APPENDIX 7
Attachment 1

THE McKELL INSTITUTE

GIVING LOCAL GOVERNMENTS THE REBOOT

IMPROVING THE FINANCIAL SUSTAINABILITY OF LOCAL GOVERNMENTS

SEPTEMBER 2016

ABOUT THE MCKELL INSTITUTE

The McKell Institute is an independent, not-for-profit, public policy institute dedicated to developing practical policy ideas and contributing to public debate. The McKell Institute takes its name from New South Wales' wartime Premier and Governor-General of Australia, William McKell.

William McKell made a powerful contribution to both New South Wales and Australian society through significant social, economic and environmental reforms.

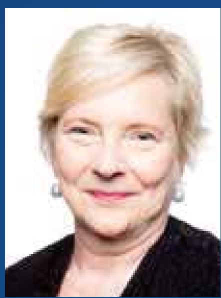
For more information phone (02) 9113 0944 or visit www.mckellinstitute.org.au

ABOUT THE AUTHORS

DR JOSEPH DREW

Dr Joseph Drew is a Research Fellow in the Institute for Public Policy and Governance at the University of Technology Sydney. His research interests focus on expenditure and revenue structures for local government, performance measurement and corporate governance. Previously Joseph worked in senior management positions in performance monitoring within the retail banking sector. Joseph is the author of over 35 scholarly works and has consulted with numerous Victorian and New South Wales councils on municipal reform, accounting, finance and economic matters.

ASSOCIATE PROFESSOR ROBERTA RYAN



Associate Professor Roberta Ryan is a leading social researcher and policy, program evaluation and stakeholder engagement practitioner with over 30 years' experience in both the public and private sectors. Roberta is the Director of the Institute for Public Policy and Governance and the UTS Centre for Local Government at the University of Technology Sydney. Roberta has completed over 300 social research and evaluation projects, including major national reviews and evaluations, methodologically complex projects using outcome and process evaluation approaches, program logic and many service reviews and evaluations.

UTS INSTITUTE FOR PUBLIC POLICY & GOVERNANCE & UTS CENTRE FOR LOCAL GOVERNMENT

The Institute for Public Policy and Governance at the University of Technology Sydney (UTS:IPPG) is a leading group of researchers and practitioners in the areas of applied policy, social research, stakeholder engagement, and leadership. The UTS Centre for Local Government is part of the UTS:IPPG, and is a leader in local government research, teaching and advisory.

For more information phone (02) 9514 7884 or visit www.ippg.uts.edu.au

UTS:CLG
CENTRE FOR LOCAL GOVERNMENT

THE McKell Institute

The opinions in this report are those of the authors and do not necessarily represent the views of the McKell Institute's members, affiliates, individual board members or research committee members. Any remaining errors or omissions are the responsibility of the authors.

THE MCKELL INSTITUTE

GIVING LOCAL GOVERNMENTS THE REBOOT

IMPROVING THE FINANCIAL SUSTAINABILITY OF LOCAL GOVERNMENTS

SEPTEMBER 2016

CONTENTS

FOREWORD

> When the Central Darling Shire local council in far-west New South Wales was suspended at the end of 2013, it sent shock-waves throughout other local governments across the country: it was the first ever local government in Australia to fail.

The ensuing analysis found that the council was in such dire financial straits, it shouldn't have come as a surprise. Since then, there have been numerous reports arguing that local governments all over the country are facing serious financial sustainability crises.

The example of Central Darling Shire plays into the common misconception that potholes and dilapidated play equipment are as a direct result of council's inadequate revenue. This report takes a close look at that claim, and finds that council expenditures have grown, on average, 7.3 per cent per year for the past twenty years.

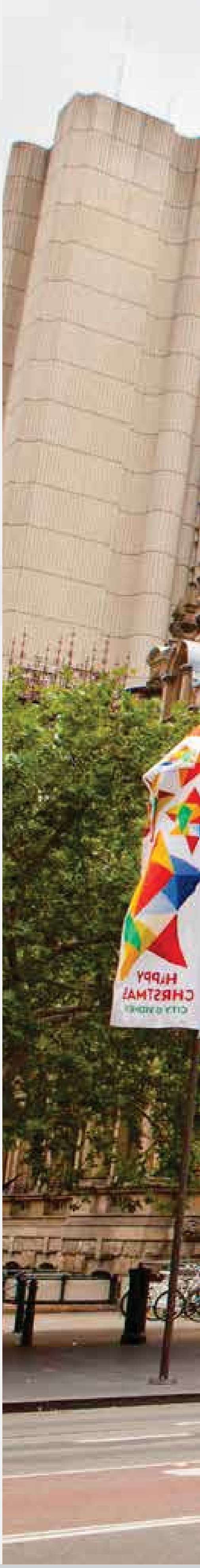
This report delves deeply into the financial issues facing most local councils and finds that in fact, many local governments are suffering from expenditure problems due to demand from the community that has been rising steeply over two decades. Driving this increase in community demand is a gap that has emerged between the community's propensity to pay for various amenities and the cost to council in providing those services. This has resulted in local governments under-charging and failing to effectively demonstrate the cost to consumers.

The report makes a series of 18 recommendations that are designed to promote the transparency, accountability and equity of local government operations and revenue-raising capabilities.

Local governments are an important part of our community. They provide the services that we, as citizens, rely heavily on: waste management, roads maintenance, and the provision of local libraries and public swimming pools, to name a few. This report makes a series of recommendations that, if implemented in a coordinated fashion, will allow local governments to provide the goods and services they promise, in an efficient and sustainable manner: because no one can afford for more councils in Australia to fail due to financial difficulties.

The Hon John Watkins
CHAIR,
MCKELL INSTITUTE

Sam Crosby
EXECUTIVE DIRECTOR,
MCKELL INSTITUTE



EXECUTIVE SUMMARY

In the two decades from 1995 to 2015, Australian local governments experienced a fourfold increase in expenditure. This represents 7.3 per cent per annum compound growth rate. Even more striking though, is that during this same period many local governments were stripped of their water and sewerage functions – so these figures actually underrepresent the real picture.

An increase in local government expenditure is not in and of itself problematic, but if the current level of spending continues then there needs to be a corresponding increase in council revenues. This is relatively unlikely as Australians would not be willing to substantially increase their local council rates each year, for twenty years. Even if state and federal governments provided funding, which seems unlikely in the current political environment, then the money would still be derived from higher levels of tax but just levied by other government sources.

At least part of this problem relates to citizens' awareness and perceptions about how local government services are paid for. We argue that part of the answer to the financial sustainability of local governments is to adopt a number of broad measures aimed at re-establishing the link between demand for local government services and the revenue used to meet the demand. When citizens can perceive the link between the increase in local government services and the price which must be paid to fund that increase, then the current state of fiscal illusion will be tempered by citizens' willingness to pay.

This report proposes a range of suggestions to address the financial sustainability of local government. These encompass a number of broad measures aimed at re-establishing the link between the demand for local government services and the revenue used to meet the demand. A series of 18 recommendations, based on economic and taxation principles, are primarily designed to increase the transparency, accountability and equity of local government revenue-raising efforts.

The report begins with an overview of local government revenue and expenditure. This is followed by an examination of the connection between revenue and expenditure. This section reveals that *public* taxes are often used to provide *private* benefits. This results in inefficient levels of demand due to inadequate price signals and in some cases this can lead to a lack of transparency and equity.

Australia already has relatively high levels of land-based taxes (although in other countries the level is on the rise) and there are arguments that there is room for further increases, although the picture is confused by other state taxes in this area.

This report finds that the taxation limits (i.e. rate capping) which now operate in New South Wales and Victoria have a number of harmful effects, as they lower levels of efficiency, lower rates of infrastructure renewals, increase debt and increase levels of inter-jurisdictional inequity. We have presented a number of alternatives to address this harmful practice.

The report also provides a number of recommendations relating to local government fees and charges. Of particular note are the obstacles to calculating supply and demand. It is important that fees and charges are levied according to established economic principles. In relation to developer levies, which result in inefficient economic outcomes, the report recommends the adoption of legislation in all jurisdictions to establish a developer levy price floor and the removal of price ceilings.

Another area that the report examines is intergovernmental grants – with a particular emphasis on federal financial assistance grants. There is evidence of problems with the legislation as well as failures of local government grant commissions to allocate financial assistance grants in a way that is empirically grounded. Recommendations are provided to amend legislation and to allocate grants at the federal rather than the local level. Another recommendation is for financial assistance grants to be issued in a manner which re-establishes the crucial connection between public demand and revenue expenditure.

The final area examined in this report is regarding additional debt that local councils take on. Evidence reveals that when local governments do not have good information on which to decide to incur more debt, taking on debt has the potential to raise intergenerational equity issues. To date, little debt capacity modelling has been completed for local governments. Calling for councils to take on debt without first calculating debt capacity is like a bank providing a home loan without asking to see customers' pay slips. Accordingly, it is crucial that councils secure good empirical evidence about their capacity to service debt.

While none of these recommendations alone will prove to be a solution, together they have the potential to address local governments' financial sustainability. If we expect local governments to remain an integral part of the governmental service delivery model, then we cannot afford to remain on the same path.

RECOMMENDATIONS

RECOMMENDATION 1

Local government taxation should only be used to fund local government public goods and the subsidised component of merit goods and positive externality goods. Local government taxation is most decidedly not a fee for service.

RECOMMENDATION 2

The level of subsidy should be justified and clearly communicated to donors and recipients. The subsidised amount should be displayed on receipts and at places where subsidised goods and services have been provided.

RECOMMENDATION 3

Higher tiers of government should be discouraged from crowding-out the local government tax base. Ideally, retreat by state governments is desirable, but may not be practical. Moreover, serious consideration should be given to returning Capital Gains Tax (CGT) relating to subdivision of land to local governments (which bear the costs of providing infrastructure related to the subdivision). If it is not possible for the Australian Taxation Office to identify and transfer these amounts to local government then the same effect could be achieved by local governments levying a tax-deductible fee on subdivisions equivalent to CGT liabilities.

RECOMMENDATION 4

Exemptions and concessions should be reduced and abandoned wherever possible. Welfare is the legitimate responsibility of federal governments. If exemptions and concessions are desired then they should be provided outside of the local government tax cycle, to preserve the link between revenue and expenditure. These can include discounts for pensioners as well as exemptions on crown or other government lands.

RECOMMENDATION 5

Every council should be required to make public the calculation method of each of the differential rate categories (in an accessible form), in order to increase transparency and thus reduce opportunity for rent-seeking. Comparative differential rate category data (expressed in cents in the dollar terms) should be clearly stated on all local government rate notices – to increase transparency and discourage rent-seeking.

RECOMMENDATION 6

Rate capping should be abandoned as a matter of priority. Local government tax limitations (rate capping) erode the link between revenue and expenditure and diminish financial efficiency and sustainability.

RECOMMENDATION 7

A local government ombudsman, with broader remits, should be established in each jurisdiction to provide opportunity for sanction outside of the electoral cycle. The responsibilities of the ombudsman could be to review governance issues but also rent-seeking activities which disadvantage the broader local government taxpayer community, and monitor cost-shifting behaviour.

RECOMMENDATION 8

Councils should be provided with the flexibility to make incremental adjustments to local government taxation on a quarterly cycle.

RECOMMENDATION 9

A schedule of fees and charges should be publicly available for every council and fully justified according to a demand-side or supply-side approach. This occurs in some jurisdictions, however, it is also important for the information to be both accessible and accessed by local government taxpayers.

RECOMMENDATION 10

Regulated fees and charges should be abolished on the grounds that they erode the link between revenue and expenditure.

RECOMMENDATION 11

A floor on developer levies should be legislated to prevent councils from eschewing developer levies entirely, or imposing an inadequate levy out of fear of litigation. However, it is important that legislation clearly provides councils with the opportunity to pursue higher fees and charges when justified. In addition, caps on developer charges should be removed.

RECOMMENDATION 12

Intergovernmental grant transfers made with the objective of mitigating horizontal fiscal imbalance should be paid directly to the local government taxpayer by way of a rebate outside of the local government tax cycle. This will help to re-assert the link between demand and willingness to pay.

RECOMMENDATION 13

Financial assistance grants should be allocated by a central national authority free of political interference.

RECOMMENDATION 14

Financial assistance grants should be linked to a predictable and growing source of revenue to ensure financially sustainable local government. The most likely path to achieving this aim is for financial assistance grants to be linked to a share of personal and corporate income tax revenues for which the allowed amount is no more than the existing grant allocation. However, if reform of the GST was to be seriously contemplated by federal, state and territory governments, then a case could be made for local government to be allocated a share of this consumption tax.

RECOMMENDATION 15

Authorities issuing matching grants should be conscious of the constraints imposed on councils which have limited revenue raising capacity. Particularly councils operating in an environment dictated by taxation limitations and regulated fees.

RECOMMENDATION 16

Recommendation: Section 6(2)(b) of the Local Government (Financial Assistance) Act 1995 should be repealed. This section of the Act subverts principles of horizontal fiscal equalisation, compounding other inequitable stipulations.

RECOMMENDATION 17

Financial assistance grants should be allocated on the basis of robust empirical methodology which principally responds to horizontal fiscal imbalance. There already exists an empirically robust methodology that has been demonstrated in the scholarly literature since at least 1989.

RECOMMENDATION 18

Recommendation 19: Robust empirical analysis of debt capacity should be conducted to support the analysis of the suitability of local government borrowings. It is imperative that, before local governments take on debt, the mechanisms for mitigating the moral hazards posed to past and future generations are clearly understood. Should the preceding significant challenges be resolved, there is scope to improve the efficiency of debt through the establishment of a bond bank or similar institution. Similarly, borrowing for infrastructure that can support growth and future income can be useful for local governments, providing these other issues are first addressed.

PART 1: EXPENDITURES HAVE GROWN, THREATENING THE FINANCIAL SUSTAINABILITY OF LOCAL GOVERNMENTS

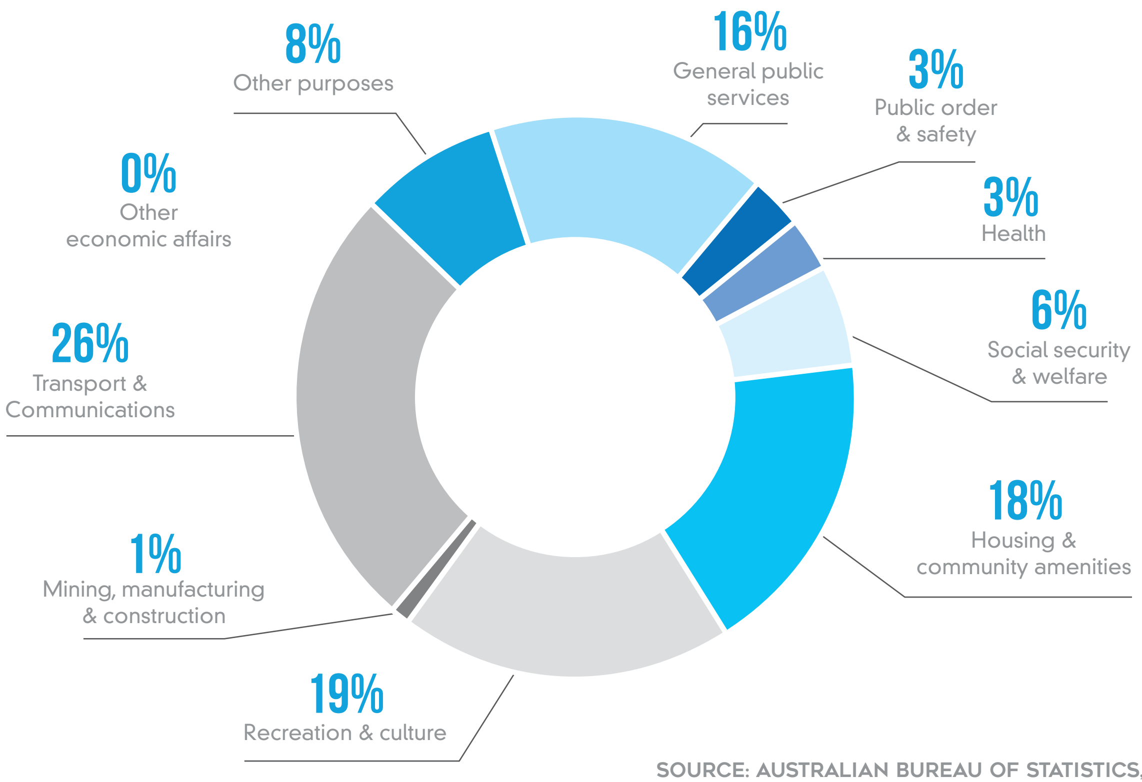
A number of recent inquiries have cast doubt on the financial sustainability of the local government sector. For instance, the PwC National Financial Sustainability Study of Local Government concluded that 'approximately 10% to 30% of Australia's councils have sustainability issues'* and that these councils were principally located in rural and regional areas.[1]

In a similar vein, the New South Wales Independent Local Government Review Panel concluded that 'the financial sustainability of many councils – and their capacity to deliver the services communities need – has declined, and a significant number are near crisis point'.[2] Moreover, the recent unprecedented liquidity crisis faced by Central Darling Shire in far-western NSW represents the first example of local government failure in Australia.[3] It thus seems prudent to conduct a close examination of the revenue and expenditure structures of Australian local government with a view to identify the underlying cause of the looming financial sustainability crisis.

It has been argued that the expanding remit of Australian local government is the principal factor behind declining financial sustainability.[4] In the last two decades there has been a fourfold increase in spending by local government in nominal terms (7.3% p.a. compound growth rate) from total outlays of A$8.2 billion in 1994-95 to A$33.6 billion in 2014-15.[5] This is despite the fact that in some jurisdictions (such as NSW and Queensland), significant public service responsibilities (such as water and sewerage) have been stripped out from local government and are now provided by regional water corporations. Moreover, there has been a significant shift in the proportion of local government outlays expended in the various functional categories employed by the ABS – the most notable changes have been in the expenditure categories of Housing and Community Amenities (18.5% in 1994-95 to 24% in 2014-15) and Economic Affairs (from just 0.2% in 1994-95 to 3.6% in 2014-15).[6] What this demonstrates is that both the scale and functional scope of local government spending has been the subject of a remarkable amount of change in the last two decades.

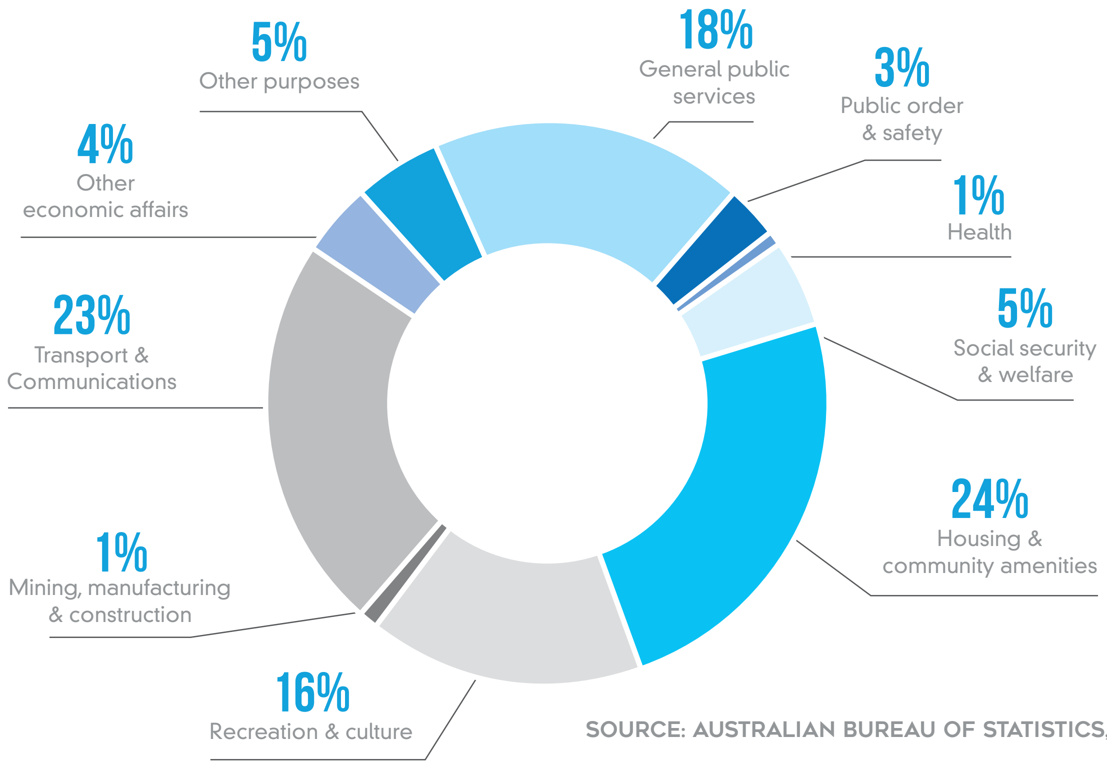
* It should be noted that – somewhat alarmingly – despite the conclusions posited in the two cited reports a robust empirical analysis of the financial sustainability of all Australian local governments does not currently exist. The PwC (2006) report was based on just a sample of 100 councils employing as little as five financial ratios (and also attempting to extrapolate from state based inquiries conducted in just four states).

FIGURE 1.1 Australian Local Government Spending By Category, 1994-95 (Total Outlays $8.2 billion)



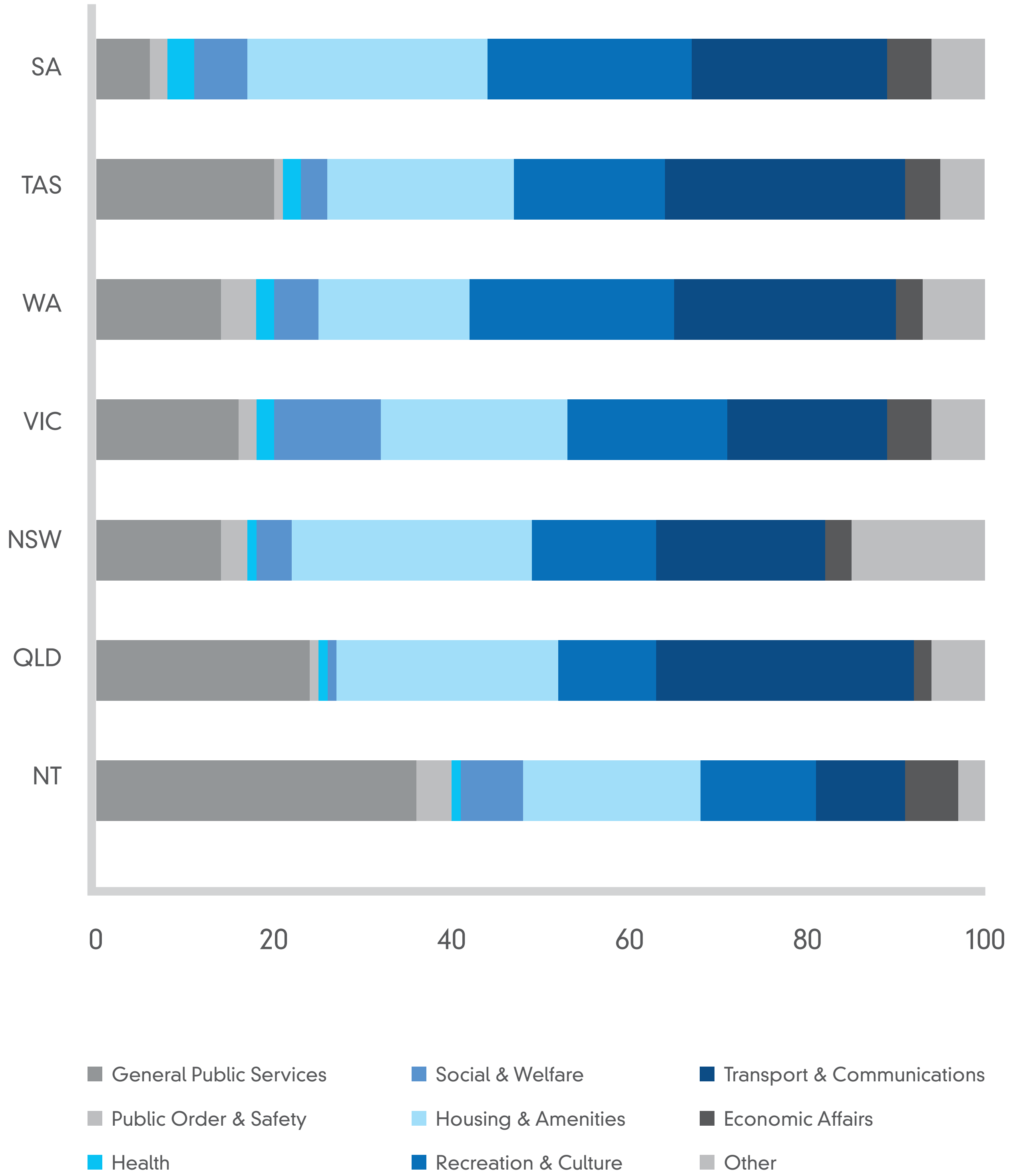
SOURCE: AUSTRALIAN BUREAU OF STATISTICS, 2016

FIGURE 1.2 Australian Local Government Spending By Category, 2014-15 (Total Outlays $33.6 billion)



SOURCE: AUSTRALIAN BUREAU OF STATISTICS, 2016

FIGURE 1.3 Australian Local Government Expenditure by Function and Jurisdiction, 2014-15



SOURCE: AUSTRALIAN BUREAU OF STATISTICS, 2016

Three causes are often cited for the functional expansion of Australian local government expenditure. These include cost-shifting (whereby unfunded or partially funded mandates are imposed on local government by higher tiers of government), the need to address market failure (particularly in rural areas where it is commonly not financially viable for the private sector to provide essential goods and services such as aged care or childcare) and increasing community demand (which is said to be 'rising at an exponential rate'.[7*] As to the first of these factors, the solution is relatively straight forward (although politically difficult to implement) – a commitment to the proposition that the tier of government instigating a mandate is responsible for funding that mandate. To ensure this occurs, a suitably resourced and independent statutory institution should provide oversight. The second cause of functional expansion is most salient to rural and regional councils and should be reflected in appropriate grant transfers. The final matter – recognising community demand – represents the substantive component of our present inquiry.

The key argument of this paper is that the financial sustainability of local government is threatened by the erosion of the link between local government expenditure and local government revenue. When inadequate price signals are sent to resident-consumers, then an inefficient quantity and quality of local government goods and services is likely to result.[8] Put simply, price (while not the only important consideration) has information value for consumers and producers of goods and services. If we fail to accurately signal the price of local government goods and services then an inefficient pattern of consumption of these goods and services will arise.[9] We argue that the current revenue sources for local governments deviate from the desired link thus eliciting demand for local government goods and services which is not tempered by willingness to pay considerations.[10] However, it is possible to strengthen the link between local government revenue and expenditure and recommendations to achieve precisely this outcome form the substantive contribution of the paper.

Part Two examines the principle sources of local government revenue with a view to demonstrating how the current application erodes the link and hence financial sustainability. Part Three presents the results of our interviews with key stakeholders with an emphasis on identifying the obstacles for reform, whilst Part Four outlines important research which remains outstanding. The paper ends with a consideration of the public policy implications and direction for future research.

* In fact, looking over the last few decades of local government expenditure there is no trend (linear or exponential) in growth. Rather expenditure growth is 'lumpy' – periods of rapid growth followed by periods of relatively muted growth. However, it is clearly the case that growth in local expenditure – when considered over a long time horizon – occur at rates which appear to be unsustainable.


aqualink

PART 2: ASSESSING THE BALANCE SHEETS OF LOCAL GOVERNMENTS

The Link Between Revenue and Expenditure Must Be Re-Established

Figure 2.1 details the major sources of local government revenue which can be broadly classified as: taxation (38%), grants and subsidies (11%) and sales of goods and services (27%). Before any judgements can be made regarding whether the sources of revenue are appropriate for the goods and services provided by local government, it is first necessary to understand the basic types of outputs produced by the sector.

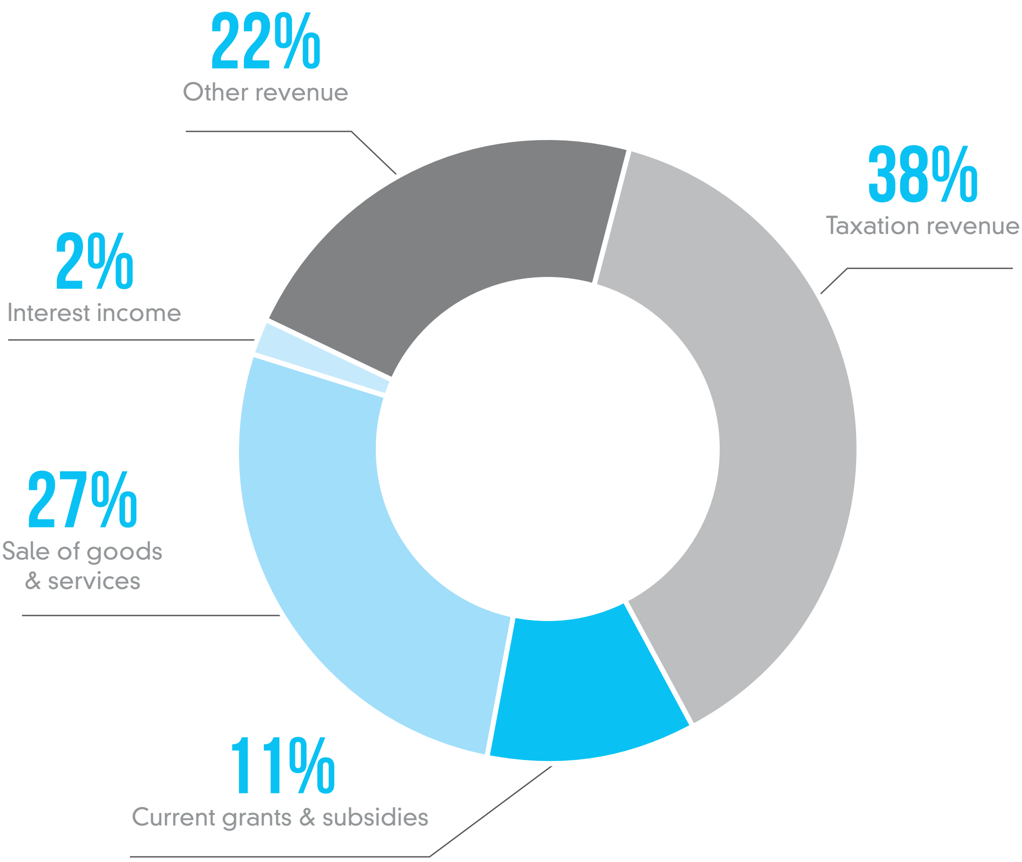


FIGURE 2.1 Australian Local Government Revenue by Category, 2014-15

The mandate of government is to produce public goods and services.[11] Pure public goods are items which are both non-excludable, which means that it is not possible to prevent consumption – for instance, one cannot be prevented from driving down a public road; and non-rival, which means that consumption by one individual does not affect the quantity of the good available for consumption by others – for instance, the number of times one person drives down a road doesn't materially reduce the ability of others to drive down the same road. The common examples cited for pure public goods are street lighting and local roads.

At the opposite extreme lie private goods and services. Local government examples of these include aged care and sale of compost produced from green waste depots. In between these two extremes are merit goods, which are provided by governments in the belief that consumption has some intrinsic virtue which may be internalised – for example, swimming pools and libraries; and goods with positive externalities, which have benefits beyond those which can be internalised by the individual consuming the good – for instance, sewerage and solid waste disposal. It is important to be conscious of the different types of local government goods and services, as the source of funding should ideally respond to the characteristics of consumption. When this association is not observed, then inequity and inefficient levels of consumption result.

FIGURE 2.2 Australian Local Government Revenue by State, 2013–2014

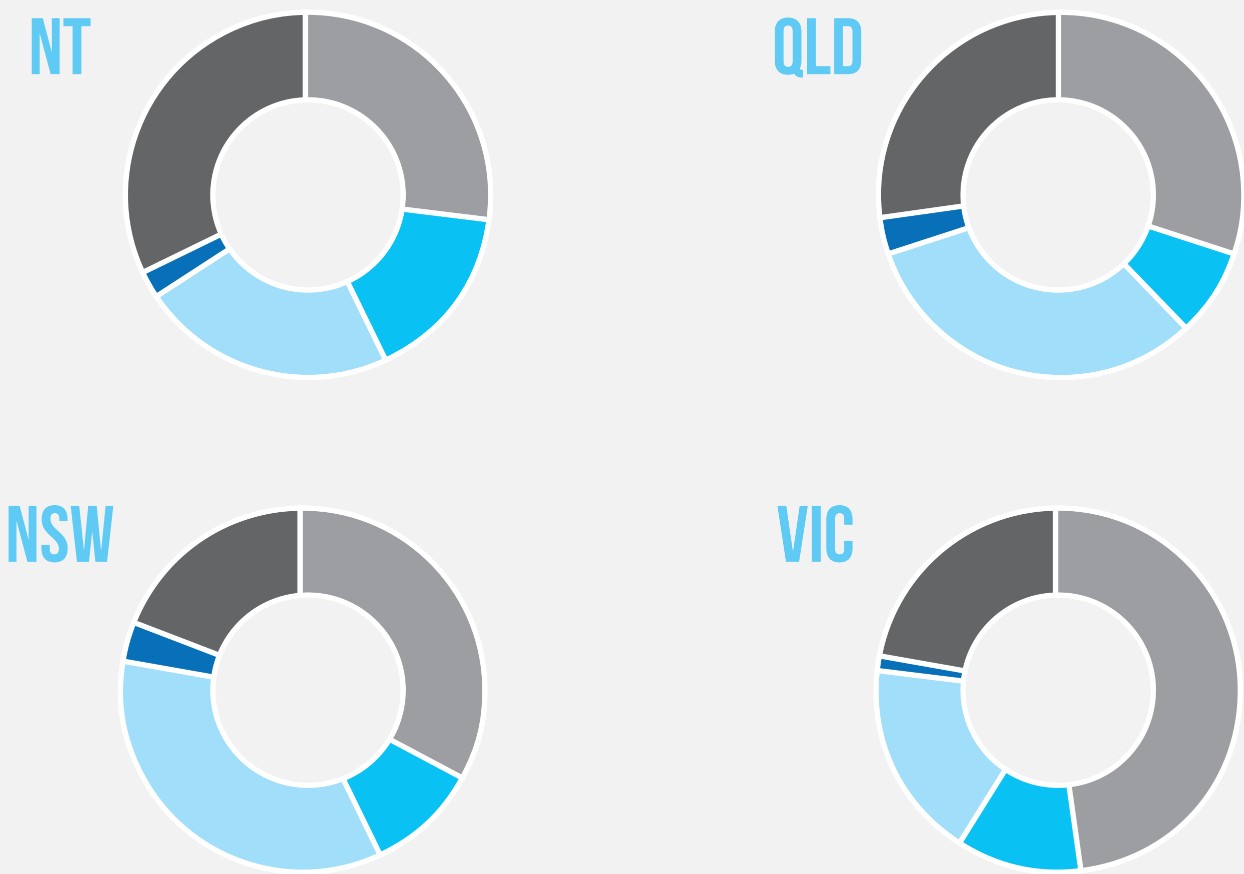
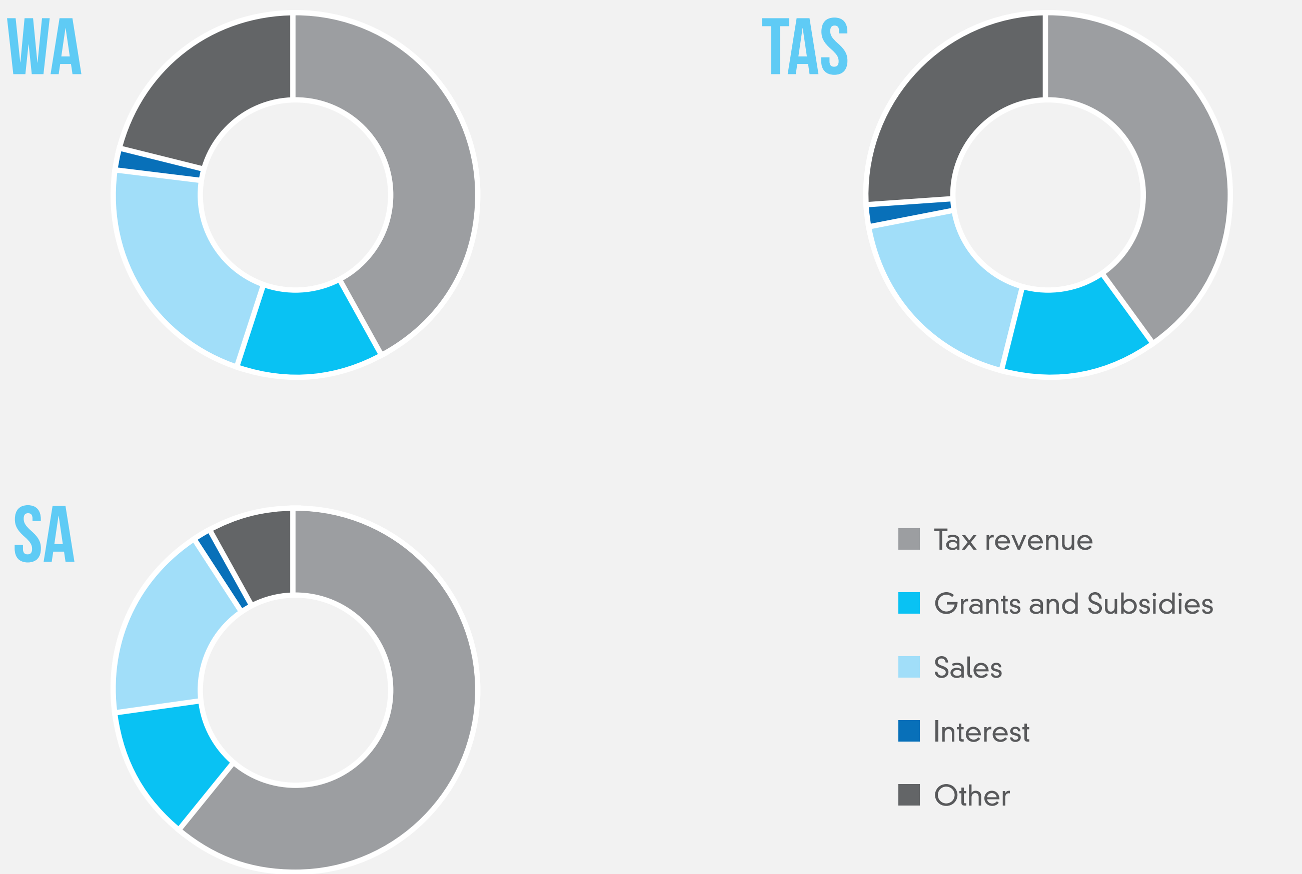


FIGURE 2.1 Types of Goods and Services Local Governments Provide

Type	Characteristics	Examples
PUBLIC GOODS	Non-excludable; non-rival	Street lighting; local roads
MERIT GOODS	Intrinsic value which may be internalised	Public swimming pools; libraries
GOODS WITH POSITIVE EXTERNALITIES	Benefits are beyond individual internalisation	Sewerage; waste disposal services
PRIVATE GOODS AND SERVICES	Goods and services provided by local government and also often provided by private businesses	Aged care; compost produced from green waste depots



SOURCE: ADAPTED FROM ABS, 2016

Local Government Taxation is Often Employed Inappropriately

It has been deemed that local government taxation is the appropriate source of revenue for the provision of local government public goods and services.[12] Due to the non-excludability characteristic of pure public goods, it is simply not possible to sustainably fund what are generally considered to be essential goods and services through any other means.

It is also deemed appropriate to fund the subsidy component of merit goods and services that have public benefit through the common tax pool.*

However, local government taxation is often employed inappropriately. One common error is to wholly or partially fund private goods from the common tax pool. When this occurs 'substantial benefits are provided to a few while imposing small costs on many'.[13] Indeed, this has been regarded as the main reason for expanding government budgets, resulting in economic distortions and all manner of social ills.[14]

The problem is perpetuated by both the political rewards attendant upon acquiescence to rent-seeking lobbies and the rational ignorance of individual citizens (because the disaggregated cost is indeed small it simply does not pay for individuals to protest against the practice).[15] The main problem with this practice – apart from the obvious inequity – is that individuals or small groups obtaining benefits at the expense of the wider community will fail to receive an adequate price signal and thus demand an inefficient level and quality of the good.

The other error, almost universally made in relation to the use of the local government tax pool, also relates to the absence of an adequate price signal for merit goods and services. As noted earlier, it is entirely appropriate to use taxation to provide the subsidy component of merit and positive externality goods – failure to subsidise the goods in this manner will result in a lower than optimal level of consumption. Moreover, the provision of a subsidy is a key justification for decentralised government embodied in local government. The problem is that the level of subsidy is rarely, if ever, communicated to the donors (the wider body of local government taxpayers) or the recipients.

Failure to communicate the level of subsidy to donors can manifest in unhelpful calls for the implementation of local government tax limitations. On the other hand, failure to communicate the level of subsidy to recipients fails, once again, to send an adequate price signal to consumers of merit and positive externality goods. In the absence of a price signal, consumers will tend to demand an inefficiently high quantity and quality of the subsidised local government good. In addition, failure to signal the level of subsidy fails to set up the conditions of moral empathy which underpin the enhanced effectiveness of decentralised governments.[16]

Irrespective of how local government taxation is employed, it is critical for economic efficiency, equity and financial sustainability that it is raised in an appropriate manner. The scholarly literature is almost unanimous in its endorsement of the use of property based taxation for subnational government.[17] The principal reasons for this preference are the immobility of the tax base, the transparency of the tax impost, relative stability, ease of administration and allocative efficiency. Immobility is an especially important trait for a subnational tax because of the relative ease of migration between subnational governments which might otherwise result in destructive tax competition. Put simply, one cannot export a land tax base to an international tax haven nor can one readily move a land tax base to a more favourable national tax jurisdiction. The transparency and visibility of a land based tax 'is a desirable feature from a decision-making perspective'[18] giving rise to a clear link between taxation on the one hand, and expenditure on public goods and subsidies on the other. Land tax is also a relatively stable base – unlike income tax or mineral royalties - and the tax impost is largely resistant to economic shocks. Moreover, land tax is recognised to be generally allocative efficient - it does not distort spending decisions – although this is dependent on the taxation method employed.[19]

* Goods with positive externalities should be subsidised at a level required to elicit optimal consumption.

RECOMMENDATION 1

Local government taxation should only be used to fund local government public goods and the subsidised component of merit goods and positive externality goods. Local government taxation is most decidedly not a fee for service.

RECOMMENDATION 2

The level of subsidy should be justified and clearly communicated to donors and recipients. Subsidy components can be indicated through footnotes on rating assessments and by clear display of subsidy on receipts and at places where subsidised goods and services have been provided.

There is Scope to Increase Australia's Land Tax Impositions

The next question to be posed in relation to local government taxation is whether there is scope to increase the size of the impost. Table 2.3 details the OECD countries which levy a higher proportion of property tax (levied by all tiers of government) as a percentage of GDP than Australia (Australia is ranked 11th in the OECD).

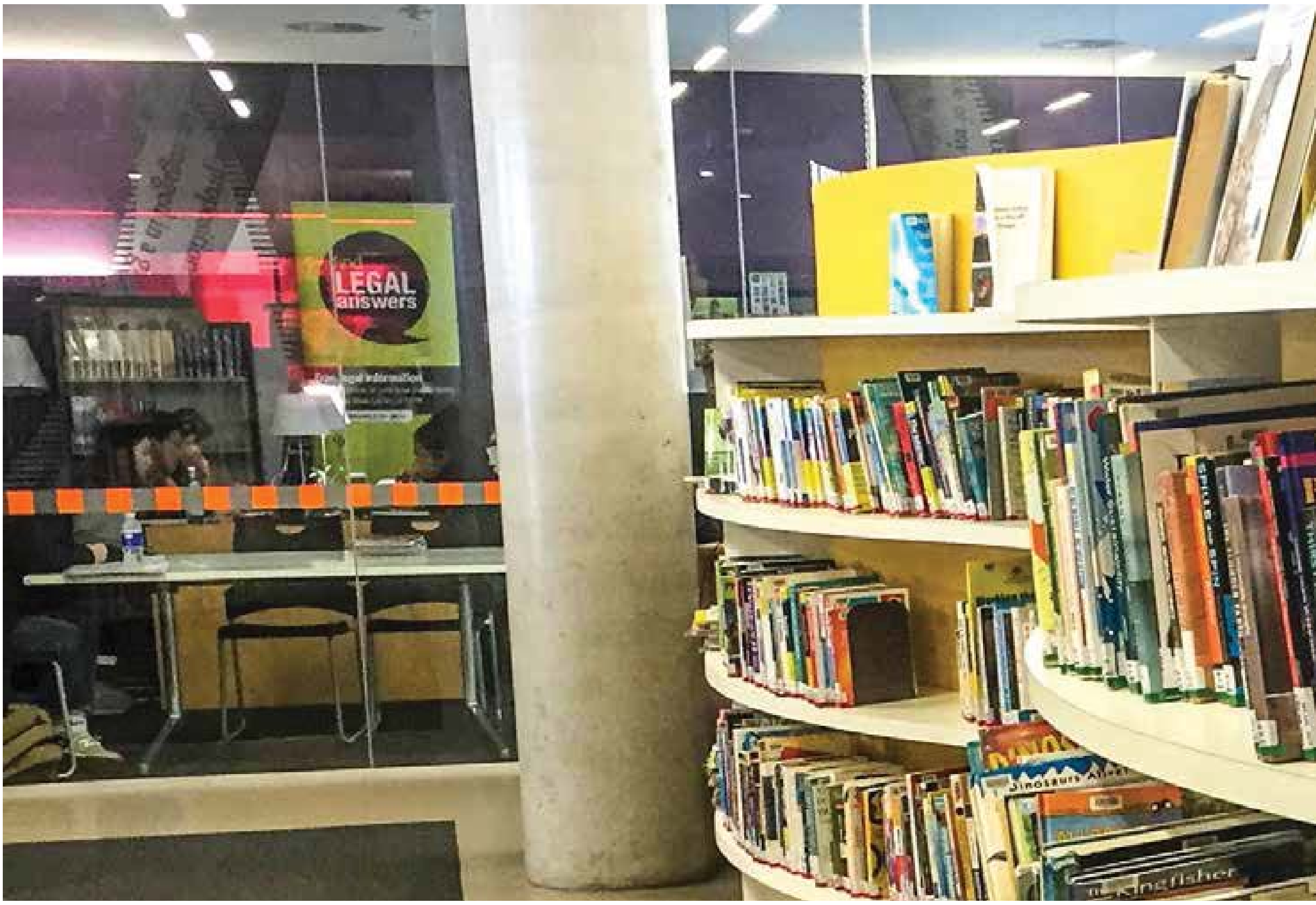
Two notable facts emerge: (i) Australia levies a far higher proportion of property tax than the OECD average and (ii) Australia has marginally reduced the proportion of tax levied when considered over the last two decades (relative to GDP) during a period when the typical OECD country increased property taxation. However, it should be noted that these figures reflect total national property tax take: local government in Australia collect just over a third of the national property tax.[20] On balance it appears – contrary to some arguments[21] – that there may be little room for higher rates of property taxation unless state governments (which dominate the space) were to reduce their imposts (which is unlikely).*

TABLE 2.3 Property Tax as a Percentage of GDP, OECD, 2003 and 2013

Country	1993	2003	2013
UNITED KINGDOM	3	3.9	4
FRANCE	2.7	3	3.8
BELGIUM	1.7	2	3.5
CANADA	3.9	3.5	3.2
USA	3	3	2.9
LUXEMBURG	2.7	2.9	2.8
ITALY	2.2	3.1	2.7
ISRAEL	n/a	2.8	2.7
JAPAN	3.1	2.6	2.7
GREECE	1	1.4	2.6
AUSTRALIA	2.7	2.8	2.6
OECD AVERAGE	1.8	1.8	1.9

SOURCE: OECD 2016

* Indeed, recent suggestion in the media that revenue capture could be employed as an innovative method of funding infrastructure development suggests that the Federal government may be considering the imposition of a property based levy. This would further crowd out the space for local government and reduce the potential for tax increases. Moreover, the idea that revenue capture is somehow innovative is rather strange given that it is the moral imperative behind existing local government property taxation – first articulated by Henry George well over a century ago.



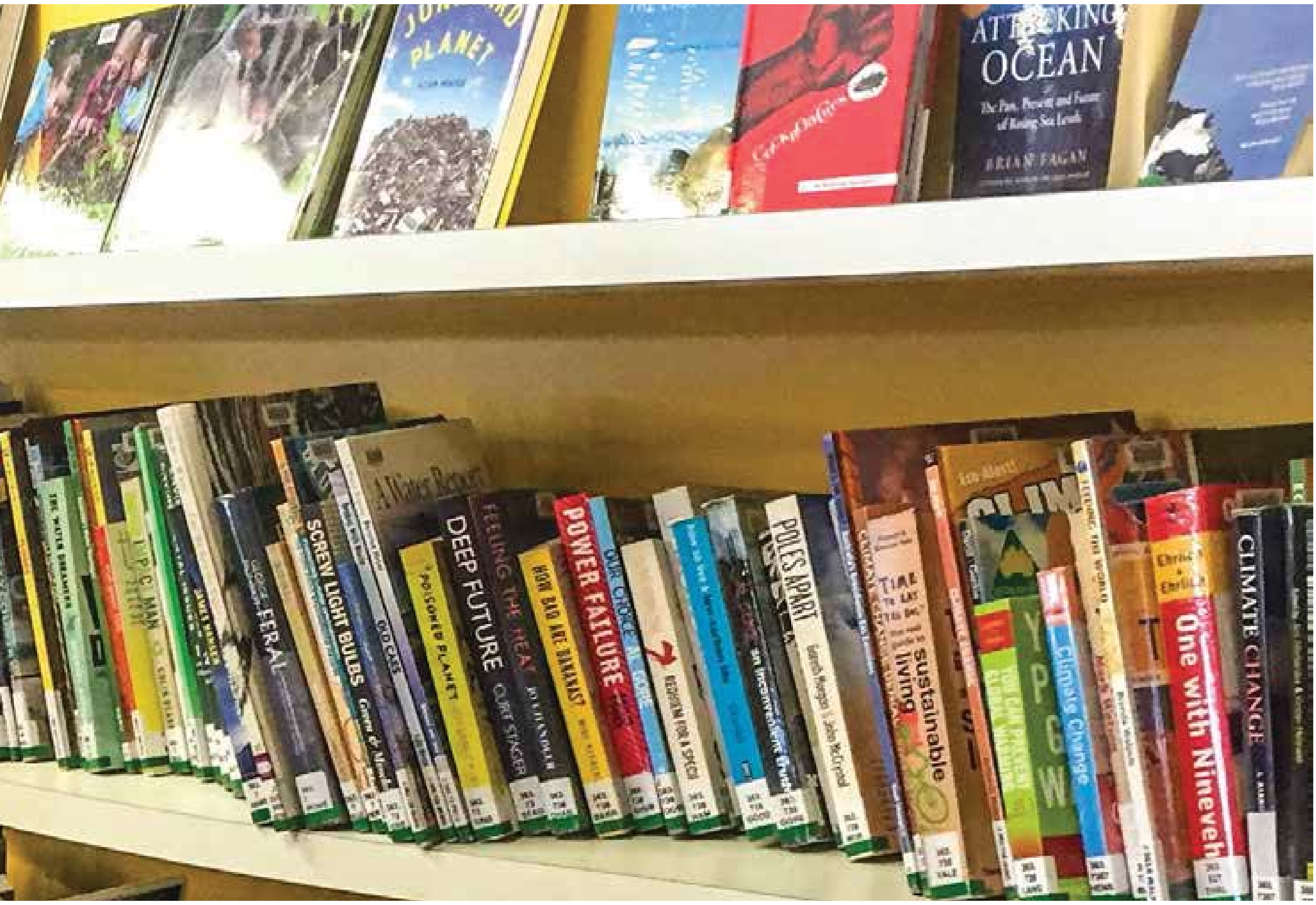
RECOMMENDATION 3

Higher tiers of government should be discouraged from crowding-out the local government tax base. Ideally, retreat by state governments is desirable, but may not be practical. Moreover, serious consideration should be given to returning Capital Gains Tax (CGT) relating to subdivision of land to local governments (which bear the costs of providing infrastructure related to the subdivision). If it is not possible for the Australian Taxation Office to identify and transfer these amounts to local government then the same effect could be achieved by local governments levying a tax-deductible fee on subdivisions equivalent to CGT liabilities.

Exemptions and Concessions Lead to Inequitable Burdens on Taxpayers

Two other important points should be considered in relation to efficiency and effectiveness of local government taxation in Australia: (i) the existence of a wide range of concessions and exemptions and (ii) the increasing use of tax limitations (commonly referred to as rate capping).

Exemptions and concessions are not desirable in view of the fact that they reduce equity – every concession or exemption clearly imposes a higher burden on the remaining taxpayers – and erode the link between revenue and expenditure. Exemptions include benevolent foundations, places of worship, schools, properties occupied by other tiers of government, sporting grounds and selected agricultural enterprises. The most



notable concessions include those given to crown land and buildings occupied by State and Federal Government, and the pensioner discounts, which generally reflect an unfunded mandate of state governments.

While this report does not advocate for the removal of all exemptions, a review of existing exemptions and concessions should be instigated in order to remove those that are not within the funded mandate of local governments. Because apart from representing a threat to the financial sustainability of councils, exemptions and concessions are an incorrect assignment of responsibility amongst tiers of government and an example of cost-shifting (via unfunded mandate). This is because the policy in effect subsidises retired couples to continue to occupy family sized properties – rather than shift into smaller accommodation. While we of course are not suggesting that retired individuals should be forced from their family home, it is clearly undesirable to subsidise continued occupancy in large residential properties. It should be noted in relation to exemptions and concessions that the provision of welfare is not a sub-national function under any specification of fiscal federalism owing to both capacity and inefficient migration problems.[22] There is, thus, strong grounds for abandoning this practice on both the link between revenue and expenditure and fiscal responsibility considerations.

RECOMMENDATION 4

Exemptions and concessions should be reduced and abandoned wherever possible. Welfare is the legitimate responsibility of federal governments. If exemptions and concessions are desired then they should be provided outside of the local government tax cycle, to preserve the link between revenue and expenditure. These can include discounts for pensioners as well as exemptions on crown or other government lands.

Council Rates Should Be Applied with More Transparency

A notable aspect of local government taxation is the use of various differential rate categories. Generally different rate categories exist for residential, commercial, agricultural and mining enterprises, although many councils use multiple sub categories for levying rates. Two serious problems exist in relation to this practice. First, it is almost impossible to find data on local government taxation expressed in cents in the dollar of land value terms, which is the most common way of calculating rates. This is entirely unsatisfactory as the lack of transparency aides rent-seeking activities of special interest groups. Secondly, certain categories of rates – in particular taxation for agricultural enterprises – typically attract substantial concessions, whilst other business categories such as commercial enterprises typically pay a premium rate of local government taxation.*

It is important that a justification is provided for this practice which responds to the nature of local government rates: that is, rates are a form of taxation, not a fee for service, as is often misconceived. Nor is income re-distribution a legitimate function of sub-national government.[23] It is thus difficult to see how different rates of local government taxation can be justified – particularly for different business enterprises.

RECOMMENDATION 5

Every council should be required to make public the calculation method of each of the differential rate categories (in an accessible form), in order to increase transparency and thus reduce opportunity for rent-seeking. Comparative differential rate category data (expressed in cents in the dollar terms) should be clearly stated on all local government rate notices.

Rate Capping is Destroying Local Government Efficiency and Effectiveness

Rate capping also erodes the link between revenue and expenditure and distorts the overall efficiency and effectiveness of local government taxation. Proponents of rate capping assert that it: (i) prevents the misuse of monopoly powers of local governments, (ii) prevents the provision of non-core services and infrastructure and (iii) improves local government efficiency.

Conversely, opponents of rate capping commonly argue that it: (i) increases debt, (ii) increases infrastructure backlogs, (iii) elicits blame shifting and learned helplessness and (iv) introduces inter-jurisdictional inequity (different levels of revenue effort** across jurisdictions). It is commonly held that the reduction in taxation revenue is the biggest problem associated with rate capping. However, we believe that the erosion of the link between revenue and expenditure leading to fiscal illusion and resulting unsustainable levels of demand is a much larger problem.[24]

Somewhat surprisingly, the empirically contestable claims regarding the advantages and disadvantages of rate capping remained unexamined in the Australian scholarly literature until early this year. Those various claims were tested in a 2016 comparative study between NSW (which at the time of the study was the only jurisdiction in Australia operating a pervasive rate cap regime) and Victoria (just prior to the recent introduction in rate capping).[25] They found empirical evidence to suggest that the councils operating under a rate cap regime did indeed have higher levels of inter-jurisdictional revenue effort inequity (but significantly lower rates of revenue effort – see, table 2.4), higher liabilities per assessment, lower rates of infrastructure renewal and lower levels of efficiency.

This study provides empirical evidence against the desirability of tax limitations which is consistent with overseas experiences. Moreover, the authors demonstrate that there are more efficacious methods of achieving the objectives of rate capping proponents according to personal

* It is conceded that rates on business and farm properties represent a deduction on income taxation and thus could be used as an argument for relatively higher rates for these categories of property. However, this exporting of local government taxation (as it is referred to in the literature), also applies to landlords of residential property – thus, on this basis alone there is an argument for higher rates for residential rental properties. However, the export of taxation liabilities is not a desirable element of a federation and we certainly don't promote the practice. Moreover, the tax deductibility argument fails to explain why farm business should be subject to lower rates than other businesses – given that they are often subject to the same federal taxation rules.

** Residential revenue effort is the total fees and local government taxes expressed as a proportion of incomes accruing to individuals residing in the local government area.

finance perspectives. Personal finance theory 'hinges on the perceived value of local services relative to the tax burden imposed'.[26]

Thus, measures which enhance the perception of value will put downward pressure on populist calls for rate capping. Such measures include removing exemptions and concessions, providing information on subsidy to donors and recipients, enabling councils to implement taxation increases on a more frequent basis to reduce the likelihood of rate shock (the authors recommend flexibility on a quarterly basis) and adherence to user pricing for non-public services.[27]

It's a fair assumption that in general, property owners are sceptical of councils over-taxing and mismanaging funds. Thus remedies under this approach would focus on reducing information costs through addressing existing asymmetries and providing an avenue for redress outside of the electoral cycle (an appropriately funded Ombudsman with broad powers which include the ability to investigate claims of rent-seeking activities).

RECOMMENDATION 6

Rate capping should be abandoned as a matter of priority. Local government tax limitations (rate capping) erode the link between revenue and expenditure and diminish financial efficiency and sustainability.

RECOMMENDATION 7

A local government ombudsman, with broader remits, should be established in each jurisdiction to provide opportunity for sanction outside of the electoral cycle. The responsibilities of the ombudsman could be to review governance issues but also rent-seeking activities which disadvantage the broader local government taxpayer community, and monitor cost-shifting behaviour.

RECOMMENDATION 8

Councils should be provided with the flexibility to make incremental adjustments to local government taxation on a quarterly cycle.

Figure 2.4 displays the revenue effort – or local government fees and taxes as a proportion of individual incomes – that residents must pay in different regions of New South Wales and Victoria. As can be seen, people living in rural Victoria paid the highest proportion (1.84 per cent on average) of their incomes to local governments in 2012, but some local governments in urban New South Wales derived as much as 3.3 per cent of average residents' incomes in the same period.

FIGURE 2.4 Revenue Effort Equity NSW and Victoria, 2012 (%)

	Smallest	Largest	Average
NSW (STATE)	0.61	3.30	1.39
VICTORIA (STATE)	0.91	2.62	1.75
NSW URBAN	0.61	3.30	1.52
VICTORIA URBAN	0.91	2.62	1.69
NSW RURAL	0.33	2.37	1.12
VICTORIA RURAL	1.1	2.57	1.84

NOTE: RESIDENTIAL REVENUE EFFORT IS THE TOTAL FEES AND LOCAL GOVERNMENT TAXES EXPRESSED AS A PROPORTION OF INCOMES FOR INDIVIDUALS.

SOURCE: DREW AND DOLLERY, 2016

Local Government Fees and Charges Should Be Re-Assessed

We have already noted that where local government provides private goods and services, it is imperative that benefit pricing is observed. Failure to price private goods appropriately not only erodes the link between revenue and expenditure but also induces an inefficient quantity and quality of production as well as creating inequity for the wider cohort of local government taxpayers. Furthermore, we have noted that merit goods and goods with positive externalities should only have the subsidy component funded from the common tax pool, with the remainder funded by fees and charges imposed on the beneficiaries.

Many scholars and stakeholders have asserted that government does not have a legitimate role in providing private goods.[28] However, this is really just a normative judgement based on political philosophy which cannot be adequately addressed in a paper of this length. However, where market failure is evident, there is a clear and unequivocal role for local government, hence the need for a brief review of pricing concepts.*

Local Government Goods and Services Must Be Priced Accordingly

In essence, there are two approaches to the problem of setting appropriate fees and charges: a supply-side methodology and a demand-side approach. A supply side approach seeks to price goods and services at a long run marginal cost (which is the cost of producing an additional unit with all factors of production accounted for).[29] An approach of this type promotes financial sustainability and equity. However, the calculation of the long run marginal cost is far from a simple matter. For instance, the 'lumpy' nature of facilitating additional capacity, seasonal consumption patterns and cost differentials based on geographic proximity can conspire to confound estimates.[30] Moreover, it has long been noted that local government accounting systems are simply not up to the task.[31] Furthermore, where private goods are supplied in response to market failure, prices calculated through a supply-side approach would likely be beyond the reach of citizen-consumers, thus entirely defeating the purpose of the intervention.

* We note that this is a matter which relates principally to rural councils. However, there are many examples of the market failure rhetoric being applied where there are, in fact, market participants active in the local government area. We also need to remain cognisant of the desirability of ensuring 'existential space' for business and not-for-profit associations (Sirico, 1997).

The alternate demand-side approach minimises market distortion in the local economy, but may not recover costs, and thus not contribute to financial sustainability or equity. The simplest application of demand-side pricing is to conduct price benchmarking, whereby goods and services are priced according to the level charged by private producers or adjoining municipalities. However, this is problematic for the case of market failure, as there will not be existing private providers in the local government area – although the market price in comparable areas could be invoked; or where adjoining municipalities do not employ a robust method for pricing goods and services (which is commonly the case).

Needless to say, the regulation of fees and charges – which occur in some jurisdictions – erodes the link between revenue and expenditure and is contraindicated for much the same reasons as rate capping (that is, it necessarily dictates the cross-subsidisation of services, fails to send an adequate price signal and does not promote allocative efficiency).

RECOMMENDATION 9

A schedule of fees and charges should be publicly available for every council and fully justified according to a demand-side or supply-side approach. This occurs in some jurisdictions, however, it is also important for the information to be both accessible and accessed by local government taxpayers.

RECOMMENDATION 10

Regulated fees and charges should be abolished on the grounds that they erode the link between revenue and expenditure.

Fixed Minimum Fees Should Be Applied to Developer Levies

The final substantive aspect of local government fees and charges income relates to the contentious matter of developer levies. There is a strong economic case for the imposition of developer levies to cover the cost of additional infrastructure attendant upon new developments – once again, the key idea is to send an adequate price signal. By forcing developers to internalise some of the costs associated with developments, allocative efficiency is enhanced – that is, developers will be motivated to produce a more appropriate quantity of development in the areas of greatest social value. This should encourage 'in-fill' developments, discourage urban sprawl and make better use of existing infrastructure capacity.[32] Moreover, it has been argued that it is equitable to shift the costs of supporting infrastructure onto those who directly benefit from the public investment.[33]

However, developer charges are far from problem free and this has given rise to a good deal of litigation. Matters of dispute usually revolve around establishing a sufficient link between the development and the supporting infrastructure, estimating the benefit region of public infrastructure and calculating the long-run marginal cost for associated public infrastructure. The costs involved in calculating and defending developer levies are so great that many councils fall back on voluntary agreements and some councils eschew developer levies entirely.

It is a somewhat surprising fact that in some jurisdictions regulators have imposed a ceiling on developer levies but not a floor. The recent implementation of fixed minimum levies in Victoria can be broadly considered a positive development in this field in terms of promoting financial sustainability and going some way towards establishing a link between revenue and service demand (provided that they are not misinterpreted as regulated fees – councils must still be able to capture the full cost of additional infrastructure).

RECOMMENDATION 11

A floor on developer levies should be legislated to prevent councils from eschewing developer levies entirely, or imposing an inadequate levy out of fear of litigation. However, it is important that legislation clearly provides councils with the opportunity to pursue higher fees and charges when justified. In addition, caps on developer charges should be removed on the basis that they erode the link between revenue and expenditure and financial sustainability.

Intergovernmental Grants Are an Integral Part of the Federation

Intergovernmental grant transfers are a necessary counterpart to federations. Of late there has been lot of commentary which suggests that own source revenue is inherently virtuous and intergovernmental transfers are somehow undesirable. This interpretation is simply incorrect and ignores the underlying disparities which exist in every federation and the desirability of correcting them.

Intergovernmental grants seek to redress inequities which exist along two dimensions: vertical fiscal imbalance and horizontal fiscal imbalance. Vertical fiscal imbalance (VFI) arises from the fact that subnational taxes must be levied on a relatively immobile base in order to avoid inefficient migration of capital and labour as well as destructive sub-national taxation competition. Moreover, as noted and demonstrated in the tax assignment literature, progressive taxation – particularly income taxation – can only be effectively levied by the federal tier. As a result, higher tiers of government generally levy taxes well in excess of their immediate responsibilities – for instance, the federal government levies 80.1% of taxation nationally whilst local government levies just 3.5%. Vertical fiscal imbalance will always exist because of the fundamental nature of federations. The only relevant question is how much of the taxation revenue collected by the federal tier should be reallocated and on what basis should the allocations occur.

This brings us naturally to the second characteristic of federations which requires mitigation through grant transfers: horizontal fiscal imbalance (HFI), or a situation in which local governments find themselves in dissimilar financial situations but with similar financial commitments. Because a federation is comprised of decentralised units with different wealth, levels of industrialisation, natural endowments, climate and topography, horizontal fiscal imbalance is almost certain to occur. The essential point is that different local governments will have different revenue raising capabilities and different expenditure needs. A system of inelastic grants allocated according to robust empirical methodology is therefore essential in order to (i) eliminate inefficient migration of capital and labour, (ii) reduce the opportunities for pork-barrelling, (iii) eliminate wasteful lobbying,[34] and (iv) reduce the potential for political conflict.[35] In addition, horizontal fiscal equalisation (HFE) grants, which are intergovernmental grants designed to mitigate the imbalance between different local governments, are required to respond to the normative proposition that 'different persons should be treated similarly unless they are dissimilar in some relevant respect'.[36]

Intergovernmental Grants Should Preserve the Link Between Demand and Willingness to Pay

If we accept the strong arguments in the corpus of scholarly literature for a system of intergovernmental grants, then the next task is to specify its desirable traits. It is important to note that intergovernmental grants carry significant risks: in particular, grant transfers erode the link between demand and willingness to pay. Thus, the scholarly literature contains a number of studies on the fiscal illusion they create – the well-known flypaper effect.[37]

Therefore, a desirable feature of intergovernmental grants is that they preserve, wherever possible, the link between demand and willingness to pay. This can be accomplished by allocating HFE grants directly to the householder (by way of rebate outside of the local government taxation cycle) rather than to the council. This practice would re-establish the crucial link between demand for public goods and the subsidy component of merit and positive externality goods, because increases in the provision would be met with noticeable increases to the local government tax impost.

RECOMMENDATION 12

Intergovernmental grant transfers made with the objective of mitigating horizontal fiscal imbalance should be paid directly to the local government taxpayer by way of a rebate outside of the local government tax cycle. This will help to re-assert the link between demand and willingness to pay.

Intergovernmental Grants Should Be Allocated Transparently

The second desirable trait is for intergovernmental grants to be inelastic and based on robust empirical methodology. This condition is important given the ever-present threat to communities via soft budget constraints.[38] If grants are elastic owing to a lack of transparency, consistency and robust empirical methodology, then this deficiency may be exploited by local governments to expand services to unsustainable levels at the expense of the wider community.

For example, a local government may run successive deficits and take on unsustainable levels of debt and then lobby to have intergovernmental grants increased in order to address the resultant liquidity crisis. There are many examples of brinkmanship games of this sort in the international literature,[39] however, we also have an example of precisely this behaviour by a remote NSW council.[40] Exploitation of soft budgets is an ongoing risk because Australia does not allocate intergovernmental grants in a transparent, consistent and empirically robust manner.

RECOMMENDATION 13

Financial assistance grants should be allocated by a central national authority free of political interference.

Intergovernmental Grants Should Be Linked to a Predictable Source of Revenue

The third desirable trait of a system of intergovernmental grants transfers is that they are linked to a predictable and growing source of revenue. Much has been written about the three year freeze to financial assistance grants which was implemented in order to attempt to arrest the decline in the federal budgetary position.[41] This event underlines the need for legislation to link financial assistance grants to a source of federal revenue – and doing so would also go some way to arresting VFI over time.

Under the Fraser Government's Local Government (Personal Income Tax Sharing) Act 1976, grants were linked to a growing source of federal tax receipts according to a share which was initially set at 1.52% and rising to 2.00% in 1985. In a similar vein, it was originally proposed that local government would be allocated a fixed proportion of GST revenues, however, this plan was abandoned after negotiations with the senate substantially reduced the scope of the consumption tax.[42]

We do not believe that a call for an increase in financial assistance grants is a practical proposition at present given the pressures on the federal budget. However, linking these grants to a source of federal revenue, such as a fixed percentage of the combined quantum of income and corporate taxation, may be a politically acceptable proposition with clear long term benefits. If the legislation was modified to reflect this and the other recommendations then the result would be a system of intergovernmental grants which are more predictable, equitable, transparent and consistent.

Councils do receive other specific purpose grants – particularly in the form of matching grants. We do not review this practice because it can be a unreliable source of revenue, which is not specifically tied to structural characteristics of the federation. However, we will note that matching grants can act to disadvantage councils with limited resources: particularly, councils with relatively little opportunity to raise own-source revenue (such as rural councils) exacerbated by taxation limitations and regulated fees and charges.

RECOMMENDATION 14

Financial assistance grants should be linked to a predictable and growing source of revenue to ensure financially sustainable local government. The most likely path to achieving this aim is for the grants to be linked to a share of personal and corporate income tax revenues for which the allowed amount is no more than the existing grant allocation. However, if reform of the GST was to be seriously contemplated by federal, state and territory governments, then a case could be made for local government to be allocated a share of this consumption tax.

RECOMMENDATION 15

Authorities issuing matching grants should be conscious of the constraints imposed on councils which have limited revenue raising capacity. Particularly councils operating in an environment dictated by taxation limitations and regulated fees.

Financial Assistance Grants Are Currently Not Achieving Their Mandate

The major source of grant transfers to address imbalance are the financial assistance grants provided by the federal government according to the Local Government (Financial Assistance) Act 1995. The Act states that grants should be allocated according to the principle of horizontal fiscal equalisation (HFE), which it defines thus:

(a) Each local governing body in a state is able to function, by reasonable effort, at a standard not lower than the average standard of other local governing bodies in the state; and

(b) Takes account of differences in the expenditure required to be incurred by local governing bodies in the performance of their functions and in their capacity to raise revenue.'[43]

However, for some time it has been evident to scholars that financial assistance grants are not achieving their legislated purpose. The first reason for this failure is the stipulation in section 6(2)(b) of the Act of a minimum allowed amount of 'no less than the amount that would be allocated to the body if 30 per cent of the amount to which the State is entitled under that section in respect to the year were allocated among local government bodies in the state on a per capita basis'. This section of the Act clearly subverts the HFE objectives and is compounded by the fact that initial allocations to the states are also made on a per capita basis.

The second reason why the grants fail to achieve HFE is that they are allocated by state local government grants commissions rather than by a single national office. This practice occurs as a result of the commonly held belief that direct funding of local government would be 'vulnerable to constitutional challenge if anyone had the standing and motivation to take such an action'.[44*]

* It is by no means certain that this is indeed the case and we note that the Commonwealth has been allocating Road to Recovery grants directly to local government for the last 16 years and an individual of sufficient motivation and standing has not yet materialised.

The reason why state and territory allocation is problematic is that each and every jurisdiction is allocating the grants in a completely different and often opaque manner. Moreover, most of the allocation methodologies are chaotic and empirically indefensible.[45] There are well developed robust methodologies for allocating intergovernmental grants and it is something of a mystery as to why none of the local government grant commissions have adopted a defensible approach.[46]

RECOMMENDATION 16

Section 6(2)(b) of the Local Government (Financial Assistance) Act 1995 should be repealed. This section of the Act subverts principles of horizontal fiscal equalisation, compounding other inequitable stipulations.

RECOMMENDATION 17

Financial assistance grants should be allocated on the basis of robust empirical methodology which principally responds to horizontal fiscal imbalance. There already exists an empirically robust methodology that has been demonstrated in the scholarly literature since at least 1989.

The Risks of Local Governments Taking on Debt Should Be Appropriately Considered

A number of commentators have recently advocated for local governments to take on higher levels of debt in order to mitigate rising infrastructure backlogs.[47] However, the matter is nowhere near as simple as has been presented and it can be a cause for concern that the discussion to this point has not adequately considered the potential risks.

First, it is important to clarify a common and pervasive misconception: debt is not a source of revenue. All debt can do is to bring forward future revenues. Debt must be repaid as must the cost of debt.

The second problem to recognise in relation to the use of debt is the matter of intergenerational equity. Proponents of debt regularly cite intergenerational equity as a strong reason for the use of debt – the idea being that long-lived assets funded by the current generation of local government taxpayers will be in use by successive generations long after those who funded the infrastructure have moved on. However, this argument does not stand up to close scrutiny given the fact that the current generation has benefitted from infrastructure funded by previous generations.[48] Thus, to achieve the much lauded intergenerational equity, it is readily apparent that we must also exact intergenerational inequity on earlier generations of local government taxpayers.*

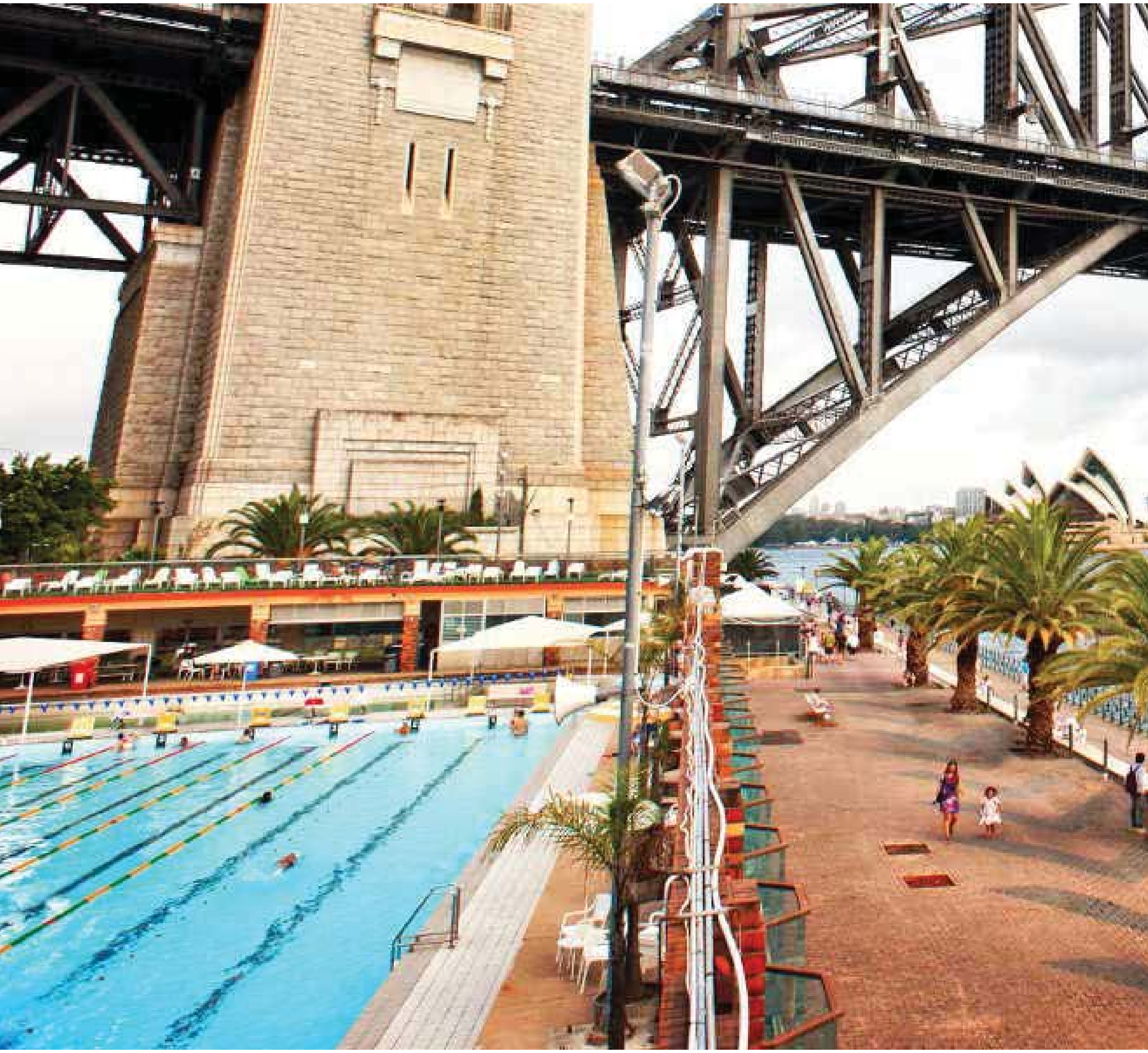
A similar - and yet unresolved - moral hazard is also evident in relation to future generations. It is difficult to see how committing future generations of taxpayers to debt, without their consent – is in anyway morally licit. Moreover, there is a great risk that the fiscal commons of the next generation will be raided by incurring debt for current consumption or by borrowing for an inappropriate portion of infrastructure expense. These significant moral hazards do not appear to have been considered by those advocating that Australian local governments should take on higher levels of debt.**

There are two even more serious problems with the current arguments for local governments to take on more debt: erosion of the link between revenue and expenditure and introduction of soft-budget constraints. As we have noted throughout this paper, expenditure and functional expansion in Australian local government is running at previously unseen unsustainable levels. It is thus of paramount importance that demands for additional services at the margin are tempered by willingness to pay considerations. Debt erodes this crucial link and therefore has an unintended consequence of fuelling higher levels of demand which could well result in a debt spiral.

On the grounds of the link argument alone debt is clearly contraindicated. The second serious problem associated with debt is that it opens up yet another channel of soft-budget constraints which can manifest as a raid on the fiscal commons. Moreover, when considered in

* There are also substantial obstacles owing to the fact that Australia does not have a mature municipal bond market or bond bank. However, we believe that it is important to work through the moral hazard and linking problems before even countenancing appropriate bond products and market structures.

** We do note, however, that it is politically expedient for politicians of the current generation (particularly politicians of higher tiers of government) to advocate debt as a quick fix to the infrastructure backlog – it will be local government politicians (in particular) of the next generation (and the taxpayers of the next generation) who will likely have to deal with the fallout when things go awry.



conjunction with existing chaotic and elastic grant allocations the risk seems particularly high.

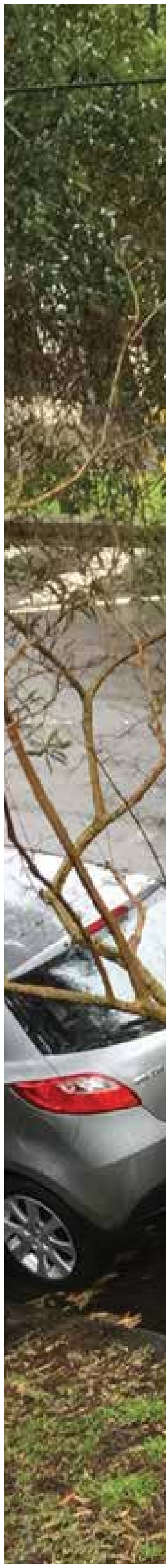
Before debt is countenanced as a systematic option for addressing local government infrastructure backlogs, mechanisms for addressing the substantial moral hazards and defending the link between revenue and expenditure must first be articulated. It is also important before encouraging local government to take on debt that careful debt capacity modelling be conducted (which is currently occurring in at least one Australian jurisdiction).

RECOMMENDATION 18

Robust empirical analysis of debt capacity should be conducted to support the analysis of the suitability of local government borrowings.

It is imperative that, before local governments take on debt, the mechanisms for mitigating the moral hazards posed to past and future generations are clearly understood. Should the preceding significant challenges be resolved, there is scope to improve the efficiency of debt through the establishment of a bond bank or similar institution. Similarly, borrowing for infrastructure that can support growth and future income can be useful for local governments, providing these other issues are first addressed.

PART 3: OBSTACLES TO CHANGE



We conducted semi-structured interviews with a range of stakeholders, including representatives of the state governments, scholars, local government peak bodies, special interest lobby groups, unions representing local government employees, and individual councils. Some of the comments arising from the interviews have been summarised below, along with our response.

Rate-capping is Widely Derided, But Here to Stay Unless Reforms Are Undertaken

There was a general condemnation of rate-capping from councils, peak bodies and lobby groups. As we have noted the scholarly community also condemns the practice. Moreover, it is not the reduced revenue which is the biggest problem associated with the practice, but rather the fiscal illusion which it generates amongst ratepayers.[49]

However, one interviewee expressed wonder as to why a state government would instigate rate capping when it shifts the blame for rate rises to the state government. It is important to understand what purportedly motivates populist calls for rate-capping: the calls come about because efforts to match own-source revenue to the rapid increase in budget outlays (of over 7.3% per year each and every year over the last two decades) can put a strain on personal budgets. It seems to be a common perception that local governments' stress is, in the main, a revenue problem. No matter how important we think the functional expansion is, this sort of growth in outlays cannot continue indefinitely. Eventually, efforts to fund the budgetary expansion exert a heavy burden on ratepayers (of this or future generations) while providing fertile ground for a politician of a higher tier of government to campaign on a platform of rate-capping. Thus it is likely that other jurisdictions will follow in the footsteps of NSW and Victoria.

Cost-Shifting is a Perennial Political Tool That Can Be Eradicated Through COAG

Cost-shifting is a perennial issue of concern for council representatives – and often the seat of blame for local government financial distress. Current efforts to expose the degree of cost-shifting have failed to mitigate the problem. We believe that the only resolution to this problem is a political agreement at the COAG level along the lines that the tier of government instigating a mandate is responsible for funding the mandate. In truth, cost-shifting affects all levels of government and occurs in both directions. Moreover, there is the potential to descend into destructive patterns of cost-shifting (including tax exporting) if an agreement is not reached. Undoubtedly, cost-shifting is a pressure on local government. However, the main problem associated with a failure to resolve the matter is that it will continue to be a convenient topic for political blame games by all tiers of government.[50]

CITY OF SYDNEY
1074

Reforms to Intergovernmental Grants Must Be Communicated Effectively

Two main themes arose from the various interviews in response to our material on intergovernmental grant transfers:

1. Grants should be targeted more effectively on the basis of need
2. Concern that the proposed allocation of HFE grants direct to householders would result in lower revenue for councils and less certainty when planning budgets.

Quite a few participants expressed their concern that the HFE grants were not being targeted towards communities of the greatest need. There seems to be general consensus that the legislation needs to be changed and that a robust and empirically defensible allocation methodology should be adopted. There was no specific response to the idea of having grants allocated directly by the Commonwealth Grant Commission; however, it seems quite clear that if we are to have a uniform approach across the nation then this transfer of allocation power must be executed. Moreover, there was some reason to believe that stakeholders might be confused about the purpose of HFE grants (which are a redistribution of wealth attendant upon progressive taxation which can only be executed by the highest tier of government in a federation).

Some interviewees expressed concern that our proposal to provide HFE grants direct to householders would reduce the revenue of councils and increase the uncertainty in council budgeting. In fact, changing the method of paying HFE grants would have no immediate effect on council revenue nor would it make ratepayers any worse off. Moreover, it would reduce uncertainty in the budgetary process and discourage the federal government from manipulating the system. See Box 3.1 for a simple explanation of the proposal.

We understand that this is a radical departure from current practice and that change can be disconcerting. However, it is also clear that current practice is failing on a number of fronts, thus suggesting the need for fresh thinking on the matter.

BOX 3.1

PROPOSAL TO PROVIDE HFE GRANTS DIRECTLY TO THE COUNCIL RATE PAYER

Suppose an individual lived in a council area where the annual rate bill was $2,300 and the HFE grant was $200 (on a per assessment basis). Our proposal would simply mean that the council would issue a rates notice for $2,500, thus receiving exactly the same revenue. Moreover, the ratepayer would be no worse off because they would receive $200 directly from the federal government.

The main difference would be that the link between demand and willingness to pay will have been r easserted and the ratepayer will be aware of the precise amount of the subsidy provided by the larger body of Australian taxpayers. Moreover, the council would have greater certainty in budgeting because they would be somewhat insulated from the variation in allocations which occur from year to year.

An additional, and very important, benefit of the proposal would be that if future federal governments tried to manipulate the HFE component of grants to address their own budget problems, they would find themselves directly responsible to the individual ratepayers. Rather than councils having to launch, what have proven to be over time, largely ineffective campaigns to resist manipulation of financial assistance grants, the result would instead have ratepayers making their federal representative directly aware of their feelings on the matter.

There is Support for an Independent Ombudsman

One interviewee drew our attention to the need for 'independent umpires to be deployed more often – as too many matters regarding local government are politicised and decisions are not made on evidence or merit'.

We agree with this sentiment and believe that it is validation for our call for Ombudsmen to be granted broader remits (see recommendation 7).

There are Mixed Feelings About Local Governments Taking on Debt

Our material on debt elicited a strong response from interviewees. Some stakeholders believed that in view of local governments 'strong revenue sources' and 'low levels of debt' that there was a clear case for 'sensible borrowings'. However, as we have seen it might be hard to argue that local government has strong revenue sources – land tax is being crowded out by state governments and the federal government is considering a new foray into land tax; two jurisdictions operate rate capping regimes and state jurisdictions also regulate fees and charges. Moreover, the populist support for rate-capping in NSW and Victoria suggests that the revenue source is nowhere near as strong as one might hope. Moreover, 'low levels of debt' seem to be a relative concept – thus we note the importance of comprehensively measuring debt capacity.

Yet another interviewee stated that there was a clear need for guidance for councils regarding 'responsible' borrowing and how to navigate the moral hazards surrounding intergenerational equity. This same respondent noted – quite rightly – that it was important to separate out the debate on funding infrastructure from debates regarding debt in general. We agree entirely and note that we did draw attention to the undesirability of incurring debt to fund operational expenditure.

Own-Source Revenue is a Serious Issue for Rural Councils

Interviewees drew our attention to the relatively limited opportunities for rural councils to raise own-source revenue (for instance, rural councils do not generally have much scope to raise revenue from car parking). This is a valid point and a factor which is explicitly considered in the academic literature for intergovernmental grants transfers.[51]

The Path to Efficiency is Not as Simple as Amalgamating

One interviewee from a council expressed concern that potential efficiencies have been exhausted and wondered 'what's next?' This is a particularly astute observation.

For many decades, local government regulators have amalgamated, imposed performance management, tried to reduce information asymmetries through performance monitoring, reformed legislation and publicly exhorted councils to improve their efficiency and effectiveness. In response councils have cut costs and entered into arrangements which are purported to reduce expenditure (for instance, voluntary amalgamations and shared service agreements).

Yet the (scant) evidence suggests that the sustainability of local government continues to deteriorate. Clearly, the well-trod paths of local government reform are not paying the dividends which reform proponents might wish them to.

Things must change – no government can absorb increases in expenditure in the order of 7.3% per annum; year after year; decade after decade. Nor will local government taxpayers be able to absorb increases to the local government taxation in the order of 7.3% per annum on the same basis. Nor is it reasonable to believe that the solution is larger intergovernmental grants (no matter how desirable they might be): the federal government has its own budget issues, and the money from the federal government is ultimately paid for by much the same group of taxpayers who pay local government rates.

If we want to improve the sustainability of local government then we have to do things differently.

The most important thing we can do is re-establish the link between demand for local government goods and services and willingness to pay. Our recommendations relate principally to reasserting this balance which must exist in any sustainable system of government.

PART 4: DIRECTIONS FOR FUTURE RESEARCH

We believe that there are a number of clear research priorities that have emerged from the undertaking of this report.

First, it is somewhat surprising – and alarming – that a comprehensive robust analysis of the financial sustainability of Australian Local Government has yet to be undertaken. We cannot know the scale of the assumed financial sustainability issues without undertaking a study which goes well beyond the current work comprised of a few financial ratios with arbitrary benchmarks. Instead, we must measure all of the dimensions of sustainability – debt, liquidity, risk, efficiency, resilience and budgetary accuracy – to gain a credible picture of the state of local government. This task should be made a priority given the national importance of the local government sector.

Second, we have outlined the need for debt capacity modelling along with research to address the questions of moral hazard associated with debt. This need was also recognised by the various parties who participated in our interviews. It may be politically expedient to shift the infrastructure backlog onto the next generation of ratepayers, but this may not be either morally licit nor in the nation's long-term interests.

Third, several authors have demonstrated that our current system of intergovernmental grant transfers are not allocated according to a consistent and empirically defensible methodology. We therefore strongly recommend legislative changes and adoption of a sound empirical strategy for allocation.

There is also a clear need to put in place more formal and rigorous education for elected representatives and council staff. In addition, the democratic nature of local government requires education at the community level. Re-establishing the link between expenditures and revenues is a start in the education process. However, there is also good reason to believe that education via effective community engagement would pay handsome dividends for the sector. Our own experience in running deliberative panels which directly involve a representative group of citizens in the allocation of expenditure demonstrates that citizens are willing to work with local government to attain more sustainable futures if they are made aware of the issues and trade-offs. This suggests that it is time for local government and local government regulators to start reaching out to the community – not just when electoral cycles or political expediency dictates consultation, but rather on a regular basis and in a manner which treats ratepayers as capable of making fully informed decisions.


PLEASE
WAIT
HERE

CONCLUSION

This report has taken a wide-lens view of local governments, and has provided a series of recommendations that, if implemented, will allow councils to continue providing the services Australians have come to expect and enjoy, at a sustainable price, and in an equitable way.

The most important finding of this report is that the link between local government revenue and local government expenditure is broken. In the absence of such a link, demand for local government goods and services is not tempered by willingness to pay considerations. This has resulted in a level of demand which does not seem to be sustainable in the long-term. Additionally, much work must be done to improve the transparency and equity of intergovernmental grants, and to establish whether taking on debt is the right move for individual councils.

As we have demonstrated throughout this report, a holistic approach is required to address the concerns regarding the financial sustainability of the sector. To this end, we have made a total of 18 recommendations. Individual recommendations do have merit and may improve matters somewhat. However, only a complete overhaul of the way local government goods and services are paid for will ensure long-term sustainability. Moreover, it is clear that difficult decisions will need to be made and it is important that all stakeholders are genuinely involved in reforms. It is equally clear that we cannot continue in the same way as we have done in the past. Australians rely on local government goods and services on a daily basis, we must therefore make all efforts to ensure that Australians continue to be able to rely on local government goods and services into the future.

REFERENCES

1. PricewaterhouseCoopers, 2006, *National financial sustainability study of local government,* PwC: Sydney, p.12.
2. New South Wales Government, Independent Local Government Review Panel (ILGRP), 2013, *Revitalising Local Government: Final Report of the Independent Local Government Review Panel,* ILGRP: Sydney, p.7.
3. Drew, J., & Campbell, N, 2016, 'Autopsy of Municipal Failure: The Case of Central Darling Shire,' *Australasian Journal of Regional Science*, (in print).
4. Dollery, B. and Grant, B, 2011, 'Financial Sustainability and Financial Viability in Australian Local Government', *Public Finance and Management*, 11(1): pp. 28-47.
5. Australian Bureau of Statistics (ABS), 2016, *Government Finance Statistics, Australia, 2014-15,* ABS: Canberra.
6. Australian Bureau of Statistics (ABS), 2016, *Government Finance Statistics, Australia, 2014-15,* ABS: Canberra.
7. Dollery, B., Crase, L. and Johnson, A., 2006, *Australian Local Government Economics,* UNSW Press: Sydney, p.28.
8. Drew, J. and Dollery, B, 2015(a), 'A Fair Go? A Response to the Independent Local Government Review Panel's Assessment of Municipal Taxation in New South Wales', *Australian Tax Forum,* 30(3): pp. 471-489.
9. Oates, W, 2001, *Property Taxation and Local Government Finance,* Lincoln Institute of Land Policy, Cambridge, Massachusetts, p26.
10. For a review of this substantial literature, see: Glaser, M. and Denhardt, R, 1999, 'When Citizen Expectations Conflict With Budgetary Reality: Discontinuity Between The Public's Demand for Services and Its Willingness to Pay Taxes,' *Public Budgeting, Accounting & Financial Management,* 11(2): 276-310; and Simonsen, B. and Robbins, M, 2003, 'Reasonableness, Satisfaction, and Willingness to Pay Property Taxes,' *Urban Affairs Review,* 38(6), pp. 831-854.
11. Oates, W, 1999, 'An essay on fiscal federalism,' *Journal of Economic Literature,* XXXVII: pp. 1120–1149.
12. Oates, W, 1999, 'An essay on fiscal federalism,' *Journal of Economic Literature*, XXXVII: pp. 1120–1149.
13. Friedman, M, 1993, *Why Government Is the Problem,* Hoover Institution: Stanford, p.7.
14. Friedman, M, 1993, *Why Government Is the Problem,* Hoover Institution: Stanford.
15. Friedman, M, 1993, *Why Government Is the Problem,* Hoover Institution: Stanford.
16. Sirico, R, 1997, 'Subsidiarity, Society and Entitlements: Understanding and Application,' *Notre Dame Journal of Law*, Ethics & Public Policy, 11, pp. 549-579.
17. Oates, W, 2001, *Property Taxation and Local Government Finance,* Lincoln Institute of Land Policy, Cambridge, Massachusetts; Drew, J. and Dollery, B, 2015(a), 'A Fair Go? A Response to the Independent Local Government Review Panel's Assessment of Municipal Taxation in New South Wales', *Australian Tax Forum,* 30(3): pp. 471-489; and Drew, J. and Dollery B, 2016(a), 'Careful What You Wish For: Rate-Capping in Victorian Local Government,' *Journal of Australian Taxation,* 17(1): pp. 139-167.
18. Oates, W, 2001, *Property Taxation and Local Government Finance*, Lincoln Institute of Land Policy, Cambridge, Massachusetts, p.23.
19. Drew, J. and Dollery, B, 2015(a), 'A Fair Go? A Response to the Independent Local Government Review Panel's Assessment of Municipal Taxation in New South Wales', *Australian Tax Forum,* 30(3): pp. 471-489.
20. Australian Bureau of Statistics (ABS), 2016, *Government Finance Statistics, Australia, 2014-15,* ABS: Canberra.

21. Mangioni, V, 2016, 'De-siloing and defining recurrent land tax revenue in Australia'. In Grant, B., Ryan, R. and Martin, J. (Eds.). 'Local Governance and regional development': *Special Edition of Australasian Journal of Regional Studies,* 22(1): pp. 2-8.

22. See, for example: Oates, W, 1999, 'An essay on fiscal federalism,' *Journal of Economic Literature,* XXXVII: pp. 1120–1149.

23. Musgrave, R, 1997, 'Devolution, grants and fiscal competition,' *Journal of Economic Perspectives,* 11(4): pp. 65-72.

24. Duncombe, W. and Yinger, J, 2001. In: Oates, W. (Ed.) *Property Taxation and Local Government Finance,* Lincoln Institute of Land Policy: Cambridge Massachusetts.

25. Drew, J. and Dollery B, 2016(a), 'Careful What You Wish For: Rate-Capping in Victorian Local Government,' *Journal of Australian Taxation,* 17(1).

26. Drew, J. and Dollery B, 2016(a), 'Careful What You Wish For: Rate-Capping in Victorian Local Government,' *Journal of Australian Taxation,* 17(1): p. 146.

27. Drew, J. and Dollery B, 2016(a), 'Careful What You Wish For: Rate-Capping in Victorian Local Government,' *Journal of Australian Taxation,* 17(1): p. 146.

28. See, for instance: Olson, M, 1969, 'The Principle of Fiscal Equivalence: The Division of Responsibilities Among Different Levels of Government,' *The American Economic Review,* 59(2), 479–487; Brennan, G., & Buchanan, J, 1980, *The power to tax: Analytical foundations of a fiscal constitution,* Cambridge University Press: Cambridge; and Friedman, M, 1993, *Why Government Is the Problem,* Hoover Institution: Stanford.

29. McNeill, J., & Dollery, B, 2003, 'Calculating developer charges for urban infrastructure: A feasible method for applying marginal cost pricing,' *The Engineering Economist,* 48(3): pp. 218–240.

30. Dollery B, Witherby A and Marshall H, 2000, 'Section 94 Developer Contributions and Marginal Cost Pricing,' *Urban Policy and Research,* 18(3): pp. 311-328.

31. Carnegie, G., & West, B, 2010, Conceptual Analysis of Price Setting in Australian Local Government,' *Australian Accounting Review,* 53(20): pp. 110–120.

32. Ladd H, 1992, *'Population Growth, Density and the Costs of Providing Public Services,' Urban Studies,* 29(2): pp. 273-295.

33. Bird, R. M, 1976, *Charging for Public Services,* Canadian Tax Foundation: Toronto.

34. Boadway, R., & Shah, A, 2009, *Fiscal Federalism: Principles and Practice of Multiorder Governance,* Cambridge University Press: Cambridge.

35. Lecours, A. and Beland, D, 2013, he Institutional Politics of Territorial Redistribution: Federalism and Equalisation Policy in Australia and Canada,' *Canadian Journal of Political Science,* March 2013: pp. 93-113.

36. Pigou, A, 1929, *A Study in Public Finance,* London: Macmillan, p.9.

37. See Oates, W, 1999, 'An essay on fiscal federalism,' *Journal of Economic Literature,* XXXVII: pp. 1120–1149 for a summary of such studies and for an example of the Australian research on this topic: Dollery, B. and Worthington, A, 1995, 'Federal Expenditure and Fiscal Illusion: A Test of the Flypaper Hypothesis in Australia,' Publius: *The Journal of Federalism,* 25: pp. 23-34.

38. Oates, W, 2005, 'Towards a Second-generation Theory of Fiscal Federalism,' *International Tax and Public Finance,* 12: pp. 349–373.

39. Oates, W, 2005, 'Towards a Second-generation Theory of Fiscal Federalism,' *International Tax and Public Finance,* 12: pp. 349–373.

40. Drew, J., & Campbell, N, 2016, 'Autopsy of Municipal Failure: The Case of Central Darling Shire,' *Australasian Journal of Regional Science,* (in print).

41. Drew, J. and Dollery, B, 2015(b), 'Less Haste More Speed: The Fit for Future Reform Program in New South Wales Local Government,' *Australian Journal of Public Administration,* 75(1): pp. 78-88.

42. Dollery, B., Crase, L. and Johnson, A, 2006, *Australian Local Government Economics,* UNSW Press: Sydney.

43. Local Government (Financial Assistance) Act 1995, s6(3).

44. Twomey, A, 2012, 'Always the Bridesmaid—Constitutional Recognition of Local Government,' *Monash University Law Review,* 38(2), p. 161.

45. Drew, J. and Dollery, B, 2015(a), 'A Fair Go? A Response to the Independent Local Government Review Panel's Assessment of Municipal Taxation in New South Wales', *Australian Tax Forum,* 30(3): pp. 471-489; and Drew, J., & Campbell, N, 2016, 'Autopsy of Municipal Failure: The Case of Central Darling Shire,' *Australasian Journal of Regional Science,* (in print).

46. See, for instance: Ladd, H. and Yinger, J, 1989, 'America's Ailing Cities: Fiscal health and the Design of Urban Policy,' John Hopkin's University Press, London.

47. See, for instance: PricewaterhouseCoopers, 2006, *National financial sustainability study of local government*, PwC: Sydney, p.12; and New South Wales Government, Independent Local Government Review Panel (ILGRP), 2013, *Revitalising Local Government: Final Report of the Independent Local Government Review Panel,* ILGRP: Sydney, p.7.

48. Bruekner, J, 1997, 'Infrastructure Financing and Urban Development: The Economics of Impact Fees,' *Journal of Public Economics*, 66, pp. 383–407.

49. See, for instance: Drew, J. and Dollery B, 2016(a), 'Careful What You Wish For: Rate-Capping in Victorian Local Government,' *Journal of Australian Taxation,* 17(1): p. 146.

50. See, for example: Hood, C, 2011, *The Blame Game: Spin, Bureaucracy, and Self-Preservation in Government.* Princeton: Princeton University Press.

51. Ladd, H. and Yinger, J, 1989, 'America's Ailing Cities: Fiscal health and the Design of Urban Policy,' John Hopkins University Press, London.


CUSTOMER
3
LIBRARY
LIBRARY
Ashfield Council
PLEASE
WAIT
HERE

www.mckellinstitute.org.au

Analysis of Revised Budget 2016-17 per McKell Matrix

Gross Costs - MYR 16/17		Revised Budget 2016-17			
Cost Code Type	**MYR 2016-17**	**Public Goods and Services**	**Merit Goods and Services**	**Goods with Positive Externalities**	**Private Goods and Services**
A - Administration	87,485,884	38,833,635	8,940,198	29,107,500	10,604,549
B - Buildings	6,158,426	1,626,370	2,571,280	0	1,960,776
E - Elected Members	699,414	699,414			
F - Fleet and Plant	1,697,862	1,448,436	32,177	200,598	16,651
L - Litter Collection	1,253,604			1,253,604	
N - Natural Areas	1,624,027	1,624,027			
P - Parks	15,908,605	15,908,605			
R - Roads	10,065,660	10,065,660			
	124,893,483	**70,206,147**	**11,543,655**	**30,561,703**	**12,581,977**

Revenue (Other than Rates) - MYR 16/17		Revised Budget 2016-17			
Cost Code Type	**MYR 2016-17**	**Public Goods and Services**	**Merit Goods and Services**	**Goods with Positive Externalities**	**Private Goods and Services**
A - Administration	(46,633,922)	(11,190,808)	(487,021)	(22,718,285)	(12,237,808)
B - Buildings	(1,307,458)	(81,408)	(512,974)	0	(713,076)
E - Elected Members	(309)	(309)			
F - Fleet and Plant	0				
L - Litter Collection	0				
N - Natural Areas	0				
P - Parks	(786,039)	(786,039)			
R - Roads	(25,186)	(25,186)			
	(48,752,914)	**(12,083,750)**	**(999,995)**	**(22,718,285)**	**(12,950,884)**

Net Cost (after revenue) - MYR 16-17		Revised Budget 2016-17			
Cost Code Type	**MYR 2016-17**	**Public Goods and Services**	**Merit Goods and Services**	**Goods with Positive Externalities**	**Private Goods and Services**
A - Administration	40,851,962	27,642,827	8,453,177	6,389,216	(1,633,259)
B - Buildings	4,850,968	1,544,962	2,058,306	0	1,247,700
E - Elected Members	699,105	699,105	0	0	0
F - Fleet and Plant	1,697,862	1,448,436	32,177	200,598	16,651
L - Litter Collection	1,253,604	0	0	1,253,604	0
N - Natural Areas	1,624,027	1,624,027	0	0	0
P - Parks	15,122,566	15,122,566	0	0	0
R - Roads	10,040,474	10,040,474	0	0	0
	76,140,569	**58,122,397**	**10,543,660**	**7,843,418**	**(368,907)**