The South Australian
Centre for Economic Studies

Adelaide & Flinders Universities

Financing Local Government's Contribution to Community Development

Final Report

Prepared for:

Local Government Association of South Australia

Prepared by:

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Executive Summary

Appropriateness and adequacy of local government revenue sources

At present South Australian local governments fund their operations primarily from a combination of rate revenue, user charges and grants. When one considers the nature of the activities that local governments carry out, it is apparent that each of these mechanisms has a useful role to play. Most importantly, rates and user charges give local governments a substantial degree of discretion over revenue levels and thus levels of service provision. The conclusion of this study is that local government has available to it revenue sources which are broadly speaking appropriate and adequate, although there may be some room for improvement at the margins.

During the 1990s the structure of South Australian local government has been through a series of reforms designed to increase the capacity of local government to make strategic choices at the local level. This raises the prospect of local government taking a more active role in "non-traditional" fields of activity where these are seen as supportive of community development. These changes are a gradually occurring process.

At present local government budgets are under pressure. Accrual accounting aggregates show that local government has been running deficits on operations in recent years, and only substantial rises in the value of local governments' own land holdings have averted a fall in the net value of the local government sector.

In the late 1990s increases in the share of total spending have been in the areas of: sanitation and garbage, cultural services, "other purposes", libraries administration and footpaths. There have been only small increases in the share of spending on health and welfare. The spending share has fallen for parking, roadworks and bridges, sport and recreation, town planning, CFS (due to the introduction of direct funding arrangements from State Government under the Emergency Services Levy arrangements), land development and housing. The data are not suggestive of any substantial increase in the budget shares of social welfare or economic development functions.

Consultations with officials in the local government field reveal a range of upward pressures on local government spending. First, there are unavoidable costs associated with an upward creep of imposed standards, these arising from the actions of higher level governments (e.g. heightened accountability standards and consultation requirements) and judicial actions (extensions of concepts of liability and individual rights). Second, there appears to have been some cost shifting from State to local government, even if local government has had a degree of choice about whether to provide services that other governments have ceased. Third, there are community pressures to enhance services and introduce new services. And, finally, it is clear that councils face new budget pressures arising from infrastructure rehabilitation/replacement over the next 10 to 20 years.

Revenue pressures exist in terms of a long term decline in grant funds from higher levels of government and a keen community awareness of council rates. Councils feel constrained by electors in their ability to lift rates. Accountability measures in the recent legislative changes (such as requirements for rating policies) seem likely to enhance this pressure. At the same time, there is reluctance to increase the extent of user charges.

The fact that local governments in South Australia are keenly aware of financial stresses is not a sign of a failing system. It is at face value evidence of a system that is working as it should. But this in itself does not mean that the mix of revenue instruments available to local government is ideal for its roles.

Theoretical principles suggest that the optimal structure of council revenues depends upon the roles that councils are required to carry out. It is possible to make a conceptual separation of these roles into two categories: the provision of services which are funded according to a benefit principle, and interpersonal distributive activity which involves shifting the revenue mechanism away from a benefit principle in accord with principles of equity. The distinction is useful because the differences in objectives suggest different design criteria for the associated revenue instruments.

Where the objective is to fund according to a benefit principle, local government should have available to it mechanisms which allow it to implement user charges for private and club goods, and tax mechanisms which enable it to target effectively the beneficiaries of public goods. A central conclusion of this report is that general rates, supplemented with the power to set more closely targeted other rates, provide a reasonably good benefit tax for recovering the costs of local public goods. User charges and rates account for the bulk of local government revenues at present.

Whether or not councils have optimised the mix of user charges and rates to achieve the best possible targeting of benefits is a separate question. However, it is important to note that councils appear to have the flexibility to change the balance of user charging and rates if they choose to do so.

Although the revenue instruments available to local government are believed to be broadly adequate for the purpose of benefit funding, this is not to say that they have the best possible set of instruments. The matter of possible enhancements is discussed subsequently.

To the extent that there is a need to finance general public services and interpersonal distributive activity by local government, rates are probably a less than ideal tax base although certainly better than many alternatives. The ideal might be to finance these costs by means of income or consumption taxes set at uniform rates across jurisdictions. Arguably this is what happens now – the Commonwealth Government provides untied grants to local governments from its own tax collections and income taxes are a major component of these. The alternative of grants from State Government financed from, say, payroll taxes or transactions taxes is probably inferior to rate revenue.

In 1999-2000 untied grants amounted to about 10 per cent of South Australian councils' revenues. Whether or not this is adequate to meet aggregate distributive burdens is unclear. But what is clear is that the inequitable distribution of these funds, owing to incomplete fiscal equalisation arrangements, means that some councils through no fault of their own face relatively larger distributive burdens than other councils, with these extra burdens apparently passed on to ratepayers.

Options for supplementing or displacing existing revenue sources

It follows from the previous discussion that measures to supplement or displace existing sources of local government revenues may be warranted primarily on grounds that:

- they achieve more effective targeting of benefit taxation; or
- they are more efficient and equitable means of funding interpersonal distributive activity.

In many cases local government already is able to impose user charges, although it may choose not to do so. Two interesting possibilities for the extension of these powers are into the field of road use charges and use charges for environmental resources. The conclusion reached is that "fee per use" arrangements for roads probably have limited merit at the local level as local roads typically do not suffer congestion. There may be a case for extending local government's powers to charge fees for environmental "bads", although there are likely to be major practical difficulties in the way, including the High Court's interpretations of excise clauses in the Constitution and community resistance to councils appearing to make money out of environmental degradation.

Local government's capacity to carry out targeted benefit taxation is supported by its capacity to set different rates in the dollar for different land uses, to set fixed charges and to set minimum rates, and to set other rates for specific activities and for small areas. However, it is possible that this targeting could be reinforced by the provision of instruments which more directly address beneficiary groups.

The power to impose a local registration charge (on top of State charges) would allow more direct targeting of road costs at those users who register vehicles locally. It does, however, have a disadvantage in that it does not target vehicles from outside the region which use the road network. Some land parcels which benefit significantly from the local road network, but which do not have vehicles registered at them, would effectively receive exemption from the costs. For example, a supermarket might make reduced contributions to local road costs on the basis that it does not have vehicles registered at it. The case for local registration fees is clearly ambiguous.

If it is thought to be desirable to enhance local government's capacity to finance interpersonal distributive outcomes above and beyond the current level of untied grants, the most satisfactory mechanism for doing so is probably a levy on income or consumption imposed by the Commonwealth at uniform rates across jurisdictions with the proceeds remitted to local government. Such an approach has a secondary advantage in that it would allow the local government fiscal equalisation system more closely to approach the goal of equalisation. A system like this could involve the Commonwealth agreeing to some negotiated increase in financial assistance grants to local government. Or a more complex variant might allow local governments themselves to set a tax rate on the Commonwealth income or consumption tax bases, with the Commonwealth acting as a collector. The latter mechanism entails more discretionary powers for local government.

Preferred options

The preferred options that emerge from this analysis are as follow.

First, local government needs to recognise that it is primarily responsible for its own revenue raising. It has user charge and rate mechanisms to allow it to do this. In the years ahead it will face continuing spending pressures in the form of imposed standards, cost shifting, new service demands and an increasing asset refurbishment task. The decision whether or not to accommodate these pressures has direct ramifications for revenue levels. If local electors want the services, they will need to pay councils to provide them either via user charges or rates.

Second, there is a case for councils continuing to think about the mix of revenue instruments that they use. There may be a case for greater use of user charges. There may also be a case for more extensive use of special rates. If not, the role to be played by general rates will be correspondingly higher.

Third, while it might be possible to allow councils access to some new forms of user charges and benefit taxation, and while there is probably little harm in doing so, it is not clear that councils particularly want these powers or that they would use them extensively. Road user charges and local vehicle registration fees, for instance, could take the pressure off general rates but pose some difficulties of their own. There is considerable interest around the world in allowing local governments access to taxes on environmental bads, and there is a good economic case for doing so, but as noted previously there are major legal complications with doing so in Australia.

Fourth, there is a case for giving local government access to a growing grant stream, for instance one linked to the Commonwealth income or consumption tax bases. The case for an expansion of grants rests on the benefits that would flow in terms of improved equalisation outcomes. But even if no major increase were to be contemplated, it should be recognised that under the current "real per capita maintenance" arrangements grants have gradually dwindled as a proportion of local governments revenues. Linking the grant quantum to one of these bases would leave general purpose grants as a minority component of the local government revenue structure, but rising broadly in line with incomes to accommodate expenditure pressures that are also income elastic. Local government has, and will continue to have, some obligations to implement which are of a distributive nature and therefore not amenable to recovery from benefit taxation.

It may be unrealistic to ask the Commonwealth to entertain an arrangement in which local government (collectively) has discretion over the setting of an income tax surcharge. But an arrangement which linked growth in Financial Assistance Grants to growth in the income or consumption tax bases would provide a stable measure of support for local government in its interpersonal distributive obligations and assist with the implementation of fiscal equalisation.

1. Introduction

The South Australian Centre for Economic Studies has been asked by the Local Government Association to:

(1) Examine the appropriateness and adequacy of current sources of local government revenues relative to the scope and nature of local government's current and prospective roles in community development in South Australia.

— While particular attention should be paid to local government rates, the role, potentials and limitations of other significant current sources of revenues also should be examined and evaluated in a context which gives recognition to the evolving scope and nature of local government's responsibilities.

(2) Identify and evaluate options for supplementing (and/or displacing or reducing) existing sources of local government revenues to promote both adequacy and appropriateness in local government access to revenues over time.

— Without limiting the options considered worthy of examination, particular emphasis should be placed on the capacity of local governments to be able to flexibly and independently adjust their revenue streams to meet changes in expressed community needs and/or to be assured of future revenues commensurate with community needs and expectations.

(3) List the preferred options, together with the key arguments in favour of their adoption and any possible obstacles to their adoption that would need to be addressed.

(4) In the course of the study consultations should be held with

- senior officers of LGA; and
- senior officers of selected councils from the metropolitan and non-metropolitan areas.

This report summarises the conduct of the study. The second chapter discusses the structure of local government in South Australia. The third presents statistical information on trends in local government finances, and reports the views put to the Centre during consultations. The fourth considers guiding principles for tax design from the public finance literature. The final chapter considers the existing revenue system for South Australian local government and possible alternatives.

2. The Structure of Local Government

2.1 Legislative framework

Local governments in South Australia are constituted under State law. The legislative framework for local government in South Australia is set out in a number of Acts. Prime among these is the Local Government Act 1999 (the Act), which replaced the Local Government Act 1934.

In the second reading speech for the Local Government Bill the Minister noted that the Bill contained new provisions *"reflecting the function of councils in strategic planning at the local and regional level, in support for business and economic development; and in local environmental management and protection"*. Furthermore, the Bill included *"common objectives for councils, including reference to councils' role in coordination and cooperation in a regional, State and national context"*. [Minister for Local Government 1999, p. 805]

Section 7 of the Act sets out the functions of a council, and these are presented in Box 1. The functions that the Act allows to a council are very broad.

Box 1
Functions of a council

(a) to plan at the local and regional level for the development and future requirements of its area;

(b) to provide services and facilities that benefit its area, its ratepayers and residents, and visitors to its area (including general public services or facilities (including electricity, gas and water services, and waste collection, control or disposal services or facilities), health, welfare or community services or facilities, and cultural or recreational services or facilities);

(c) to provide for the welfare, well-being and interests of individuals and groups within its community;

(d) to take measures to protect its area from natural and other hazards and to mitigate the effects of such hazards;

(e) to manage, develop, protect, restore, enhance and conserve the environment in an ecologically sustainable manner, and to improve amenity;

(f) to provide infrastructure for its community and for development within its area;

(g) to promote its area and to provide an attractive climate and locations for the development of business, commerce, industry and tourism;

(h) to establish or support organisations or programs that benefit people in its area or local government generally;

(i) to manage and, if appropriate, develop, public areas vested in, or occupied by, the council;

(j) to manage, improve and develop resources available to the council;

(k) to undertake other functions and activities conferred by or under an Act.

Source: *Local Government Act 1999* sec. 7.

Section 10 of the Act sets out council powers in respect of rates and charges. Councils may impose general rates, separate rates, service rates and service charges on land, and fees and charges for access to council facilities or provision of services by councils. The Act says that *"rates constitute a system of taxation for local government purposes (generally based on the value of land)"* [s. 151]. In addition, the Act provides a range of provisions to recover costs of services where these relate to specific groups within the council area.

Broadly speaking councils are required to have a relatively uniform rate structure across the council area in terms of its treatment of properties with like land uses and land values, although this still leaves councils choices between rating policies with quite different interpersonal distributive impacts. The Act does not place limits on the amount of rate revenue that can be raised.

There are two allowable elements of the general rate: a component based on a rate in the dollar of value and a fixed charge component. The rate in the dollar may be levied on site value (i.e. land value only), capital value (a value including land value and the value of most improvements) or annual value (akin to an imputed rental value). Most councils use capital value.

General rates are intended to apply across the council area, with minor exceptions. However, the rate in the dollar component may be varied according to location or allowable categories of land use (residential, commercial-shop, commercial-office, commercial-other, industry-light, industry-other, primary production, vacant land and other). It is common for councils to use these provisions to try to adjust rates to match more closely the perceived benefits of council services. In setting general rates councils are required to consider issues of consistency and comparability across council areas in the imposition of rates on various sectors of the business and wider community

Councils may set separate rates for a particular area of the council for the purpose of carrying out work of particular benefit to that land, its occupiers or visitors. The linkage between the activities and the rate needs to be explicit. Separate rates are required to be set on the basis of land values or, with the approval of the Minister, some other scheme which reflects the distribution of benefits across ratepayers.

Councils may impose service rates and annual service charges in respect of water provision, waste collection, treatment and disposal, and (by regulation) television retransmission stations.

Councils may rebate rates for a variety of purposes – for instance to support community services organisations and urban redevelopment.

2.2 State/Local Government Partnerships Program

The State/Local Government partnerships program was set up by State and local government with the task of *"jointly reviewing the roles and responsibilities of State and Local Government … [and to] look for better ways to work together to improve efficiencies in the way we deliver services to the community"* [Minister of Local Government, and President, LGASA (2000)]. It is seen as the third phase of a reform of local government in South

Australia, following on from boundary reforms and reforms to the local government legislative framework.

A Scoping Study for the implementation of the Program was prepared by Mack Management Consulting early in 2001. One of the outputs of this study was the development of an evaluation and screening process for potential partnership initiatives and projects, based on criteria of strategic relevance, improved service delivery, cost saving, local strengthening, ease of implementation, innovation and partnership demonstration.

An important finding of the Scoping Study was that *"partnering is not new"*. It was noted that *"the current status of State/Local Government partnering is too extensive to 'catalogue' as part of this Scoping Study. There are widespread existing partnership activities and partnership opportunities in virtually every area of service delivery"*. [p. 2]

The Scoping Study put forward a detailed Action Plan for the implementation of the Program, and concluded that:

> in the longer term, successful implementation of the State/Local Government Partnerships Program should see a high degree of alignment between the strategies of both spheres of government, greater 'ownership' of the government's strategic direction at the community level, a high degree of partnering in State/Local Government policy setting and service delivery across the State, and a significant improvement in the effectiveness and efficiency of government service delivery to South Australians.

Early in 2002 a new State Government was elected and while this may lead to some changes in the Program the Government is committed to preserving a constructive working relationship with local government.

3. Budget Structure and Trends

3.1 Current Structure

Table 3.1 summarises the accrual operating statement for the South Australian local government sector (data relate to "the general government" sector only, i.e., excluding commercial enterprises).

There was an operating deficit of $74.4 million in 1999-2000, or nearly 9 per cent of operating revenue. Deficits of this order were reported in each of the preceding two years, but prior to that estimates are unreliable.

The change in community net wealth was a smaller $18.6 million, as there were capital revenues of $55.8 million in the form of donations of physical resources, capital grants and capital contributions. If these revenues were untied, a case could be made for including them in an "adjusted" operating surplus. But in fact they are strongly linked to non-discretionary "purchases" of fixed assets by local government.[1]

The data can be interpreted as indicating that local government is not fully funding the costs of depreciation of existing assets. The extent of run-down in net wealth is mitigated by capital revenues received. But unless those capital revenues are directed towards refurbishment – which clearly is not the case for donated assets and in fact is generally not the case with capital grants (virtually all are tied) – the failure to make provisions against depreciation will eventually lead to funding difficulties when refurbishment becomes necessary.

Table 3.1
Operating account for South Australian local government, 1999-2000

	Operating revenue		861.6
less	Operating expenses		935.9
of which:	Depreciation	217.7	
equals	**Operating surplus**		**-74.4**
plus	Physical resources donated		30.7
plus	Capital contributions		1.9
plus	Capital grants received from other governments		23.2
equals	**Change in community wealth**		**-18.6**

Source: SACES calculations, ABS unpublished data.

In Table 3.2 revenues are broken down by source. General rates, which are the primary tax base for local government, are the main source of revenues, accounting for 58.9 per cent of total revenues. Other rates, charges and reimbursements (each of which can be viewed as entailing a degree of "fee for service") account for a further 21.1 per cent of revenue. Operating grants and subsidies, property income and other items such as donations, all of which are largely beyond the control of local government, account for 20.0 per cent of revenue. Operating grants and subsidies included about $86 million of untied grants — $68 million of general purpose funding and $18 million of untied roads funding.

1 "Purchases" in this context include notional purchase of donated assets.

Table 3.2
Selected revenue items South Australian local government, 1999-2000

	$m	Per cent of Total
General rates	507.5	58.9
Other rates, charges and reimbursements	182.1	21.1
Other rates	26.1	3.0
Statutory charges	22.2	2.6
Other charges	103.7	12.0
Reimbursements	30.1	3.5
Operating grants & subsidies	119.0	13.8
Property income	28.3	3.3
Other	24.6	2.9
Operating Revenue	**861.6**	**100.0**

Source: SACES calculations, ABS unpublished data.

Table 3.3 presents a breakdown of expenditures by functional area. There are also some significant non-allocated administrative expenses. The traditional council functions relating to management of the physical environs are prominent: roads, bridges and footpaths; waste management, drainage and street lighting; parks and gardens. There are also significant, but smaller amounts spent on libraries and sporting facilities. Outlays on welfare functions are fairly modest.

3.2 Trends

3.2.1 Expenditure trends for local government

Figure 3.1 shows trends in local general government "cash spending" over the last 30 years expressed in per capita terms and after stripping out an inflation component. The "spending" concept considered is expenses on an accruals basis, net of depreciation, plus expenditures on capital formation. This concept is probably inferior to the pure accrual expenditures measure, but unfortunately the accruals data is available only for a few years, and this modified measure is the best available for long term analysis (see Appendix A for discussion).

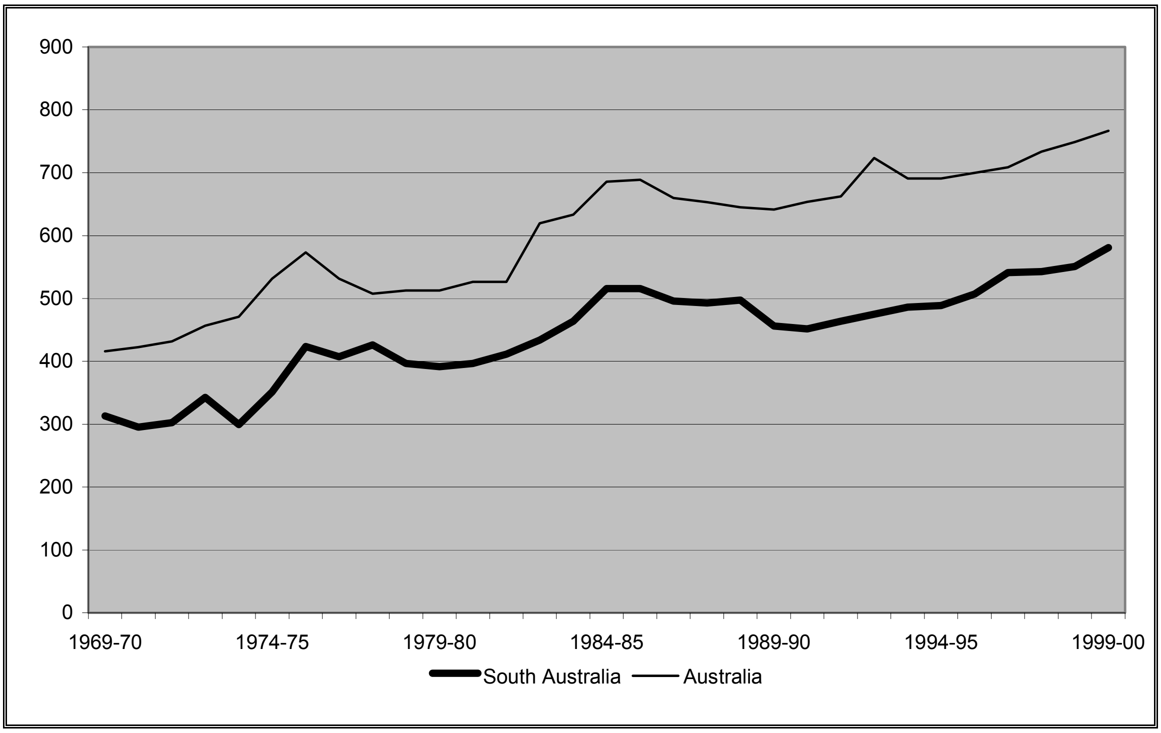
In South Australia local government spending has shown a trend increase, although with some periods of contraction. Over the 10 years to 1999-2000, there was an average annual increase of 2.4 per cent, and this reflected consistently rising spending through the period. Over the 30 years to 1999-2000 there was a similar average annual increase, although this reflects periods of rapid growth in the mid 1970s and early 1980s and decline in the late 1980s.

Table 3.3
Selected expenditures by function South Australian local government, 1999-2000

Functional area	($'000)	%	Functional area	($'000)	%
Administration	**157.2**	**17.1**	**Fuel & Energy**	**5.3**	**0.6**
Public Order and Safety	**13.9**	**1.5**	**Agricultural Services**	**2.7**	**0.3**
CFS	1.9	0.2			
Fire Protection	3.2	0.3	**Building Control**	**10.9**	**1.2**
Other	8.8	1.0			
			Mining & Manufacturing	**1.7**	**0.2**
Health	**20.0**	**2.2**			
Health Inspection	6.4	0.7	**Transport & Communication**	**236.9**	**25.8**
Other Health	13.6	1.5	Roadworks and Bridges	195.8	21.3
			Footpaths	22.5	2.4
Welfare	**31.2**	**3.4**	Aerodromes	2.3	0.3
Aged & Disabled Services	17.2	1.9	Parking	12.5	1.4
Families & Children	5.8	0.6	Bus	3.7	0.4
Other Welfare	8.2	0.9	Other	0.0	0.0
Housing & Community Services	**172.7**	**18.8**	**Economic Affairs**	**27.3**	**3.0**
Housing	1.9	0.2			
Town Planning	17.0	1.8	**Finance charges**	**24.3**	**2.6**
Land Development	3.2	0.4			
Sanitation & Garbage	73.5	8.0	**Other Purposes n.e.c.**	**57.5**	**6.3**
Sewerage	8.4	0.9			
Water supply	2.1	0.2	**STATE TOTAL**	**918.4**	**100.0**
Urban Stormwater Drains	23.3	2.5			
Protection of the Environment	6.8	0.7			
Street lighting	14.5	1.6			
Other Community Amenities	22.0	2.4			
Recreation and Culture	**156.9**	**17.1**			
Libraries	39.2	4.3			
Museums and Art Galleries	0.6	0.1			
Heritage	2.0	0.2			
Cultural Venues	4.5	0.5			
Other Cultural Services	4.8	0.5			
Parks and gardens	45.6	5.0			
Indoor sport	7.2	0.8			
Outdoor sport	27.1	2.9			
Indoor swimming	6.8	0.7			
Outdoor swimming	5.3	0.6			
Other Recreation	13.7	1.5			

Source: SACES calculations, ABS unpublished data.

Figure 3.1
Local government cash spending
$ per capita at 1999-2000 prices

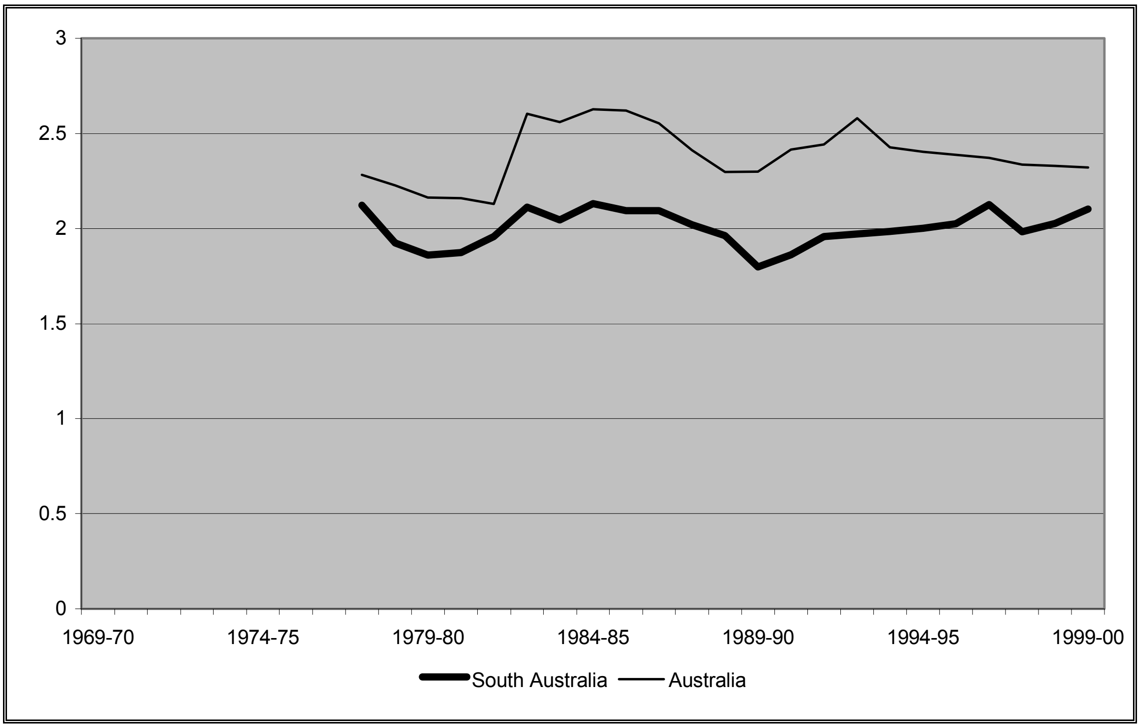


Source: Australian Bureau of Statistics, *Government Finance Statistics* unpublished data, *Consumer Price Index, Australian Historical Population Statistics.* SACES calculations. Estimates are believed to be anomalous and are therefore excluded for South Australia in 1992-93 and for Australia in 1995-96. Data are for the general government sector. See Appendix A for definition of "cash spending".

Local government expenditure trends Australia-wide show broadly similar growth to South Australia, but the per capita level of spending for the nation as a whole is significantly higher than in South Australia. The difference is much smaller if one considers just the government funded element of local government spending, by netting off amounts that are recovered via sales of goods and services. Although there are still differences from State to State in the functions allocated to local government (e.g. water supply in Queensland) these appear not to produce major differences between South Australia and the national average once a "net of recoveries" concept is considered.

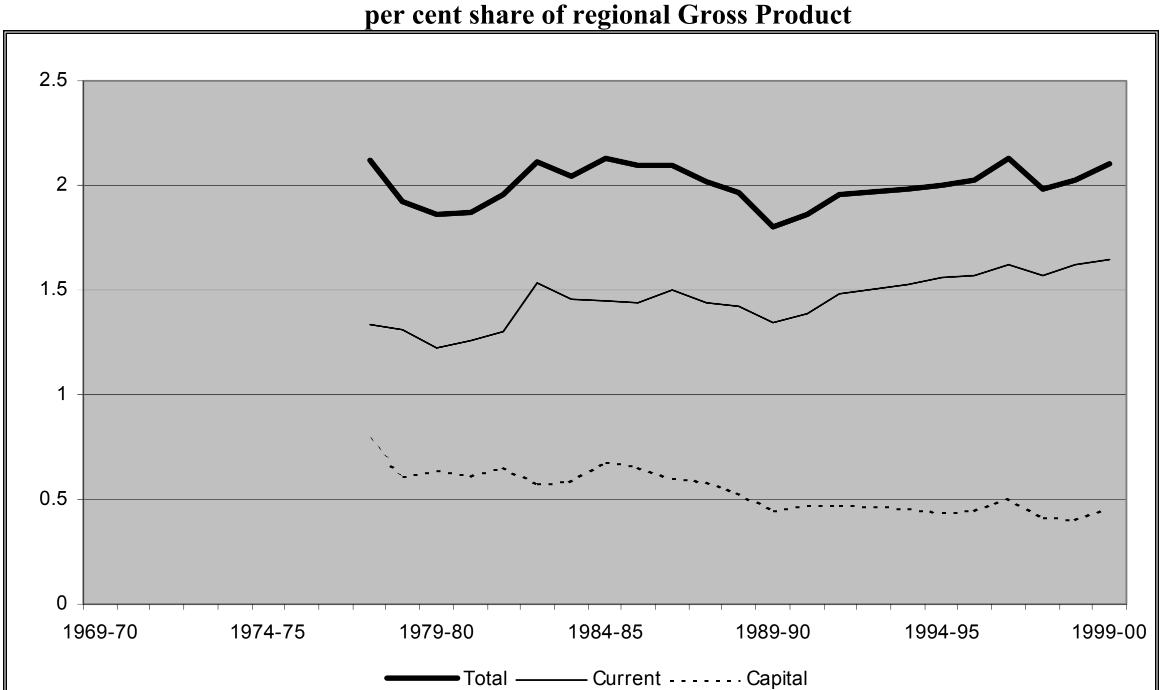
Although spending has risen, per capita incomes have risen as well, and the demand for local government services is likely to be positively related to income. Figure 3.2 shows the ratio of local government spending to gross product since the late 1970s (when the gross product data first becomes available at the State level). There has been an upward movement for South Australia recently. By historical standards the current ratio is at the high end of the range recorded in the past, although not above levels recorded in the first half of the 1980s.

Figure 3.2
Local government cash spending
per cent share of regional Gross Product



Source: Australian Bureau of Statistics, *Government Finance Statistics* unpublished data, *Australian National Accounts.* SACES calculations, modifications to published Gross Product estimates for South Australia. Estimates are believed to be anomalous and are therefore excluded for South Australia in 1992-93 and for Australia in 1995-96. Data are for the general government sector. See Appendix A for definition of cash spending.

Figure 3.3
South Australian local government current, capital and total spending
per cent share of regional Gross Product

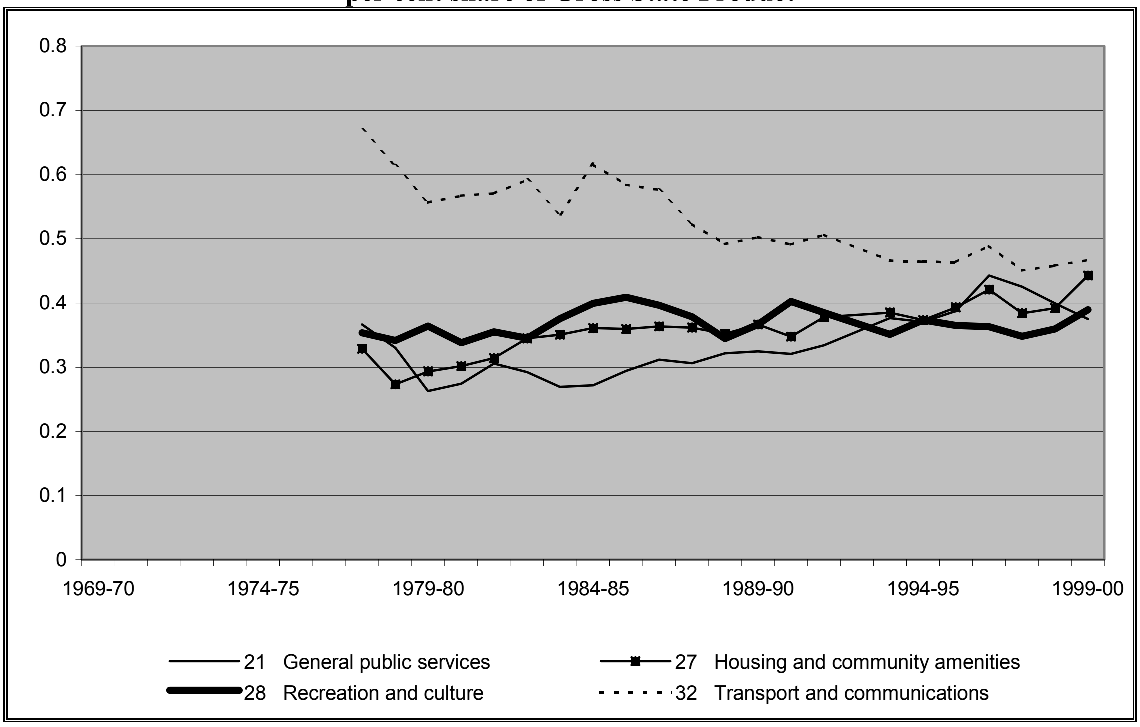


Source: As for Figure 3.2.

Figure 3.3 shows trends in current and capital spending by South Australian local government. It is apparent that spending of a current nature rose through the 1990s (as a proportion of gross product) while capital spending has been at low levels. Capital spending is prone to be delayed in conditions of budgetary stress, and the combination of rising recurrent spending and low capital spending is suggestive of such a situation. This interpretation is supported by the findings of the major infrastructure study *A Wealth of Opportunities* initiated by the South Australian Local Government Metropolitan Chief Executive Officer's Association (Burns, Roorda and Hope 2001). That study reported that South Australian councils spend $55 million a year on asset renewal, whereas to maintain the existing stock requires expenditure of $160 million a year. It concluded that: *'Without asset renewal, services we take for granted will decline in quality and (eventually) cease.'*

Figure 3.4 shows trends in local government cash spending, in each of four spending categories, over the period 1969-70 to 1999-2000. The four categories, and their share of total spending in 1999-2000, are general public services (18 per cent), housing and community amenities (21 per cent), recreation and culture (19 per cent) and transport and communications (21 per cent); other elements collectively account for the remaining 21 per cent (see Table 3.1 for further details). It is evident from Figure 3.4 that there is significant year-to-year volatility in spending levels. The most striking feature of the chart is the contrast between spending trends for transport and communication (falling as a proportion of gross state product since the mid 1970s) and the other three categories (gradually rising).

Figure 3.4
South Australian local government cash spending by purpose
per cent share of Gross State Product



Source: As for Figure 3.2.

Over the decade to 1999-2000 there were increases in spending in excess of gross state product on: housing and community amenities (rising 1.9 per cent per annum in excess of GSP), general public services (1.5 per cent per annum in excess of GSP), and recreation and culture (0.6 per cent per annum in excess of GSP). Spending on general public services was at historically high levels in the second half of the 1990s, although there was a modest reduction in spending at the end of the decade.

Ideally one could extract information from very recent data to identify contemporary changes in spending. The data set covers the period only up to 1999-2000, and is thus about two years old. In addition, the degree of volatility in year by year movements is quite substantial, and it would therefore be meaningless to try to infer much about underlying trends on the basis of a comparison of 1999-2000 and 1998-99. A compromise is to consider the two trienniums 1997-98 to 1999-2000 and 1994-95 to 1996-97. There is a sacrifice of timeliness in the data, but this is necessary to smooth some of the volatility out of the data. Table 3.4 shows changes in the shares of local government outlays by function between these two three year periods.

The most significant increases in the share of total spending have been in the areas of: sanitation and garbage, cultural services, "other purposes", libraries administration and footpaths. There have been only small increases in the share of spending on health and welfare. The spending share has fallen for parking, roadworks and bridges, sport and recreation, town planning, CFS (due to the introduction of direct funding arrangements from State Government under the Emergency Services Levy arrangements), land development and housing. The data are not suggestive of any substantial increase in the budget shares of social welfare or economic development functions.

3.2.2 Revenue trends for local government

Figure 3.5 shows long-term trends in South Australian local government revenue sources in the form of taxation (rates), grants from other governments and sales of goods and services.

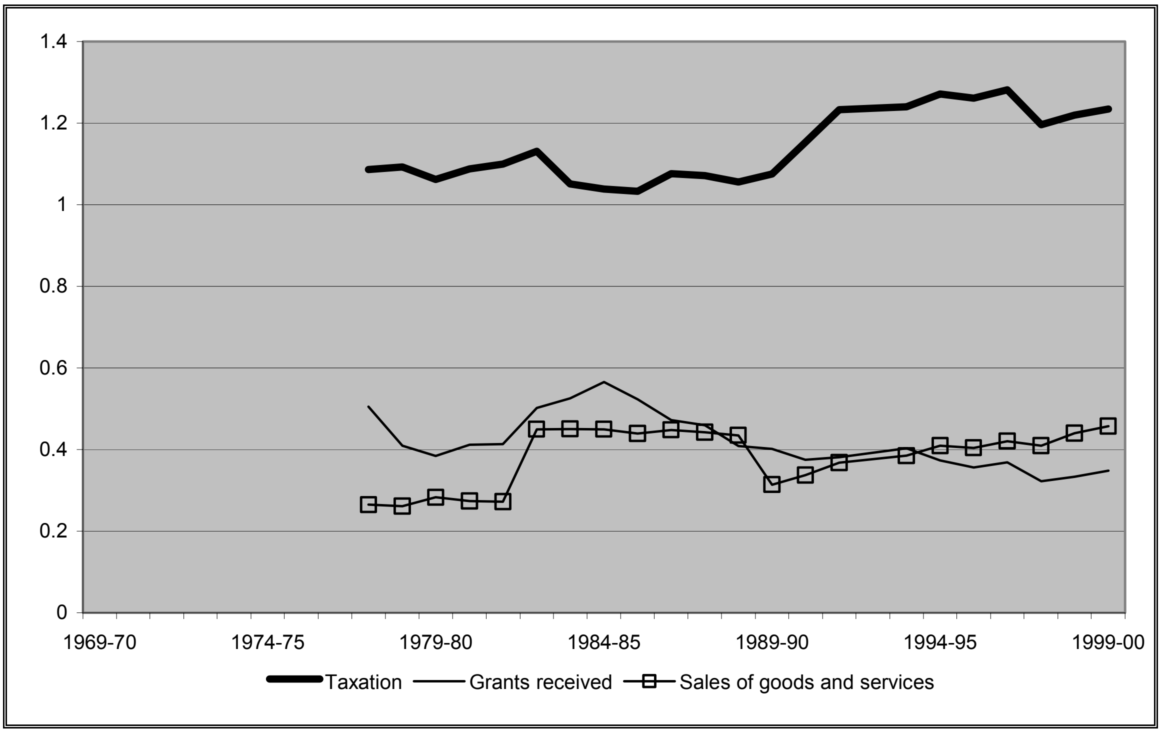
Grants have shown a downward trend since the mid 1980s. Although the sharpest falls occurred in the 1980s, there was a continued downward drift through most of the 1990s, consistent with Commonwealth "real per capita maintenance" policies. Between 1989-90 and 1999-2000, grants grew 1.4 per cent per annum more slowly than GSP. Only at the end of the decade was there an apparent stabilisation. In 1999-2000 untied grants amounted to $86 million, or 10 per cent of operating revenue.

Over the course of the 1990s, local government has increased its revenues from the two main discretionary instruments available to it: taxation and sales of goods and services. Taxation revenue growth outpaced GSP by 1.4 per cent per annum between 1989-90 and 1999-2000 although most of the increase was in the early 1990s. Recently local government tax collections have declined modestly as a proportion of GSP. Revenue from sales of goods and services (including compulsory sales arrangements such as separate rates) outpaced GSP growth by 3.8 per cent per annum, although this growth appears to include catchment levies; local governments have no discretion over their level or application. They amounted to about $10 million in 1999-2000, or 0.02 per cent of GSP.

Table 3.4
Shares of local government outlays on goods services and land by purpose

	Share in 1994-95 to 1996-97 (%)	Share in 1997-98 to 1999-2000 (%)	Absolute change in share	Per cent change in share
STATE TOTAL	**100.0**	**100.0**	**0.0**	**0**
Broad aggregates:				
Other Purposes n.e.c.	8.0	8.4	0.4	5
Administration	19.3	19.5	0.2	1
Mining & Manufacturing	0.1	0.2	0.1	113
Economic Affairs	2.8	2.9	0.1	4
Recreation and Culture	17.7	17.8	0.1	1
Health	2.4	2.5	0.1	4
Welfare	3.2	3.3	0.1	3
Building Control	1.3	1.3	0.0	-2
Agricultural Services	0.3	0.3	0.0	-15
Fuel & Energy	0.7	0.6	-0.1	-8
Housing & Community Services	19.7	19.6	-0.1	0
Public Order and Safety	1.9	1.7	-0.3	-14
Transport & Communication	22.6	21.9	-0.8	-3
Detailed aggregates:				
Sanitation & Garbage	7.3	8.1	0.8	11
Cultural services	0.9	1.3	0.4	39
Other Purposes n.e.c.	8.0	8.4	0.4	5
Libraries	4.1	4.3	0.3	6
Administration	19.3	19.5	0.2	1
Footpaths	2.9	3.1	0.2	8
Aerodromes	0.3	0.4	0.1	51
Protection of the Environment	0.6	0.7	0.1	22
Aged & Disabled Services	1.8	1.9	0.1	6
Other Health	1.7	1.8	0.1	6
Other Public Order and Safety	0.9	1.0	0.1	9
Mining & Manufacturing	0.1	0.2	0.1	113
Economic Affairs	2.8	2.9	0.1	4
Fire Protection	0.1	0.2	0.0	32
Sewerage	1.2	1.2	0.0	0
Health Inspection	0.7	0.7	0.0	1
Other Welfare	0.8	0.8	0.0	-1
Families & Children	0.6	0.6	0.0	-2
Other Community Amenities	4.2	4.1	0.0	0
Building Control	1.3	1.3	0.0	-2
Agricultural Services	0.3	0.3	0.0	-15
Fuel & Energy	0.7	0.6	-0.1	-8
Water supply	0.3	0.3	-0.1	-16
Bus	0.5	0.4	-0.1	-18
Urban Stormwater Drains	2.7	2.5	-0.2	-8
Housing	0.5	0.2	-0.3	-62
Land Development	1.1	0.8	-0.4	-34
CFS	0.9	0.5	-0.4	-44
Town Planning	1.8	1.4	-0.4	-23
Sport & Recreation	12.7	12.2	-0.5	-4
Roadworks and Bridges	17.0	16.5	-0.5	-3
Parking	2.0	1.5	-0.5	-27

Figure 3.5
Taxation, grants and sales of goods and services per cent share of Gross State Product



Source: Australian Bureau of Statistics, *Government Finance Statistics* unpublished data, *Consumer Price Index, Australian Historical Population Statistics.* SACES calculations. Estimates are believed to be anomalous and are therefore excluded for South Australia in 1992-93 and for Australia in 1995-96.

One should be careful about drawing conclusions about causative factors. However, it is notable that tax effort and recoveries have risen in proportion to Gross Product while grants received have fallen.

3.2.3 Cost recovery

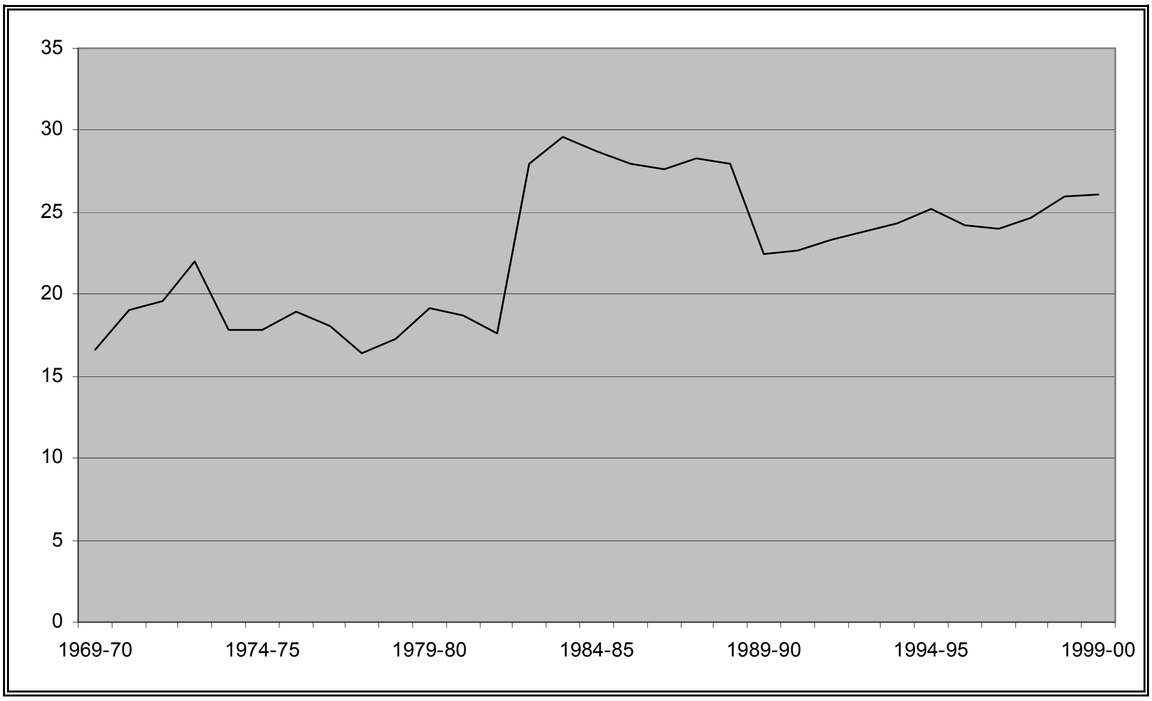
During the 1990s local government substantially raised its cost recovery efforts. Figure 3.6 shows trends in a measure of cost recovery efforts: sales of goods and services divided by "cash spending less grants received". The sales figures include revenues collected via service rates and charges. Cost recovery efforts were static or even slightly declining in the 1970s. Since then, there has been a general upward movement in cost recovery ratios.[2] Over the ten years to 1999-2000 revenues from sales of goods and services outpaced GSP growth by 3.8 per cent per annum. Clearly local government was increasingly seeking to recover the costs of services from users, and there is no sign that those efforts have abated. On this measure the degree of cost recovery now stands at a little over 25 per cent.

Figure 3.7 shows cost recovery trends in South Australia for the main functional areas. The rise in sales during the 1990s has been particularly pronounced in respect of housing and community amenity services, and the ratio now stands at 25 per cent. Cost recovery ratios are

2 The transitory rise in the ratio for the period 1982-83 to 1988-89 should probably be disregarded as aberrant; the cause of it is not clear but it relates to a sharp rise in sales under the "other purposes" category which includes certain intergovernmental transactions.

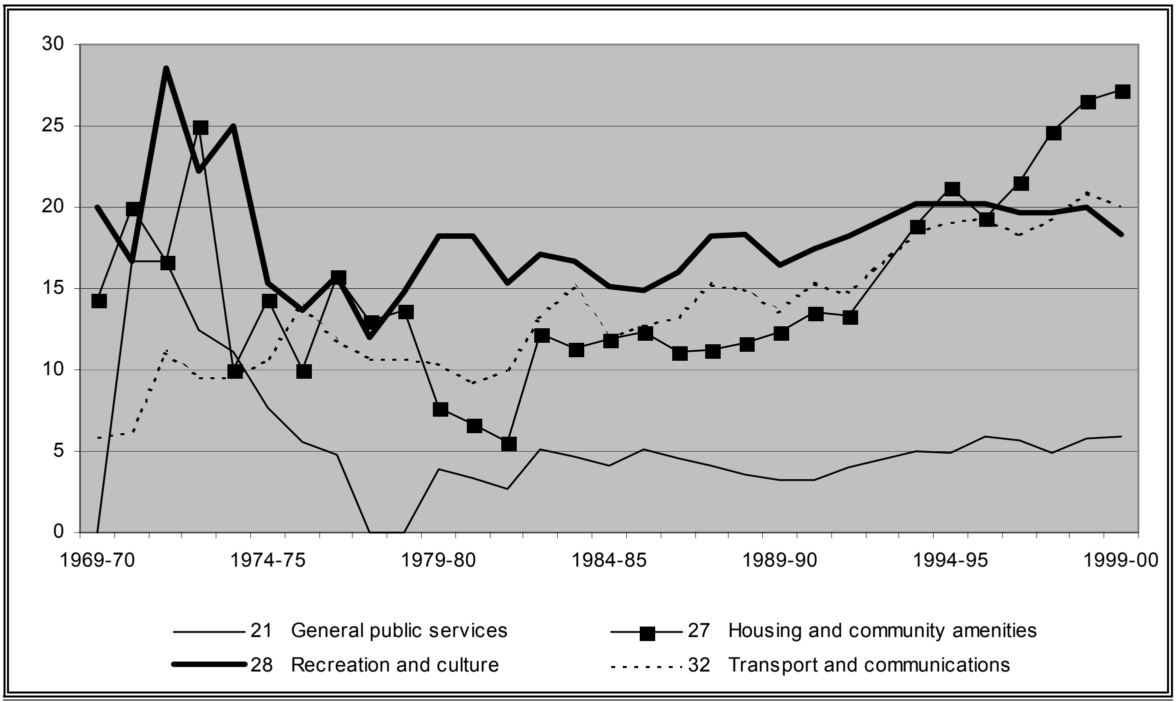
relatively low for general public services; this reflects the difficulty in establishing explicit linkages with provision and usage for these types of functions.

Figure 3.6
Ratio of sales to cash spending less grants received
Per cent, South Australia



Source: Australian Bureau of Statistics, *Government Finance Statistics* unpublished data. SACES calculations. Estimates are believed to be anomalous and are therefore excluded for 1992-93.

Figure 3.7
Ratio of sales to cash spending less grants received – functional areas
Per cent, South Australia



Source: Australian Bureau of Statistics, *Government Finance Statistics* unpublished data. SACES calculations. Estimates are believed to be anomalous and are therefore excluded for 1992-93.

Table 3.5 shows the degree of cost recovery according to functional area. These ratios differ from those in Figures 3.6 and 3.7 in that they are calculated on the basis of selected accrual expenses and revenues. It is apparent that there is a quite wide variation in the degree of cost recovery across different areas of activity.

Table 3.5
Cost recovery by South Australian local government, 1999-2000

Functional area	%	Functional area	%
Administration	**5**	**Fuel & Energy**	**138**
Public Order and Safety	**38**	**Agricultural Services**	**27**
CFS	16		
Fire Protection	9	**Building Control**	**72**
Other	55		
		Mining & Manufacturing	**107**
Health	**56**		
Health Inspection	6	**Transport & Communication**	**18**
Other Health	79	Roadworks and Bridges	5
		Footpaths	4
Welfare	**51**	Aerodromes	86
Aged & Disabled Services	71	Parking	223
Families & Children	48	Bus	55
Other Welfare	9	Other	59
Housing & Community Services	**28**	**Economic Affairs**	**73**
Housing	81		
Town Planning	7		
Land Development	85		
Sanitation & Garbage	29		
Sewerage	131		
Water supply	108		
Urban Stormwater Drains	5		
Protection of the Environment	25		
Street lighting	1		
Other Community Amenities	24		
Recreation and Culture	**18**		
Libraries	10		
Museums and Art Galleries	16		
Heritage	8		
Cultural Venues	32		
Other Cultural Services	44		
Parks and gardens	3		
Indoor sport	61		
Outdoor sport	24		
Indoor swimming	52		
Outdoor swimming	43		
Other Recreation	15		

Source: SACES calculations, ABS unpublished data.

3.3 Conclusions

Accrual accounting aggregates show that local government has been running deficits on operations in recent years.

Taken in isolation these deficits erode community wealth, although the impacts have been mitigated to some degree by the receipt of donated assets and receipts of capital grants and, more importantly quite substantial upward revaluations of land holdings. Local government's liabilities have risen modestly but remain at quite low levels, and holdings of current assets have not changed much.

This means that local governments net worth is increasingly held in the from of land and other infrastructure assets rather than liquid assets. This in turn implies that as local government faces asset replacement tasks it will either have to meet the costs by liquidating existing holdings of non-financial assets or by recourse to increased revenue raising effort (with the timing effects managed by use of debt).

There has been a long term change in the spending mix of South Australian local government. Over the past three decades general public services, housing and community amenities and recreation and culture have become increasingly prominent and spending on roads relatively less important.

In the late 1990s increases in the share of total spending have been in the areas of: sanitation and garbage, cultural services, "other purposes", libraries administration and footpaths. There have been only small increases in the share of spending on health and welfare. The spending share has fallen for parking, roadworks and bridges, sport and recreation, town planning, CFS (due to the introduction of direct funding arrangements from State Government under the Emergency Services Levy arrangements), land development and housing. The data are not suggestive of any substantial increase in the budget shares of social welfare or economic development functions.

Since the mid 1980s, grants to local government have declined in real per capita terms and as a proportion of GSP. Grants (including tied grants) now amount to about 16 per cent of revenue. Local governments have been forced to make greater use of user charges and rates to achieve their own revenue needs. These trends are still evident in very recent years.

4. Consultations

Consultations were held with officers from:

- three local governments: Barossa Council, City of Onkaparinga and City of Unley;
- the Office of Local Government; and
- the Local Government Grants Commission.

The purpose of the consultations was to identify common pressures upon councils' budgets. Accordingly, the focus of reporting here is upon common themes, or at least issues with potentially wide applicability. The issue of differential needs of councils is avoided except in so much as it highlights a systematic issue.

4.1 Outlays

There is a range of potential pressures on local government outlays in the form of standards creep, cost shifting, new community demands and infrastructure refurbishment. These pressures are to some extent interrelated.

Imposed standards creep

Higher levels of government and the courts impose standards on local government, and these standards are not avoidable. For instance, local governments cannot avoid certain types of damages liability (although they can protect against them by insuring at a cost) and they are required under legislation to engage in some processes which are intended to ensure transparency and accountability. These imposed standards are to be distinguished from standards that local governments choose for themselves. 'Imposed standards creep' is the upward movement of these imposed standards over time, with associated cost implications.

Councils said that there have been pressures over the last few years on local government running costs as a result of reforms to the local government legislative framework. For instance, enhanced accountability and transparency measures have imposed significant extra costs – potentially absorbing 2 per cent of revenue. And the legislated requirement to allow rate payments by instalment has increased processing costs to councils and sacrificed some interest receipts. In one instance these impacts were recouped with a 2 per cent rise in rates. It was pointed out that while these amounts do not sound large in absolute terms, they are contentious when translated into rate increases above CPI with little to show for them. It may of course be argued that standards like these are part and parcel of a democratic system. Even so, while the community may favour accountability, it is not particularly receptive to paying increased rates for the costs associated with it.

Standards creep also arises through court judgments. Councils said that their operating environment is increasingly litigious, and that this creates new budgetary burdens. In part this relates to a tendency for councils to be found liable for an increasingly wide range of events. But standards creep is not just in terms of damages awarded against councils. Councils are also seeing an increase in the occurrence of suits which have very weak grounds – e.g. contesting the validity of parking fines. Although councils can expect to win these cases, the costs awarded by the courts do not cover the costs to councils. It is arguable that the courts allow, on public interest grounds, for councils to carry some of the cost of challenges to their powers even when they are found to be acting lawfully. Seen in isolation these cases are not worth fighting, but in fact councils must fight them if they are to maintain the effectiveness of their regulatory activities.

Cost shifting

Councils have concerns about cost-shifting, which typically occurs via State Government reducing its own expenditures in some area and councils picking up the shortfall. It was said that cost shifting is a "creep" process, occurring via a large number of small State agency decisions rather than via large decisions. Examples mentioned by councils included: introduction of SA Water charges for some works on roads, failure to support coastal management and erosion control issues in line with pre-agreed (and statutory) cost sharing arrangements, withdrawal of PIRSA support functions in rural areas, withdrawal of funding for animal/plant boards, cutbacks to police and other social services forcing councils into crime prevention and substance abuse issues etc. It was observed that the extent of cost shifting was probably more pronounced prior to the commencement of the reform program. One metropolitan council estimated the burden (upon itself) associated with cost shifting since the late 1980s at about $1m per annum.

Although cost shifting does sometimes occur, councils said that they are philosophically committed to the idea of effective interaction with other levels of government to deliver requisite services to their communities. Partnering is extensive, predating the Partnerships Program, and will continue to be so. Such interaction is easiest where there is an agreed view about the respective roles of different levels of government and a willingness on the part of those levels of government to provide the resources required to carry out their own roles. When State Government vacates an area, councils are increasingly hesitant to take over the role, although this is not to say that they will never do so.

It is notable that reforms to local government legislation have not much changed councils' functions. But they do foreshadow a more active role for councils in strategic planning.

New areas of activity

Councils roles have evolved over recent years, for instance involving increased commitments of resources to economic development, community and social services, and environmental management.

Councils have always had an important role in economic development via the provision of infrastructure. However, councils are now interpreting their economic development role more broadly, for instance: by setting up marketing and urban improvement measures at the precinct level (potentially funded by special rates), by engaging in research tasks relevant to the local area, by taking a more active role assisting business to find its way around government (including State and Commonwealth), and by promoting the provision of non-traditional infrastructure (e.g. communications). It was suggested that there is some overlap between councils and economic development boards, and a question about the optimal allocation of economic development responsibilities.

There is a trend for councils to move further into the area of community and social services. This appeared to be more pronounced with the non-metropolitan council in our consultations, although perhaps from a lower level of involvement. Areas of new activity include social services such as youth counselling and support services for the aged. There is community demand for new recreational facilities, not always matched by a willingness to pay for those facilities. Councils are having to make careful decisions about whether to upgrade facilities, and if so whether to fund them by phasing out other recreational facilities.

Councils are also finding themselves under pressure to support ever-higher community expectations in the environment. The nature of the challenges varies. Issues to be dealt with include catchment and native vegetation management issues. In rural areas councils have moved to fulfil roles which they see as formerly the domain of PIRSA – e.g. the promotion of good water and soil management practices on farms. There are also community demands for waste management solutions which are attuned to environmental concerns – e.g. green waste collections.

There are few offsets to these pressures in terms of councils vacating traditional areas of activity. The only one identified was councils having less responsibility for the Metropolitan Fire Service, Country Fire Service and State Emergency Service under new emergency services levy arrangements.

Infrastructure refurbishment

Governments at all levels tend to prefer supporting the provision of new infrastructure to supporting asset refurbishment. This is understandable in political terms – taxpayers tend to see new infrastructure as a tangible result of their tax dollar, but tend to take existing infrastructure, and the refurbishment of it, for granted.

A major study for the South Australian Local Government Metropolitan Chief Executive Officers' Association (Burns, Roorda and Hope 2001) has recently carried out detailed analysis of councils' asset stocks and refurbishment expenditure and concluded that current levels of refurbishment spending are insufficient to maintain existing assets. The study emphasised the need for councils to consider divestment, and argued that in the past they have been excessively concerned with the provision of services, rather than facilitating community access to services. A degree of less than complete refurbishment may be – indeed probably is – justified on the basis of considered decisions to scrap some under-used facilities. But the current situation of refurbishment spending running at less than a third of the level required for replacement – which indicatively suggests a scrapping of about two thirds of the existing stock – seems unlikely to be genuinely reflective of community preferences. The implication is that there is a need for increased spending on refurbishment.

Furthermore, refurbishment requirements are projected to increase significantly over the next 10 to 15 years.

All of the councils in the consultations recognised that refurbishment is an important issue, and that reductions in refurbishment are a common means of balancing cash budgets; one described infrastructure as the most "elastic" part of the budget. It was apparent also that perceived infrastructure pressures vary according to the characteristics of local government areas. The inner urban council (which has relatively old infrastructure) was the most concerned about the significant infrastructure renewal task in prospect. The outer urban/rural fringe council and the rural council placed more emphasis on new infrastructure demands (those councils encompass wine districts, and in each there are major pressures to improve rural roads and bridges to cope better with heavy vehicles).

One council argued that because Commonwealth and State Governments' specific purpose funding tends to favour the creation of new assets over refurbishment, infrastructure funding tends to flow disproportionately to urban fringe areas.

It was also noted that councils provide infrastructure which is extensively used by, or intended to ameliorate problems created by, non-residents – e.g. roads in inner suburban and rural areas, drainage infrastructure. One council observed that it is very wary of creating new assets because it then takes on an ongoing maintenance and asset replacement role which is very difficult to exit. This caution extends to situations where State Government offers packages involving contributions for up-front costs of assets with councils then taking responsibility for ongoing maintenance; councils will say "no" if the ongoing burdens seem too onerous.

4.2 Revenue

Council revenues come mainly in the form of rates, user charges and grants.

General Rates

Council rate setting behaviour is potentially subject to a range of constraints:

- statutory limitations;
- ad hoc interventions by State Government; and
- community attitudes to and tolerance of rates

There was general agreement that there is little or no "arm twisting" from State Government regarding council rating policies, in contrast to the experience of some other States. There were some caps during the amalgamations process, but these have now expired.

All of this means that the constraining influence on councils in their rate setting behaviour is community attitudes to and tolerance of rates. Some members of the community are very vocal about increases in rates – one council said that it had received 500 phone calls in two days after it announced increased rates in 2001.

Some councils have recently raised their rates above CPI to catch up from the rate freeze during the boundary reform process and also to defray new cost imposts under the reformed Act (e.g. one council has increased its rates 2% to cover the extra costs and interest loss associated with instalment payments). However, there is a consensus that there is very limited ratepayer tolerance for further rate increases beyond CPI. Obviously attitudes on this will vary from ratepayer to ratepayer, and the appropriate interpretation probably is in terms of the attitudes of the electorally decisive voter.

Consistent with this, it appears that demographic trends may have some impact on the degree of rate resistance. In inner metropolitan areas which are experiencing urban regeneration and an influx of younger, higher income households, there is probably a greater willingness to pay for enhanced public services.

There have been significant property value increases in recent years. At constant rates in the dollar this would boost council revenues quite significantly. However, councils said that they (and their ratepayers) typically compare revenue increases with CPI movements and growth in numbers of residences. Under the Act they are required to set their rates with reference to expenditure plans.

Other rates, user charges, etc.

The new Act allows councils to impose fixed charges on properties. One of the councils we spoke to uses the fixed charge provision in tandem with a rate in the dollar of capital value. The other councils used rates in the dollar without explicit fixed charges, but it was noted that their minimum rate provisions are akin to fixed charges. Fixed rate/minimum rate provisions were generally rationalised as notional fee for service elements.

Use of special rates, linked to specific activities, is also fairly limited (see "Other rates" in Table 3.2), although some of the rate differentials such as town/rural and land use type perform a similar function. One council said that there may be a scope for greater use of separate rates on user pays grounds.

It was generally believed that the capacity and will to raise extra revenue outside the rate base is limited. Cost recovery levels are of course much less than 100%, but it was argued that a substantial part of councils' outputs is of a public good nature, which makes direct cost recovery difficult. Councils could introduce user charges in areas like libraries, and increase fees at recreational facilities, but there was reluctance to pursue this. This was especially so in as much as these services are oriented towards youth: one council said that greater cost recovery for adult use of sporting facilities may have merit. It was noted that attempts at higher cost recovery for facilities of this type would probably also prompt a rationalisation of service levels.

Grants

Councils like the idea of increased grants from higher level governments, and indeed this is their preferred solution to budgetary pressures. Councils said that the GST arrangements between the Commonwealth and the States should also include local government (although apparently an early draft of the arrangements did provide for local government, but was rejected by local government because it gave discretion to the States regarding the on-passing of funds from the Commonwealth).

Another suggestion was that councils should have a share of motor vehicle registration fees.

New tax powers

Councils were generally cautious on the idea of being given new tax powers, but favoured the idea of new tax sharing arrangements, for instance a proportion of GST revenues.

The distinction between, on the one hand, tax powers (which involves councils assuming responsibility for the setting of tax levels) and, on the other, increased grants (these being funded from taxes imposed by other levels of government) needs to be emphasised here. The key point of distinction lies in the power to determine the tax rate and a related requirement to answer to the electorate for it. The GST and motor registration revenue sharing options alluded to above do not constitute an allocation of new tax powers to councils (regardless of any intrinsic merit that they may have): they are simply a form of grant hypothecated to taxes raised by a higher level of government.

Council officers' reaction to the suggestion of new tax powers for local government was lukewarm. It was thought that new tax powers would not be a bad thing, but there was scepticism as to whether they could actually achieve any very useful effect. The general view was that there would be considerable reluctance to use such powers even if they did exist. Of course the attitude might vary according to the specifics of any such proposal, and a few possibilities were briefly discussed:

- poll taxes – could not seriously be contemplated;
- local registration fee on locally registered motor vehicles – regarded as an interesting possibility, and having merit in terms of its connection with council roads costs;
- usage charge for heavy vehicles on local roads (could be implemented with electronic sensors, reported to be a pilot in Queensland) – regarded as having some merit in terms of sheeting major enhancement costs to their cause, but also concerns regarding consistency with economic development objectives; and
- usage of environmental damage levies – regarded as having limited scope and possible conflicts with development objectives.

Without suggesting that there was endorsement of any particular option, it is probably fair to say that council officers found more attractive those tax bases which could be hypothecated – i.e. for which costs could be tied to particular beneficiary groups. Because hypothecated taxes tend to have less community resistance, availability of tax mechanisms that are more easily identified with benefits could have advantages.

4.3 Debt

Some media reports have suggested local government debt is high in South Australia. This perception is questionable — for the South Australian local government sector as a whole the ratio of total liabilities to assets is about 7 per cent. The sum of principal, interest and finance lease payments accounts for about 11 per cent of total revenue, and interest and finance lease payments for just 3 per cent of revenue. Council officials did not subscribe to the view that debt could not be higher. They all saw debt as an acceptable – possibly even desirable – solution to the funding and management of long-lived infrastructure. And it was recognised that pressures to use debt financing seem likely to grow as the asset refurbishment task grows.

One council observed that the fundamental issue with infrastructure is to base the decision about whether or not to provide assets on whole of life cost considerations. Debt financing decisions thus become an adjunct to strategic infrastructure decisions based on whole of life costs and benefits. Strategic use of debt finance can help to minimise these whole of life costs by ensuring that asset refurbishments or upgrades occur at optimum times.

It was noted that some elected councillors are quite resistant to the idea of taking on debt. Council officers are therefore keen to engage their councillors' thinking on this issue. Although grant funding would be the easiest solution for councils, this is unlikely to be forthcoming in quantities sufficient to avoid the issue. Council officers recognise that the environment today requires them to be more active in making asset choices and accepting and managing the financial consequences. Strategic use of debt can help.

4.4 Summary of issues

There is a range of upward pressures on local government spending. First, there are unavoidable costs associated with gradual increases in imposed standards, which may arise from State Government actions (e.g. accountability, consultation requirements) and judicial actions (concepts of liability). Second, there appears to have been some cost shifting from State to local government, even if local government has had a degree of choice about whether to provide services that other governments have ceased. Third, there are community pressures to enhance services and introduce new services. And, finally, it is clear that councils face new budget pressures arising from infrastructure replacement costs over the next 10 to 20 years.

There is a keen community awareness of council rates. Councils feel constrained in their ability to lift rates, and accountability measures in the recent legislative changes (such as requirements for rating policies) seem likely to enhance this pressure. At the same time, there is reluctance to increase the extent of user charges.

It is possible that access to new discretionary revenue instruments would allow councils to optimise their revenue raising. Reforms like this are not primary in councils' thinking – their preference is for increased funds from State/Commonwealth governments, possibly in the form of revenue sharing arrangements. But there was a (cautious) view that new tax powers might be helpful, especially if they lend themselves to hypothecation (e.g. a local registration charge linked to local road provision).

There may be a case for councils taking on higher levels of debt. Higher levels of debt may be a way of smoothing the cash flow implications of infrastructure replacement, and council officials regard their present debt levels as low. There is considerable reluctance on the part of councils to go into debt, but it may be unavoidable in the absence of grants to fund infrastructure replacement.

5. Public finance considerations

5.1 The functions of government

To determine the appropriate assignment of revenue powers between different tiers of government one needs to consider the characteristics of those tiers – for instance the nature of their roles and their operating environments.

A standard approach to the question, put forward by Richard Musgrave, suggests a consideration of government roles in three broad categories: a stabilisation role, a distributional role and a resource allocation role.[3] Expenditure and tax assignment then needs to take into account the appropriate assignment of these functions between different tiers of government and the relative merits of different tax bases in fulfilling these roles. It is usual to treat the allocation of expenditure powers as the primary issue to be determined, with revenue assignment then tailored to support this.

It is common to characterise local government jurisdictions as highly open to trade and migration. This characterisation would appear to have great force in the Australian context. Trade barriers are minimal and there is substantial trade between States and regions. This characterisation leads to the conclusion that local government can serve no useful purpose carrying out macroeconomic stabilisation activity. Attempts to provide temporary stimulus or dampening influences within local jurisdictions would be subject to very high trade leakages and therefore be ineffective.

It is also common in the Musgravian tradition to regard local governments as a poor place to assign interpersonal distributive responsibilities. There is a range of reasons for this view. First, concepts of national identity typically imply some nationally applicable distributive objectives which the national community is unwilling to see attenuated at regional level. This is especially significant when one allows that differences in regional distributive preferences, presumably determined according to some sort of median voter model, are entirely dependent on quite arbitrary regional boundary definitions. Secondly, differences in local jurisdiction distributive policies can have distorting effects on human and business location decisions. The extent of the potential distortions is likely to be greater the higher is the degree of mobility across jurisdictions. Mobility of residents across local government jurisdictions is certainly higher than across States or nations.[4]

It is when we turn to the resource allocation function that the strong rationale for an assignment of expenditure and revenue powers to local government emerges. Local governments are more likely than higher level governments to have a clear understanding about the public goods and services that their constituents want, and in particular about the detailed design and delivery attributes which most closely meet their citizens needs. The effective channelling of this knowledge can be reinforced by providing accountability: if local governments are required to raise revenue at the margin to cover marginal spending decisions, then candidates whose revenue/spending policies meet with the favour of voters are likely to be elected. So long as revenue raising is conducted according to a "benefit principle" (i.e. the principle that charges for government services are met by the beneficiaries of those services)

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3 See for instance Musgrave and Musgrave (1980).

4 A challenge to the mainstream view is presented in Pauly's (1973) development of a conceptual case for decentralised distributional decisions. Application of Pauly's framework requires resolution of difficult boundary and spillover issues, and it has not generally held sway in thinking about assignment.

then the system should tend to adopt spending proposals if their benefits exceed their costs and reject them if their benefits fall short of their costs. In plain language, the resource allocation role is then one of taking demand and cost based decisions about the provision of goods and services.

5.2 The respective roles of user charges and taxes

The fulfilment by councils of their role deciding what goods and services to provide to the community requires a system in which councils make decisions about levels of service provision according to benefit cost tests. If the benefits of a service exceed its costs, then it is justified on resource allocation or efficiency grounds.

To make judgments about service provision, one therefore needs to make assessments of benefits and costs. Typically the sorts of services that councils are interested in involve benefits to a number, possibly a large number of people, and costs in respect of a single "production" unit (which might be in-house or outsourced). The question that then arises is: What is the best way to make these assessments of benefits and costs?

To answer the question it is useful to consider the distinction between private goods, club goods and public goods. The distinction hinges on two concepts – rivalry in consumption and excludability in consumption. A good is said to be rival if the consumption of a unit of it by one individual means that there is one unit less for everyone else to consume; a non-rival good is one for which provision of one unit for one person for his own consumption also enables consumption by others. A good is said to excludable if it is possible to prevent a person from enjoying the benefits that arise from it. Drawing on these two concepts:

- a pure private good is a good which is both rival and excludable in consumption;
- a club good is a good which is (at least partially) non-rival but excludable; and
- a pure public good is one which is non-rival and non-excludable.[5]

In reality many goods involve a combination of these attributes, but the distinction is useful for analytical purposes.

For pure private goods, and assuming no externalities, benefit cost analyses of consumption decisions can meaningfully be carried out at the individual level. The individual simply decides whether the benefits of consumption exceed costs, and purchases or does not purchase a good accordingly. Of course this decision could be carried out by a government, but to do so it would need to collect information about the benefit level of the individual, and in general it is hard to see how it would do this better than the individual. There is therefore a good case for consumption decisions about pure private goods to be carried out at the individual level, and correspondingly little role for governments to make choices about individuals' consumption levels.

[5] See Rosen (1985) Ch. 6 for further explanation and examples.

However, there are good reasons to believe that choices at the individual level will under-provide non-rival goods. Suppose that there are three individuals Jane, Kym and Liam facing a choice about whether to consume a non-rival good, each with benefits from provision equal to (respectively) B_J, B_K and B_L and a common cost equal to C. Suppose that $B_J + B_K + B_L > C$, i.e. that aggregate benefits exceed costs. It is possible that this situation exists even though $B_J < C$, $B_K < C$ and $B_L < C$, i.e. that at the individual level benefits are less than costs. Under independent private decision making, provision of the good is not justified for either individual and therefore does not occur – even though in an aggregate sense it is justified.

One solution is for Jane, Kym and Liam to agree to share the costs of the good. But suppose that Liam knows that the benefits to Jane and Kym collectively are enough for them to go ahead with just the two of them, regardless of whether he contributes or not (i.e. $B_J + B_K > C$). Then Liam does not need to contribute – he can choose to be a "free rider" on the efforts of Jane and Kym, letting them meet the costs of provision and enjoying the benefits for free. And by a similar line of argument it may also be rational for Jane and Kym to try to "free ride". But if everyone free rides, then the good still is not produced, even though its aggregate benefits exceed its cost.

If the non-rival good is excludable – a "club good" – it may be possible to form a club, with non-members excluded from consumption of the good. By setting its membership charge high enough to cover the cost of the good, but below the benefit level for each potential member, the club induces each potential member to join. In this case the incentive for free riding is removed. Of course it is important that in setting the scale of membership fees the club accurately assesses benefits to each potential member. It could ask members what their benefit levels are, but there is then an incentive for a potential member to understate benefits (the free rider problem returning again) so as to minimise his or her membership fee. It might instead make its own assessment, accepting that its assessment may be imperfect. There is obviously still some risk that a good which passes the aggregate benefit cost test is not provided with the club arrangement.

If the non-rival good is also non-excludable, the club option is inoperable; the good is a "pure public good". In this case the market cannot accurately reveal individual benefit levels, and a government may decide to assess what these are. Drawing on the example above, if it assesses $B_J + B_K + B_L > C$, then provision of the public good is justified. There are of course difficulties with assessing B_J, B_K and B_L. For instance, the collection of stated benefit levels may be problematic if self-declaration is seen as likely to influence the allocation of costs to each individual (the free rider problem arises again). An alternative is for government to make its own assessment of benefits, possibly differentiated from individual to individual according to some observed characteristics which are believed to correlate with benefit levels. Because aggregate benefits exceed costs, there must be some allocation of taxes which ensures that for each individual the benefits received exceed the taxes.[6]

The distinction between private, club and public goods has important implications for the structure of local government revenue sources. Where private choice processes, including club approaches, are believed to be preferable to public choice processes, user charges should be used to raise revenues. Where public choice processes are deemed to be necessary, taxes will be needed to raise revenues. The quality of public choice processes seems likely to be

6 This property raises the potential for "unanimity" in decisions about the provision of public goods.

reinforced to the extent that specific areas of activity are financed from taxes on the beneficiaries, so long as the taxes do not in other ways distort activity.[7]

Retaining, for the present, the assumption of no externalities, this means that:

i) Where local government is involved in the provision of private goods, cost-reflective user charges are the best mechanism to promote efficient production and consumption choices, primarily on the grounds that they do not require local government to carry out the difficult task of estimating benefits at the individual level.

ii) Where local government is involved in the provision of club goods, one possibility is to fully recover costs through membership charges (a form of user charge). But if it is difficult to set membership charges strictly according to the rule that the charge does not exceed the benefit for any potential member – for instance because benefits are known to vary according to difficult to observe characteristics of individuals or according to characteristics which are regarded as unacceptable as a basis for discriminating membership charges – a policy of less than full cost recovery may be warranted.

iii) Where local government is involved in the provision of pure public goods, it generally will be necessary to recover costs through tax revenues – either rates or grants from other governments. The tax mechanism employed would ideally be one which performs well on criteria of efficiency, equity and simplicity.

To round off this discussion, attention should also be given to the important matter of externalities. An externality exists when one person's consumption of a good has an impact (positive or negative) on some third party. For instance, a child's decision to consume membership of a basketball court may benefit residents of the broader community to the extent that the child is not instead on the street committing crime. In this situation there is a case for the beneficiaries contributing to the cost of the basketball court. As there is a strong public good dimension to reduced crime, a government intervention in the form of taxpayer support might be the appropriate remedy.

In New Zealand legislation requires that councils identify the beneficiaries of services that they provide and attribute costs to them. Councils are then expected to raise funds according to these cost attributions, but with some modifications in the light of factors such as affordability, market neutrality, acceptability and consistency with strategic policies. Box 5.1, taken from Wellington City Council (2001), summarises the cost allocation principles.

Table 5.1, taken from Scott (1999), shows data from a sample of New Zealand local authorities which shows the range of cost allocations between "public" and "private" benefits. Two features emerge from the data. First, there is a considerable variation across functions in the degree to which benefits are believed to be public or private. Secondly, for some of the individual functions there are some significant divergences of thought about the public/private allocation across different councils; for instance, wastewater was regarded as being as little as 5 per cent public and as much as 85 per cent public. Although the difference might be explained in terms of different council characteristics, one suspects that the differences may instead be a reflection of the difficult and subjective judgements involved. There may also be

[7] See for instance McLure (1999) Sec. I.C.

some differences between councils in the interpretation attached to the terms "public" and "private"; certainly the economists' textbook definitions should not be assumed to prevail.

Box 5.1
Cost attribution rules for local government in New Zealand

- If a service (or activity) benefits identifiable individuals or group(s) the costs should be allocated to those individuals or group(s) **(user pays**). An example is rubbish bags.
- If those that benefit directly cannot be identified and/or if those that benefit directly cannot be excluded from using the service, the costs should be allocated to the community **(public good**). An example is footpaths.
- If there are indirect or "flow-on" benefits and those that receive these benefits cannot be identified, the costs should be allocated to the community **(positive externality**). An example is libraries.
- If the service prevents the negative effects of the actions of (identifiable) persons the costs should be allocated to those persons **(polluter or exacerbator pays**). An example is parking fines.
- If the service will benefit future generations, costs should be allocated to reflect the distribution of benefits over time (**intergenerational equity**). An example is most of the Council's capital expenditure which is funded by loans.

Source: Wellington City Council (2001), p. 215.[8]

Table 5.1
Cost allocations: a sample from New Zealand

Function	Public/private benefits (%)
Libraries	80/20 to 95/5
Civil defence	100/0
Rental housing for the elderly	0/100
Solid waste management	10/90 to 30/70
Sportsfields	75/25 to 93/7
Parks/beaches	85/15 to 97/3
Wastewater	5/95 to 85/15
Parking	0/100 to 25/75
Transport/roading	23/77 to 100/0
Democratic representation	100/0

Source: Scott (1999) p. 149.

The implication of a New Zealand style costing model is that user charges would typically be used to finance the 'private' component and taxes, such as rates, for the 'public' component.

[8] It is interesting to note that the cost allocation exercise for Wellington City Council produced a rate in the dollar for commercial properties which was significantly higher than for residential properties.

5.3 Local government's distributional role

Although the traditional public finance prescription is to confer responsibility for interpersonal distributive decisions on higher levels of government, as a practical reality local governments are involved in the performance of this function (albeit to a smaller extent than the State and especially the Commonwealth Governments). For instance, local government provides services to the aged yet does not fully recover the costs of those services. It also provides some services to youth without recovering costs, and in this sense redistributes towards youth. The cost of providing roads to rural properties may also not be sheeted home to road users, in which case there is a redistribution to those road users. More generally, some classes of ratepayers may receive discounts on the rates which would be levied according to the benefit principle.

Although these local area redistributions are not supported by traditional public finance prescriptions, they are a fact of life and at least some of them have broad community support. Furthermore, it probably is the intention of higher level governments that local governments take on some of these functions.

5.4 Design criteria for local government taxes

In cases where local government provides local public goods user charges will not be a practical mechanism for cost recovery. This raises the question of what taxes are most appropriate for the role. It is common to compare the available alternatives in terms of characteristics such as efficiency, equity and simplicity.

There are several important efficiency attributes to take into account. Taking first the most obvious, corresponding to a lay interpretation of "efficiency", collection costs (administration, enforcement and taxpayer compliance costs) should be low. Secondly, the costs arising from "distortions" to consumption and production should be low. Thirdly, the way in which the tax structure interacts with public choice processes may also have efficiency implications. Targeted benefit taxes are preferred from this perspective as opposed to untargeted general taxes. Two aspects which need special attention in the context of local government are tax exporting and impacts on location choices.

The implementation of a targeted benefit tax can at times be difficult. The existence of geographic boundaries to local public goods suggests a local delineation, but this can be made difficult by gradual, rather than abrupt, diminution of benefits. Where there is likely to be a strong correlation between benefits and some other observable characteristics of beneficiaries, it may be appropriate to use those characteristics in targeting the benefit tax. For instance, a targeted benefit tax:

- to fund flood prevention works for several properties with equal flood risk could be based on property values;
- to reduce salination of rural land could be based on land values;
- to reduce commuting times could be in proportion with per capita incomes (as a proxy for variations in value of time); and
- to fund a private good might be distributed flat per capita (on the basis that each recipient simply avoids the prevailing market price).

It is thus apparent that in practice the appropriate pattern of taxes for implementation of a benefit principle will have some uncertainty. However, this does not rule out attempts to implement the principle: an approximate solution may be better than some relatively arbitrary alternative. It is desirable that local governments have available the revenue instruments to implement the benefit principle with a satisfactory degree of precision.

There are, however, likely to be some costs which cannot sensibly be recovered with targeted benefit taxes, meaning that a general tax mechanism is required which performs well on efficiency, equity and simplicity grounds.

The equity dimensions of local taxation involve both vertical and horizontal aspects. The vertical dimension relates to capacity to pay, which may be best proxied by wealth, income or consumption measures (or a combination thereof). It is useful to recognise a distinction between income and capacity to pay, in that some groups with low measured incomes still have relatively good capacity to pay. Consider for instance a person who does not own a home but rents one out of earned income, and compare her with an individual with the same earned income who does own a home. The second person obviously has a better capacity to pay, even though incomes are identical. It is possible that taxes on housing value may, imperfectly, offset the exempt status of owner occupied housing in the income tax system. This possibility is reinforced to the extent that housing values bear a good correlation with lifetime income.

Other things equal, simplicity is a desirable feature of a tax system. In some respects simplicity may contribute to low collection costs. It may also have more general status because of the importance of the community understanding the way in which its tax liabilities are allocated. However, it is a principle that is often abandoned once a detailed consideration of equity issues takes place.

This then leads to the question of what is the appropriate tax mechanisms for local government. The main candidates would appear to be:

- benefit taxes which relate to local government expenditure functions;
- broad based taxes levied by higher level governments and remitted to local government as grants; and
- broad based taxes on immobile resources levied by local government.

5.5 Conclusions

From these considerations it is possible to distil a checklist of issues to consider when considering the revenue structure of local government.

Where the intention is to fund according to a benefit principle, local government should have available mechanisms which allow it to implement user charges for private goods, and tax mechanisms which enable it to target effectively the beneficiaries of public goods. Revenue mechanisms which promote this goal have merit. But one needs to take into account the collection costs associated with these revenue mechanisms.

Where there is a need to finance general public services and interpersonal distributive activity by local government, tax mechanisms will have merit if they have a relation to capacity to pay, if they minimise distortions, and if their collection, administration and compliance costs are low. The distortions associated with taxes will depend to some extent on the way in which they are operated. Taxes on mobile resources will involve extra distortions if rates vary across regions.

Having considered revenue mechanisms against this checklist, the decision maker must then decide what weight to attach to these attributes. Writing in the US context, Oates (1999) says of a system of capital value rating:

> On one side, Bruce Hamilton, William Fischel and others argue (persuasively, I believe) that local property taxation, in conjunction with local zoning ordinances, produces what is effectively a system of benefit taxation that promotes efficient location and fiscal decisions on the part of households. On the opposing side, Peter Mieszkowski and George Zodrow view local tax differentials much like excise taxes, which have a distorting effect on local decisions and tend to discourage the use of capital. Thus the case for property taxation purely on efficiency grounds is not altogether clear (although it probably gets better marks than other available tax bases aside from user charges).

6. Does local government have the right revenue powers?

It is clear from consultations that local governments in South Australia are keenly aware of financial stresses. However, this is not itself a sign of a failing system. Indeed it would be of concern if there were no financial pressures. Local governments use valuable community resources to provide services to the community, and as such they are in competition with other users of those resources. The fact that most local government expenditure commitments involve hard choices about where to find the necessary resources is at face value evidence of a system that is working as it should. But this in itself does not mean that the system could not be improved.

To determine whether it could, one needs to ask whether the mix of revenue instruments available to local government is appropriate to its roles.

It has been argued that local government needs revenue mechanisms for two main purposes. First, mechanisms are required that allow it to raise revenue according to the benefit principle. Second, mechanisms are need to raise revenue for general public services and interpersonal distributive activity. These mechanisms need to be efficient and equitable.

As a practical matter, constitutional constraints on local government also must be allowed for. Local governments are creations of State Governments, and State Governments can only empower local government in accord with the powers allowed to the States under the Australian Constitution. The Constitution and the High Court's interpretations of it, and other Commonwealth Government policy, to a significant degree limit the range of powers which State Government could confer on local government.

This chapter considers the strengths and weaknesses of the current revenue structure of South Australian local government.

6.1 International comparisons

The primary revenue sources for local government in South Australia and Australia are rates (immovable property taxes), grants and user charges. Figure 6.1 and Table 6.1 illustrate the degree of reliance on "taxes on immovable property" (i.e. rates) at different levels of government for selected OECD members.

Usage of the rate base in Australia is not particularly high by international standards. Although most countries make less use of rates than Australia does, large countries such as Canada and the United States (among federal countries) and the United Kingdom, Japan and France (among unitary nations) use rates considerably more.

It is notable that, with the sole exception of the United Kingdom, none of the countries on the list – federal or unitary – use rates at central government level. Figure 6.1 compares Australia with other federal countries, and shows use of the rate base by state and local governments. Use of the rate base in Australia is well below Canada and the United States, but higher than in the other countries shown. The base is used more by state level governments in Australia than in any other country, although local governments still have the major presence in the field.

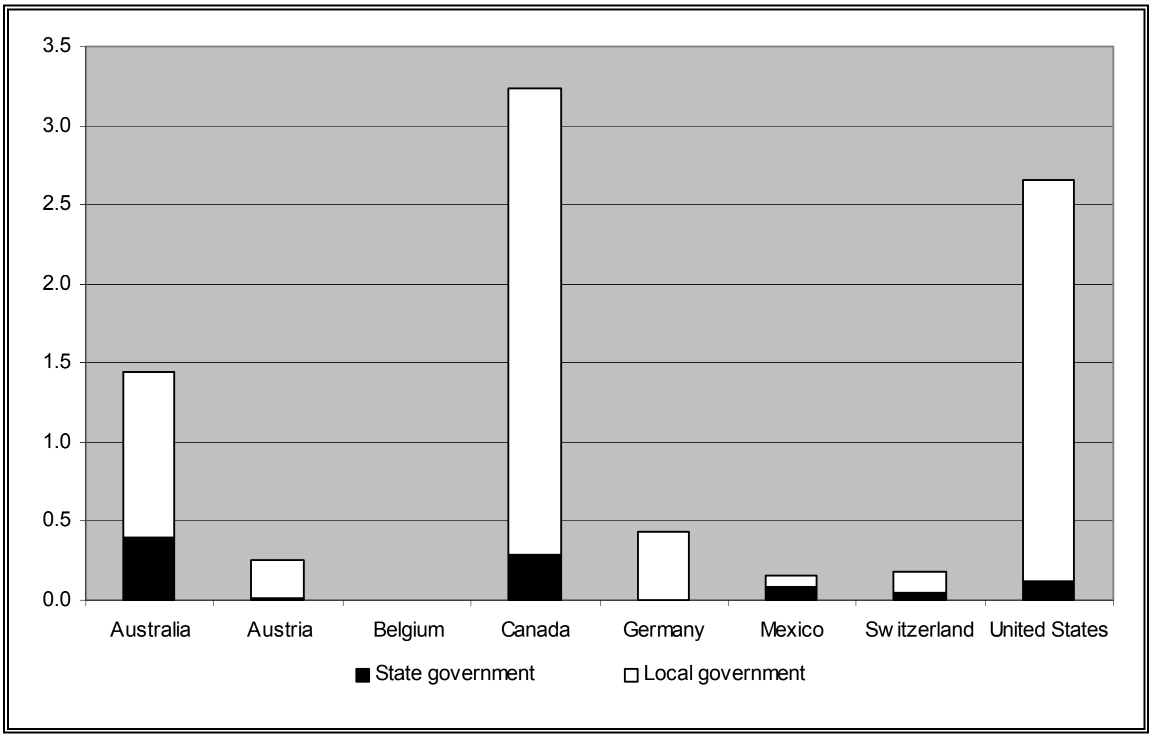
Figure 6.2 illustrates the composition of local government taxes by tax base for the federal countries. Australia's local government sector is easily the smallest among the countries considered. Australian local government relies entirely on rates. Local governments in Canada and the United States also rely mainly on rates. However, in Europe the use of rates is relatively limited, with extensive use instead of income taxes, payroll and workforce taxes. In Austria and the United States local governments make use of goods and services taxes. There is some usage of other taxes on property, most particularly in Switzerland (recurrent taxes on net wealth), and to a smaller extent in Austria (financial and capital transactions taxes) and Canada (non-recurrent taxes on property).

Table 6.1
International comparison of levels of recurrent taxes on immovable property in 1998 as a proportion of gross domestic product

	Federal Countries			
	Federal	**State**	**Local**	**Total**
Australia	0.0	0.4	1.1	1.4
Austria	0.0	0.0	0.2	0.3
Belgium	0.0	0.0	0.0	0.0
Canada	0.0	0.3	2.9	3.2
Germany	0.0	0.0	0.4	0.4
Mexico	0.0	0.1	0.1	0.2
Switzerland	0.0	0.0	0.1	0.2
United States	0.0	0.1	2.5	2.7
	Unitary Countries			
	Central		**Local**	**Total**
Czech Republic	0.0		0.2	0.2
Denmark	0.0		1.0	1.0
Finland	0.0		0.4	0.4
France	0.0		2.0	2.0
Hungary	0.0		0.2	0.2
Iceland	0.0		1.0	1.0
Ireland	0.0		0.7	0.7
Italy	0.0		0.8	0.8
Japan	0.0		2.1	2.1
Korea	0.0		0.7	0.7
Luxembourg	0.0		0.1	0.1
Netherlands	0.0		0.8	0.8
Norway	0.0		0.2	0.2
Poland	0.0		1.1	1.1
Portugal	0.0		0.4	0.4
Spain	0.0		0.7	0.7
Sweden	0.0		1.3	1.3
Turkey	0.0		0.0	0.0
United Kingdom	1.8		1.4	3.3

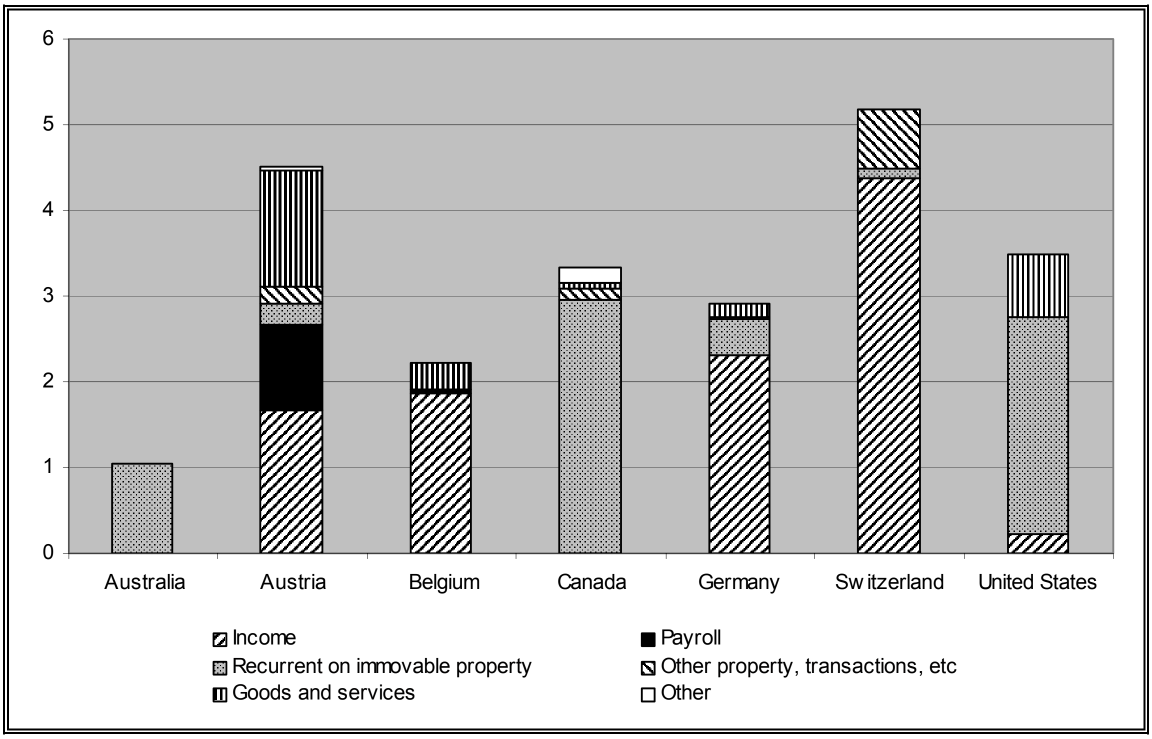
Source: OECD (2000), *Revenue Statistics 1965-1999,* Australian Bureau of Statistics, *Australian National Accounts.*

Figure 6.1
Recurrent taxes on immovable property by level of government
per cent share of Gross Domestic Product, 1998



Source: OECD (2000), *Revenue Statistics 1965-1999.*

Figure 6.2
Local government taxes by type of base
per cent share of Gross Domestic Product, 1998



Source: OECD (2000), *Revenue Statistics 1965-1999.*

6.2 Capacity to implement the benefit principle

There are two main mechanisms which can be used to implement benefit funding: user charges and benefit taxation.

6.2.1 User charge mechanisms

User charges are to be distinguished from taxes in that they can be avoided by a decision not to use the good or service in question. As Figure 3.7 shows, the extent of user charging in South Australia (the data include service rates) has risen significantly over recent years especially in the housing and community amenities area. And as Table 3.5 shows, cost recovery levels are well below full recovery in many areas.

In consultations with councils, scepticism was expressed as to the potential for further increases in user charges. Broadly speaking there are two ways in which such an increase might be realised – either by increasing the degree of cost recovery on services already subject to user charges, or by introducing new user charges.

The case for increasing user charges on services which are already subject to cost recovery is one that needs to be taken in context: there is no general case for or against. A decision to have less than full cost recovery will in many instances be justified on public good or externality grounds.

However, it is possible to canvass some options for the introduction of user charges to a broader range of areas and thus to rely less on rate revenue. Possibilities include:

- waste disposal charges
- road usage fees
- environmental damage levies

Many local governments provide waste disposal services without explicit user charging. However, it is possible to use weight or volume based charges, or to charge for each collection. White et al (2001) say that:

> In the United States approximately 4,000 communities are using a 'pay as you throw' (PAYT) system, which has proven highly successful in reducing municipal solid waste, increasing recycling and reducing the waste pick-up and disposal costs incurred by councils … The fear of increased illegal dumping as a result of implementing waste disposal charges has generally been unfounded. [p.34]

Schemes like this may have some attraction in terms of reducing reliance on rate revenue. But their primary purpose probably is in terms of setting in place an environmentally friendly set of waste management incentives (whether or not it has major behavioural impacts).

The possibility of usage fees for local roads is the subject of considerable discussion in Australia. Usage fees have already been introduced by some other State Governments on some major new arterial road developments, with electronic collection mechanisms greatly facilitating the introduction of "pay per trip" charging. However, it is important to recognise that the level of user charges that is required for cost recovery may not be equivalent to the level of user charges that is consistent with opportunity cost of road use. Often the opportunity cost of road use will be less than the level of charges which would achieve cost recovery. Where this is so, the appropriate pricing structure would be one which includes an "availability" component and a "fee per use" component. On a non-congested road the availability component would be the more efficient cost recovery mechanism. Seen in this light, "fee per use" charges at the local level seem less than ideal, and availability charges are likely to be better.

When one looks at the issue of upgrading local roads for heavy vehicles, there may be a case for sheeting the costs to the heavy vehicles for which the improvements are developed. This could in principle be done with a "per use" charge on heavy vehicles. But where the heavy vehicles collect or deliver freight to sites along the local roads, the usage charges are likely to be passed on to the owners of those properties. It may therefore be more practical to finance the improvements with special rates on the land parcels which heavy vehicles are travelling from or to. If there are land owners who do not make use of the upgrade, this might need to be accounted for, for instance by allowing exemptions if their entry points onto the road are capable of passing heavy vehicles. If a usage charge were desired on equity grounds one possibility would be heavy vehicle counters at the access points to the road.

In principle councils might charge polluters a fee for the resources that they consume in their polluting activities. This possibility is more likely to be feasible when the pollution imposes direct financial remediation costs on councils, but instances like this may be unusual. Another possibility, perhaps more difficult, is to charge polluters for consumption of common property resources – e.g. to charge odour emitters for the disamenity of odours, etc. While this is defensible in a textbook sense, it is probably much more difficult in a real world situation where perceptions of a council failing to adequately protect the environment and at the same time raising revenue from not doing so might place a council in an invidious position. Command and control regulation (as implemented by means of zoning) is much more common than market based solutions. Notwithstanding, there may be some merit in councils exploring options to impose charges on environmental "bads".

6.2.2 Benefit taxes

Where local government finances public goods according to a benefit principle, the primary issues are to target effectively the beneficiaries, to have a revenue mechanism that does not distort their behaviour, and to have a mechanism that is not excessively costly to administer. Capacity to pay issues are not at the fore with benefit taxation, on the ground that the tax paid has an associated benefit linked with it. It is clear that the appropriate instruments will to some extent depend upon local government's areas of spending activity.

There is a range of taxes which might be approximately appropriate for implementation of benefit taxation, depending on the nature of the benefit, such as:

- special rates
- general rates on land value
- general rates on capital value (i.e. land plus improvements)
- fixed charges (i.e. per property taxes)

- poll taxes
- local income taxes
- re-zoning taxes
- local vehicle registration taxes

Among these, targeted special rates are most obviously of a benefit character. But the others are also likely to correlate with some sorts of benefits.

Although local government rating in South Australia is ostensibly based on capital values or land values, the operation of minimum rates and various exemptions means that the scheme is in substance akin to an amalgam of capital values and poll tax, with differentiation according to the personal attributes of ratepayers. Where local government carries out works with general community improvement effects, these mechanisms seem likely to have some connection with benefits, albeit imperfect. The case for land-based instruments is reinforced to the extent that councils provide local public goods, as enjoyment of these tends to be tied to occupancy. Certainly there are taxes which would appear to have weaker links with benefits, such as:

- transaction taxes (e.g. stamp duties, deposits duties)
- death duties
- payroll taxes
- excises (from which local government is in any case constitutionally precluded)
- trade taxes, such as tariffs (precluded from these)

It is possible that local government could have better targeted benefit taxes. Local government's own use of special rates, for instance in respect of sewerage, water and other local services, is very low. Special rates offer considerable flexibility in targeting and there is merit in exploring their more extensive use. However, it needs to be recognised that there is also a limit on the degree to which local government costs can be split into separate functional areas and have separate benefit taxation schemes applied to them, this limit being in terms of the fixed costs of setting up schemes of benefit taxation. In a purely administrative sense these costs might not be particularly high, particularly if the underlying information is a by-product of a benefit cost analysis. But when one takes into account the existence of a potentially large number of allocations of costs (via benefit taxes) which satisfy the underlying requirement that nobody is worse off, a potential for rent seeking behaviour exists.[9] It may therefore be preferable to have a scheme of benefit taxation – e.g. rates – which does not seek to mimic assiduously the pattern of benefits of every decision that local government takes, and even to accept that there may be a limited number of violations of the "everyone better off" rule.

9 To illustrate, consider two properties which have access to the local road network. Assume also that one property has a high value and the other has a low value. Access to the local road network is potentially very valuable. It is easy to envisage a situation in which the benefits for each property exceed the costs allocated to each under a flat fee per property arrangement. And it is also easy to envisage a situation in which the benefits for each exceed the costs allocated to them under a rate in the dollar of site value arrangement. So either arrangement passes a "unanimity" test – i.e. the requirement that everyone subject to the tax be better off as a result of the public good that it funds. But which arrangement gets adopted? The owner of the high value property supports the flat tax per property and the owner of the low value property supports the rate in the dollar. If there is case by case flexibility on the tax mechanism, there is an incentive for the two property owners to engage in lobbying, which is a costly activity. Relative inflexibility, on the other hand, takes away this incentive to lobby.

Local vehicle registration taxes are an interesting possibility as a means of benefit funding local roads improvements. Given the low levels of congestion and potential collection costs, usage charges would seem to be inappropriate (at least until there is a widespread adoption of necessary supporting technology). But a local registration charge would allow more direct targeting of road costs at vehicle owners. It does, however, have a disadvantage in that it does not target vehicles from outside the region which use the road network. In addition, some land parcels which benefit significantly from the local road network, but which do not have vehicles registered at them, would effectively receive exemption from the costs. For example, a supermarket might make reduced contributions to local road costs on the basis that it does not have vehicles registered at it. The case for local registration fees is clearly ambiguous.

It is notable that attempts to introduce an emergency services levy in South Australia a few years ago (which as a tax hypothecated to emergency services is an example of a tax hypothecated to local public goods) were highly contentious.

6.3 General taxes

When one turns to the matter of appropriate revenue instruments for interpersonal distributive purposes, it is apparent that taxes which accord with the community's interpersonal distributive objectives, and do so at least cost in terms of distortions and compliance, are desirable. An important attribute of taxes raised to support distributive objectives is that the link between payment and benefit which is present under benefit taxation no longer holds. For instance, when a council decides to provide subsidised transport for the elderly, meeting the cost by increasing average rates for other members of the community, it is not necessarily the case that those other ratepayers have themselves received something in exchange for those higher rates.[10]

Interpersonal distributive objectives typically involve capacity to pay principles. In their most basic form, these principles are implemented with reference to aggregate per capita income or consumption. In real world application, more sophisticated capacity to pay measures are put in place, involving for instance allowances for differential income "needs" according to personal or household attributes, and discounted tax rates on certain types of consumption where those expenditures may reveal something about capacity to pay.

There are some potential anomalies in the assessment of capacity to pay at present. Not least among these, where relief is given to ratepayers on "cash flow" grounds, there is a good case for putting deferral arrangements in place, rather than simply forgiving the liability. In the case of pensioner owners, for instance, rates could be "borrowed" against the property and recovered at the time of sale.

Tax bases such as income tax and consumption tax[11] are generally regarded as the most satisfactory for achieving interpersonal distributive objectives, but they have a serious

10 The distinction between a benefit tax and a distributive burden is clear in concept but often hard to quantify. Local government might decide to provide a basketball court for youth for instance, and impose part of the cost on a childless ratepayer. This attribution could arise from:

- a view that the ratepayer benefits from having youth diverted from pursuits that are harmful to the ratepayer (e.g., roaming the streets with a risk of antisocial actions), implying a benefit tax; or
- a decision to provide a redistribution to youth on some sort of equity concept (e.g., young people often have limited discretionary income and may not have a supportive family unit), implying a distributive decision.

11 Given the High Court's interpretation of the Constitution's excise clauses, sales or consumption taxes at the local government level are in any case ruled out.

deficiency as revenue instruments for local government. Because they are imposed on mobile bases, they establish incentives for mobile households and businesses to migrate to jurisdictions in which distributive burdens are low. This dynamic in turn makes it difficult for local government to accommodate distributive burdens.

Property taxes are generally regarded as inferior, although this should not be overstated in the case of residential property taxes. Residential property values may have a fairly good correlation with lifetime income and thus with capacity to pay. Furthermore, they could be seen as fulfilling a useful role in addressing the inequities arising from the non-taxation of income and consumption streams associated with owner occupied housing. (This neutralising character could not be said to exist in respect of rental property.)

Two different taxation approaches which can be consistent with neutrality in location choices are:

- land value taxation operated at the local level with rates allowed to vary from region to region; and
- a broad based tax (e.g. income or consumption) encompassing mobile resources implemented at a uniform rate across regions so as to avoid location distortions – this mechanism probably being implemented by means of taxation by a higher level of government and grant of funds to local governments.

To achieve locational neutrality, the inter-council allocation of funds must allow for differences in interpersonal distributive burdens from council to council. That is to say, allowance ought be had for the relative presence of "good contributors" and "needy" residents (in the interpersonal distributive sense). An example of a good contributor might be an office block, to the extent that it contributes more to the council budget than it draws from it. An example of a needy resident might be an elderly person who draws on home support services provided by local government. In principle differences in distributive burdens from one council to another could be allowed to fall entirely on an immobile factor, that factor being land. However, the implausibility of this outcome, and the likelihood that it would fall on mobile factors such as people, implies a need for a fiscal equalisation arrangement. Differences in distributive burdens on mobile factors would tend to induce migrations towards local governments with low numbers of dependents, a distortion from decisions based on underlying costs and benefits of alternative locations.

Fiscal equalisation can correct for these anomalies, although by virtue of its incomplete application in Australia at local government level it does not do so properly. The Commonwealth Government imposes minimum grant requirements which mean that some well off councils receive more than is necessary to equalise their fiscal capacities. The degree of inter-council inequity could most logically be reduced by the removal or weakening of minimum grant provisions, but if this is infeasible an increased level of financial assistance grants to local government in the local financing system would help to achieve more equitable funding arrangements.

Leaving aside the inter-council allocation of grant funds, it is notable that aggregate untied grants to local governments in South Australia in 1999-2000 amounted to about $86 million, an amount which must go a considerable way towards covering any identified rate/charges concessions which are justified on 'needs' grounds.

The prospect of increased differences in distributive burdens from council to council also brings to the fore the question of how much State or Commonwealth Governments want councils to be involved in interpersonal distributive activity.

If local government is, in the future, to be increasingly involved in activities with a substantial interpersonal redistributive content – such as aged care and welfare functions – the adequacy of the current combination of rates and grants comes into question. If extra revenues are raised from higher rates, the incomplete nature of fiscal equalisation suggests inter-council differences in distributive burdens will become more significant. A preferable alternative is to increase grant levels, with those grants funded from broad based taxes imposed at uniform rates across councils – e.g. income or consumption taxes. This requires action on the part of the Commonwealth. Any State Government measure would have to rely on tax bases like payroll tax or transactions taxes, and these are probably inferior to property taxes on capacity to pay grounds.

In the absence of an expansion in grants, property taxation remains available as a second best source of general revenue, although it is a less than ideal base in capacity to pay terms.

6.4 Conclusions

The fact that local governments in South Australia are keenly aware of financial stresses is not a sign of a failing system. It is at face value evidence of a system that is working as it should. But this in itself does not mean that the mix of revenue instruments available to local government is ideal for its roles.

Local government faces spending pressures at present in terms of rises in imposed standards, new community demands, cost shifting and infrastructure replacement. These pressures seem likely to intensify in the future, particularly in respect of infrastructure replacement. These pressures mean that local government is likely in future to need to expand its revenues unless it is able to deal with spending pressures by means of rationalising services.

While user charges have risen in importance as a revenue source for South Australian local governments, there is still a significant proportion of the funding burden to be met from other sources, particularly rates but also, to a lesser extent, grants. Although there may be cases where user charges could be used to a greater extent, a substantial reliance on taxes seems appropriate when one takes into account the "public good" character of much that councils do.

Local government in South Australia relies almost exclusively on rates as a tax base, as does local government in the other Australian States. Overseas, there are countries that make less use of rates, but there are also major countries that use them more. There is therefore not much in the national or international comparison to suggest that the use of rates here is either too high or too low. The analysis is therefore cast on to a consideration of tax design principles.

It is possible, in concept, to characterise local government revenue needs in two classes: revenues raised from the beneficiaries of goods and services according to a benefit principle, and revenues raised from the community at large to fund general public services and interpersonal distributive activity. The distinction is useful because the differences in the objectives suggest different design criteria for the associated revenue instruments.

The "benefit principle" is the principle that the beneficiaries of local government provided goods and services pay for them. It may be invoked by means of user charges in the case of private and club goods or by benefit taxation in the case of local public goods. Not all local government goods and services are public goods, and this implies that cost recovery mechanisms should involve a combination of user charges and benefit taxes.

It is possible that local government could make more extensive use of user charges, but the decision needs to be taken on a case by case basis with reference to (among other things) the inherent degree of "publicness" in goods and services that are currently subject to less than full cost recovery.

The primary benefit tax at councils' disposal is general rates levied on the value of land and buildings and structures. This is supplemented by a limited use of other rates to fund specific works.

This leads to the question of whether general rates are a good tax for funding public goods according to the benefit principle. The conclusion reached in this study is that, when one takes into account councils' interest in public goods with local relevance, and their capacity and propensity to adjust rates away from pure ad valorem property tax (adjustments such as minimum rates, differential rates and the possibility of separate rates and service charges), it appears that the rate base allows a significant degree of targeting of revenue collection and in so doing employs a mechanism with relatively low collection costs.

Councils make surprisingly little use of separate rates for the financing of local public works. This may be a reflection of the costs of a large number of separately structured benefit taxes. Use of a general rate avoids some of these costs, albeit with some imperfections in the application of the benefit principle. Use of separate rates may be most justified when there is a relatively small number of beneficiaries of a public good and the amounts involved are large. There is probably a case for councils exploring the scope for further use of special rates.

There is also a question as to whether access to some other relatively general tax mechanism might reinforce councils' capacity to implement benefit taxation. It is possible that allowing councils to levy vehicle registration charges on top of the existing State vehicle registration fees would serve this objective. The advantage of such a mechanism is that it would allow councils to target the costs of local road improvements more effectively at the intended beneficiaries, local vehicle owners.

As well as carrying out goods and services provision according to a benefit principle, councils carry out the provision of some general public services for which allocation of benefits is tenuous and carry out some interpersonal redistributive activities. Interpersonal redistributive activity would typically occur in the form of concessions to the beneficiaries of council goods and services − for instance the provision of services to the aged or rural roads to rural properties without implementation of user charge or benefit taxation arrangements to recover costs fully. Often these concessions have broad community support.

Although the rate base is probably less than ideal as a funding mechanism for funding general public services and interpersonal distributive activity, it is by no means the worst possibility.

Local governments' interpersonal distributive burdens can be efficiently financed by either land value taxation or broad based income or consumption taxes operated at uniform rates across all Australian local government areas. These mechanisms are consistent with efficient location decisions across councils so long as they are complemented by a system of fiscal equalisation to allow for differences in interpersonal distributive burdens from council to council.

Broad based income or consumption taxes are typically seen as being more equitable than rates. However, the degree of inequity entailed in rates on owner occupied property can be overstated. Property values for owner occupiers are likely to have a reasonable correspondence with whole of life income, and may also be seen as redressing the anomalies arising from the tax exempt status of the income and consumption streams associated with owner occupied property.

The most effective means of financing local government's interpersonal distributive functions would therefore seem to be for the Commonwealth to raise revenue from broad bases such as income or consumption taxes by means of a common rate across jurisdictions, with the proceeds remitted to local government according to the horizontal fiscal equalisation principle — which to a significant extent is what happens. Application of the fiscal equalisation principle is important because there are uneven burdens in connection with interpersonal redistribution from one council to another, and equalisation balances these out.

Untied grants to local government in 1999-2000 were about $86 million. This may be adequate to cover the costs of concessions on user charges and benefit taxes, but it is hard to be sure. If it is not, there is a case for increased untied grants funded from income and consumption taxes. But in the absence of grant funding based on income or consumption taxes, rates may be at least as good a general tax as any of the other alternatives. Other tax mechanisms such as payroll taxes and transaction taxes have imperfect correlations with capacity to pay, as do rates, and may actually have worse efficiency consequences than rates. Consequently they would appear to have questionable merits as mechanisms for funding distributive burdens.

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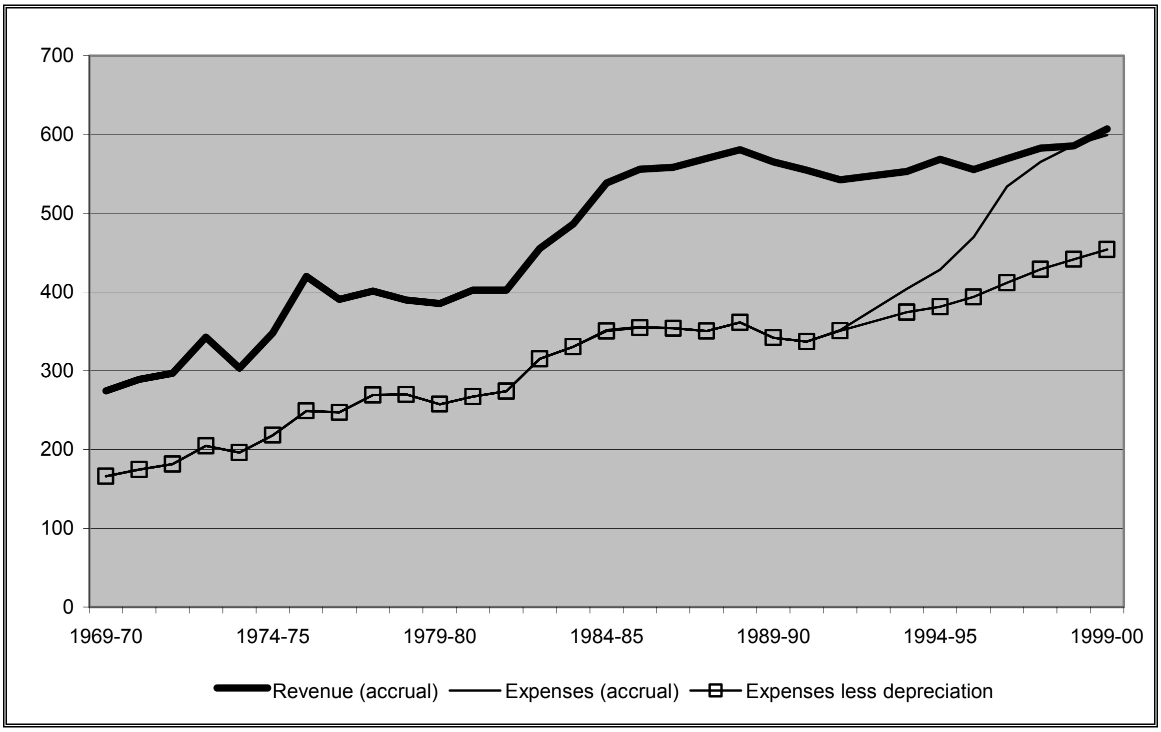
Appendix A

Government Finance Statistics – Cash and Accrual Presentations

In recent years local government has changed the way it presents its accounts from a cash basis to an accrual basis. The Australian Bureau of Statistics has also changed its presentation from a cash to an accrual basis. Unfortunately not all of the information necessary for accrual accounts is available for past years. However, reasonably consistent information is available on a cash basis for current and past years.

Figure A1 shows trends in some key Government Finance Statistics (GFS) accrual aggregates for South Australia over the last 30 years (in real per capita terms): revenue, expenses, and expenses net of depreciation. Until 1991-92 no depreciation is recorded, but after 1992-93 depreciation estimates are introduced. Movements over time in the "expenses" item are therefore quite misleading. For analytical purposes it is preferable to start with the item "expenses less depreciation".

Figure A1
Key Accrual Accounting Aggregates for the Local General Government sector
$ per capita at 1999-2000 prices, South Australia

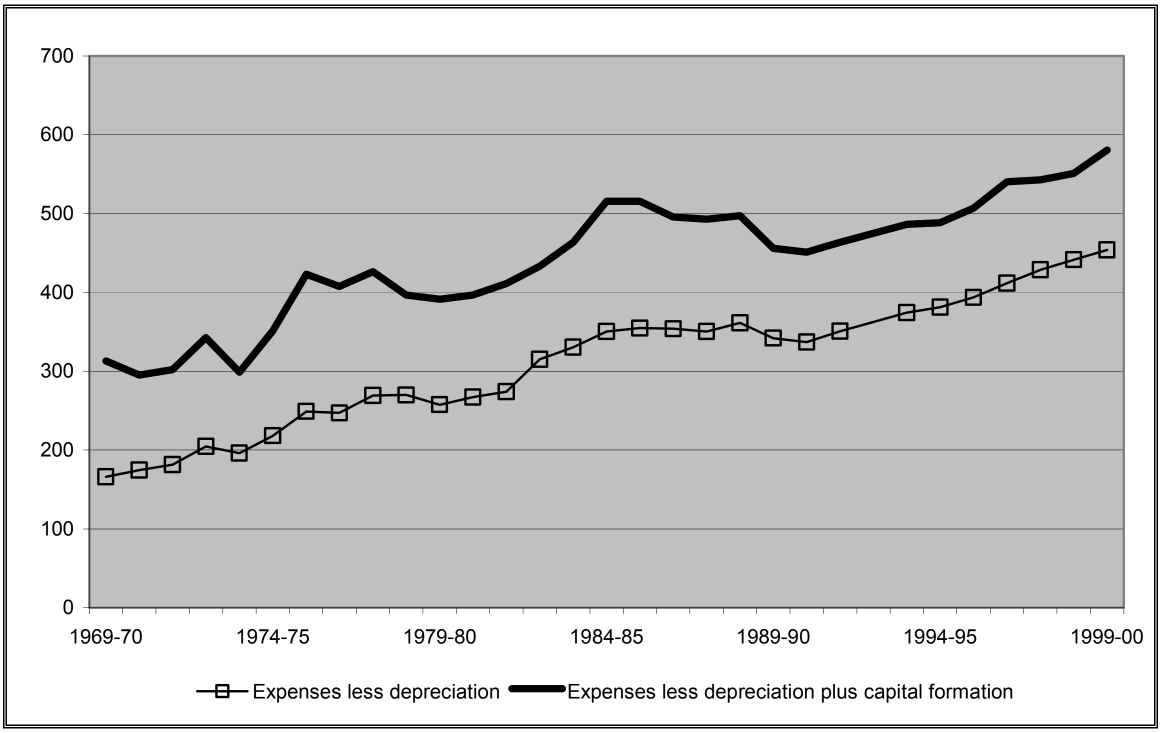


Source: as per Figure 3.1.

However, local government operations do make use of capital. The accruals treatment is to measure consumption of capital – i.e. depreciation. As this is not available, an alternative is to record capital works on an outlays basis – i.e. to charge them when they are purchased rather than consumed. This assumption will be valid if capital formation expenditures and depreciation are of similar magnitudes. The use of capital outlays in lieu of depreciation exposes analysis to a potential distortion if capital outlays and depreciation differ markedly.

For instance, if capital outlays are less than depreciation, an analysis based on outlays could cause the analyst to underestimate the true extent of resource consumption. Such an influence has been present in local government accounts in South Australia, as discussed in the body of the report. Figure A2 shows expenses less depreciation and expenses less depreciation plus capital formation expenditures.

Figure A2
Expenditure aggregates
$ per capita at 1999-2000 prices, South Australia

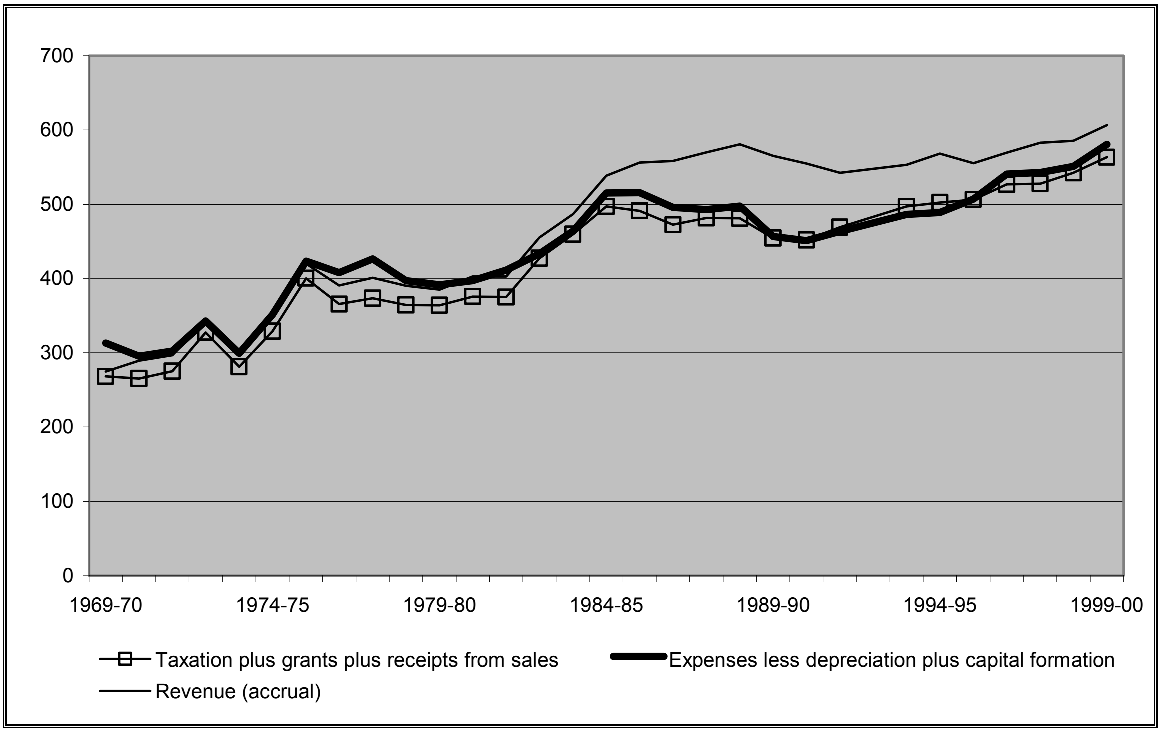


Source: as per Figure 3.1.

The item expenses less depreciation plus capital formation corresponds fairly closely to local government cash expenditures on goods and services and capital. This is the expenditure concept that is emphasised in this analysis, and for brevity it is denoted as "cash spending".

It is interesting to compare cash spending with accrual revenues, and with the sum of taxation, grants and sales of goods and services (which are major cash components of accrual revenue). Figure A3 presents such a comparison. The historical correspondence between spending and taxation, grants and sales is very close – much closer than the correspondence between the spending and the accrual revenues measure. The items taxation, grants and sales form the bulk of accrual revenue, but the data indicate that from the mid 1980s other accrual revenue sources (e.g. property income) played an increasingly significant role until the 1990s, when they shrank again.

Figure A3
Revenue and expenditure aggregates
$ per capita at 1999-2000 prices, South Australia

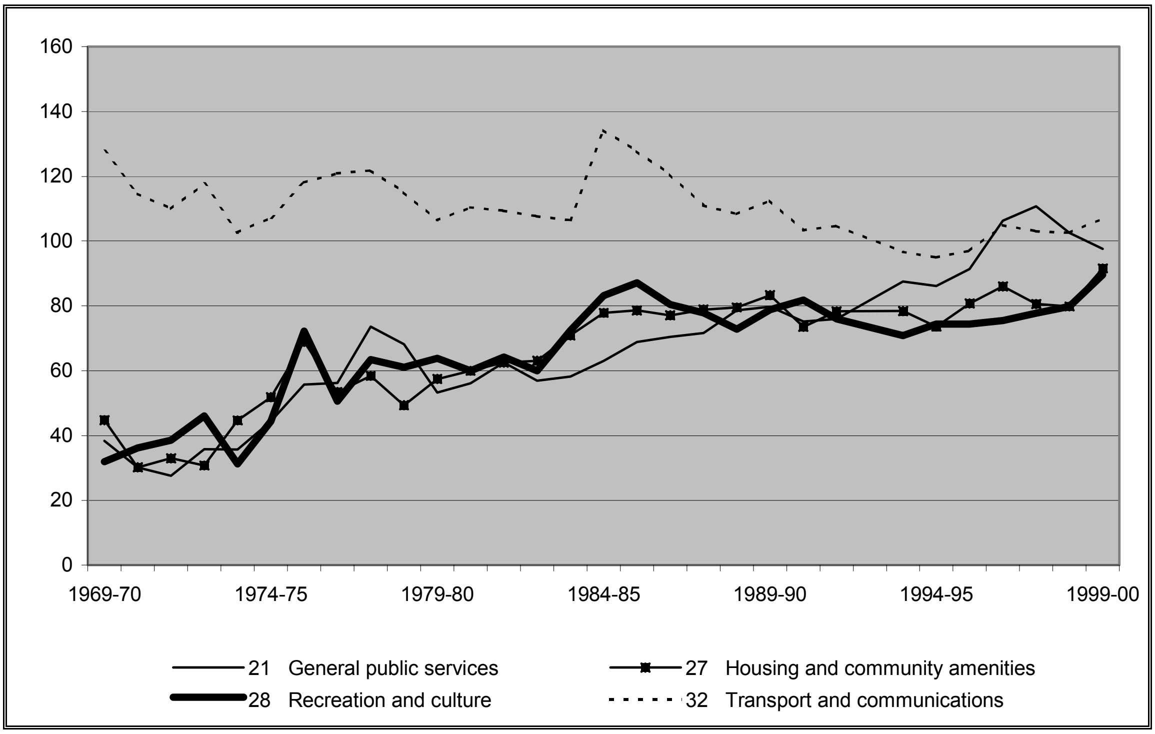


Source: as per Figure 3.1.

Appendix B

Supplementary Charts

Figure B1
"Spending" less sales
$ per capita at 1999-2000 prices, South Australia



Source: as per Figure 3.1.