in effect can be a 'liability' facing a council much like borrowings but one that does not show up on its balance sheet.

An **annual renewals gap** refers to the *expected* gap between, in a particular year:

- the amount required to be spent to meet programmed asset maintenance and asset renewal/replacement as they fall due
- the amount actually planned to be spent in the council's long-term financial plan if the latest asset management (financing) policies and plans were to continue unchanged.

This gap is therefore the renewal (and maintenance) that a council's asset managers expect to program to occur during a coming year but which is not expected to be carried out by the end of that year (due to a lack of finance or other reasons) and which would still be required to be done. In general, this gap directly adds to any present infrastructure backlog.

Our experience is that many councils have responded to budgetary stress over recent years primarily by postponing expenditure on maintenance and asset renewal/replacement. This has induced an ongoing annual renewals gap and seen the emergence of infrastructure backlogs.

Rather than incurring debt in order to finance their annual operating deficits, many councils instead have been relying for some time on capital revenues (such as capital contributions, capital grants and the proceeds of asset sales) for this purpose. In effect, councils typically have been running surpluses on their capital accounts in order to fund deficits on their operating accounts.

Capital surpluses mainly reflect the deferral of capital spending that should be undertaken on existing and new infrastructure and for which purposes the collection of capital revenues (such as capital contributions and capital grants) can only be justified. Hence, instead of the usual net borrowing (and accumulated debt) consequences of operating deficits, infrastructure backlogs have emerged for many councils and with it the need for rehabilitation capex.

As to the funding of the different types of capital expenditure:

- Enhancement capex needs to be funded from capital charges, present rates and (via borrowing) future rates. Many within local government hold to the view that funding the acquisition of long-lived assets on a 'pay-as-you-go' basis from rates and annual charges is best. This needs to be closely examined, as it ignores inter-generational equity considerations. Inter-generational equity refers to a fair balance in the relative contributions of current and future generations to funding local government expenditure. This concept is particularly important for the funding of infrastructure, which provides benefits over long time horizons. Enhancement capex undoubtedly gives rise to infrastructure services benefiting future (as well as current) ratepayers.
- Renewals capex should be financed from depreciation (and the sale proceeds from asset disposals which usually represent over-recovered depreciation). Fully funding depreciation is the most equitable (in an inter-generational sense) means of funding renewals capex.
- Rehabilitation capex needs to be funded in the main by future ratepayers, via borrowing.[6] In our view, the associated present infrastructure backlogs have arisen in the past because operating deficits have been effectively financed by the deferral of asset maintenance and renewal rather than borrowing. Besides, it may be that financing rehabilitation is too sizeable a task to be addressed entirely by current ratepayers.

Future pressures

The recent financial sustainability studies have all shown that local government infrastructure expenditure in Australia is generally inadequate. The present infrastructure backlog problem has emerged essentially because many councils have not had adequate sources of revenue to fund all their activities appropriately, and consequently they often postpone infrastructure expenditure to fund instead their current obligations. Future annual renewals gaps are to be expected if existing (financial and asset management) policies continue and councils struggle to fully fund their annual depreciation charges.

Our experience in analysing the finances of a large number of councils across Australia is that present infrastructure backlogs indeed exist, and that – over the next 10 years – significant future annual renewals gaps are in prospect on a no-policy-change basis.

At the Commonwealth and State levels, the concern is with ageing population issues. At the local level, the primary concern is with the consequences of ageing assets. Failure to incorporate any forward-looking perspective would be unsatisfactory were the PC assessing

[6] Strictly speaking, borrowing is a "financing" issue while the choice between rates now and rates into the future is a "funding" issue. The funding options typically generate an income flow at a point later than the desirable timing for the provision of infrastructure. This income flow, however, provides the wherewithal to service the finance – debt or equity – that has been raised earlier to allow the capital works to proceed. Hence, once appropriate funding mechanisms have been determined (i.e., taking the form of a stream of anticipated revenues), decisions as to how best to finance the upfront investment that will generate these revenues can then be taken. Efficient capital markets allow funding and financing decisions to be taken quite independently of each other.

the financial capacity of the Commonwealth and the States. So it is too when applied to local government.

For some councils, it is simply a matter of making further progress in eliminating their operating deficits.

For those councils with present infrastructure backlogs *but without* operating deficits, they need to take on more debt. Borrowing is an appropriate financing source for such councils to finance needed rehabilitation capex. Low-geared councils without operating deficit problems have the requisite earnings (or cash flow) coverage of the resultant interest payments. There is little doubt that many such councils are under-using debt. To an informed external observer, the level of indebtedness of councils is well below levels appropriate to their circumstances, reflecting a widespread reluctance by councils to borrow even when it may be prudent to do so.

Only those councils currently still burdened with operating deficits (and so probably future annual renewals gaps) *and* significant present infrastructure backlogs face problems which may be outside their capacity to address. Borrowing is only likely to add to their problems. To the extent that rural or remote councils are involved, and as the PC's analysis has shown, higher rates are likely to exacerbate already high rates burdens. Besides, such councils are not really good candidates for additional borrowing, given their weak finances and often their lack of requisite borrowing and debt management skills. For these types of councils, only additional general purpose grants will ensure their present infrastructure backlogs are addressed and they can close their operating deficits (and future annual renewals gaps). This involves the equivalent of the Commonwealth and State governments borrowing on behalf of smaller councils and distributing the proceeds in the form of general purpose (capital) grants.

Hence, there are strong grounds for any additional funding that might come in the form of grants and subsidies from other governments to be directed at renewing and rehabilitating assets. In fact, this was the basis of the ALGA's proposal to the Commonwealth a year ago, based on the PricewaterhouseCoopers study (PwC (2006)), for a Community Infrastructure Fund. The case for increased grants funding for local roads and for community infrastructure is particularly strong.

2. "SINGLE TAX" AND "TAX ROOM" ISSUES

In terms of operating revenue, rates on properties are the key revenue source of councils.

In this chapter, we focus on two ratings-related issues raised by the LGA,[7] namely:

- the "single tax" issue
- and the "tax room" issue.

2.1 LGA's VIEWS

While the State government's current legislative constraints on rating in South Australia are relatively limited and generally supported, a core argument put forward by the LGA was that there are much more effective limits on the capacity of SA councils to apply property rates as they see fit. Notable among the LGA's reasons for this view are the "single tax" and "tax room" issues.

"Single tax" issues

In its July 2007 submission to the PC, the LGA made the following set of arguments:

- Local government is, under State statute, **limited to only one tax** – commonly known as council rates.
- Local government's revenue raising capacity is **significantly impacted by councils having only one tax available to them**, in the following senses:
  - Councils have **no capacity to switch between taxes** in response to economic conditions. Other governments can reduce one tax and increase another either to respond to circumstances or to encourage particular behaviours.
  - Councils **must rely on using differential rates and rating structures** to shift the balance between ratepayers with different 'ability to pay' and 'pattern of benefit' characteristics.
- These problems are compounded by some particular features of local government's sole tax (council rates):
  - Councils **cannot set a tax rate beyond one year** as they do not have the legal power to do so. Each year a council knows precisely what it will receive in rates and it legally cannot receive a "windfall".[8]

[7] In the time available, we have opted not look at other ratings issues raised by the LGA, namely the impact of rating concessions, and the role played by rating exemptions enjoyed by State or Commonwealth properties.

[8] Governments can experience a "windfall" where a tax rate applied to an economic variable is left unchanged and the variable grows above a budget prediction. This occurs with company tax, income tax, payroll tax and land tax. But under the *Local Government Act 1999* and similar legislation in other States, a council must first set its budget including an amount recoverable from rates, then it must adopt a valuation, and finally it must calculate a rate in the dollar by dividing the two figures. The rate in the dollar is then applied to each valuation at the time to calculate the rates payable and, as a result, the total rates are the figure adopted in the budget.

- The annual tax decisions of councils are subject to **more transparency** than is the case for other governments.[9] As a result, ratepayer attitudes place limits the council's capacity to apply property rates, more so than do perceptions of State government intervention.
- **Uneven property valuation movements** can give rise to their own set of problems. Councils must employ a range of tools to respond to the issue of uneven valuations including remissions, postponements (deferment), rebates, flexible payment options and as a last resort applying a cap to the growth of rates for individual ratepayers.

"Tax room" issues

In its July 2007 submission to the PC, the LGA also made the following set of arguments:

- Local government **does not have an exclusive right** to taxation based on property.
- The SA government raises a considerable portion of its own-source revenue from property-related taxation. In 2006-07, property-based tax revenue accounted for almost 40% of the total taxation revenue collected by the SA government.
- The **State's property tax take has increased significantly** since 2001-02. New taxation measures on property have been introduced such as the Emergency Services Levy, what is now the Natural Resources Management Levy, and the Save the River Murray Levy. In addition, windfalls have arisen as property values and housing market activity have both increased significantly over the period.
- All this gives rise to the possibility of competition in the same tax "room" and so of a **tax "room" crowding problem**.

  ... as a result of this growth in State tax revenue there is less "room" available for Local Government in the only area of taxation available to it. ...Currently there are no mechanisms by which the State and Local Government can debate or plan taxation approaches to the area of property taxation and as a result policy decisions are taken in the knowledge only of the past decisions of the other government(s). (LGA (2007), p.21)

- **Additional research is required** into the tax room implications of growth of the State government's use of property-based taxes in order to quantify any impact and to identify appropriate ways of better managing concurrent use of the same tax bases.

2.2 PC's TREATMENT OF THE ISSUES

In its draft report, the PC limited its analysis and findings to the following:

- Rates levied on property are the **only source of tax revenue** available to councils.
- The **political visibility of rates is high**, largely because they are paid in a lump sum or quarterly.

  The political environment, rather more than legislative and regulatory constraints of State governments, is likely to be the key factor driving revenue raising decisions of local governments. (PC (2007), p.106)

[9] Councils' taxation levels and efforts are relatively transparent. Unlike other governments, councils provide every taxpayer with a statement at the start of every financial year outlining the total tax to be raised. This tends to create a level of public debate and accountability around council rates which is generally higher than for other taxes, particularly transaction-based taxes which are less visible individually and not visible in total to the taxpayer.

- Overall, property **rates represent an attractive method of financing** many forms of local government expenditure, because:
  - rates are generally 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
  - rates are **predictable** and **stable**.
- The **flexibility** of differential rates and rating structures provides councils with considerable ability to influence the distribution of the rates burden among ratepayers. However:

  > *...there are often administrative costs associated with a wider choice of prescribed rating structures. As a result, councils sometimes choose not to utilise fully the flexibility permitted with respect to differential rates and rating structures. (PC (2007), p.94)*

- The distribution of the rates burden on ratepayers probably reflects a combination of the benefit principle and the ability to pay principle.

  > *...where, for example, [rates setting] includes a minimum charge and an ad valorem component..., 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). (PC (2007), p.155)*

- Councils, at least implicitly, acknowledge that ratepayers pay their rates and charges out of their incomes when they set these rates and charges.

  > *First, councils determine required expenditures. They then set the level of rates, fees and charges to raise the revenue required. In times of rapidly rising property values, councils often decrease the rate in the dollar, so as to reduce the revenue raised to match the revenue required to fund the budget. Councils are also required under State legislation to provide concessions to pensioners, and also voluntarily offer their own concessions to people facing hardship in paying rates. (PC (2007), p.47)*

The PC did not address either the single tax issue or the tax room issue as raised by the LGA. This seems to have been because the focus on State government regulatory limits on revenue raising required by its terms of reference was taken to mean:

> *... the limits imposed through local government legislation, regulation and Ministerial direction. It is not taken to mean Australian or State constitutional restrictions on the powers of local governing bodies to raise taxes more generally, such as through income, and goods and services taxes. (PC (2007), p.3)*

2.3 ACCESS ECONOMICS' ANALYSIS

Single tax issues

In our national perspective report, we highlighted the role of vertical fiscal imbalance (VFI), and its alternative "solutions", namely granting additional tax powers to local government or maintaining a sufficient system of general purpose grants from the Commonwealth to local government.

VFI is compounded – and further explained – by the fact that local government possesses a single source of tax only. The various single tax issues canvassed below reinforce the importance – under current arrangements – of the role of general purpose grants. Councils targeting self-sufficiency while at the same time being reliant only on a single tax face a range

of problems not confronted by the Commonwealth and State governments (with their multiple tax powers), and which are given scant regard in the PC's report.

Role of objectives besides efficiency

Were the sole objectives behind tax design efficiency and stability/predictability, local government couldn't have a better single tax. This seems to be the PC's position. Council rates are an efficient tax system because they raise revenue with minimal distortion to the allocation of resources in the economy. Council rates too are largely invariant to cyclical fluctuations and changes in the underlying growth rate of the economy, maximising the confidence with which economic agents can make investment decisions.

However, there are other tax design criteria that are just as important to governments, and explain the difficulties presented to local government by having to rely solely on council rates in order to tax their citizens. These include equity (fairness) and simplicity.

Some of the difficulties with reliance on a single tax revolve around whether or not the resultant tax burden is equitable. The two main types of equity are:

- **Horizontal equity** which involves treating taxpayers who are similar in all relevant respects in a similar way.
- **Vertical equity** which requires those in a position to pay higher taxes than others to do so. In Australia, the issue of vertical equity is mostly addressed through the personal income tax and welfare systems.[10]

Other difficulties with reliance on a single tax revolve around the **complexities** involved to achieve the desired tax burden. There are direct costs to a government of running the tax system and indirect costs to taxpayers of compliance. These costs will be affected by:

- record keeping requirements
- the difficulty of assessing the taxpayers' liability
- the complexity of the tax rules
- differential rates, that may encourage shifting to other, lower taxed, categories.

Moreover, the principles of efficiency and stability/predictability on the one hand and equity and simplicity on the other are often in conflict with each other. For example:

- Applying council rates as a lump-sum tax levied equally on all individuals would make the rates system less distorting. However, by disregarding the large differences in the ability to pay of individual ratepayers (for example), the potential increase in economic efficiency would come at the cost of a (substantial) reduction in equity.
- To achieve the optimal distribution of the rates burden among ratepayers (in terms of horizontal and vertical equity) would require a multitude of differential rates and rating structures, require substantial information that is not always easy to obtain and, while theoretically efficient, certainly would fail the simplicity test.

[10] Inter-generational equity is not included here because rating structures and differential rates have little or no effect on inter-generational equity. The achievement of inter-generational equity depends entirely on the way that capital costs are recovered over time. This, in turn, depends on the degree to which councils uses debt (and other long-term funding mechanisms) to match the period of funding with the perceived period of benefit. Once raised, these loans may be repaid using any combination of rating tools, without any effect on inter-generational equity.

- Differential rates and rating structures that promote (vertical) equity are almost certain to generate large deadweight efficiency costs.
- Efforts to simplify the rates system, through the use of 'one size fits all' rules of thumb, may compromise both efficiency and equity.

In practice, it is difficult to achieve balance, and this is particularly so when a government is forced to rely on a single tax. With a single tax, efficiency and certainty – the objectives focussed on by the PC – cannot be the sole objectives of relevance to rates design and thus the analysis of policy options. Achieving multiple objectives with a single tax instrument will always be problematic.

Hence, whether having rates as its (single) tax power is necessarily a blessing to local government may not be as clear-cut as the PC assumes.

Efficiency, and the role of the benefit principle

For a government reliant upon a single tax, notions of efficiency other than minimising deadweight efficiency costs or achieving stability/predictability are also important.

In this sense, the PC did acknowledge the role of the **benefit principle**,[11] which requires the rates burden to be allocated to ratepayers based on some notion of the benefits that are derived from the goods and services being provided by councils.

Nevertheless, the PC's analysis focussed mainly on the ability to pay principle, with its stress on community income as the main indicator of each council's revenue raising capacity. This downplays the role that the benefit principle can (and should) also play in rates setting.

There are two types of **benefits**:

- private benefits, which accrue directly to the users of services
- public benefits, which capture a range of non-user benefits as well as the direct-use benefits of public goods for which the identification of users is impractical.

In general it is appropriate for private benefits to be funded by user charges and public benefits to be funded by rates.

Where councils finance public goods according to the benefit principle, the primary issues are to target effectively the beneficiaries, to have a revenue mechanism that does not distort their behaviour, and to have a mechanism that is not excessively costly to administer.[12]

General rates are best focussed on recovering the costs of:

- general benefits from all services
- direct benefits that, in the opinion of the council, cannot be charged to the direct beneficiaries as user charges or targeted rates
- direct benefits of services where the ratepayers at large are the beneficiaries, in proportion to the value of the rates base.

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[11] The benefit principle can be viewed as an equity criterion where the focus is on the distribution of benefits between residents, businesses, and others, and possibly the distribution between ratepayers within the residential group.

[12] SACES (2002), pp.36-40.

In some circumstances, targeted rates have greater potential than rating differentials to reflect the benefit principles. Targeted rates should be used where they can reflect:

- variations of service levels
- customer benefit assumptions leading to differentials
- distribution of expenditures by uniform charges
- where the rates catchment is less than all the (fully rateable) rating units in the locality.

However, there are limits on the degree to which local government costs can be split into separate functional areas and have separate benefit taxation schemes applied to them, this limit being in terms of the fixed costs of setting up schemes of benefit taxation.

Once again, being forced to achieve multiple objectives with a single tax instrument poses sigificant problems.

Ability to pay, and affordability

Inter-personal equity objectives typically involve the **ability to pay principle**, which requires the rates burden to be based on some notion of the ability of ratepayers to pay, such as income. Taxes raised to support equity objectives effectively de-link payment from any benefit which is present.

Ability to pay is concerned with taxpayers' abilities to meet financial demands. In its most basic form, the ability to pay principle is implemented with reference to aggregate per capita income or consumption. A more sophisticated approach requires consideration not only of the cost of rates relative to income (and wealth) but also of:

- having sufficient income to pay for rates without crowding out other critical expenditure
- ratepayers earning greater income as a result of council investment in infrastructure and services.[13]

While there may be a broad relationship between rates based on property values and ability to pay, this relationship is likely to be far from perfect. Consequently, the use of property values to set rates can result in:

- horizontal inequity, because some ratepayers on similar incomes own properties of markedly different value and, therefore, pay quite different rates
- vertical inequity, because some ratepayers with markedly different incomes own properties of similar values, and hence pay similar rates.

The most prominent example of a breakdown in the property value-to-income relationship is ratepayers described as "asset rich but income poor". These people, many of whom are retired, own high-value properties that now attract high rates but their income is not high.

As a result, rates rebate schemes and rates postponement and remission policies are also needed. However, achieving inter-personal equity goals at the same time as efficiency and simplicity goals is rarely likely to be effective with a single tax source.

In fact, tax bases such as income tax and consumption tax are generally regarded as the most satisfactory for achieving inter-personal equity objectives. The only means by which these

[13] Shand Report (2007), p.185.

taxes are available to local governments is in the form of general purpose (or tax sharing) grants from the Commonwealth. Because local government only has a single tax source, the case is strong for inter-personal equity objectives at the local level to play a much greater role in determining the level and distribution of general purpose grants.

Differential rates have their problems

The PC puts a good deal of faith too in the role to be played by rating differentials.

Rating differentials involve councils setting different levels of rates for different types of properties with the same property value.

Differentials may be used for various reasons, but are most often used to:

- increase the incidence of rates on business properties
- or ease the burden on high-value properties (for example, farming properties in coastal areas where rates increases are influenced by the recent sharp increases in coastal land values).

Differentials have been also justified based on differences in:

- levels of service, with a group receiving a higher level of service than other groups or a disproportionate share of benefits being charged more
- cost, with a group receiving services that are more costly than other groups paying more.

In most cases, however, businesses receive largely the same benefits as other ratepayers, and at a similar cost to the council. Services that are regarded as providing a greater benefit to the business sector than to other ratepayers include economic development, improvements to central business districts, and tourism promotion. In addition, councils sometimes consider that business causes more road expenditure than other ratepayers because businesses generate more and heavier traffic. However, businesses counter with the argument that residents in the wider area benefit from having businesses in their locality and therefore should contribute to the costs that might otherwise be funded by a targeted business rate.

With only a single tax, business differentials are more likely to be so as to achieve objectives for which they are less suited.

Tax room issues

Importance of property taxes to State and local governments

The GST reforms have narrowed the list of existing State/local taxes to:

- taxes on immovable property (land tax and municipal rates)
- stamp duty on property conveyances
- payroll taxes
- gambling taxes
- motor vehicle fees
- stamp duty on motor vehicle conveyances
- insurance taxes including fire service levies and health insurance levies.

Distribution of State/Local Tax Revenue, 2005-06

Tax	NSW %	VIC %	QLD %	SA %	WA %	TAS %	NT %	ACT %
Property taxes	**43**	**46**	**51**	**49**	**58**	**48**	**42**	**51**
Land tax[a]	10	6	5	8	5	5	0	8
Conveyance duty[b]	18	20	23	15	34	17	27	23
Council rates[c]	15	19	20	22	15	23	15	18
State levies[c]	0	1	4	4	3	3	0	2
Non-property taxes[d]	**57**	**53**	**49**	**51**	**41**	**52**	**58**	**49**
Total tax revenue	**100**	**100**	**100**	**100**	**100**	**100**	**100**	**100**

Source: Australian Bureau of Statistics cat 5506.0 Table 9.

(a) Land tax is paid by the land owner based on the unimproved value of the land.

(b) Property conveyance (transfer) duties levied on the buyers of a residential property are based on the assessed value of the transferred unimproved land and improvements to the land and structures. Property conveyance (transfer) duties levied on the buyer of a non-residential property are based on the assessed value of the transferred property.

(c) Council rates and State property based levies are paid by the land owner.

(d) Includes: payroll tax, gambling taxes, insurance taxes, motor vehicle taxes.

The above Table shows that States have quite similar sources of tax revenues across their combined State and local sectors. Property-based taxes (including council rates) typically make up about one half of all the tax revenue collected by the State and local sectors combined, with council rates and property conveyance duty accounting for the majority of-property based taxes.

It is also notable are that State levies are the highest in South Australia, and councils rates are the second highest.

Additional pressure due to reform options

Property taxes could well become subject to more State use. This increases the case for a serious examination of tax room issues.

A good deal of lobbying is going on at the national level at the moment aimed at getting States to shift their tax base away from as heavy a reliance on stamp duties as is the case today.

The potential gains from the reform of State taxation have always been regarded as large and sufficient to rival the gains derived from past microeconomic reforms. The Australian economy has benefited significantly from microeconomic reforms of, especially, the 1980s and 1990s. However, the benefits of past reforms are starting to wane as evidenced by the slowing in productivity growth in recent years. The establishment of new reform agendas would help to reinvigorate productivity growth.

While their revenue bases are relatively narrow, there is nothing to stop the States from shifting the mix of their taxation towards a more efficient structure, possibly involving the replacement of stamp duties on at least business to a heavier reliance on land-related taxes.

Local government needs to push to get tax room issues onto the table. This advocacy will need to be at the same level as arguments being put by others pushing the States to consider increasing their use of land-based rates and levies on the grounds that these are the more efficient taxes available to them.

3. DEVELOPER CONTRIBUTIONS

Developer contributions are lump-sum charges designed to recover the public costs incurred in the provision of infrastructure from the beneficiaries of that infrastructure, typically levied on the owners/developers rather than the occupiers of land or the users of specific services.

3.1 LGA's VIEW

In its July 2007 submission to the PC (2007), the LGA made the following set of arguments:

- Compared to both the State government and interstate local government, **SA councils are limited in their capacity to raise developer contributions**. SA councils are limited to obtaining developer contributions to local roads, street lighting and community facilities in areas to be developed.

  In South Australia there is no clear, consistent and enforceable Developer Contributions Scheme that defines and facilitates timely, coordinated and consistent contributions to support the infrastructure requirements for new urban developments and renewal projects. (LGA (2007), p.16.)

- Some councils are also able to negotiate their own infrastructure funding agreements with various land owners and developers to address infrastructure challenges. However, **reliance on voluntary arrangements creates**:
  - **significant inequities**: e.g., rapidly growing larger councils tend to have stronger bargaining positions and more successful funding outcomes on a case by case basis when compared with slower growing and smaller councils
  - and **economic distortions**, with too much of the burden of new development falling on the wider community.
- **Amendments to both the Development Act 1993 and the Local Government Act 1999 are required** to provide councils with greater flexibility and scope to achieve a more equitable and transparent basis for providing economic and social infrastructure through developer contributions.
- **A national review of developer contributions would also assist** with a view to developing a best practice model which balances appropriately the interests of new developments with those of existing taxpayers.

3.2 PC's TREATMENT OF THE ISSUES

In its draft report, the PC limited its analysis and findings to the following:

- Councils in **some States do not have the authority** under State legislation to require developer contributions for some facilities.
- Unless prevented by legislation, **voluntary arrangements** can be made.
- **Regulation of developer charges and contributions** is not a constraint on revenue raising capacity to meet specific expenditure needs.
- The developer contributions component of local government revenue has grown considerably in recent times in most States.

The PC did not deal with the following issues raised by the LGA:

- The implications of interstate differences in legislative impediments to use of developer contributions, let alone what policy developments may be best suited to South Australia.
- The uneven impact among councils of reliance on voluntary rather than statutory arrangements.
- The call for a national review.

3.3 ACCESS ECONOMICS' ANALYSIS

The role of developer contributions

A key challenge facing local government particularly in South Australia is to achieve broad based and whole of life infrastructure funding. Developer contributions have an important role to play in this regard. However, SA councils are generally disadvantaged by the lack of a legislative framework facilitating a role for developer contributions in enabling equitable and efficient cost recovery over time.

The establishment of prices for infrastructure services (in the form of user charge and/or an annual access charge) represents one possible source of **funding** of the underlying cost of the infrastructure. However, the imposition of pricing may not always be a feasible, or indeed the most efficient or equitable, source of funding. Hence, other funding options such as rates and levies/contributions also need to be considered.

When applied properly, developer contributions are consistent with both efficiency and equity objectives. Efficiency is promoted by forcing developers to internalise the cost of additional infrastructure that is caused by the development. If this were not done, excessive levels of development would be expected. Developer contributions are also equitable, because they avoid some sections of the community (those already living in a location) subsidising others (new residents).

Developer contributions are therefore an attractive funding instrument that can assist growing councils in securing adequate infrastructure funding and, when carefully designed, can achieve this in an efficient, equitable and inter-generationally sustainable manner.

The choice of funding mechanism should be based on considerations of efficiency and fairness that, in turn, depend upon how the benefits of the development are likely to be dispersed. The impact among and between groups directly involved in the development (existing landowners, developers and purchasers of the new dwellings) and those external to the development (those resident within the growth areas, residents in neighbouring regions who may use some of the infrastructure that is provided and the State-wide taxpayer base) need to be carefully assessed.

The imbalance between existing ratepayers and the beneficiaries of new development is a key issue. Existing ratepayers can receive some benefit from facilities provided to serve new populations. The benefit region for a particular facility rarely has a sharply defined edge, particularly community services and facilities playing a role beyond the council area, with utilisation based on a function of distance. Although a specific facility may be fully justifiable on the basis of a specific development, the benefits can be more spread and so should the costs.

Addressing equity issues and ensuring that developer contributions respond to local communities and their specific needs requires the adoption of often complex arrangements.

However, developers much prefer simplicity, applying pressure for a 'trade-off' between a complex but sophisticated system and a transparent 'easy-to-use' system. Getting such a trade-off right requires careful consideration.

Ideally, developer contributions should possess a number of attributes.[14] They should:

- involve full net cost recovery from the beneficiary
- reflect variations in the cost of servicing different development areas
- result in new developments meeting the cost, but no more, of the services provided through developer contributions
- cover infrastructure expenditures which can be clearly linked to the development and be reliably forecast
- include ancillary costs
- be applied to existing and fringe areas alike
- and be calculated in a transparent manner so that developers can understand and assess the calculated charges.

In practice, achieving all these attributes too may be difficult to achieve.

The above principles need to be reflected in any legislative arrangements to be put in place in South Australia. Clearly, a national review, and template, would be helpful in this regard.

One thing that is certain is that voluntary arrangements will invariably involve *ad hoc* and incomplete consideration of the issues. If based on best practice, a tried and tested framework embodied in legislation is the best – and possibly the only – way to get the complexities right.

Source of under- and over-recovery

In using developer contributions, councils need to acknowledge up front that there are clear limits on the extent to which they can and should use developer contributions:

- if developer contributions exceed the cost imposed on existing communities by new developments, development would be discouraged
- existing residents may obtain some benefit rather than just new residents, with the risk being that going too far with developer contributions could see new residents subsidising existing residents.

Councils need to target reaching those limits, because doing so is efficient and equitable. But care is required to ensure that such limits are not exceeded.[15]

Pressure for double dipping is most likely to arise in response to short-sighted State government intervention, as may be the case in NSW, or a legislative framework for developer contributions that fails to implement efficient and equitable arrangements.

However, for some councils, the introduction of a suitable legislative framework will not be sufficient. For councils with generally static or declining populations in particular, developer contributions will inevitably be insufficient to address infrastructure shortfalls and must thus be

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[14] Audet, D. and Warner, R. (1997), 'Background of Calculation of Developer Charges' in NSW Independent Pricing and Regulatory Tribunal, *Developer Charges for Water, Sewerage and Drainage Services: Proceedings of Conference*, Sydney.

[15] see Shand Report (2007), pp.152-153.

greatly supplanted by other sources of funding borne by existing ratepayers already funding renewal of their own infrastructure. Once again, for many councils, grants from other governments need to play a greater role.

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