Municipal Association of Victoria

Submission to the Commonwealth Review of Taxation

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MUNICIPAL ASSOCIATION OF VICTORIA

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MAV members have not been consulted on its contents. This submission has been discussed by the MAV Economics and Finance Advisory Group.

The MAV is the statutory peak body for local government in Victoria, representing all 79 municipalities.

While this paper aims to broadly reflect the views of local government in Victoria, it does not purport to reflect the exact views of individual councils.

MUNICIPAL ASSOCIATION OF VICTORIA

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Executive Summary

The Municipal Association of Victoria (MAV) welcomes the opportunity to provide a submission to the Commonwealth's review of taxation. In making this submission, the MAV wishes to comment on issues of direct relevance to councils.

The MAV contends that the existence of vertical fiscal imbalance – the mismatch between taxing powers and spending responsibilities – has negative consequences for local (and state) government and should be addressed by this review.

The MAV believes that property taxes, on which Australian local government is highly reliant, have a number of shortcomings when compared with some other taxes. Further, a significant proportion of the funding requirements of a number of councils need to be met from external fiscal sources. Issues with local property taxes are particularly relevant in circumstances where financial stress is evident in councils which generally have high property taxes relative to local incomes and socio-economic characteristics.

In comparison to income tax and other broad-based consumption taxes the major advantages submitted with respect to property taxes are that the immobility of the property tax base makes them difficult to avoid; they can be administered at relatively low cost and that they are simple and transparent given that local constituents can easily access information about, and have a general understanding of how, their local property tax systems work.

While local property taxes are simple in theory they can be quite complex and a lack of understanding often extends from constituents to councillors. Most ratepayers do not understand rates any better than income and sales taxes and possibly less so.

The wide discretion provided by the states' legislative provisions covering rates – and resort to maximising this discretion – are an acknowledgement by both of the difficulties of property taxes, in particular their wrestling with the issue of capacity to pay. Property taxes find it difficult to deal with the situation where ratepayers are "asset rich" and "income poor". While this is less important when council rates consume only a small portion of household income, it becomes problematic where there is local disadvantage or income is depressed.

In Victorian access to **local** income taxes, although enabling a more equitable spreading of the local tax burden, would not overcome the viability issue for those councils with small/declining populations, relatively high socio-economic disadvantage and that require a high tax effort. Clearly, access to local income tax through a "piggy-backing" arrangement on Commonwealth collections would allow a better matching of capacity to pay and tax incidence but the effect would be around the margin because of the mismatch between revenue raising capacity and local responsibilities and cost disabilities. The MAV believes the solution requires access to and redistribution of national income. Collection by central/higher governments is more efficient and would allow for the addressing of regional inequality and disparity through equalisation processes.

Deficiencies in specific purpose programs increase the fiscal demands on councils and hence the need for financial reform.

MUNICIPAL ASSOCIATION OF VICTORIA

Introduction

The MAV is pleased to present this submission to the Commonwealth's consideration of tax reform. Appropriately the Association has confined its submission to the issues considered relevant to the sector, rather than as an independent observer of the impact of taxes generally.

However, it would support any measures that allow for the simplification of current taxation arrangements, the equitable sharing of the tax burden and the replacement of narrower and more regressive taxes with broad-based and progressive taxes where possible. In particular it would support measures to broaden the income tax base.

Professor John Freebairn of Melbourne University has indicated that he believes the opportunity to broaden the national personal income tax base by 10 per cent and by as much as 20 per cent, is possible through the elimination of special exemptions and deductions that favour those on higher incomes. Given revenue neutrality, the broadening of the tax base would allow for a flattening of tax rates and improve economic activity. Alternatively, additional tax revenues could be directed to areas with high social welfare dividends.

Based on the most recently available ATO data, a 10 per cent broadening of this base would be equivalent to tax rate cuts worth $15 billion i.e. with unchanged tax scales an additional $15 billion would be generated. The Association believes that any initiatives that would improve the after tax position of lower income earners would be beneficial in terms of their ability to pay for the cost of living, including council rates.

Context

The issue of tax reform is a significant one for local government but one that cannot be divorced from that of intergovernmental funding under Australian federalism. As in other developed nations the trend in Australia has been demographic and social change that has increased the demand for, and the decentralisation of, municipal services.

Local government is increasingly being asked to take on additional responsibilities, both in the breadth and volume of services. Together with factors such as cost-shifting, structural diversity (including diseconomies of scale) and the high cost of infrastructure renewal, pressure continues to grow for Australian councils to raise more own-source revenues. Despite a focus on the local delivery of services and facilities, there has not been a commensurate change in the financial autonomy of local government and vertical fiscal imbalance (VFI), the mismatch between taxing powers and expenditure responsibilities, has grown. A strong reliance on inter-governmental transfers to state and local government in Australia persists.

The MAV has presented data that shows the potential for Victorian councils at financial risk to significantly increase fees, fines and charges is highly constrained and hence increased internal funding is limited fundamentally to local taxes (rates)[1].

[1] See MAV submissions to Productivity Commission's Reports on the Revenue Raising Capacity of Local Government that discuss the heavy involvement of councils in the provision of public goods, which do not lend themselves to charges,

The issue is therefore why councils cannot use their taxing powers to seriously improve their position?

The answer is that property taxes, on which Australian councils are highly reliant, have a number of shortcomings when compared with some other taxes and a significant proportion of the funding requirements of a number of councils need to be met from external fiscal sources. This is particularly so in circumstances where financial stress is evident in councils which generally have high property taxes relative to local incomes and socio-economic characteristics.

Vertical Fiscal Imbalance and its History

Issues arise when significant disparities exist between relative revenue raising and spending responsibilities of governments. VFI exists when the functions undertaken by a level of government are not financed through its own assigned tax bases. VFI is common to all federations, although it is noted that Australia has the largest degree of any federal country.

The major taxing powers in Australia, apart from those related to property, are reserved by the Commonwealth Government. In 2006-07 the Commonwealth raised about 82 per cent of all tax revenues, primarily through broad based taxes on income and consumption, despite being responsible for only two-thirds of government expenditures. By comparison, Australian states raised 15 per cent of taxes and undertook 27 per cent of outlays and local government raised just under 3 per cent of taxes but were responsible for about 7 per cent of government expenditures[2]. A complex system of inter-governmental grants has been developed to address this situation of VFI.

History shows the Commonwealth's fiscal power has increased over time at the states' expense. In 1926 the Commonwealth enunciated a basic principle of national finance according to which every government shall have the responsibility of raising the revenue which it is expending. This has never been achieved – influenced by a lack of will by the states and interpretations by the High Court that extended the fiscal predominance of the Commonwealth. The states have vacillated on the matter of regaining income taxing powers since the Commonwealth took control during the Second World War. There has been a lack of unanimity arising from the fear of the less populous states that they would be disadvantaged by the replacement of equalised tax reimbursements/grants and perceived political problems associated with the double taxation of personal income. The opportunity provided to the states during the time of the Fraser Government (later repealed by the Hawke Government) – a two-year progression from a fixed share of net personal tax income to the right of each state to impose a surcharge tax rate "piggy-backing" on Commonwealth collections, was baulked at when the Commonwealth indicated that it would not reduce its own collections.

The question of income tax has been raised on the occasion of later Premiers' Conferences when all states have united – apparently too belatedly arguing for the partial replacement of Financial Assistance Grants by state income taxes. More

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and the impact of regulatory and other constraints which either preclude or restrict their freedom to set charges.

[2] Excludes inter-governmental transfers

recently the High Court has redefined excise and tobacco franchise fees that resulted in their transfer from the states, and its determinations that have precluded the states from imposing broadly based consumption taxes such as the GST. Perhaps the only concession made or achieved on VFI over time has been the transfer of payroll tax from the Commonwealth to the states in 1971. Working parties of state treasury officials and government reviews have focused almost entirely on the issues around VFI through the prism of the Commonwealth-states relationship and the reference of any change being revenue neutral i.e. no increase in overall tax burden.

The Commonwealth has recently espoused its satisfaction stating “it was always envisaged when the constitution was being drafted that the Commonwealth would raise more than it needs to perform its core functions. Consequently, explicit provisions were included to transfer surplus revenue in the form of general revenue assistance to the states[3]”.

The stark fact is that most of the debate has centred on the states’ problems with VFI. There is nothing to guarantee or even imply that there would be a change in the lot of local government if the states were afforded more fiscal autonomy. Moreover, the likelihood of linking Commonwealth-state tax reform to any requirement for revenue neutrality would not provide any comfort for local government. The 2006-07 Annual Report of the Victoria Grants Commission (VGC) calculated net standardised expenditure for its 79 LGAs of $3.8 billion but standardised revenues of only $2.7 billion - a whopping gap of $1.1 billion required to enable all councils to function at a standard not lower than the average for the sector. Studies from a number of the states have identified serious financial problems for local government authorities arising from infrastructure renewal spending shortfalls. The MAV has estimated that the gap in Victoria is probably growing at around $250 million per annum, unevenly spread across the sector. The fiscal reform of interest to local government is one that would provide increased funding, guarantee the sector automatic growth and reduce pressure on property rates.

Arguments for VFI

A number of arguments and principles have been espoused in support of VFI and the Commonwealth’s monopoly over the major broad based taxes. These include:

- different levels of government are more suited to different tax collections and service provision;
- the Commonwealth Government is best placed to determine the national interest in terms of priorities such as natural resources (e.g. water), economic development and regulation of the economy and hence influence the spending of other jurisdictions;
- VFI provides the opportunity for the Commonwealth to achieve equity objectives through the taxation system such as addressing regional socio-economic differences and safeguarding the interests of the less populous states/jurisdictions. Tax bases which are distributed highly unequally among sub-national jurisdictions therefore should be imposed centrally;

[3] Commonwealth Budget Papers

- a single centralised tax system is much less costly than several decentralised ones and avoids the inefficient allocation of resources that may arise through tax competition between other jurisdictions (competitive federalism); and

- economies of scale are obtained through the collection of broad based taxes by higher government. There are also lower compliance costs for taxpayers in dealing with only one agency and with one set of rules.

Criticisms of VFI

VFI has been criticised from a number of theoretical and practical standpoints. These criticisms include:

- if a government does not raise all the revenue that it spends it will not be fully accountable to its taxpayers and it spending decisions are likely to be inefficient – the spending of untied grants, compared with specific purpose payments, has minimal political costs for recipients. The raising of revenues locally makes the financing of expenditures more transparent;

- the existence of VFI has resulted in "blame-shifting" between governments that has resulted in program inertia rather than improvements in outcomes. Recipients can blame donor governments for inadequate funding and donor governments blame recipients for wastage, while citizens cannot hold any level of government accountable;

- decentralisation of spending responsibilities can generate substantial benefits in terms of allocative efficiency because it minimises spill-over effects to other jurisdictions;

- sub-national governments are ideal deliverers of most services other than things like national defence and social security payments;

- sub-national governments are more likely to be more responsive to spatial variations in the demand for public goods and best placed to assess regional needs;

- VFI, at least in the Australian context, has resulted in the ongoing development of expensive systems of equalising inter-governmental grants (there have been many Grants Commission Reviews and more than 20 documented changes have been made to grant allocation methods over a 50-year period) at the expense of policy development;

- a focus on inter-governmental transfers encourages grant seeking and competitive inefficiencies between jurisdictions in seeking such grants;

- VFI forces the states to rely on inefficient, (more) regressive taxes and narrower tax bases for own-source revenues;

- compliance and administrative costs associated with state taxes are inordinately high relative to the revenue collected;

- other states and a number of local government sectors in OECD Federations raise a much larger proportion of their revenue from broad-based taxes on income and consumption - proportional income taxes on income or accommodation taxes could be levied by other levels of government as long as administrative, collection and compliance costs are kept low;

- overseas experience shows that sub-national governments may “piggy-back” on national income tax collections at minimal cost; and

- there is no real basis for the contention that people and resources will migrate between sub-national jurisdictions because of differences in taxes and tax rates. Differences in rates have been in place between Australian states for some time (e.g. stamp duties on land sales and payroll taxes) that has not resulted in such migration. Other factors are also extremely important.

The MAV is of the view that the arguments for reducing VFI in Australia are compelling and supports any moves to increase the financial autonomy of local government. It believes, however, that any discussion about the provision of local access to broader fiscal powers should have regard to local diversity and capacity and the extent to which this would practically improve their ability to deliver required services and facilities.

What changes would reduce VFI?

There are various approaches to reducing VFI in Australia. As argued earlier, increasing the fiscal autonomy of the states does not necessarily provide greater financial security for local government. A number of options might be used to reduce VFI including the handing over of taxing powers to sub-national governments or a realignment of spending responsibilities. One option to reduce VFI is for the Commonwealth to take over some of the functions of other government. Recently, the Commonwealth has floated the idea of taking over the delivery of the aged care components of the Home and Community Care (HACC) program. The MAV contends that the most important factor to be considered in relation to any consideration of changed responsibilities for service delivery is that the most appropriate agency for delivery be given this task and that sufficient funding should be provided for the purpose.

The main issue of concern to the MAV is the financial viability of councils and its interest in tax reform is to this end. The fiscal autonomy of local government could be improved materially by the linking of untied funding to Commonwealth tax collections rather than the provision of local taxing powers over income and/or consumption.

The Limitations of Locally Based Property Rates Compared with Income and Consumption Taxes

Broad-based taxes are taxes on incomes, consumption and payroll. “Land” taxes levied by Australian councils are probably better defined as broad-based as they apply generally with a few specific exemptions. State land taxes on the other hand are narrower-based taxes as substantial exemption exists in land used for primary production and principal places of residence. Other narrow-based taxes include

duties on financial transactions such as house sales, motor vehicles and insurances and gambling taxes.

Income tax is the only tax used in isolation by local government sectors worldwide other than property taxes. There are many arguments in favour of income taxes over other broad-based taxes. Of the broad-based taxes, income tax is considered largely progressive as higher rates are applied to higher personal incomes. In Australia corporate income tax (with a single rate) and the other broad-based taxes are proportional taxes. It is accepted that what a person earns or spends has more to do with their everyday circumstances (their disposable incomes) than the value of their homes. Broad-based consumption taxes like the GST have been criticised for their tendency to be regressive in that they may account for a higher proportion of the disposable incomes of lower socio-economic groups. In Australia this resulted in protections provided on a number of items including making fresh fruit and vegetables, staples such as bread and milk and council rates GST free.

Payroll tax is considered to inhibit productive capacity. In Australia, the perceived cumulative impact of Commonwealth's Superannuation Guarantee levy, other increased business costs (e.g. insurances), the desire for job creation and particular concern for small-to-medium-sized businesses has seen to a trend of states reducing payroll taxes. A situation of high growth in income and little growth in employment also results in no increase from payroll tax. It should also be noted that most of the states have agreed to take part in payroll tax harmonisation projects.

Income and consumption taxes are less sensitive to fluctuation and subject to non-discretionary growth. A large part of the Commonwealth's revenue is generated without the need to broaden or change the tax base or increase tax rates – indeed increased Commonwealth income tax collections have occurred despite the lowering of tax rates and raising of tax thresholds. Arguably there are greater political ramifications involved in the adjustment of taxes other than those on income, in particular narrow-based taxes.

In comparison to income tax and other broad-based consumption taxes the major advantages submitted with respect to property taxes are that the immobility of the property tax base makes them difficult to avoid, they can be administered at relatively low cost and that they are simple and transparent given that local constituents can easily access information about, and have a general understanding of how, their local property tax systems work.

Local property taxation while simple in theory is quite complex and a lack of understanding often extends from constituents to councillors. Most ratepayers do not understand rates any better than income and sales taxes and possibly less so. The complexity arises from:

- the various "land" bases that may be used (although in Victoria comprehensive adoption of one base);

- volatile swings in property valuations within and across municipal districts, even within suburbs;

- dates of effective valuation and differences between the valuation returned and true current market value;

- the fundamental misunderstanding of the importance of relative, rather than individual valuation movements, in determining the rates burden;

- the allowable fixed components of rates;

- the ad valorem rates that may be used e.g. the various differential rates and constraints between the highest and lowest rates; and

- the various softeners that may or may not be applied, including rebates.

Councils have the option of maintaining a uniform (single) rates system (that is, without differential rates) with no fixed rates components. However, the wide discretion provided by the states' legislative provisions covering rates and resort to maximising this discretion are an acknowledgement by both of the difficulties of property taxes, in particular their wrestling with the issue of capacity to pay. Property taxes find it difficult to deal with the situation where ratepayers are "asset rich" and "income poor". Horizontal tax equity, one of the characteristics of a good tax, requires that similar tax burdens apply to people in similar circumstances. Where the only discriminating factors available to councils are property type and value, local property taxes are not really able to take account of the true economic circumstances of individual and families. While this is less important when council rates consume only a small portion of household income, it becomes problematic where there is local disadvantage or income is depressed.

The Productivity Commission in its Review of Local Government Revenue Raising Capacity indicated that most councils could increase rates. Notwithstanding its flawed approach to assessing local business income, it reasonably reflected the fiscal capacity and incidence of rates and charges for municipalities *as a whole* but could not do the same *within* municipalities. As it is the latter that fundamentally determine the capacity of the community to bear increases in local rates and charges, the PC's theoretical finding does not have any practical worth. The issue of trying to make rates something they are not is exactly the vexed issue that councils face. Property rates struggle in dealing with the issue of diversity.

Despite the "likeness" of members of property classes, there exists considerable diversity in the economic circumstances of households to pay rates – in household income, the number of breadwinners, numbers of members, liquidity and debt levels. Similarly, enormous diversity exists within business – local businesses range from small businesses with owner operators and few employees to multinational corporations. Production may cover a diverse range of goods and services for local, national or overseas markets. They may vary considerably in terms of turnover, net worth, and profitability – just to name a few characteristics. Clearly, there are issues around how well the assumptions that are being made about a large class of ratepayers, based on the value of their property, accurately reflect the circumstances of many of its members. Councils have often adopted a plethora of differential rates to try to deal with this which does not assist with simplicity and transparency.

By comparison taxes on income and consumption are much more reflective of diversity, especially the former, in which the personal circumstances e.g. the number of dependents, are able to be taken into account. It is not possible to expect a property tax system to deal practically with the issue of capacity to pay based on the circumstances of individual households and businesses. In fact the issue takes up considerable time and resources of governments with more diverse taxing and

investigative powers and resources. The Commonwealth Government takes a range of factors relating to diversity into account with respect to taxing income, data about which it only has access. It is also able to take into account both capital and income levels, for example, it applies assets as well as income tests for pensioner households.

Property taxes (the rates notice) have high visibility – they are the most visible of all taxes and charges that ratepayers face. They are more controversial than income and consumption taxes that are being paid continuously by individuals. Rates, as a single bill, generally exceed those for utilities and other specific State Government services because they are payment for a range of services when compared with income and consumption taxes and therefore are easily subject to politicisation. The contention that property taxes are administered at relatively low cost also has a caveat.

Whereas the costs of valuation and administration are relatively low per assessment and few(er) resources need to be directed at avoidance and compliance compared with income taxes, councils often incur significant costs in terms of the time of councillors, council staff and consultants in the strategic review of their rate systems. Because of the political sensitivity of local property taxes significant resources may need to be directed to consultative processes. It should not be lost on higher governments that local government is the only tier that appears to have to specifically justify decisions about its taxation decisions on equity and efficiency grounds[4]. The point needs to be made that despite the wide discretion councils have, they have frequently sought further legislative change to deal with the vagaries of the property market and reflect capacity to pay.

Some other reasons also make income and consumption taxes more accepted by the community than council rates. Fluctuations in property values are far more dramatic than changes in incomes and consumption patterns. Due to changes in properties' relative share of valuations, even with short valuation cycles (two yearly in Victoria) enormous variations have arisen in the amounts payable.[5]

For example, the following table provides data on recent changes in property values for a regional city council in Victoria. This indicates that substantial movements in the tax base are common for property taxes, with variations of 50 per cent from the average movement common. This compares with movements in household or individual earnings of approximately three to five per cent annually.

	Actual Change First Valuation	**Actual Change Second Valuation**
Average Movement in Valuations	30%	53%
Standard Deviation	34%	28%
Co-efficient of Variation	111%	53%
Less than Average Increase	58%	48%
More than Average Increase	42%	52%
More than 50% lower than Average Increase	27%	9%
More than 50% higher than Average Increase	21%	16%
More than 100% lower than Average Increase	5%	1%
More than 100% higher than Average Increase	11%	4%
More than 200% lower than Average Increase	0%	0%
More than 200% higher than Average Increase	4%	1%

[4] S. 161 of the LG ACT requires councils to justify the application of differential rates in terms of equity and efficiency
[5] It is not unknown for valuations to increase by 60 per cent where the average is five per cent across the municipality.

Local property rates are also limited to the extent that they capture contributions from non-residents that make demands on services. They attempt to address this indirectly through the property rates levied on tourist/accommodation properties. Finally, council rates are revenue neutral - they have no automatic growth such as some other broad based-taxes and state land taxes.

OECD Comparisons

The OECD stated that fiscal autonomy is greatest if sub-central governments are free to determine their taxable base and rates of tax without rate capping or where the base or rates are not imposed by central government.

Its Working Party Report 'Taxing Powers of State and Local Government', delivered in 1999, identified eight categories of fiscal autonomy as follows:

a. local government sets tax rate and tax base (Switzerland, US?)
b. local government sets tax rate only (Belgium, Sweden)
c. local government sets tax base only
d. tax sharing arrangements
    i. local government determines revenue-split
    ii. revenue-split can only be changed with consent of local government
    iii. revenue-split fixed in legislation, may unilaterally be changed by central government
    iv. revenue-split determined by central government as part of the annual budget process
e. central government sets rate and base of local government tax (Canada, UK, Australia, New Zealand).

The data show that the tax collections of Australian local government as a proportion of total tax collections are relatively low overall and low in comparison to other federations.
Two main forms of local taxation exist in OECD countries, taxes on income and taxes on property. The tax share of local government is not necessarily an accurate reflection of its fiscal autonomy as similar proportions of tax may be generated by centrally determined splits (e.g. Norway) or by the setting of own tax rates (e.g. Finland).

Income taxes take a number of forms including tax sharing arrangements determined by higher levels of government (Germany and Norway), tax surcharges piggy-backed on national collections and those levied independently and separately at the local level (e.g. Finland).

In the US some municipalities are able to use income tax, a sales tax and a property tax while in others they are limited to one or the latter two (depending on the state). Local income taxes are generally imposed at 1 per cent to 5 per cent, and in some cases, such as commuters, lower rates are applied. Generally income tax generates 20 per cent to 50 per cent of total revenue of these authorities. Specific sales tax rates where applied are generally around 0.25 per cent to 5 per cent. They are not used universally by local authorities in many individual states but most large cities use them and they are piggy-backed onto state sales tax collections and remitted back. There are controls placed on the levels of sales tax by senior government.

In Nordic countries income tax is the only local tax of significance and levied at a flat, locally established rate on the national income base and collected and remitted back by it. In Belgium where income tax is also the predominant revenue source it is levied as a percentage surcharge on the national tax liability (i.e. not on income but the tax take).

In Switzerland local surcharges are levied on the income and assets tax liability of the cantons (the middle levels of government) rather than the national base.

In Japan local rates are set locally and applied to individual and corporate incomes while corporations may also be taxed based on proportions of employees in their jurisdictions.

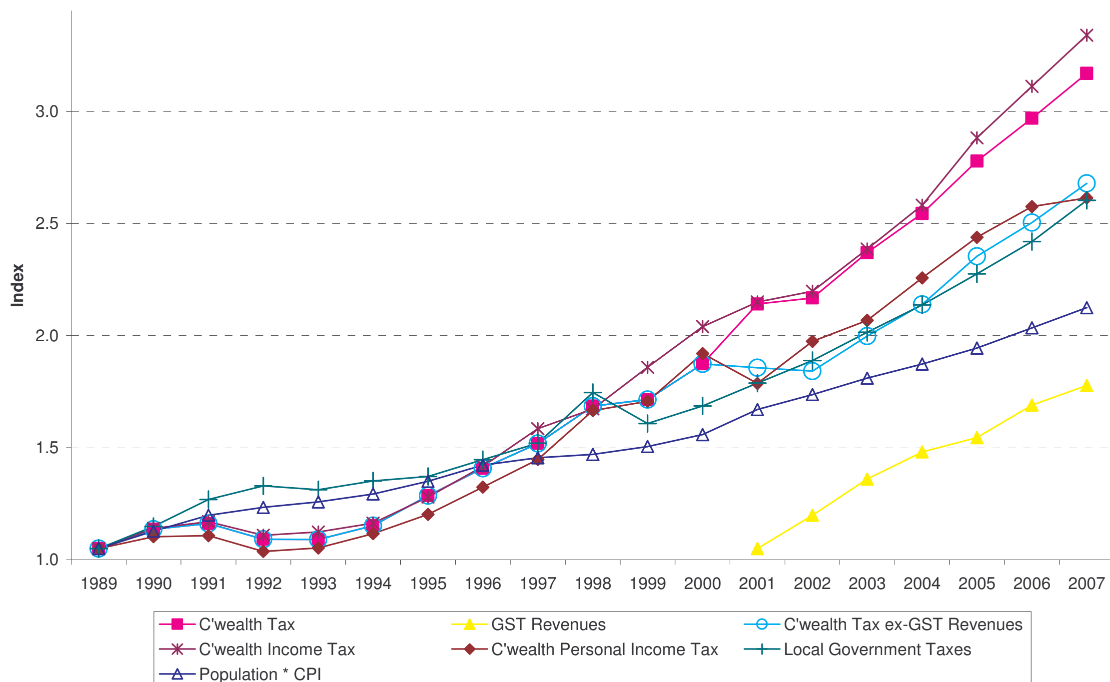
In Germany councils constitutionally receive 15 per cent of national personal income taxes - the distribution determined by state governments and subject to an equalisation process and minimum distribution (15 per cent of national GDP per capita in a jurisdiction). Councils also obtain business taxes on corporate profits with the base set nationally but rates set locally. Local property taxes in Germany are miniscule.

Research indicates that the most diverse countries are Austria, Spain and Japan where local government sectors have 6 or 7 different tax bases to draw upon.

Taxation Trends

Data show that Commonwealth tax collections have grown a lot faster than population and prices. Commonwealth income and total tax collections have exceeded the combined growth in population and prices by more than 100 per cent over the period 1988-89 to 2006-07. This growth has been achieved despite the impact of cuts in income tax rates and the raising of tax-free thresholds over recent years, a direct result of the level of economic activity.

Movement in Commonwealth and Local Government Taxation



Local Income Taxes or a Share of Commonwealth Levied and Collected Income Tax?

A precedent exists for a tax sharing arrangement between the Commonwealth and local government. It existed between 1974-75 to and 1985-86. The history of Commonwealth funding of local government as a share of tax receipts has shown a general trend of decline. Since the introduction of Commonwealth assistance in 1974-75 the following milestones are relevant:

- in 1976-77 legislation was introduced that formalised a tax sharing arrangement that entitled all councils to a fixed portion of personal income taxation revenue collected in the previous year, known as a personal income transfer. The rate was set at 1.52 per cent and was subsequently increased to 1.75 per cent in 1979-80 and 2 per cent in 1980-81;

- in 1985-86 this tax sharing arrangement was replaced with general revenue assistance that increased assistance in that year by the change in the CPI plus an additional 2 per cent growth factor on the previous year;

- this was subsequently replaced with a system of general purpose payments under the Local Government Financial Assistance Act 1986 where increases for 1986-87 and 1987-88 were adjusted by the greater of CPI or the percentage change in general purpose payments to the states, both applied to the previous year amounts;

- from 1988-89 assistance has been linked to increases in GPPs provided to the states with the pool for distribution based on CPI escalation of state's per capita shares.

It is interesting to identify the difference in general purpose funding for local government had tax sharing arrangements been maintained at 2 per cent of previous year personal income tax collections and equivalent levels of 1.65 per cent of income tax and 1.1 per cent of Commonwealth tax collections as recorded in 1980-81. These are summarized in the following table.

Financial Year Ending	C'wealth Outlays ($m)	C'wealth Tax ($m)	C'wealth Personal Income Tax ($m)	C'wealth Income Tax ($m)	Other C'wealth Taxes ($m)	FAGs to LG ($m)	FAGs to LG as % C'wealth Tax Previous Year	FAGs to LG as % Income Tax Previous Year	FAGs to LG as % Personal Income Tax Previous Year	GPGs to LG as % C'wealth Outlays	What grants would be at 2.0% of Previous Year Personal Income Tax ($m)	What grants would be at 1.65% of Previous Year Income Tax ($m)	What grants would be at 1.1% of Previous Year C'wealth Taxes ($m)	What grants would be at 1.1% of Previous Year C'wealth Taxes ex GST ($m)	What grants would be at 0.84% of C'wealth Outlays ($m)
1975	15463	14141	7709	10,015	4,126	56	0.52%	0.76%	1.03%	0.36%					
1976	20225	17003	9213	11,676	5,327	80	0.57%	0.80%	1.04%	0.40%					
1977	23157	19813	11047	13,800	6,013	140	0.82%	1.20%	1.52%	0.60%					
1978	26057	21549	12118	15,128	6,421	165	0.83%	1.20%	1.50%	0.63%					
1979	28272	23537	12791	15,734	7,803	179	0.83%	1.19%	1.48%	0.63%					
1980	31642	27473	15033	18,336	9,137	223	0.95%	1.42%	1.74%	0.70%					
1981	36176	32824	17532	22,111	10,713	302	1.10%	1.65%	2.01%	0.84%	302	302	302	302	302
1982	41151	38086	21205	26,107	11,979	353	1.07%	1.59%	2.01%	0.86%	353	364	361	361	344
1983	48810	41261	22943	27,636	13,625	427	1.12%	1.63%	2.01%	0.87%	427	430	419	419	408
1984	56990	45103	24671	29,142	15,961	462	1.12%	1.67%	2.01%	0.81%	462	456	454	454	476
1985	64853	52970	29256	34,753	18,217	489	1.08%	1.68%	1.98%	0.75%	489	480	496	496	542
1986	71328	59181	32673	38,677	20,504	539	1.02%	1.55%	1.84%	0.76%	585	573	583	583	596
1987	77158	66832	38000	44,573	22,259	590	1.00%	1.53%	1.81%	0.77%	653	637	651	651	645
1988	82039	75478	41811	50,459	25,019	637	0.95%	1.43%	1.68%	0.78%	760	735	735	735	685
1989	85326	83971	47433	57,539	26,432	653	0.86%	1.29%	1.56%	0.76%	836	832	830	830	713
1990	92684	91241	49928	62,712	28,529	678	0.81%	1.18%	1.43%	0.73%	949	948	924	924	774
1991	100665	93337	50156	64,409	28,928	699	0.77%	1.12%	1.40%	0.69%	999	1,034	1,004	1,004	841
1992	108472	87408	46830	60,921	26,487	1,018	1.09%	1.58%	2.03%	0.94%	1,003	1,062	1,027	1,027	906
1993	115751	87372	47528	61,765	25,607	1,049	1.20%	1.72%	2.24%	0.91%	937	1,004	962	962	967
1994	122009	92463	50571	64,048	28,415	1,059	1.21%	1.71%	2.23%	0.87%	951	1,018	961	961	1,019
1995	127619	103777	54635	70,777	33,000	1,087	1.18%	1.70%	2.15%	0.85%	1,011	1,056	1,017	1,017	1,066
1996	135538	113988	60414	78,666	35,322	1,165	1.12%	1.65%	2.13%	0.86%	1,093	1,167	1,142	1,142	1,132
1997	139689	123320	66278	88,275	35,045	1,204	1.06%	1.53%	1.99%	0.86%	1,208	1,297	1,254	1,254	1,167

Financial Year Ending	C'wealth Outlays ($m)	C'wealth Tax ($m)	C'wealth Personal Income Tax ($m)	C'wealth Income Tax ($m)	Other C'wealth Taxes ($m)	FAGs to LG ($m)	FAGs to LG as % C'wealth Tax Previous Year	FAGs to LG as % Income Tax Previous Year	FAGs to LG as % Personal Income Tax Previous Year	GPGs to LG as % C'wealth Outlays	What grants would be at 2.0% of Previous Year Personal Income Tax ($m)	What grants would be at 1.65% of Previous Year Income Tax ($m)	What grants would be at 1.1% of Previous Year C'wealth Taxes ($m)	What grants would be at 1.1% of Previous Year C'wealth Taxes ex GST ($m)	What grants would be at 0.84% of C'wealth Outlays ($m)
1998	140857	137345	76632	93,405	43,940	**1,213**	0.98%	1.37%	1.83%	0.86%	**1,326**	**1,455**	**1,357**	**1,357**	**1,177**
1999	148623	139797	78588	104,060	35,737	**1,229**	0.89%	1.32%	1.60%	0.83%	**1,533**	**1,540**	**1,511**	**1,511**	**1,242**
2000	156338	153153	88711	114,520	38,633	**1,265**	0.90%	1.22%	1.61%	0.81%	**1,572**	**1,715**	**1,538**	**1,538**	**1,306**
2001	181054	175591	82381	120,861	30,876	**1,324**	0.86%	1.16%	1.49%	0.73%	**1,774**	**1,888**	**1,685**	**1,685**	**1,513**
2002	194042	177838	91283	123,605	26,844	**1,328**	0.76%	1.10%	1.61%	0.68%	**1,648**	**1,992**	**1,932**	**1,669**	**1,621**
2003	200482	194827	95736	134,432	29,138	**1,448**	0.81%	1.17%	1.59%	0.72%	**1,826**	**2,037**	**1,956**	**1,655**	**1,675**
2004	214374	209560	104719	145,709	29,730	**1,455**	0.75%	1.08%	1.52%	0.68%	**1,915**	**2,216**	**2,143**	**1,799**	**1,791**
2005	229978	229131	113321	162,974	30,502	**1,501**	0.72%	1.03%	1.43%	0.65%	**2,094**	**2,402**	**2,305**	**1,930**	**1,921**
2006	242582	245223	119804	176,198	29,907	**1,555**	0.68%	0.95%	1.37%	0.64%	**2,266**	**2,686**	**2,521**	**2,128**	**2,027**
2007	258551	261988	121670	189,378	31,402	**1,619**	0.66%	0.92%	1.35%	0.63%	**2,396**	**2,904**	**2,698**	**2,267**	**2,160**
Total						**27,189**					**31,365**	**34,229**	**32,767**	**30,661**	**29,016**
Difference											**4,177**	**7,040**	**5,578**	**3,472**	**1,827**
Maximum							**1.21%**	**1.72%**	**2.24%**	**0.94%**					

The data show an enormous difference in the funding that would have been received by local government had a relationship with Commonwealth taxes been maintained. At 2 per cent of personal income tax collections for the previous year an additional $4.2 billion would have been received over the 25 years to 2006-07. The figures expand to $7 billion if linked to income tax and $5.6 billion if the link was to Commonwealth tax revenue. A figure of $3.4 billion is obtained if the latter figure is discounted by the GST revenues, which have been collected from 2001 and remitted to the states. It should be noted that that these reference points (in 1980-81) do not represent the maximum ratios of the respective Commonwealth aggregates. There also appears no rationale in the original tax sharing arrangements, other than progressivity, for the nexus to be with personal income tax rather than income tax (and excluding corporate tax). This effectively ignores the existence of a relationship between local government expenditures and business.

Heavy reliance on a single property tax creates distortions which could be offset by other taxes. Additional tax sources would increase revenue elasticity for local government but local income and sales taxes are not likely under the Federal system, given our inter-governmental relationships, and it is the system we operate under. In the Victorian situation access to **local** income taxes, although enabling a more equitable spreading of the local tax burden, would not overcome the viability issue for those councils with small/declining populations, relatively high socio-economic disadvantage and that require a high tax effort. Clearly, access to local income tax through a "piggy-backing" arrangement on Commonwealth collections would allow a better matching of capacity to pay and tax incidence but the effect would be around the margin because of the mismatch between revenue raising capacity and local responsibilities and cost disabilities. The MAV believes the solution requires access to and redistribution of national income. Collection by central/higher governments is more efficient and would allow for the addressing of regional inequality and disparity through equalisation processes.

Reasons for Maintenance of Local Property Taxes

The MAV believes that, in order to secure a viable future for the sector, the balance between locally raised property tax and (redistributed) income tax collections is important. It would see a situation where "base" revenue is provided through allocated income tax collections. The quantum involved should be determined at a set proportion of national income tax collections that sufficiently recognises the sector's core spending responsibilities at a reasonable standard.

The MAV is not arguing for local government having no access to local property taxes. There are some practical reasons for councils to have continuing access to property taxes including:

- the distributional issues associated with equalisation processes provide some rationale for retention of the property tax, particularly in the case of policy decisions by councils to fund services at above "average" or specified levels.

- the retention of some level of property taxation may be deemed practical and preferable given that it imposes some fiscal control on councils and imposes greater accountability for council spending;

- addressing the issue of special benefit where for some reason or another user charges are impractical but the flexibility to impose a cost on beneficiaries based on property value is appropriate; and

- to obtain a contribution from vacant land owned by non-residents and government business enterprises.

Specific Purpose Payments to Local Government

There is growing use of specific purpose grants in Australia, although greater local financial autonomy is provided through general purpose allocations. In addition to its fiscal control through control of income and consumption taxes, the Commonwealth also exerts control over large constitutionally state-assigned spending responsibilities such as aged care, health and education through its control of specific purpose funding agreements. State control also extends over local government by states – there is very little direct specific purpose funding of local government by the Commonwealth.

In Victoria local government is a principal provider of aged care, public libraries, maternal & child health and pre-schools, acting on behalf of the State. It also provides these services over and above state requirements in its own right. The MAV has no in-principle concern with the agency role that local government provides on behalf of the states. The MAV believes that on balance the specific purpose approach with respect to local government has been a bit of a failure because, while it has ensured service provision where the State and/or Commonwealth have a major interest, it has not adequately reflected the true costs of service provision. There is an equity argument that if councils are increasingly being asked to act as agents for the delivery of outcomes on behalf of other levels of government that these be reflected in funding arrangements and that they are funded at appropriate levels. While in theory it is argued that local government can refuse to provide such services the reality is that these areas are seen by constituents as local government responsibilities.

Deficiencies in specific purpose programs increase the fiscal demands on councils and hence the need for financial reform.

Summary

Tax reform cannot be divorced from the issue of inter-governmental transfers.

A strong reliance on inter-governmental transfers to state and local government in Australia persists – this would not be so bad if the transfers were adequate.

The quantum of external funding for local government, given its responsibilities, is inadequate.

Reforms based on revenue neutrality will not materially and positively impact council viability.

Tax reform is supported to the extent that it leads to net social welfare gains and may lead to additional and necessary funding for councils.

Local property taxes are inferior to broad-based taxes on income and consumption in dealing with capacity to pay, because they are subject to greater volatility and do not grow automatically. Other broad-based taxes are preferable, with the progressive nature of income tax making it most preferable.

Locally determined income tax rates or surcharges are not considered fundamental to improving the viability of the sector.

Access to local income taxation would not substantially improve the viability of councils with specific structural and socio-economic characteristics.

It is not possible to get the additional funding from ratepayers to deal with spending pressures in some councils, so that some mix of property tax and a pre-determined share of national income tax, via general purpose grants, is desirable. “Base” revenue should be provided through allocated income tax collections. This may or may not be topped-up or exceeded by local tax collections, depending on the financial situation and policy decisions of respective councils.

Centrally collected income taxes are particularly efficient. While the retention of local property taxes would not necessarily be with attendant reductions in valuation and administration costs, their reduced importance may result in other savings e.g. review costs.

Where programs are provided by councils fundamentally as agents for, or where overarching policy is determined by other governments, these should be funded by tied grants. Local taxes are being used to achieve policy objectives of state and Commonwealth governments e.g. libraries and HACC and this needs to be addressed in tied grants funding. These arrangements should be funded sufficiently to avoid the cross-subsidisation of state governments by councils.