ALGA SUBMISSION TO THE AUSTRALIAN GOVERNMENT'S TAXATION REVIEW

Introduction

The Australian Local Government Association (ALGA) welcomes the comprehensive review of Australia's taxation system announced in the Federal Budget 2008-09.

This submission from ALGA responds to calls for submissions to the review following the release of the Treasury paper 'Australia's Tax and Tax Transfer Architecture,' August 2008 (the Treasury paper). It highlights a number of issues including:

- the importance of taxation revenue for the provision of essential local government services and infrastructure at the local and regional level;

- the role local government plays in raising (some of that) taxation revenue within a federalised taxation system;

- the nature of local government's tax base (rates), having regard to the requirement that a well-designed tax should be fair, efficient, simple, transparent and adequate/sustainable;

- the constraints and restrictions that impinge upon local government's ability to fully exploit its taxation base (ability to pay, capping, concessions, exemptions and the potential for state crowding out);

- the alternative forms of own-source revenue raising being utilised by the local government sector (including borrowing) in an effort to achieve sustainability;

- the financial sustainability of the local government sector;

- the critical role of intergovernmental grants from the Commonwealth and the states to the sector (both in the form of general purpose funding and specific purpose payments) in order to promote horizontal fiscal equity for all Australians; and

- the inadequacy of current intergovernmental transfers, especially Commonwealth general purpose funding, in achieving horizontal fiscal equalization.

Comments in this submission about the adequacy of funding transfers from the Federal Government relate primarily to the Financial Assistance Grants provided to local government (which ALGA considers to be analogous to the general purpose funding provided to the state and territories[1] in the form of the GST).

ALGA notes that submissions received in response to the Treasury paper are intended to assist the Review Panel to finalise its own consultation paper, due for release by the end of 2008. This submission is designed to flag critical issues, from a local government perspective, that should be taken into consideration as the review progresses. ALGA anticipates making a further submission responding to the Review Panel consultation paper.

ALGA has consulted with state and territory local government associations in the preparation of this submission. ALGA understands that individual associations and councils are likely to make their own submissions to the review.

About the Australian Local Government Association (ALGA)

ALGA is the national voice of local government in Australia, representing 562 councils across the country. In structure, ALGA is a federation of state and territory local government associations, and includes the Government of the Australian Capital Territory. Uniquely in Australia, the ACT Government undertakes a combination of state and local government functions.

ALGA was established in 1947 and throughout its history has been closely involved in issues of national significance affecting the local government sector as a whole. ALGA has enjoyed a close, productive working relationship with the Commonwealth Government, illustrated by its current membership (through its President) of the Council of Australian Governments, and 13 other Commonwealth-State Ministerial Councils,[2] each of which considers different sets of complex policy issues across many sectors of the economy.

In addition to its representative role on key Commonwealth-State Ministerial fora, ALGA's key functions include participating in policy reviews, providing submissions to and appearing before Federal Parliamentary inquiries, and enhancing opportunities for local government to inform the development of national local government policies.

[1] References in this paper to 'states' are to be read as references to the 'states and territories' unless otherwise indicated.

[2] Some of the Ministerial Councils in which ALGA participates include: the Cultural Ministers' Council; the Online & Communications Council; the Housing Ministers' Conference; the Environment Protection and Heritage Council; the Local Government and Planning Ministers' Council; and the Australian Transport Council.

Examples of the latter are wide-ranging but include the directorial roadmap for the use of electronic technology by local councils (2001), and the recently concluded Australian Local Government Population Ageing Action Plan 2004-08.[3]

Governments and the importance of taxation revenue

While there are a number of theories about the role of government, it is relatively uncontroversial to observe that when government performs its role effectively and efficiently, the economic and social wellbeing of individuals is seen to be, or seen to be being, enhanced. As noted by Dr Peter Abelson,

> A good government supplies essential public services including law and order, economic infrastructure, and basic health and education services. It assists the poor and protects the vulnerable in society. It provides the institutions and rules that allow markets to flourish, effort to be rewarded, and people to lead prosperous and healthy lives.[4]

In Australia, governments perform numerous functions, both economic and non-economic. Their powers are generally granted to them in constitutional legislation, which in turn establishes the scope of their role and limits on their powers.

In general, it can be said that government has three main economic functions: allocation; distribution; and stabilisation.[5] Aspects of each of these functions are detailed throughout the Treasury paper (although not identified in these same terms). For the purposes of clarity, they are described briefly below.

The 'allocation' function refers to the allocation of resources by government in the presence of market failures, and particularly to the supply of public goods. This function also requires government to regulate externalities, prevent or regulate market power, facilitate competitive markets, and protect the public from information failures.

The 'distribution' function refers to the distribution of income and services in the presence of poverty and income inequality. This function, which includes the power to levy taxes on personal income and the capacity to disburse welfare payments, is designed to protect the vulnerable whilst also aimed at enhancing the aggregate economic and social wellbeing of citizens. An example of distribution that affects local government is the concessions and rebates offered to elderly or financially constrained land owners from paying rates.

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[3] ALGA acknowledges the funding assistance provided by the Commonwealth of Australia for these two initiatives.

[4] Abelson, P, 2008, *Foundations of Public Economics*, McGraw-Hill Sydney, Chapter 1, 'Principles and Practice,' p.8.

[5] Abelson, P, 2008, op cit; Rosen, H and Gayer, T, 2008, *Public Economics*, 8th edition, McGraw-Hill, New York.

The 'stabilisation' function refers to macroeconomic management, notably policy making aimed at achieving full employment and price stability. This function is designed to provide robustness in the economy and resilience from external shock. It is controlled primarily through monetary and fiscal policy.

The theory of fiscal federalism[6] suggests that these three main economic functions of government should be allocated to different spheres of government, according to the capacity of each to achieve the required objective. It is also accepted generally that central government should perform the macroeconomic management function. In Australia, it is the federal government that has prime responsibility for both the distribution and macroeconomic functions.

The Australian Government controls the key instrument of income redistribution: the taxation of personal income. This is consistent with the philosophy that only central government can create horizontal equity (the like treatment of like citizens across the country), and comes as a result of the high degree of vertical fiscal imbalance that exists in Australia between the Australian Government and the other two spheres of government.

Implicit in the acceptance that government should have a place in the life of its citizens is the acknowledgement that the allocation, distribution and stabilisation functions are made possible only if government has appropriate and adequate financial resources to do so.

The revenue available to a sphere of government should reflect the extent to which it must perform any or all of the three functions of government detailed above. Accordingly, if the role of government is to deliver services, and necessary infrastructure, then revenue (including taxation) is required to support the administration of those functions.[7]

It is ALGA's view that an analysis of local government's taxation revenue power and other revenue mechanisms cannot be undertaken in isolation from the role of, and allocation of public functions to, local government.

Consistent with the principle of subsidiarity,[8] local government is responsible for governance at the local community level and delivery of essential local services and infrastructure at the local level. The fact that local government is a common governance feature around the world underlines the significance, in practice, of the subsidiarity principle.

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[6] For example, see Musso, J, 1998, 'Fiscal federalism as a framework for government reform' in Thompson and M.T Green, *Handbook of Public Finance*, Marcel Dekkar, New York.

[7] It is important to distinguish between the roles of government as a funder of services and as a supplier of services. In some circumstances, it may be appropriate for a sphere of government to both fund and supply a service; in others, it may be more appropriate that one sphere of government fund a service whilst another supply it.

[8] Treasury paper, p.298.

Facilitating local choices and making decisions on local services through a system of local government has a number of key advantages. Local government has the ability to use local knowledge and most appropriately identify and manage local variations in needs, preferences and costs of services. Being the sphere of government closest to Australian local and regional communities, local government is best placed to actively engage the public in the decision-making process. Furthermore, democratically elected local government has the political mandate to make local choices for which an administrative system could not be made accountable.

Local governments are well-placed to provide local 'public goods'. These 'public goods' are defined as goods and services that primarily serve and benefit the local population but which private firms cannot charge for and will not supply. Examples include urban planning services, climate adaptation and mitigation, public health programs, the provision of local roads, parks and ovals, storm water and drainage systems, and various local and regional community facilities.

In practice, local councils around Australia provide public goods in the form of physical infrastructure and services. Some examples are listed below, although it is noted that they are not all provided by councils in every jurisdiction.[9]

Physical infrastructure can include:

- construction and maintenance of roads, streets, pavements, traffic lights, bridges and car parks
- stormwater, sewerage and drainage systems (in some states)[10]
- parks and sporting facilities (swimming pools, golf clubs, sports courts)
- libraries and other community facilities (art galleries, performing arts centres and museums)
- child care and aged care facilities
- caravan parks and camping resorts.

Services provided by councils can include:

- engineering (public works design)
- strategic planning and development assessment
- public health and sanitary services (food inspection and animal control, immunisation, public toilets)
- recycling, trade and household waste services
- recreational and cultural services
- tourism promotion
- local and regional economic development facilitation

[9] For example, in Tasmania, libraries are managed by the state government; in the Northern Territory, planning decisions are made at the state level. These examples are meant to be illustrative only.
[10] In New South Wales, an important additional item is water supply and sewerage infrastructure (in regional NSW, councils are the public water utility).

- community education programs
- water supply and sewerage services
- social or welfare services (child care, elderly care and accommodation, meals on wheels, counselling)
- the regulation of building standards (inspection, licensing, certification, enforcement)
- general local administration (such as regulations relating to registration and management of dogs and slaughtering).

A key feature of the provision of these public goods is that the local council is the sole supplier. For many of these services, there are no effective substitutes.

Accordingly, the revenue framework for local government needs to be commensurate with its role as the third sphere of government responsible for local matters.[11] Local government can only function effectively if a mechanism is in place to appropriately share public functions and correspondingly allocate funding or revenue raising powers between local government and the other two spheres of government.

The changing nature and role of local government in Australia

In Australia, local government has existed since 1840 (that is, prior to the establishment of some colonial governments in Australia).[12] Key milestones achieved by the local government sector in its early years included: building and establishing roads for newly formed colonies including rural roads (sometimes through the establishment of Roads Boards); establishing wharves and jetties and the means to cross rivers; provision of community public buildings, parks and gardens; the delivery of gas, electricity and in some areas, water and water sewerage services (which still remains the case today in Queensland and parts of rural New South Wales); and motor vehicle licensing in some jurisdictions.[13]

[11] Prime Minister Rudd described local government as the third arm of government in Australia when announcing the summit of the Australian Council of Local Government (refer joint media release Prime Minister and Minister for Infrastructure and Local Government, 'First meeting of Australian Council of Local government: a new partnership with local government,' 18 September 2008).
[12] The first Australian local council to be established was the Adelaide City Council.
[13] For example, in WA: despite the centralisation of licensing, Western Australia continues to allow the issue of distinctive number plates which indicate, by alphabetic prefix or suffix, the council area where the vehicle owner lives. See http://www.walga.asn.au/about_lg/history.html.

When local governments were first established, the broadly held assumption was that they would predominantly deliver what were once typically regarded as "property-based services": maintenance and building of local roads, provision of public amenities and collection and disposal of rubbish. Perhaps reflecting this assumption, local authorities were granted a power to levy taxation on property, in the form of rates – the further assumption being that services would be provided only to the rated properties within a specific municipality.

While its role has never been amenable to precise definition, there can be no doubt that if the role of local government was once assumed to be as provider of property-based services, it has changed significantly. Changes have occurred over a considerable period of time, with some human services such as immunisation, being provided by councils since the 1930s. The pace and level of change, however, has become more rapid. This was noted by the Commonwealth Grants Commission in its 2001 review of the *Local Government (Financial Assistance) Act 1995*, which concluded that the composition of services being provided by local government over the period 1961-62 and 1997-98 had 'changed markedly,' there having been 'a move away from property-based services to human services; a decline in the relative importance of road expenditure; an increase in the relative importance of recreation and culture, and housing and community amenities; and an expansion of education, health, welfare and public safety services.[14] A similar point was made by the Productivity Commission in its recent study into local government own-source revenue raising.[15] It found that the majority of local government spending was no longer exclusively in the areas of 'property-related services and roads' but also in the areas of 'recreation, health and welfare services.'[16]

There are many reasons why local government's roles and responsibilities, as well as the range of services and infrastructure provided by it, have been evolving and expanding over recent decades to include more services to people (in addition to services to property). One of the hallmarks of local government in Australia has always been its willingness to take on new functions or increase levels of service, provided they are underpinned by appropriate funding and agreements. Changing community demands and expectations prompted by demographic change (such as ageing populations), changing settlement patterns ('sea' and 'tree' changers, as well as the growth of mining communities) and different economic conditions, have caused local government to choose to expand its service types and levels. At other times, functions have been devolved to local government. Sometimes this has been done in a transparent manner with appropriate funding support. In other cases, another sphere of government has raised the requirements associated with the services being provided by local government, or has changed the operating environment in which local government services are delivered. On many occasions in the past, devolution of responsibilities to local

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[14] Commonwealth Grants Commission, 2001, *Review of the Operation of the Local Government (Financial Assistance) Act 1995*, Canberra, p.53.

[15] Productivity Commission, 2008, *Assessing Local Government Revenue Raising Capacity*, Research Report, Canberra, p.17.

[16] Productivity Commission 2008 (op cit), p.7.

government has simply been caused by another sphere of government engaging in responsibility and/or cost shifting.

In 2003, the Standing Committee on Economic, Finance and Public Administration (the Hawker Committee) issued its report into local government funding and observed that 'there is no doubt that local government has, over a number of years, been on the wrong end of cost shifting, largely by state governments.'[17] The Hawker Committee accepted ALGA's estimate that previous cost shifting to the sector is costing the sector between $500 million and $1 billion per annum. ALGA believes the result of previous cost shifting has been to place upward pressure on local government own-source revenue, which has had to absorb the ongoing cost.

Importantly, the issue of local government facing increased costs for service delivery as a result of devolution (cost shifting), raising the bar, and councils' own decision-making in response to community demands has been recently addressed by all jurisdictions through the establishment of an Intergovernmental Agreement (IGA) 'Establishing Principles Guiding Inter-Governmental Relations on Local Government Matters,' signed in April 2006.[18] The IGA sets out a framework within which services and functions delivered to the community at the local level on behalf of another sphere of government are to be funded.

ALGA believes that the sphere of government which is closest to the people it serves should be responsible for making decisions on their behalf, provided it is generally competent to do so. 'Competence' relates not only to legal competence but also to fiscal capacity. Accordingly, as local government increasingly broadens its service provision role into more human service areas, and from economic and social development through to environmental management, the cost implications for local government where it is delivering services on behalf of other spheres must be closely assessed.

Local government's role in the collection of taxation revenue in Australia

In Australia, local government is empowered to raise its own revenue through:

- council rates and charges on property
- user fees and charges
- interest
- fines and other penalties
- developer contributions and charges.[19]

[17] Standing Committee on Economic, Finance and Public Administration, 2003, ***Rates and Taxes: A Fair Share for Responsible Local*** Government, Canberra, Foreword.
[18] A copy of the IGA is available at www.lgpmcouncil.gov.au/publications/charter.aspx.
[19] These powers are granted to local government under state legislation.

Council rates levied on property are the only source of tax revenue available to local government. In other words, of an upper estimated 260 taxes nationally that may be imposed under the current taxation system,[20] local government has just one.

On average, rates revenue constitutes around 3 per cent of Australia's total taxation revenue per annum,[21] which compares with the share of total taxation raised by the states (15 per cent) and the Commonwealth (82 per cent). Rates are, however, a critical source of revenue for local government.

In the period 1998-99 to 2005-06, revenue raised by local government from property taxes accounted for almost 38 per cent of total local government revenue on average per annum, and constituted local government's main single source of revenue.[22]

It is therefore important to assess whether rates satisfy the requirements for a well-designed tax. Standard principles of taxation suggest that a well-designed tax should be are fair, efficient, simple, transparent, and adequate/sustainable.

Design principles for 'good' taxation

Fairness

'Fairness' in taxation has traditionally been assessed in two different ways: one is the benefit principle and the other is the ability to pay principle. According to the benefit principle, households which benefit from services should pay for them. For example, in so far as services are provided to properties, a property tax reflects the benefit principle. Independent analysis commissioned by ALGA to assist in the preparation of this submission states:

> Moreover, in so far as the value of the land is a result of community actions, in provision of economic or social infrastructure, the case for taxing land is even stronger.
>
> If services are provided rather to individuals, user charges may be more equitable according to the benefit principle, though not necessarily according to the ability to pay principle.[23]

The ability to pay principle in turn reflects the principle of vertical equity (or what may be described as 'progressive' taxation). This means that households with more disposable income (or less need) should pay more tax than households with less disposable income (or more need). The principle of horizontal equity holds that like households should pay like amounts of tax. Of most relevance in the local government

[20] Treasury paper, p.10.
[21] Productivity Commission, 2008, op cit, p.28, see Table 2.5. The Table shows that local government's taxation revenue has been a relatively stable proportion of total Australian taxation revenue since 1990-91, whilst Commonwealth total taxation revenue has been increasing.
[22] See ABS 5512.0 *Government Finance Statistics*; also Productivity Commission, 2008, op cit, p. xxii Figure 2.
[23] Applied Economics, 2008, *Local Government in Australia: role, finance and taxation, Report One*, p.16.

context is that the local tax bill should be divided as fairly as possible, according to the ability to pay within any given area.

Rate revenue is typically a combination of a fixed minimum rate per property and an ad valorem rate levied on the land known as unimproved capital value. While unimproved property value may not be a good measure of relative household income at the national or state level, it is usually a reasonable measure of relative household income within a local council area.

Where the application of rates to low income households risks bearing the characteristics of a regressive tax, relief is usually available in the form of concessions and/or rebates (these are discussed in more detail below).

Efficiency

Rates on land are generally considered to be an efficient form of taxation in that they do not significantly distort economic activity and resource allocation.[24] Unlike taxes on capital, rates generally do not tax or deter structural improvements.[25] Of particular significance in this context is a recent study by the OECD that indicates that property taxes have the least detrimental impact on economic growth, followed by taxes on consumption, labour income and capital income.[26] As noted in the Treasury paper,[27] taxes on capital (comprising conveyance stamp duties and land taxes) are state taxes that can be relatively inefficient taxes in the sense that they may either discourage turnover or become embedded in the cost of production.

Simplicity

ALGA agrees with the Productivity Commission that accounting for the actual ability of individuals to pay rates (that is, through measuring income) may provide some better overall consistency with the fairness principle of 'ability to pay.' However, introducing such a system at the local government level would involve myriad complexities, suggesting that the benefits may be outweighed by the costs.

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[24] Productivity Commission (2008), op cit, p.177. See also the State of the Regions 2006-07 report, commissioned by ALGA and prepared by National Economics, which states that 'rates are preferable to most other taxes on efficiency grounds, at least to the extent that they are imposed on values arising from scarcity of land. These scarcity-values or location rents are approximated by site and unimproved values. Scarcity values are not affected by the decisions of individual land owners to build or otherwise improve their properties, so a site value rate has no incentive effects other than the incentive to earn as much income as possible from the site. By contrast, most other taxes have unwanted incentive effects. For example, the income tax reduces the incentive to paid work' (p.58).

[25] In some jurisdictions, councils may levy rates on the capital improved value of land. However, the Productivity Commission (2008) noted the general consensus that 'the distortions and efficiency costs are small' (p.177).

[26] Johannson A, et al, 2008,'Tax and Economic Growth', OECD, Paris, as cited in the Treasury paper p.215.

[27] Treasury paper, p. 217.

Rates are a 'simple to use' tax. Land is immobile and easy to identify for taxation purposes. Taxes on land are also hard to avoid, meaning that tax expenditures by local government should be low.[28] This makes local property tax a relatively simple tax that is within the administrative competence of individual local governments, and is low cost to administer.

Whilst the main administration cost for rates is in the valuation process, the stability of both property and property ownership makes rates administration relatively easy and cost efficient.

Transparency

A good tax must be transparent and certain. Apart from some issues ratepayers may experience in understanding the different types of valuation methods that can be applied to land, local property tax is transparent, highly visible and generally predictable.

Adequacy/sustainability

There is a widely held misconception that local government income from land rates increases proportionally with increases in land values. In practice, local councils in Australia determine an annual budget and then strike a rate (this is usually a requirement mandated in state legislation). The Productivity Commission noted that local governments have capacity to set different rates in the dollar for different land uses and specific activities, depending on what is permitted under state legislation, in order to raise the requisite revenue.

Levying a tax on the basis of property values therefore enables councils to determine autonomously the level of public services to be provided, so long as rates are not limited by the state government (as they are in New South Wales [NSW] and the Northern Territory [NT]) and local households and businesses have sufficient disposable income to fund that level of local services.[29] As noted in the Treasury paper '…all taxes are ultimately paid out of the income of individuals.'[30]

As noted in the State of the Regions 2006-07 report, commissioned by ALGA and prepared by National Economics, 'local government has a history of rating in line with rate paying capacity' and 'take(s) their taxpayers' incomes into account when setting the rate…'.[31] For those councils where there are low levels of local business and household income, real issues arise about the financial sustainability of the council. For Australian taxpayers, general rates revenue accounts for about 1 per cent of gross state product

[28] It is noted that concessions and rebates are tax expenditure but as they bear characteristics that are in the nature of welfare funding, should be borne by central government as it has appropriate revenue heads of taxation (income) to fund these expenditures. This point will be discussed later in this submission.
[29] This compares with systems in Europe under which the revenue is centrally collected and distributed back to the local government sector.
[30] Treasury paper, p.168.
[31] See p.78 and p.73 respectively.

(GSP) on average across Australia and between 1.3 and 1.9 per cent of household disposable income. For most councils, the rates incidence is between 1.5 and 1.8 per cent of after tax income.[32]

The taxation revenue of local councils is neither constrained by the nature of the tax nor the tax base (or its value). Rather, the key constraint on the level of revenue that local jurisdictions can raise is the level of local household incomes. The rate base does not constrain tax revenue in areas with adequate household (and sometimes business) incomes.

Whilst ALGA is confident that local councils in general are making the best efforts to raise appropriate levels of taxation revenue, as broadly confirmed in reports such as those of the Productivity Commission (which concluded that local government on average is raising close to 90 per cent of its theoretical maximum revenue[33]), taxes raised from property cannot fully support the provision of the many services and infrastructure functions of local government noted above. For example, in mining communities that are undergoing rapid growth, high levels of disposable income are not necessarily able to be converted into additional revenue because of factors such as small resident populations, and so cannot be used to address increased demands being placed upon roads and other community infrastructure, which raise the costs for council of maintenance and renewals.

In addition, local government rates are insufficient to redress the significant community infrastructure investment backlog being carried by the sector (estimated at $14.5 billion), which is discussed later in this submission.[34]

Conclusion

Consistent with the principle of subsidiarity, access to a stable local taxation base is critical for local government to continue to deliver the level of services it currently undertakes, whilst providing and maintaining local community infrastructure in a way that responds to community needs and expectations. As the Productivity Commission noted, 'the capacity of local governments to raise revenue is important to their financial stability and their ability to promote the well-being of their local communities.'[35]

Rates are an efficient head of taxation and are non-distortionary. There is a very strong case for rates as a major source of finance for local services provided by the local government sector.[36]

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[32] Productivity Commission, 2008, op cit, p.135.
[33] Productivity Commission, 2008, op cit, Finding 5.4.
[34] It is noted that in calculating the maximum hypothetical cost recovery that may be made by local government for public goods and services delivered by local government, the Productivity Commission (2008) did not take into account any reference to local government's future liabilities, such as local community infrastructure renewals where adequate provision has not been made to cover these liabilities (see p.93). The Productivity Commission acknowledged that if future costs turn out to be higher than currently reported costs, the aggregate cost recovery ratios would be correspondingly lower (see p.xxix).
[35] Productivity Commission, 2008, op cit, p.xix.
[36] See further Productivity Commission, 2008, op cit, p.139.

Constraints on local government's ability to fully exploit its taxation base

ALGA contends that there are a number of limitations imposed on local government that impede it from raising rates revenue to a greater extent. One of them is the ability of communities to pay (as described above). Another is the increasing reliance of the states on property taxation revenue. Finally, state-imposed regulatory restrictions also affect local government's ability to fully exploit its taxation base.

States' increased reliance on property taxes is affecting local government taxation revenue

Beside local government rates, there are a number of other forms of taxation in Australia that are property-based and whose use by other spheres of government potentially diminishes the fiscal capacity of local government rates.

Property tax is a revenue source that state governments rely on increasingly to supplement other own-source revenue, despite rapidly growing GST revenue which is returned fully to the states by the Commonwealth.

In 2006-07, taxes on property comprised the main single source of total state taxation revenue, at 40.6 per cent. Over recent years, of all property taxation raised in Australia, around two-thirds is raised by the states.[37] This may help explain why total property taxes contribute some 3 percentage points more than the OECD average to total national taxation revenue in Australia (that is, just under 9 per cent compared with an OECD average of 6 per cent).[38]

States have generally raised raise property-based taxes in the form of land tax and conveyance stamp duties.[39] Conveyance duties (also a transaction tax) have 'delivered increasing amounts of revenue to the states in recent years.'[40] Together, land tax and conveyance duties taxes, which Treasury categorises as taxes on capital,[41] represented a contribution that was 50 per cent higher than taxes levied by the states from consumption and labour.[42] Specifically, land taxes raised $4.35 billion in 2006-07 for the states (a rise of almost 21 per cent from the previous year) and conveyance duties totalled $13 billion (a rise of 19 per cent).[43]

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[37] In 2006-07, they constituted 68 per cent of total property taxation – see ABS 5506.0.
[38] See the Treasury paper p.206 citing OECD 2005 data in an OECD 2007 report.
[39] ALGA would also note increases in recent years of increased royalties revenues raised by the states.
[40] Treasury paper p.292.
[41] See Treasury paper p. 217.
[42] Op cit.
[43] ABS 5506.0 *Taxation Revenue* 2006-07.

Overall, in the period from 2001-02 to 2006-07, taxes on property raised by state governments increased 59.5 per cent.[44] In comparison, local government taxes on property, the only taxation able to be levied by the sector, increased by 38.9 per cent over that same period.

The increased reliance of the states on property taxes not only risks diminishing the capacity of ratepayers to pay local government rates, but suggests that there are serious issues that need to be considered in the tax review about the role of the states and how best to address their vertical fiscal imbalance. ALGA is of the view that states' reliance on property-based taxes is undesirable and needs to be considered in the context of intergovernmental transfers to the states.

Finally, ALGA submits that state property taxes may constitute a form of double taxation, at least in some cases, such as investment land holdings. This may introduce distortions where state government taxation discriminates against various kinds of land. ALGA believes this issue merits further examination.

Regulatory constraints

As noted in the Treasury paper, the states exercise a range of legislative controls over the manner in which local governments may levy rates. These can include the valuation methods that may be applied, the ability of councils to charge different rates for different types of rate payer, the provision of exemptions and concessions, and restrictions on the annual percentage increase in rates revenue (known as 'rate pegging' or 'rate capping'). It is noted that some exemptions from rates and concessions are also imposed by the Commonwealth.

Local government considers that regulatory rules imposed upon it in relation to own-source revenue raising have the potential to diminish revenue collection efforts and may also cause distortions and inequities as local government attempts to seek revenue from alternate sources in order to meet expenditures.

Rate pegging (or capping)

In Australia, councils in NSW have been affected by rate pegging since 1977. From 1 July 2008, shires in the NT will also be subject to rate pegging for a period of three years. ALGA submits that rate pegging undermines the principle of subsidiarity, and is both unnecessary and undesirable.

Rate pegging is unnecessary from an accountability perspective in that councils are directly elected by their local communities, and are therefore already highly accountable to them for the decisions they make that affect the community. Councils' own democratic, governance and managerial processes determine their revenue and

[44] Op cit.

expenditure decisions.[45] Accordingly, unless councils raise rates in a manner that fairly accords with the demands and expectations of their communities, and its overall capacity to pay, they risk voter backlash at local government elections.

Further, to the extent that rate pegging may have been motivated by fears that councils would otherwise exploit 'land booms,' it is instructive to note that during the land boom of 1996 to 2005, despite land values rising faster than disposable income, councils at a national level maintained their rating effort constant in relation to earned income.[46]

Rates pegging undesirably adds pressure to raise revenue from other sources. The Allan Inquiry[47] commissioned by the Local Government and Shires Associations of NSW showed that between 1995-96 and 2003-04, rate revenues increased by significantly less in NSW than in all other states, and by less than half the increase in GDP, as noted in Table 1 below.

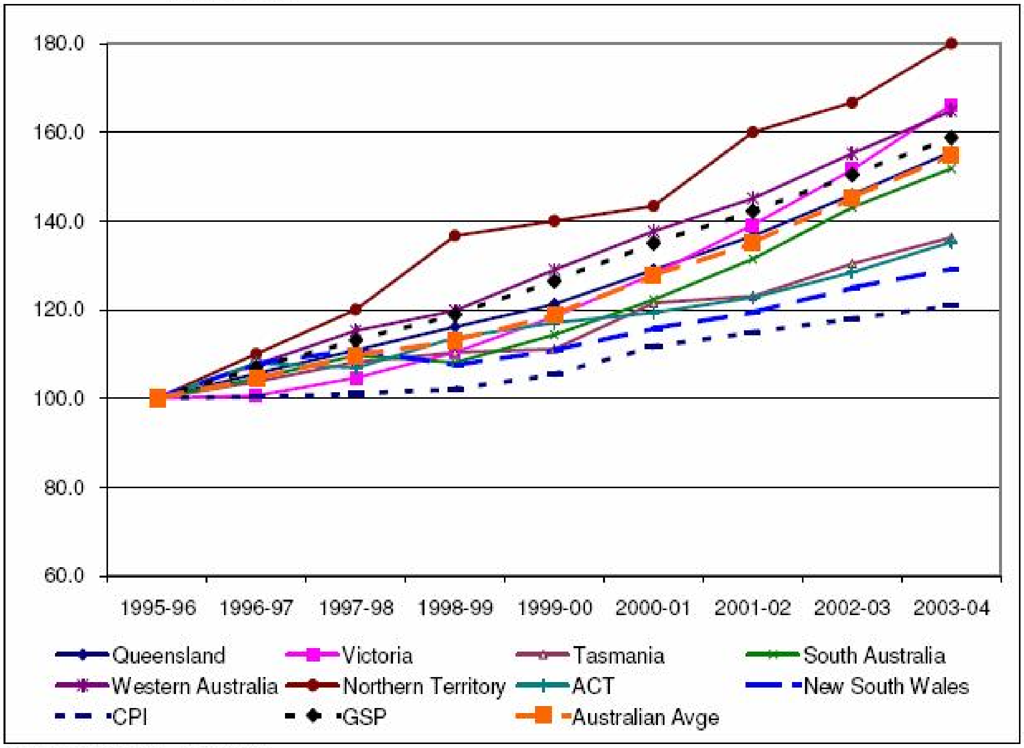
TABLE 1: Rate revenues between 1995-96 and 2003-04

STATE	*Per cent increase*
NSW	**29.2**
ACT	35.2
Tasmania	36.3
South Australia	55.1
Queensland	55.6
Western Australia	64.8
Victoria	66.1
GDP	**61.8**

The Productivity Commission has recently confirmed that in NSW, rate pegging has had a dampening effect on the revenue raised by councils (Finding 6.4), and that NSW councils have experienced the lowest growth in real own-source revenue per person of all jurisdictions in the period 1998-99 to 2005-06 (0.3 per cent a year, compared with the national average of 2.2 per cent).[48] This is consistent with the Allan Inquiry, as seen in Figure 1 below.

[45] Productivity Commission, 2008, op cit, p.61.
[46] State of the Regions 2006-07, p.78. This was also observed by the Productivity Commission, 2008, op cit, at p.53 which stated 'In times of rapidly rising property values, councils often decrease the rate in the dollar, so as to reduce the revenue raised to match the revenue required to fund the budget.'
[47] Allan, P, Darlison, I and Gibbs, D, 2006, *Independent Inquiry into the financial sustainability of local government*, Sydney, p.207.
[48] Productivity Commission, 2008, op cit, p.115.

FIGURE 1: Growth in NSW council rates compared to those of other states 1995-96 to 2003-04



Source: Brooks, J. (2006).

In addition to dampening revenue growth, rate pegging has other negative consequences. For example, the rate pegging limit provides an easy default option from both a political and managerial perspective. Possible reasons for this include:

- Rate pegging alleviates the need for councils to undertake community consultation to justify rate increases within the rate pegging limit;
- Increasing rates within the rate pegging limit avoids the need to enter into the complex process of applying for special rate variations;
- Councils can blame the State Government for their financial deficiencies; and
- Rate pegging reduces the need for long-term strategic and financial planning.

In relation to the latter point, ALGA considers that rate pegging may operate as an incentive to under-invest in less visible, less politically sensitive, responsibilities such as infrastructure maintenance and renewal, where a council is faced with ever increasing community expectations in other areas, and does not have the option to increase revenue to match these expectations. It is notable that of the $14.5 billion estimated infrastructure renewals backlog identified by PriceWaterhouseCoopers for the local government sector, which is often driven by the difference in growth rates between operating expenditure and operating income, the highest was found to be in NSW.[49]

[49] PriceWaterhouseCoopers, *National Financial Sustainability Study of Local Government*, 2006, Sydney, p.113. The renewals backlog is discussed later in this submission under the heading 'Local government financial sustainability.'

In addition, rates pegging creates pressure to increase non-rates revenue as an alternative source of revenue.[50]

Finally, rate pegging might add considerable compliance and administrative costs to local government's taxation system.[51]

Mandatory concessions and rebates relating to rates

The Treasury paper notes that in 2005-06, around 17 per cent of households relied on government pensions and allowances for at least 90 per cent of their income (these were more likely to be comprised of people living alone or aged 65 years and above than households with higher private income).[52] Local government accepts that these households may not be able to pay, or would struggle to be able to pay, a range of costs, including their local government rates.

Local government fully supports the principle that those who require genuine assistance in order to pay rates should be supported. However, it is inconsistent with the economic functions of government detailed earlier in this submission to impose the obligation on local government (and local ratepayers) to support what is essentially an income assistance measure most appropriately funded from income tax revenue and income re-distribution.

The Treasury paper has noted that tax expenditures for local government rates exemptions and concessions, as prepared by each state jurisdiction, are around \$175 million (excluding the ACT). It is submitted that these figures very likely underestimate the total impact on the 'state and local government' sectors, not only because of the acknowledged weaknesses in the data available to the Treasury, but because in NSW, pensioner concessions are only reimbursed at the rate of 55 per cent, compared with other states which reimburse local government at 100 per cent.[53] This funding gap is likely to raise both equity and distribution issues for other ratepayers in affected councils.

As revealed in the two Intergenerational Reports,[54] Australia faces numerous emerging macroeconomic challenges and opportunities into the 21st century. Principal among these is the ageing of Australia's population, which is occurring at an unprecedented rate and represents one of the most significant demographic changes in Australia's modern history. As a result, it can be expected that into the future, an increasing percentage of local community populations will become entitled to these concessions which, if not adequately funded, will add to the financial pressures affecting local government.

[50] However, the Productivity Commission (2008) did conclude that in NSW, this option has largely been exhausted (see p.116 and Finding 6.4, p.117).
[51] This was an observation made to the Productivity Commission, 2008, op cit, p.112.
[52] Treasury paper, p.183
[53] The reimbursements are generally paid to local government in the form of a grant. This forms a significant component of state intergovernmental funding to the local government sector.
[54] See Intergenerational Reports (2002 and 2007).

Other restrictions on local government taxation

Other forms of regulation also have an impact on local government's ability to fully exploit its capacity to raise own-source taxation revenue.

In particular, exemptions of land from rating (such as for crown-owned land including state and national parks, indigenous land, mining leases, and religious organisations) are a key issue. For some councils, a relatively large percentage of land is non-rateable. As noted by Applied Economics,

> Rates exemptions can limit the revenue that some councils can raise, notably those with low rates bases, such as some rural and many remote and Indigenous councils, or those that have large exemptions relative to their rates base.
>
> They also have some efficiency and distributional implications. For example, exemptions might reduce the cost of producing various goods and services and so may distort economic activity by lowering the price and encouraging increased consumption of these goods and services.[55]

As a general principle, agencies receiving similar services should pay similar taxes or user charges. This encourages the most efficient use of land. Economic efficiency and transparency principles further suggest that religious and charitable organisations should receive income subsidies rather than subsidised inputs.[56]

The Productivity Commission concluded in its study that 'there is a paucity of data available to assess the net effect of rates exemptions plus the gains from Commonwealth and State provided tax benefits (that is, reciprocal tax arrangements).'[57] [58] Nonetheless, it concluded that such exemptions have efficiency and distributional implications that may result in the burden of rates being higher than otherwise on rateable properties.

ALGA would further observe that where rate equivalent payments are made directly to the Australian or state governments by entities that receive local government rates exemptions, they are not always subsequently re-distributed to local government.[59] This is likely to exacerbate efficiency and distributional effects and, as with concessions and rebates that are not fully reimbursed, place pressure on local government finances.

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[55] Applied Economics, 2008, op cit, p.20.
[56] Applied Economics, 2008, op cit, p.21.
[57] Productivity Commission, 2008, op cit, p.108
[58] It is noted that there is at least one exception: in Tasmania, state government properties pay rates to councils.
[59] This was also noted by the Productivity Commission, 2008, op cit, p.202.

The issue of reciprocal tax arrangements between the three spheres of government has been the subject of consideration by the Hawker Committee[60] and subsequently in intergovernmental fora. Governments agreed in general not to pursue this issue and ALGA does not propose that the Review revisit this complex area.

Conclusion

Local government notes the Australian Government's commitment to reducing unnecessary red tape and promoting more uniform or at least more consistent legislation across the states in areas such as consumer product safety and consumer credit, licensing of trades, and personal property securities. In a similar vein, ALGA submits that state laws and/or regulations that directly affect the ability of the sector to levy appropriately adjusted rates revenue, should be reviewed.

As a minimum, ALGA supports the Productivity Commission's suggestion that periodic reviews of state laws and regulations that affect local governments' ability to raise own-source revenue should be conducted as a matter of course.[61] ALGA notes that reform efforts could be encouraged by the Commonwealth within the context of its fiscal relations reforms, particularly the new National Partnership Payments.

Local government non-taxation own-source revenue

Whilst rates are the only form of taxation that can be raised by local government, local government also raises other forms of own-source revenue. Local government has three major sources of revenue: municipal rates (that is, taxation, which accounted for around 38 per cent of revenue in 2005-06), charges for goods and services (29 per cent of 2005-06 revenue) and grants and subsidies from other levels of governments (around 17 per cent).[62]

Other non-taxation own-source revenue includes interest earned on deposits, fines and other penalties, and developer contributions and charges.

Non-taxation own-source revenue mechanisms are important for local governments. Together with own-source taxation revenue, local government has been raising more than 80 per cent of its total revenue (aggregated at the national level) throughout the period 1998-99 to 2005-06, and 83 per cent in 2005-06.[63] This is very high by international standards.[64]

[60] Op cit at footnote 17.
[61] Productivity Commission, 2008, op cit, Finding 6.8.
[62] See ABS *Government Finance Statistics 2005-06,* cat. no. 5512.0, ABS, Canberra, and Productivity Commission, 2008, op cit, p.xxii, Figure 2.
[63] Productivity Commission, 2008, op cit, p.xxi and Table 2.6, p.29.
[64] Applied Economics, 2008, op cit, p.13.

Further, as previously noted, the Productivity Commission found that local councils are, on average, raising almost 90 per cent of their hypothetical benchmarks in own-source revenue, and that for 50 per cent of councils, own-source revenue constitutes at least 72 per cent of their total revenue.

User fees and charges

As noted by the Productivity Commission, a wide variety of local government services are now provided on the basis of users paying a fee to cover at least part of the cost of supply.[65] These can be levied for 'compulsory services' that ratepayers cannot avoid, such as garbage collection, or 'discretionary services' such as for the use of sporting facilities or camping grounds, licences (such as dog registrations) and fees for permits such as on-street parking.

User fees and charges are an important component of local government own-source revenue and their use by local government has been increasing in recent decades. In the 1970s, revenue from the sale of goods and services comprised 13 per cent of total local government revenue. In 2006-07, revenue from the sale of goods and services accounted for about 30 per cent of total local government revenue ($7.6 billion, up $1 billion from 2004-05) and has remained around 30 per cent of total revenue since 1999-2000.

This increase in goods and services revenue also reflects the significant increase in the number and diversity of services and more disciplined cost recovery pricing for services under National Competition Policy, particularly water and sewerage.

Independent analysis commissioned by ALGA in the preparation of this submission states:

> In general, user charges [being user fees and charges] are an efficient method of funding private goods. These are goods or services that provide private benefits to the user…User charges are efficient because they provide a financial discipline on both consumers and suppliers. Consumers determine the amount of the good that they are willing to pay for. Suppliers have an incentive to control costs so that prices do not rise unduly….User charges are also equitable in that those who benefit from a service also pay for it.'[66]

Local government would note that a significant proportion of its expenditure is devoted to roads. Local government owns and maintains over 80 per cent of the total length of Australia's roads, and ALGA believes that the application of user charges to the use of local roads by heavy vehicles, as part of a national road pricing model, is appropriate from an economic perspective.[67]

[65] Productivity Commission, 2008, op cit, p.117.
[66] Applied Economics, 2008, op cit, p.28.
[67] Further analysis is available in the State of the Regions 2006-07 report, p. 61.

Developer contributions

According to the Productivity Commission, developer contributions per new dwelling commencement have increased substantially over the four years to 2005-06.[68] At times, they constitute a significant part of council revenue, especially in New South Wales.[69] Importantly, they have been found not to increase the costs of new housing.[70]

Local governments in most jurisdictions can levy the applicant and/or developer for the cost of service provision or have developers construct infrastructure and/or allocate land for public uses, at their own expense. Developer contributions have limited application and essentially seek to reflect the incremental costs attributable to specific developments.

The use of developer charges is subject to state legislation. Generally local councils can:

- levy property developers/applicants up-front for the cost of providing a service or infrastructure;
- require developers to construct infrastructure and transfer it to local government upon completion; or
- require developers/applicants to donate land to local government for facilities such as public open space and roads/car parking.

In NSW, Victoria and Queensland, a publicly exhibited and transparent development plan is required before developer contributions can be levied by local government. As a general rule, developer contributions can be used only to fund specific infrastructure investments that are directly generated by the proposed development. Contributions that are collected do not form part of councils' general revenue but are specifically earmarked for particular types of project consistent with the development contributions plan. In short, they cannot be used to subsidise other services to the community.

Developer charges vary by state and by geography and purpose. The scope for collecting developer contributions is greatest in Queensland and parts of NSW because of several factors. One is that local governments are responsible for providing commercial water and sewerage services to which much developer activity relates. Another is that the state governments have decided to reduce the level of infrastructure historically provided through consolidated revenue and instead introduce wider 'user pays' principles to fund major new development.

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[68] Productivity Commission, 2008, op cit, Finding 6.9, p.134.

[69] This may be an indication of the extent to which rates pegging has led local government to utilise other legitimate forms of revenue to meet the demands placed upon them, although is most likely to reflect changes in development patterns.

[70] Abelson, P and Joyeux, R, 2007, 'Price and efficiency impacts of taxes and subsidies for Australian housing,' *Economic Papers*, 26, 147-169.

All jurisdictions can levy developer contributions for roads, and all, except the Northern Territory, for parks. According to the Productivity Commission (2008), NSW and Victoria have the most flexible legislative arrangements for accessing developer contributions, with legislative scope to levy for a broad range of economic and social infrastructure needs (such as public transport, child care centres, libraries, community centres, recreation facilities and sports grounds) beyond basic infrastructure. Other jurisdictions may not have scope to apply a levy for these facilities. However, in some jurisdictions, local governments are allowed to negotiate voluntary agreements for developer provision of infrastructure to meet economic, social and environmental needs as a condition of obtaining various approvals, although these amount to very low charges overall.

South Australian councils have more limited means to legally access contributions from developers. Consequently, South Australia has the lowest level of developer contributions in Australia. The result is that some of the cost of providing infrastructure for new and infill development is shifted from developers and purchasers of land to all ratepayers, which also causes greater inequity between council areas.

Notwithstanding the apparent equity of charging developers for the costs that their developments incur, there have been criticisms of developer charges, some of which were noted by the Productivity Commission:

- Developer charges may involve double charging where an agency such as a local council obtains revenue first via up-front developer charge and then again through recurrent property taxes or other user charges.

- Developer charges are excessive and not justified properly or accurately by evidence of related infrastructure costs.

- Local councils do not use the funds for the purposes for which they are levied or fail to employ them in a timely manner.

- Local councils are less cost-efficient than private firms. There is ‘gold plating’ of infrastructure quality.

- Developer charges increase house prices and reduce housing affordability.

ALGA considers that these criticisms are not substantiated by evidence and rejects them. In the independent analysis commissioned by ALGA in the preparation of this submission, the following conclusions were drawn:

> The first four dot points are essentially empirical or pragmatic issues. In so far as they occur, they reflect poor practice rather than poor pricing principles.
>
> With regard to the fifth dot point, developer charges are generally a tax on land and have little effect, if any, on house prices in most states (Abelson and Joyeux, 2007). The reason for this is

> that new houses make up a small part of the housing stock and new house prices are determined by the prices of established houses, or more particularly by the relative provision of services. Unless developer charges actually affect the supply of houses, house prices are not affected by changes in developer charges. With housing stock unchanged, a change in developer charges affects the price of land for housing which is a residual after subtracting land development, building costs and developer charges from the price of housing.[71]

ALGA considers that there is a close nexus between developer contributions revenue and the betterment provided to the community as a result of local councils' expenditure of the revenue on local community infrastructure. As the Productivity Commission noted:

> Developer contributions revenue is tied to future infrastructure investment and/or reflects current sunk assets, therefore, revenue and expenditure relating to developer contributions are likely to be equal over time. That is, where assets are contributed in-kind in year one, these are depreciated over their useful lives which might be across many years (except for the related land component because this does not depreciate). Actual cash contributed in year one is (presumably) offset by a corresponding liability in the form of a provision for future capital purchases and is spent on land, facilities and infrastructure, sometimes in a subsequent year.[72]

In general, developer charges are consistent with the benefit principle of equity and encourage the efficient consumption of goods and the efficient use of resources. Given the benefits that accrue from local public investment in infrastructure or other services, 'there is no reason why local landowners should obtain tax free capital gains from developments funded by other taxpayers.'

Finally, ALGA welcomes the decision of the Australian Government to provide funding support for infrastructure associated with new housing. In its design of the Housing Affordability Fund, which will see the allocation by the Commonwealth of $512 million over five years across all jurisdictions in order to promote affordable housing, the Australian Government is providing funding which will be able to be used by successful local government applicants to subsidise the cost of developing new infrastructure such as water, sewerage, transport, and parklands.

Conclusion

Local government raises a very high level of own-source revenue, including own-source taxation, notwithstanding various limitations that act as constraints upon its ability to raise the fullest amount of its hypothetical own-source revenue benchmark. Many, but not all of these limitations, are imposed upon local government by state governments and merit review.

Local government financial sustainability

[71] Applied Economics, 2008, op cit, pp. 31-32.
[72] Productivity Commission, 2008, op cit, p.134.

The financial sustainability of the local government sector is a major challenge that will impact on the future economic and social wellbeing of many local and regional communities. ALGA agrees with the Productivity Commission that the ability of a council to cost recover is not the same as being financially sustainable.[73]

In recent years there have been several in-depth studies of local government finances, such as the Hawker Committee (2003), the Financial Sustainability Review Board (FSRB, South Australia, 2005), the Allan Inquiry (NSW 2006) and Access Economics (SA, NSW, Tasmania, Western Australia). In addition, ALGA commissioned PriceWaterhouseCoopers (PwC) in 2006 to provide independent analysis into the extent of the local community infrastructure backlog in 2006, titled National financial sustainability study of local government.

These studies have focused on two related issues: (i) the sustainability of local government in the face of increasing demands for locally provided services and limited income sources and (ii) infrastructure backlogs. In aggregate, they found that a significant number of councils, typically between 10 and 30 per cent, are financially vulnerable or, in extreme cases, not sustainable and that many councils have substantial infrastructure renewal backlogs.

For example, PwC concluded that:

- 36 per cent of councils have an interest coverage ratio (Earnings Before Income Tax after depreciation allowances divided by interest payments) of less than 3;
- the estimated infrastructure backlog across Australia was $14.5 billion (in the mid-case); and
- there was an estimated funding gap to cover the backlog and underspending, of $2.2 billion per annum.

One of the most significant concerns of local government is the size of its asset management task. Councils have far more assets (in value relative to income) than any other sphere of government in Australia. ABS data show, for example, that depreciation makes up around 20 per cent of local government expenses, which is significantly higher than for the state government sphere (around 7 per cent) and the Australian Government (around 3 per cent).[74] The Productivity Commission study acknowledged that councils are responsible for an estimated $183 billion of non-financial assets.[75] ALGA notes that this estimate indicates the written-down value of council assets, and that the replacement costs are likely to be far higher. The South Australian Local Government Association

[73] Productivity Commission, 2008, op cit, p.93.
[74] See PwC report, 2006, op cit, in reference to ABS Government Finance Statistics 2004-05.
[75] Productivity Commission, 2008, op cit, p.xix and p.11.

has estimated that the replacement value of non-financial council assets across Australian councils could be as much as $300 billion.[76]

In working toward more sustainable funding for the sector, local government is fully committed to the 'twin track' approach recommended by the PwC. The first part of this approach is that individual councils pursue internal reforms to improve efficiency and effectiveness, through for example, improved internal asset and financial management, and business practices; the second is to pursue changes to intergovernmental funding.

However, as the Productivity Commission study found, some council areas have too low an income base to generate adequate services by current national standards and no matter how great their internal reform and own-source revenue raising efforts, are simply not able to be financially independent. In particular, the Productivity Commission found that 20 per cent of local councils relied on Commonwealth and state grants for half of their revenue. More tellingly, finding 5.5 of the Productivity Commission report found that even with additional own-source revenue raising efforts:

> A significant number of councils, particularly in rural (87 per cent) and remote (95 per cent) *would remain dependent on grants from other spheres* of government to meet their current expenditure. *Some councils would remain highly dependent on grants*.[77] *(ALGA emphasis)*

Restrictions on borrowing may impact on the provision of local community infrastructure

ALGA observes that the ability of councils to borrow against future tax revenue in order to invest in strategic infrastructure is restricted in many jurisdictions (largely by state governments). In the State of the Regions report 2006-07, National Economics noted that:

> …there is certainly a case for prudence in local borrowing, and indeed for a rule that borrowing should be reserved for the finance of infrastructure which is expected to yield an increase in rate paying capacity. However, prudence is always a matter of judgement, and it is arguable that current regulations unduly restrain local government from shouldering infrastructure investment risk.[78]

The Productivity Commission observed that when undertaken prudently, borrowing is an appropriate means for local governments to finance long-lived infrastructure assets which might otherwise be delayed in the absence of borrowing. However, ALGA also acknowledges that because the future income streams of some councils are uncertain, the ability to borrow may not be able to be utilised by many local governments.

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[76] See the South Australian Local Government Association's submission to the Productivity Commission draft report on Assessing Local Government Revenue Raising Capacity 2008, at www.lga.sa.gov.au/site/page.cfm?u=19&c+14733.
[77] Productivity Commission, 2008, op cit, Finding 5.5 and p.xxxviii.
[78] State of the Regions 2006-07, op cit, pp. 59-60.

Other sources of funding to local government

Historically in Australia, both the state and local government sectors have needed to be supported by distribution mechanisms that provide a national equalisation of public services. ALGA considers that it is economically most efficient for the national government to continue to collect relatively more revenue than the other spheres, given administrative efficiencies, incentive effects and the nature of our constitution.

Grants from other spheres of government are an important component of total local government revenue. Whilst it is difficult to gauge the precise level of grants, particularly from the state sphere, local government derives around 17 per cent of its total revenue from intergovernmental grants, divided in roughly equal shares between the Commonwealth and the states.[79]

The majority of state 'grants' represent reimbursements for concessions mandated by them on the sector or contract payments for maintenance of state government-owned roads.[80] In comparison, the majority of Commonwealth funding to local government is for general purposes. There are also Specific Purpose Payments made to local government by the Commonwealth in areas such as childcare and disabilities services. Specific Purpose Payments also include roads, the major component of which is the very successful Roads to Recovery program.[81]

ALGA acknowledges that the Commonwealth has long understood the need to distribute its taxation revenue to the local government sector, in order to support local councils' key functions (building and strengthening local communities). Since 1974-75, the Australian Government has provided untied financial assistance grants (FAGs) to local government. (FAGs were also provided to the states until the introduction of the GST saw their abolition. Accordingly the states now have access to a growth tax which reflects the real economy). Between 1976 and 1985, the FAGs were set as a proportion of net personal income tax collections. From 1986 to 1995, they generally increased at a rate equal to the increase in general purpose payments to the states. Since 1995, the rate of increase has generally been equal to growth in population and the consumer price index (CPI), with the exception of 1997-98 when they were escalated only for the CPI. The total amount of

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[79] See Productivity Commission, 2008, op cit, p.xxii, Figure 2, for breakdown in percentage terms. ALGA would note it has significant concerns with data regarding grants, and from state governments in particular. This is due to a range of factors including that some states do not identify grant funding separately in state budget documentation, the lack of uniformity in how or whether all local councils report grants received, and definitional differences in ABS data. Some of these issues were expanded upon in ALGA's 2008 submission to Senate Select Committee on State Government Financial Management, which recommended that 'the Australian Government impose more stringent requirements on state governments having regard to the identification of Commonwealth funds flowing through states to local government'. See further, Senate Select Committee on State Government Financial Management report, September 2008, Recommendation 11.

[80] There is some evidence that grants from the states to the local government sector are falling.

[81] This funding has greatly assisted local government in being able to provide for much needed renewals and upgrades of Australia's local roads.

funding is escalated each year to maintain the real per capita value of the FAGs. Commonwealth general purpose grants represented around 5.2 per cent of total local government revenue in 2006-07.

The Australian Government provides FAGs under the *Local Government (Financial Assistance) Act 1995* (the Act). FAGS have two components: general purpose grants ($1.288 billion in 2008-09), which are divided among the states on a population basis; and identified but untied roads grants ($571.5 million in 2008-09), which for historical reasons are allocated to the states on the basis of fixed shares. It is then for the states to distribute the funds to local councils in accordance with recommendations made by local grants commissions, which each have their own methodology but must adhere to the seven national principles for distribution as set out in the Act. These are replicated in the Box below:

Box 1 **National principles for allocation of financial assistance grants**

The State grants commissions are required to observe the National Principles relating to grants allocation under the *Local Government (Financial Assistance) Act 1995* (Cwlth):

- *Horizontal equalisation* **—** this principle requires that each local governing body in a jurisdiction is able to function, by reasonable effort, at a standard not lower than the average standard of other local governing bodies in that State. Further, it takes account of differences in the expenditure requirement and revenue-raising capacity of local governing bodies.
- *Effort neutrality* **—** the revenue and expenditure policies of individual local governing bodies shall not, as far as practicable, affect grant determination through the assessment of revenue-raising capacity and expenditure requirements.
- *Minimum grant* **—** the minimum general purpose grant allocation for a local governing body is to be no less than 30 per cent of its per person share of the total amount of general purpose grants available for allocation among local governing bodies in the States or Territory.
- *Other grant support* **—** this principle requires recognition of other relevant grant support to local governing bodies to meet any expenditure needs.
- *Aboriginal peoples and Torres Strait Islanders* **—** financial assistance shall be allocated to councils in a way which recognises the needs of Aboriginal peoples and Torres Strait Islanders within their boundaries.
- *Council amalgamation* **—** where two or more local governing bodies are amalgamated into a single body, the general purpose grant provided to the new body for each of the four years following amalgamation should be the total of the amounts that would have been provided to the former bodies in each of those years if they had remained separate entities.
- *Identified road component* **—** the identified road component of the financial assistance grant should be allocated on the basis of the relative needs of local governing bodies for road expenditure. Relative needs should be determined based on length, type, and usage of roads in each local governing area.

Source: DOTARS (2007); CGC (2001).

Clearly, general purpose grants are supposed to supplement the ability of local government to support functions. However, FAGs have been reducing over time as a proportion of overall Commonwealth taxation revenue, and despite significant and ongoing Australian Government Budget surpluses.

ALGA notes that the current level of FAGs is insufficient to achieve horizontal fiscal equalization, a point also observed by the Productivity Commission.[82] Grants Commissions have reported that general purpose funding at current/recent levels is not achieving horizontal fiscal equity. Further, in the State of the Regions 2006-07 report, National Economics concluded that:

> '…the quantum of grant availability only compensates approximately 30 per cent of the amount required to equalize resources available to councils because of inequalities in revenue available for standard effort.'[83]

The Productivity Commission recently concluded that 'there is a case to review the provision of Australian Government general purpose grants to local government' (finding 5.6). This confirms ALGA's long-held view that FAGs must be reconsidered, and gives its examination in the context of the current taxation review added weight.

In the past, ALGA has identified that its preferred option to overcome the insufficiency of Financial Assistance Grants in achieving horizontal fiscal equalization is to establish commonwealth grants as a fixed minimum percentage of total Commonwealth taxation revenue (excluding the GST). This would return local government to a 'fixed share' mechanism such as it had in the late 1970s and early 1980s, thereby creating more certainty for councils and the communities that depend upon them for the delivery of critical services and infrastructure.

Conclusion

Local governments now have greater autonomy than ever to exercise general powers within their competence. Consistent with the expectations and preferences of their local and regional communities, and reflecting past cost and responsibility shifting, their roles now extend across governance, advocacy, service delivery, planning, community development and regulatory functions.

As the Hawker Committee noted in 2003, 'each council provides local solutions to local issues'. As detailed above, the sector is confronted with many funding challenges. Yet, it is already raising most of its maximum possible own-source revenue. Appropriate intergovernmental funding is crucial to the ongoing viability of the sector as a whole, and to numerous individual councils in particular, if the sector is to continue building and strengthening local communities throughout the 21st century.

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[82] Productivity Commission, 2008, op cit, p.23.
[83] State of the Regions 2006-07, op cit, p.82.

It is ALGA's view that the current Financial Assistance Grants system is outdated and narrow, and is failing to achieve the horizontal fiscal equalization objective due to the inadequacy of the total funding and its indexation mechanism. ALGA believes the Financial Assistance Grants system therefore requires significant reform if local government is to be placed on a more sustainable financial footing in the interests of the people it serves.

Conclusion

Local government is a dynamic and integral feature of Australia's federal governance framework. Its existence pre-dates the coming together of our nation at Federation, and it has played a key role in building, shaping and strengthening Australia's local and regional communities.

There is no singular definition of the role of local government in Australia. What is beyond contention is that local government sits at the heart of Australia's local and regional communities, representing their interests and reflecting their needs, seeking to meet their expectations and accommodate their preferences, consistent with its role as the third sphere of government. To the extent that local government ever lent itself to definition, there is no doubt that its role has become more expansionary and extensive, with an increased and growing focus on human services whilst retaining a role in the delivery of 'property-based services'.

Local government accepts the principle that it must assess its financial competence (that is, be adequately resourced) before taking on new or expanded functions. Sometimes, local government has entered into the delivery of new or expanded services in response to community needs, and in a fully informed financial position to do so. However, at other times, the delivery by local government of new or expanded services has been less voluntary. Cost shifting to the local government sector has occurred as a result of other spheres of government withdrawing the services they once provided to communities or the financial support that once underpinned those services, or as a result of increasing service levels and standards. While all three spheres of government now operate under an agreement designed to prevent future cost shifting, local government has been left to absorb the cost of previous cost shifting practices.

In this broad operating environment, local government has used its best efforts to appropriately exploit its only source of taxation revenue – property taxes based on rates. Many studies, including that of the Productivity Commission (2008) have concluded that rates satisfy the criteria of a well-designed tax. Local government relies on rates as its main single source of income. Importantly, it has been found not to have exploited land value increases in Australia, despite some public perceptions otherwise.

Local government realises that all taxes are ultimately paid from taxpayers' income. The income of a local government area is the most reliable measure of the ability of taxpayers to pay their rates. The ability to pay is the most significant limitation on local government's total taxation revenue.

There are a number of constraints that adversely affect local government's capacity to raise taxation revenue. These include unfunded concessions and rebates imposed upon the sector by other spheres of government, rates-exempt land and rates pegging. These constraints raise fundamental issues for other taxpayers, such as equity and fairness, and call into question the roles and responsibilities of each sphere of government in Australia.

Despite the existence of constraints on its single taxation revenue source, local government has clearly sought to raise alternative forms of revenue, in order to fund the delivery of local services and the provision and maintenance of local community infrastructure. User fees and charges have been the main source of local government non-taxation revenue in recent years. The use of such fees and charges, and also of developer contributions, has been found to be a legitimate revenue source consistent with the benefit principle. Local government has consistently raised around four-fifths of its own revenue since at least 1998-99. The Productivity Commission noted that in 2004-05, local government own-source revenue accounted for 83 per cent of local government's total revenue and that on average, local councils are raising almost 90 per cent of their total theoretical maximum own-source revenue.

Local government is currently at something of a crossroads. Considered increasingly important to the smooth and effective functioning of local and regional communities and their economic wellbeing, local government is confronting serious financial sustainability challenges. The Productivity Commission noted that a number of councils, especially those in rural and remote parts of Australia, are and will continue to be dependent on intergovernmental grants no matter how high their own-source revenue raising efforts. In addition, a number of studies have concluded that between 10 and 30 per cent of councils may be financially unsustainable given the considerable liability being carried by the sector for community infrastructure renewals. This liability has stemmed in large part from previous cost shifting and cost squeezes, and is estimated to be $14.5 billion. Local government is fully committed to implementing internal reforms to enhance its financial sustainability.

Given the high degree of vertical fiscal imbalance that characterises our federal system, local government considers that the most effective tax system Australia can have into the future must not only raise revenue in a manner that is fair and efficient, but also provide for fair and transparent revenue sharing arrangements. Local government acknowledges the importance of specific purpose payments and general purpose grants. At the same time, local government observes that there has been a decline in the share of general purpose funding from the Commonwealth to the local government sector as a proportion of Commonwealth taxation revenue, despite significant and growing national surpluses over the last decade.

ALGA believes that the current system, under which centrally collected tax revenue is shared, merits serious and urgent review if local government is to continue to meet the economic and social needs of local and regional communities.