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# Local Government Finance

Geoffrey Brennan (ed.)

Centre for Research on Federal Financial Relations
The Australian National University

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IN MEMORIAM

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## The Centre for Research on Federal Financial Relations

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## PREFACE

This monograph represents the proceedings of a half-day seminar, held in conjunction with the annual general meeting of the Centre's Research Advisory Committee in May 1986. The juxtaposition of an extended seminar with this annual meeting has become a standard Centre practice. In casting around for a topic for the 1986 meeting, the theme of local government finance seemed to present itself naturally.

To be sure, local government has never been a major mover in Australian fiscal affairs. Its expenditure functions are modest compared with most other federal systems (most notably the United States) and its taxing powers are restricted to the "local rate" (a property tax) and revenues derived from the quasi-monopoly provision of certain local services. All the same, local government is an important object of study - if only to determine why it is that its role is so slight in Australia compared with elsewhere. Moreover, in recent times, there has been renewed interest in local government by the Commonwealth, as evidenced by the establishment of the National Inquiry into Local Government Finance in 1984 (the "Self Report") and the discussion surrounding its release in 1985.

It therefore seemed timely to devote the 1986 seminar to the local government question. And we were of course fortunate to have the worthy Professor himSelf (as one might say) to provide a backward look over the Report and its subsequent reception. In addition to the Self paper, David Moye provides an interesting discussion of the activities of the Local Government Grants Commissions that were set up in the early years of Fraser's Liberal-National Party Coalition government, to allocate federal grants to the States for local government activity among the local governments. To complete the fiscal picture, Norm Thomson undertook to provide a discussion of the local property tax - local "rates" in Australian parlance - as a revenue-raising instrument.

Formal commentaries were provided by Mike Gallagher, Peter Groenewegen and Bert Prowse and are here included, together with a collection of the lengthier comments that surfaced in the informal discussion and a brief reply by David Moye.

The Centre places on record its appreciation to the participants in the seminar and particularly to the authors of the papers. We believe that these papers deserve rather wider circulation and have published them in this format with that hope. Our thanks are also due to Linda Gosnell who assisted in organising the seminar and made the necessary publishing arrangements and Stephanie Hancock who typed the final draft. It is sad to report that Nancy Wilkinson, for many years the Centre's devoted research assistant, was not able to complete the editing of these proceedings. After preliminary editing, she left for a holiday and died before she could finish the task. This publication is therefore the last in which she had a hand, and it is dedicated to her memory on that account.

February 1987 — Geoffrey Brennan

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## THE FEDERAL GOVERNMENT'S ROLE IN LOCAL GOVERNMENT FINANCE

Peter Self

### Why Federal Involvement?

In the Australian context the first question to be asked is why the Federal (Commonwealth) Government is involved with local government at all, save in a marginal, *ad hoc* way. The answers to this question reveal both unique features of the Australian government system and also raise some deep issues about the desirable role of the central government in a modern federation.

First it is worth noting that the scale of local government in Australia is very small - indeed tiny - when compared with other federations. Local government's share of total public expenditure in Australia in 1981 was 5.7 per cent, compared with 23.3 per cent in the USA, 23.1 per cent in Switzerland, 20.6 per cent in Canada and 19.8 per cent in West Germany (OECD, 1983).

There are historical reasons for this small scale of Australian local government - in particular the political dominance of State governments over the capital cities and their hinterlands, and the reluctance of local citizens to take responsibility for local services. While local government is now slowly expanding in new directions, it is still the offspring of a reluctantly accepted local obligation to cope with "roads, rates and rubbish".

More fundamentally, local government in Australia is constitutionally an exclusive responsibility of the States. State Parliaments determine the numbers, constitutions, electoral systems and powers of local councils. State Ministers intervene in a variety of ways with the functions and finances of local government. It is not unusual in Australia for a local council to be suspended and its functions taken over by an appointed administrator. One Tasmanian locality has voluntarily relinquished its democratic rights. In the USA the much stronger belief in local self-government, dating from the highly democratic town meetings in colonial New England, presents a striking contrast. The autonomy of local government there is widely protected by home rule charters which have no parallel in Australia. Only Queensland has given a general competence power to local councils, and that power exists largely on paper.

Constitutional obstacles have not prevented the United States Federal Government from developing a large presence (both financial and regulatory) in the local government field. But consider this difference: in the USA, local governments actually spend a great deal more money - and provide many more services - than do the States themselves. In the USA, local self-government - for good or for ill - is a strong reality. In Australia the States spend eight times the amount of local governments. Local government is very much a dependent appendage of State administration and some commentators do not even see much difference in administrative terms between the role of local governments and of state-appointed public corporations (Howard, 1985).

Up to 1972 the Australian Commonwealth Government did in fact have a minimal and very marginal interest in local government matters. The only Commonwealth grant which all local councils got was for roads but this was merely allocated as a "local" element in the road grant to the States (and some of the money was and is kept by the States for their own locally-designated roads), and no intervention goes with this grant. Some councils also get a variety of small Commonwealth grants for health and welfare purposes, but only in competition with other providers (States or voluntary bodies). The Commonwealth was aloof from and uninterested in the "third tier of democratic government".

## The Whitlam Initiative

The agent of change was the Whitlam Government of 1972-75 which pursued two objectives.

One of these was to forge a stronger third tier of government. This aim could be interpreted either as a concern for a more rational system of decentralisation, or as a Canberra bid to undermine the States. Either way the concept failed. The preferred instrument was the creation of new regional bodies for a variety of purposes, which would to some extent build on the local government system, but these innovations were disliked not only by the States but by most local councils who feared they would be 'restructured'. The regional framework was effectively disbanded by the next (Fraser) Government.

The second, more penetrating goal of the Whitlam years was the pursuit of geographic equity between local areas. Localised differentials in resources and services were seen as a, if not the, major cause of social inequality. Measures included "catch-up" grants for water and sewerage, and area improvement grants to be spent upon projects which the local council itself thought important (Lloyd and Troy, 1981). These initiatives were also subsequently phased out.

However, one Whitlam initiative flourished and grew. This was the concept of an equalisation grant to help the poorer or needier local councils. Initially in 1973 a small and arbitrary sum was recommended for distribution by the Commonwealth Grants Commission, already responsible for advising on equalisation grants to the States. Because there are over 800 local councils, the allocation of this money was a technically tougher job than the allocation of money between six States. The Commission did a rapid *ad hoc* survey of local needs across Australia and allocated funds partly by reference to revenue-raising capacities but mainly upon its judgment of expenditure disabilities, e.g. the necessary level of costs incurred by a council in providing basic services. The Commission's calculations were later aggregated and used as the basis for the inter-state allocation of the Fraser Government's personal income tax sharing (PITS) grant, an arrangement which lasted until 1986 except for an increase in Tasmania's share and the introduction of a grant to the Northern Territory.

The heavy stress upon expenditure needs rather than revenue needs was a feature of this grant which may be somewhat unusual. One reason was the difficulty of comparing valuation systems which varied both between and within States (and sometimes, e.g. in Western Australia) within the same locality. Valuation data were and are somewhat suspect - but so of course are estimates of expenditure disabilities which ought to exclude costs caused through inefficiency or policy choice. (Another significant difference is that revenue disabilities can be derived from the data whereas expenditure disabilities involve nice judgments and plenty of discretion.) However, the stress upon necessary expenditure, whether intentionally or not, accorded with the intention of the Whitlam Government that this grant be used to raise the level of services in deprived areas and not as a subsidy to rates. In line with this Whitlam policy, the Commission considered whether the grant to a council should be made conditional upon its making an adeuqate rating effort. This concept was rejected and the grants were paid without any conditions.

This stress upon expenditure requirements was continued later in varying degrees, except in Victoria and South Australia, by the State Local Government Grants Commissions set up under the PITS Act. One longer-term consequence has been that the Commonwealth grant has been of most assistance to rural areas, with their heavy road expenditure, rather than the deprived or growing urban areas which the Whitlam Government had primarily in mind. Initially, the equalisation grant went to a large majority of councils but by no means all. Later under pressure from local government, the Commission further increased the number of councils benefiting.

## The PITS Act

The Fraser Liberal Government built upon this Whitlam initiative to produce the Local Government (Personal Income Tax Sharing) Act 1976. This Act was a combination of two goals. One was the equalisation goal taken over from Whitlam. The other and politically more dominant motive was the concept of revenue sharing, e.g. a redistribution of tax resources so as to achieve a better match between the functions and available resources of each level of government.

Revenue sharing was logical for the States but why was local government (a small sector and a State responsibility) also included? It could be argued that local rates in Australia were and are at a quite modest level, compared at any rate with other English-speaking countries, and that any necessary relief to the ratepayer could reasonably be left to the State governments. However, the Whitlam local government grant was popular among local members of parliament, other Whitlam grants of benefit to local government were being terminated and Federal tax revenues in the 1970s were quite buoyant. Consequently the Liberal Government confirmed local government's claims to be treated as a separate entity from the States. Local government was allocated 1.52 per cent of the revenue from personal income tax (all of which is in Australia paid to the Commonwealth), subsequently increased after an election promise by Fraser to 2.0 per cent.

The distribution of the PITS money was a compromise between its two objectives. At least 30 per cent of the money (or more by request from a State) had to be allocated to all councils on a population basis, which could be modified (again by agreement) to allow for sparsity. This is Element A, the basic grant which all councils receive "as of right". In practice, after some experiments, all states and the Northern Territory have settled upon between 30 and 40 per cent allocation for Element A, and three States have weighted population to assist rural areas (and towns with a large urban fringe: compare the position of Dubbo and Armidale in New South Wales).

The remainder of the grant (Element B) is for equalisation, defined in the Act as:

> "... ensuring, so far as is practicable, that each of those local government bodies is able to function, by reasonable effort, at a standard not appreciably below the standards of the other local governing bodies in the State ... [Section b(2)b]".

The Act also specifies that account should be taken of both revenue and expenditure disabilities. The administration of the Act was delegated to State appointed local government grants commissions (SLGGC).

The Act might seem to suggest that its aim was to bring the financial capacity (not the actual performance) of each council to provide a given set of services up to the state-wide average; but the meaning of equalisation is not clearly spelled out. The Act's words are taken from the legislative guidance given for grants to the States; but the tests of fiscal equalisation applied by the Commonwealth Grants Commission to six States simply will not do for more than 100 local governments per State, exhibiting much greater differences of revenue capacity and expenditure needs than apply between States. In practice the SLGGCs have had a strong (and to some extent) necessary discretion over their interpretations of the Act. Their methodologies have varied quite widely, but in every State the standards adopted have been well above the average. Indeed it is a rare local council in Australia which gets no equalisation grant in addition to its Element A entitlement. As one consequence, the payout to each council of equalisation grant has to be cut back to meet the funds available - generally by about 50 per cent or more.

How did this result come about? Basically it is because the Act's political intention has been generally understood to be one of revenue sharing or "vertical redistribution". Consequently equalisation, whatever the Act may say, has been interpreted as "partial equalisation" at the State level. This is not because the SLGGCs lack independence from State government. One the whole, and with one or two doubts, they have a genuine independence and their determinations have always been endorsed by both State and Commonwealth Ministers. Nor is the reason that the SLGGCs are casual or uninterested in the techniques of equalisation. On the contrary they are very interested and hard-working, and have produced equalisation methodologies of frightening complexity. The explanation is simply the general political and philosophic assumption that the PITS Act is about vertical redistribution; and that horizontal redistribution (between areas) should not be pushed to its logical limits.

## <u>The National Inquiry into Local Government Finance</u>

The Hawke Labor Government responded to these issues by appointing the NILGF in May 1984 and the Inquiry reported in October 1985 (NILGF Report, 1985).

Its terms of reference forcussed upon an evaluation of the working of the PITS Act and desirable improvements to the Act, but the Inquiry was required to consider the desirable principles of local government finance and the respective roles of the Commonwealth and States towards local government. Thus the Inquiry offered the first opportunity for a broad survey of local government finance within the Australian federal system, although in practice the Inquiry was not able (or expected) to take a detailed look at rating systems which are of course the products of State legislation. Its basic remit was the nature of intergovernmental fiscal flows to (and also from) local government.

The Committee of seven appointed for the Inquiry (an unusually large one) included two Town Clerks, one Deputy Under-Treasurer, two economists and one consultant besides the Chairman. There was no elected representative - a matter for some criticism. The Committee was well qualified and became strongly involved in its subject. It produced a Report of over

450 pages and 50 recommendations plus two research volumes. Its cost was somewhat under A$1 million.

Why was this Inquiry set up? The Committee was not exposed to any political advice or intervention, but the reasons for the Inquiry were not hard to guess. The Hawke Government had established for the first time a Department specifically concerned with local government headed by the same Minister (Mr Tom Uren) who had been responsible for Whitlam's most innovative department, the Department of Urban and Regional Development (DURD). The memory of DURD was not particularly popular among many Ministers (and less so among public servants) because of its alleged "confrontational" politics; Hawke was keen on "consensus". All the same there would be a natural wish to see what had become of one Whitlam initiative which had lasted, albeit in the changed form of revenue sharing.

Mr Uren's new Department was much slimmer and less powerful than DURD, but its involvement with local government itself was stronger. For the first time Local Government was the title of a Federal department, coupled initially with Territories and later with Administrative Services. New initiatives included a local government development fund to provide innovations and experiments, some increase of other grants and closer liaison with the state-local government policy field. However, the cornerstone of any Commonwealth involvement remained Fraser's PITS Act.

Clearly questions needed to be asked about this Act. Federal involvement in its administration or knowledge of its impact was minimal. Was the Act being fairly administered? Were any of the SLGGCs displaying political patronage? Was the equalisation goal being pursued effectively? Were the States using Commonwealth money to replace their own subsidies to local government (the "substitution" issue)? What was the impact of the grant upon services and ratepayers? Did local government need more or less money? Should money be provided and allocated in some different manner? Was there a better way of distributing local government money among the States than the very amateur method in place? What should be the relation between general and specific grants? There were other questions too about the effects of the Act upon local government efficiency and restructuring, and upon Aboriginal communities. This chapter must stick to a few issues.

The Inquiry looked hard into the reasons for Commonwealth support of local government. It was offered much evidence about the "ratepayers" burden', but the evidence was hardly strong. Since the PITS Act, rates as a percentage of either total taxation or G.D.P. has declined slightly. The situation varies between States, rate revenue per capita at constant prices falling in three States and rising in the other three (NILGF Report, 1985, Tables 2.1, 2.4, 2.5 and Figure 2.8). Local taxation in Australia accounts for only about 4 per cent of total taxation and the proportion has been falling. However, there is no denying that local government has become increasingly dependent upon PITS money, due to the buoyancy of income tax and the withdrawal of both Commonwealth and State specific grants, so that by 1983-84 PITS accounted for 55 per cent of all external support, while the ratio of Commonwealth to State financial support had changed since the Act from under 2:1 to well over 3:1 (NILGF Report, Tables 4.1, 4.2 and 4.5). The PITS money has been used diversely and is hard to track down (it has a low visibility in local government accounts and most ratepayers are probably unaware of its existence). Partly the money has been used to keep down rates - compulsorily so in New South Wales where rate-pegging is in force, partly to replace specific grants, partly to finance capital works at a time of high interest rates, partly to develop new services.

The provision of "human services" (recreation, libraries, arts, welfare, education, housing) by Australian local government is so far on a very modest scale but it is the growth sector. (These services accounted for the modest increase of 14.2 per cent in local government spending between 1976-77 and 1982-83.) Local government provision of these services may and perhaps should increase substantially, because of the ageing population, increased welfare needs, the switch from institutional to community care and the general case for decentralisation to the "grass-roots". Australian local government is genuinely small, hence in theory it is responsive to community wants and suited for running a flexible list of small-scale services not involving substantial economies of scale (and such economies are increasingly questioned). However, local government is not particularly responsive to minority or deprived groups, and ratepayers are often resistant to pay for 'human services' except for recreation, which is on the whole very well provided even by tiny towns or shires. Ratepayers' resistant ideology may decline now that all States have moved to adopt adult suffrage. Thus local government has a good case for increasing its involvement in human services, but it is a contingent one since State departments or voluntary bodies could be the preferred service deliverers (only Victoria has gone far in devolving welfare services upon local government).

The third argument for Commonwealth general purpose support is equalisation, which the Inquiry found the most potent one. It is true that perspectives have changed since the Whitlam era. There is increased attention to inequalities between groups (ethnic minorities, women, the unemployed, the deprived) and less to inequalities between areas. It is also the case that a rich local authority can contain many poor citizens and vice versa so that aid to local government is not (and probably cannot be) closely correlated with individual deprivation. All the same, the Inquiry's evidence demonstrated that there <u>were</u> substantial differences between local governments in respect of revenue capacity (even allowing for dubious valuations) and basic costs.

Moreover, these inequalities seem to be increasing - a function of social and economic polarisation. In fact inequalities between local areas in Australia are much sharper than those between States, hence a proper object of equalisation policy.

The States have not been active over tackling this equalisation issue. Only New South Wales had a scheme of any size and that represented only 'partial equalisation' (all councils shared). Queensland and Western Australia also had small schemes, but all three schemes have been virtually abolished now that the Commonwealth has come on the scene. The Commonwealth is much better placed than the States to finance and to steer a satisfactory equalisation scheme. It has greater impartiality and does not have the conflictual relations with local government which some States have (especially at present in New South Wales; but also, in descending degree of conflict, Tasmania, Queensland and Victoria. There are more harmonious relations in South and in Western Australia). Also State knowledge of local circumstances can be kept through giving a continued but more limited discretion to the SLGGCs, which the Inquiry was prepared to do. Only the Inquiry was clear that the Commonwealth grant ought to be more effectively equalising and that the methodologies of the various SLGGCs should be more consistent and coherent.

From these general reflections emerged the conclusions of the Inquiry. It decided that the case for a continuation of Commonwealth general purpose grant had been made out, partly (and to a limited extent) on grounds of vertical redistribution, partly as a spur to the provision of "human services", and especially as a means of equalisation. The grant need not necessarily be tied to revenue sharing for any of these reasons (but especially the second and third). The grant should respect the autonomy of choice of local councils (the "effort-neutral" principle), but it could be allocated in ways which favoured certain services. The grant should be reviewed regularly, in consultation with local government as well as the States. State measures which clearly frustrated the purposes of the grant - in particular rate-pegging - should be prohibited as a condition of grant. The structure of the grant should reflect these considerations and the meaning and requirements of equalisation should be specified and periodically monitored. In particular:

(a) Basis of the grant. This should be determined as a base amount - which ought to be not less than the present figure - adjusted annually by the same type of "real terms" guarantee as applies to the States. The inquiry saw the virtues of tax hypothecation, which enables local government to share in the ups and downs of the tax pool. (However, total taxation, not personal income tax, would be the preferred basis.) It did not necessarily share the Treasury's hostility to any form of hypothecation because it reduces the Commonwealth's budgetary flexibility, especially for a fairly small entitlement (the Commonwealth's flexibility is local government's uncertainty). However, the reliability of the PITS principle was badly damaged while the Inquiry was sitting by the Hawke Government's decision to withhold part of local government's budgetary entitlement because the increase due was deemed to be excessive in a year of financial restraint. In any case, grants to the States have been removed from direct linkage to taxation, and the Inquiry thought it better that local government should be treated in a similar way. Periodic reviews would be essential to see how equalisation was working and what changes (which might be appreciable) were occuring in local functions and finance.

(b) Structure of the grant. The Inquiry accepted that a portion of the grant (the Element A) should continue to be distributed to all councils; but the portion should be limited to 30 per cent of the total and distributed wholly upon a population basis (although population might be weighted by age or other groups to help councils with a greater need for "human services"). Element A would be a constraint upon Element B (equalisation) which would be calculated on the whole grant, with only those councils above the Element A level getting Element B as well (this is not the present practice in Tasmania and Queensland).

As a consequence, Element B could be more explicitly equalising. The Inquiry's preference was that the whole sum be concentrated upon the most disadvantaged councils, equalising fiscal capacity in full from the bottom upwards until the money was exhausted. Failing this, the Inquiry wanted the goal to be to bring all councils below the state-wide average up to that average, as being a meaningful concept of equalisation. Research in New South Wales (necessarily limited) suggested that the sum now available ought to be almost sufficient to reach that goal (NILGF Report, 1985).

The Inquiry suggested a number of desirable principles of equalisation, many taken from the practices of the Victoria Grants Commission. These principles should be incorporated in Commonwealth guidelines which the State Commissions would be expected to follow. The Commonwealth, however, would not intervene or arbitrate upon the determinations for individual councils. It would investigate the workings of the guidelines at the next review of the grant.

The Inquiry was also attracted by the idea of "categorisation", because of the wide differences in the functions and finances of types of local government - particularly those between metropolitan and rural (shires and small towns). In theory a SLGGC can allow for all these differences by many ingenious assumptions - but few if any can understand and check all these assumptions (hence the frequent complaints of local councils that they do not understand the basis of their grant). To compare more similar authorities has the attraction of intelligibility, and could enable the distinctive needs of, for example, metropolitan areas to be more closely assessed.

The issues of equalisation are actually so complex that they cannot be summarised briefly. Much of the Report was concerned in great detail with this issue. The Report also included proposals about treatment of Aboriginal councils; the treatment of State "substitution"; the use of Commonwealth money to aid desirable amalgamations or restructuring; the desirable merger of road and equalisation grants; the review and integration of small specific grants; the rating of public properties; the future role of the SLGGCs; and other matters.

Outcome of the Self Report

It is a frequent fate of committees of inquiry to be overtaken by events. The Commonwealth budgetary outlook darkened. PITS payments were reduced for the year 1985-86 only pending the result of the Inquiry. The Treasury and the Department of Finance told the Inquiry that the responsibility for supporting local government should be handed back to the States. One member of the Inquiry supported this position in a persuasive minority comment.

Thus what started out as a prospectus for some mildly radical reforms in the structure of financial support turned into a struggle to save the Commonwealth commitment to local government. The Report was more likely to be used to support this position than to advance the cause of reform. The Commonwealth supporters of local government could not easily afford to antagonise the States over such issues as equalisation guidelines, State financial substitution or even (perhaps especially) rate-pegging. Even local government associations, once the Report had endorsed the program in principle, were inclined to resist reforms which they had earlier been disposed to accept. Only the Capital City Lord Mayors, who had actually most to lose from the equalisation proposals, endorsed the Report wholeheartedly.

The Departments of Treasury and Finance wanted to end the Commonwealth program and hand back responsibility for local government finance to the States or, if this was politically unacceptable, to reduce the cost of the program in various ways. One method suggested by the Treasury was to require matching grants from the States. This would probably be the most rational Federal economy, since the States have such a direct and primary interest in the effectiveness and equity of their local government systems; but apart from State opposition, a drawback of this proposal is that equalisation objectives, which are hard enough to pursue in any event, would become politically still harder if the grant were to be jointly funded.

Another proposal for achieving economies was made through appealing to the Inquiry's stress upon equalisation and claiming that therefore there was no need to give minimum (Element A) grants to all councils; but this conclusion would upset the balance of the Inquiry's proposals between vertical and horizontal equalisation, as well as being very unacceptable to local government. Finally, the Department of Finance argued for annual budgetary flexibility over the size of the grant; but this would undermine its stability which is a major consideration with local government, especially as local government would be a weak political actor in the annual budgetary rounds in Canberra.

Mr Uren announced the Government's decisions over the Inquiry's recommendations on April 10, 1986. The Government seems to have rejected all the main arguments put by Treasury and Finance, although some of them - particularly the case for matching grants - may reappear again when the program is next reviewed. Parliament has passed legislation to replace the PITS Act. The new financial arrangements closely follow the recommendations of the Inquiry. The basic sum to be allocated to local government for 1986-87 will be not less in real terms than that for 1985-86, and it will be increased in this and subsequent years by the same real terms increase as the States receive in respect of the sum of general revenue grants plus general purpose capital assistance paid to them. Thus local government is to be supported financially on the same basis as the States which is what the Inquiry wanted. The Opposition spokesman (Mr John Moore) argued that local government support will now be dependent upon the persuasiveness of the State Premiers at the Premiers' Conference over maintaining any real terms increase in grants to the States; but in fact it will strengthen local government's weak bargaining position in Canberra to have the State Premiers acting automatically on its behalf. However, when the local government program is next reviewed, local government will certainly need to strengthen its collective voice at the Commonwealth level, as the Inquiry foresaw and believed to be desirable.

Other Government decisions are that the grant shall be divided between States upon a straight population basis; that Element A shall be allocated as a uniform 30 per cent of the total grant; that no weighting shall be given for "human services" so that the "effort-neutral" principle will continue to apply; that no conditions shall be made about State assistance to local government (subject to future review) or about State policies such as rate-pegging; and that no Commonwealth guidelines shall be laid down about equalisation, but that instead each State in consultation with local government, will formulate its own principles of allocation which have to be approved by the Commonwealth Minister.

Clearly the State governments have been fairly successful in warding-off those reform proposals in the Self Report which threatened their autonomy or presumed prerogatives. At the same time, those proposals in the Report which concern other Commonwealth departments - such as the conversion of specific health and welfare grants into block grants; and the assimilation of road grants into general-purpose assistance - have been deferred or shelved. An exception is the proposal to fund directly Aboriginal local governments in the Northern Territory which has been adopted, and to hold a fuller inquiry into the relations between Aboriginals and local government which has been referred to an inter-departmental committee (not perhaps the best instrument for this purpose). These proposals had the support of the Department of Aboriginal Affairs.

The political outcome of the Self Inquiry might have been read off from a political science text book. The rather weak status of the Local Government Department in Canberra made it essential for this Department to gain the full backing of the State governments, and the co-operation or acquiescence of other Commonwealth spending departments, if the Treasury and Finance assault on the program was to be beaten off. In the budgetary climate of

1986, it is perhaps surprising that in the end local government emerged so well from the tussle. Local government itself as well as the States seem well satisfied with the outcome, which combines the maintenance of financial support on a new basis with some modest changes in the methods of allocation. But the price of this success has been a dent in the Inquiry's reform proposals.

So far as equalisation is concerned, the main reform is that the new legislation specifies the average State-wide standard of fiscal capacity as the basic criterion for making equalisation grants. Without a clear legislative standard, and given that there are to be no Commonwealth guidelines, the SLGGCs would probably continue to go their own ways. Thus the new Bill will require that financial support should be shifted in favour of the more disadvantaged councils, but this process will be a gradual one and will have to overcome some formidable technical as well as political obstacles - particularly over the measurement of rateable capacity. There is also an unfinished agenda in Commonwealth-State relations over local government. The present division of financial responsibilities is far from clear or satisfactory, and the practice of rate-pegging continues (despite political protestations) to be clearly contrary to the purpose of Commonwealth support.

It is important that the local government program should be reviewed again in about five years time. Local government functions and finance are in a state of flux, progress with the equalisation goal is uncertain and Commonwealth-State financial relations need ironing out. The new system being introduced by the Government may prove durable, but one should remember that the possibility of more radical change still exists. A Commonwealth Minister may at some point decide that the grant program is not being effective in the way intended by the Self Inquiry. He may dust off the Report and pursue its unused ideas; or, especially if cash is short, he may prefer to move away to a system of discretionary grants targetted upon local councils with special needs, administered by agreement with each participating State and hopefully involving local government too in the consultative process. This was the type of plan put to the Inquiry by the Department of Local Government and Adminstrative Services (for a summary of this and other viewpoints see NILGF Report, Ch. 11, pp. 261-68).

## Wider Reflections

What ultimately is the purpose and rationale of the involvement of Federal with local government? Or are there merely a number of *ad hoc* pressures and pretexts for this involvement, which then get cemented into the system and perpetuated through the vested interests of participants? Is the end product merely a process of elaborate negotiation and bargaining which costs a great deal but has few visible end-effects? Then again is the situation in Australia, given the small scale of local government, really radically different from that in Canada or the USA, especially the latter? Or will Australia in its turn tread the byzantine paths of Federal engagement which can be traced in the USA? Or may there be a simpler and brighter future for inter-governmental relations in Australia?

There are three relevant theoretical issues. First comes the theory that a national government has the right to lay down certain policies and standards which apply to the whole nation. Over against this stands the theory of decentralisation, put in political terms as the desirability of local choice and in economic terms as an "efficiency" argument for enabling public service consumers to maximise their satisfactions or their tax-service package (if not, they can migrate to another jurisdiction - the theory suggests that geographic competition between governments can and should simulate market competition between firms). There are severe political constraints or distortions which strongly affect the implementation of either of these opposing positions. In practice in every Federation (and to a considerable extent in unitary states) public policies represent a confused mixture of both theories - tilting now one way and now the other, but often veering towards centralisation and national interventions although the rhetoric is different.

So far as Australian local government is concerned, this issue is at present mainly relevant to State-local relations. Federal intervention in local government, either directly or indirectly through requirements upon the States, is still minimal - and given the paradox that the Australian States though economically weaker than elsewhere are politically stronger - the situation will not quickly change. Moreover, the possibilities of financial substitution are large enough at both State and local levels to make any steering of Federal money into particular services or projects very difficult. (The main exception is highly specific incentive grants, but these are rare where local government is concerned.) It may in fact be easier to steer Federal money into particular areas.

In the USA there has been an extensive development of Federal regulation of the standards and policies of State and local government as conditions of grants (Milnor, 1985). Many of these are cross-cutting, e.g. they apply to all grants, such as racial and other forms of non-discrimination, the treatment of employees, wages, contracts, etc. Some are specific to a particular grant, e.g. a road grant may be conditional upon policies about eligibility to drive and maximum speeds. The paperwork involved and the problems of enforcement are horrendous where small local governments are concerned (as I discovered at first hand in the little town of Moundville, Alabama). There are the beginnings of such development in Australia, for example over fair employment practices. How far such national standards are desirable or feasible is an important ethical and political question. National regulatory standards can be compared to rules for policing economic markets; but they certainly reduce local freedom of choice and can sometimes be said to ignore specific local conditions. They are also very expensive to police.

A second theoretical issue concerns the rights of Federal government in respect of macro-economic management. Some aspects of this policy in Australia involve local government (in conjunction with the States), for example the Community Employment Program, and in principle this policy is quite acceptable. It leads again to local objections that the conditions of such grants, e.g. the fair employment rules, are often too restrictive for local conditions. Beyond this the Treasury may claim the right to regulate local borrowings, rates or levels of local expenditure in the interest of overall economic management - particularly in times of financial stringency. This Treasury argument has been pushed to absurd lengths in the United Kingdom, especially given the inability of the Treasury to meet its own borrowing targets and the silliness of denying local citizens the right to prefer public consumption (through the rates) to private consumption if they so prefer. Such arguments have much less salience anyhow in Australia because of the small expenditure of local government. Rate-pegging in New South Wales is a purely political phenomenon - it has no relation to economic rationality.

Thirdly, there are theories about the desirability of redistributing a portion of national taxation to the authorities with inadequate resources of their own to finance their service responsibilities. Such a theory can be presented as a question of both efficiency and justice. Whatever formula is adopted, the redistribution will be to some extent horizontal as well as vertical, e.g. it will affect the comparative financial capacities of the different States and local governments. In principle such financial redistribution should be unconditional, that is it should not interfere with the choice of recipient governments as to how the money is spent or whether it is saved.

As we have seen, the PITS legislation is a good example of a goal of financial redistribution with both horizontal and vertical objectives. The money is untied and is given after close scrutiny of local financial resources and expenditure requirements. The allocation at State level is in many ways highly sophisticated - so sophisticated indeed that the actual effects of the various assumptions and methodologies are very difficult to trace, even by an expert committee.

Equalisation policies have a particular salience in Australia, far more than in any other nation. The historical, cultural and political causes for this situation would be worth investigation. But behind the vehement rhetoric, there are perhaps different notions of what equalisation implies. It might seem to imply concentrating aid upon the poorest and neediest authorities; but in practice there are always questions about the nature and measurement of local needs - especially difficult because of the variety in the actual functions and conditions of local councils. Hence some critics declare that the first priority should be to determine more specifically the expected duties of local councils. This might be desirable, but given the rights of the States it could only be pursued at that level.

In any case the technical findings of expert bodies like the Commonwealth Grants Commission are always subject to political resolution. The final Commonwealth allocations to the States are settled by hard political bargaining at the annual Premiers' Conference. In the case of local government there is less overt political bargaining, but now that the PITS system of automatic support has been ended there will certainly be tougher bargaining in the future. But there has been a tacit understanding that Commonwealth money should be spread around widely, rules have been adopted by SLGGCs to limit changes in the grant to any council, emerging needs have not been quickly recognised and there has been a considerable degree of paternalistic judgment in the final allocations to each council.

All the same, comparatively speaking, the PITS allocations in Australia have been fairly free from political bias if one accepts a general goal of 'partial equalisation'. But given this goal or assumption, the problematic question is whether the results are worth all the trouble - or whether a simpler, more standardised formula might not achieve as much or more effective equalisation. Hence the wish of the Inquiry to make equalisation more effective if the system is to continue. As things are it is likely that the impact of the PITS Act over horizontal equalisation has been rather small (although particular councils have of course benefited or lost). Its main impact has been to strengthen the general financial capacity of local government and to redistribute the financing of local services. The national taxpayer now contributes more, and State and local taxpayers rather less than would otherwise be the case. To the extent that national taxation is progressive and rates are regressive, this may be a case of equitable redistribution. But one has to be cautious about this conclusion in the Australian context. Rates (and State land tax) are the only form of taxation of capital assets. Moreover in rural areas (the greatest beneficiaries from PITS) much of the rates are carried by farmers who can often pass on much of the cost in their farm accounts.

Considering these various theories, there still remains the central issue placed upon the political agenda by Prime Minister Whitlam and now more discreetly veiled. Has the Commonwealth acquired, through some process of constitutional evolution, a legitimate interest in strengthening the effective and democratic functioning of local government? Or is this merely another case of Canberra imperialism? The first proposition might be justified by the view that decentralisation to the local community level (in an age and country of big governments) is desirable, and that as things stand local government is too weak and the States are too powerful for this evolution to occur. The Commonwealth on this view has a general role as supporter and energiser of local government without descending into detailed interventions.

If these propositions are accepted, then the Commonwealth general purpose grant can certainly become a valuable instrument for their realisation. It should not interfere with local choice; but if it be desirable to encourage the general development of "human services" (and overcome ratepayers' resistance) the calculation of the grant could be steered in this direction - for example, as the Inquiry proposed, by reckoning actual expenditure for certain services instead of the objective calculation of local needs (irrespective of what a council actually does) which is the "effort-neutral" approach - and which the Inquiry accepted as the right general principle. Such a step would be a mild exercise of the Commonwealth's "energising" role, although it has not as yet been adopted.

Again the Commonwealth can legislate to make the equalisation provisions of the grant more effective. This again is an "energising" as well as supportive role since it strengthens the fiscal capacity of local government as a whole. Such general measures - if they can be made to work - are certainly preferable to specific grants, which are costly to administer, usually uncertain in duration and tend to go to the better staffed councils who are often also the wealthier ones. (The Inquiry suggested a number of ways in which the Commonwealth should switch from specific to more general purpose grants.) But whether the Commonwealth will pursue this broad mandate for strengthening local government still remains to be seen.

It is impossible to avoid a certain sympathy with the "States" rights' argument. Because of its vastly superior financial resources, due to its acquired monopoly of income tax, the Federal government has become the paymaster of the States. It has used its surplus resources not only to make substantial financial assistance grants to the States, which are untied but governed by complex concepts of equalisation, but also to make numerous conditional grants for specific purposes. Because of the possibilities of financial substitution, the actual impact of these grants upon State policies is somewhat limited and doubtful in many cases; but the effects are a heavy load of administrative negotiation and accounting controls, and still more seriously a dilution of political accountability due to the severance of responsibilities for taxation and expenditure.

The Commonwealth general purpose grant to local government is another conditional grant to the States, although the conditions have hardly been onerous to date. Now they will be slightly strengthened. Is this grant therefore open to the criticism that it is a debilitating exercise of Federal fiscal power which undermines State responsibilites, so that any support for local government would be better channeled through general-purpose assistance to the States? In one sense this accusation rings true since local government is so closely controlled by the States. Thus ultimately the basic argument for the grant must be that the Commonwealth has some legitimate interest in the existence and welfare of a democratic tier of local government, and in meeting needs of the local government system such as equalisation which the States have failed to satisfy. Whether this argument is ultimately convincing will depend upon both Federal and State policies and the responses of local government itself.

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# THE WORK OF THE STATE LOCAL GOVERNMENT GRANTS COMMISSIONS

D.V. Moye

## Background

As a run up to the 1972 Federal elections the Labor Party's policy included an undertaking by a Labor Government (if elected) to provide financial assistance to local government. Until that time, successive Commonwealth Governments had refused to become directly involved in local government matters by taking the strict constitutional view that local governing bodies are creations of the States and it was incumbent upon State Governments to provide whatever financial assistance was necessary for local government to fulfil its expectations.

This attitude of the Commonwealth was somewhat ambivalent as local government had benefited from a number of Commonwealth Government financial assistance programs over many years. This was because local government was classed as an eligible body under certain specific purpose programs (various welfare related programs were of this kind - e.g., Nursing Homes subsidies, Aged or Disabled Persons Homes, Children's Services, Community Arts Activities, Aerodrome Local Ownership, etc.,) or because financial assistance was delineated so as to ensure that local governing bodies or classes of local governing bodies benefited from the funding arrangements (the roads grants arrangements are an illustration of this).

However, the election of the Whitlam Labor Government substantially altered relationships between the Commonwealth and local government and added a new dimension to Commonwealth-State financial relations. The new Government moved quickly to implement its election policy to provide general revenue funding for local government.

The first step was to repeal the Commonwealth Grants Commission Act 1933-57 and replace it with the Grants Commission Act 1973 which provided for, *inter alia*, a new Commission to inquire into and report upon applications by local governing bodies, through approved regional organisations, for financial assistance.[1] The Grants Commission was itself substantially restructured to fulfil its new role by the appointment of additional members and by greatly expanding its staff and other resources.

One of the first tasks of the expanded Grants Commission was to devise methodology for the implementation of the principles of fiscal equalisation laid down in the legislation as the basis of the funding arrangements for local government. The new Grants Commission Act provided for the creation of Divisions of the Grants Commission in order to facilitate the inquiry processes. However, this did not preclude members of the Commission, who were not appointed to Divisions for the purpose of the Commission's local government responsibilities, from participating in the formulation of the methodologies for assessing the relative fiscal needs of local governing bodies throughout the six States.

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1 Grants Commission (1974), First Report 1974 on Financial Assistance for Local Government, Australian Government Publishing Service (AGPS), Canberra.

In order to inform local government of the new funding arrangements, the Grants Commission prepared a brochure outlining the provisions of the legislation, the criteria that could be employed to determine the allocation of general revenue grants to local government and the information needs of the Commission for the application of the criteria.[2] Much of the discussion on principles and methods in this brochure relied heavily upon a paper prepared by Professor Mathews, a member of the Grants Commission at that time, in which criteria for allocating grants of general revenue assistance to local government were examined.[3]

The Grants Commission's First Report (1974)[4] discussed the criteria for allocating grants of financial assistance for local government and explored the more important issues put to it in submissions in response to the discussion brochure that had been widely circulated. In the event, the Commission opted for the direct measurement of revenue-raising and expenditure needs but, because of very significant data deficiencies, had to rely heavily upon the exercise of judgment in the allocation processes. This was particularly significant in relation to the measurement of taxable capacity. The raw data for property values (which constitute the principle tax base for local government) were considered to be too unreliable at that time, particularly for comparisons of the revenue-raising capacity of local governing bodies between States. Because of this, as a matter of judgment, the Commission reduced the weighting of the calculated revenue differentials in order to modify the effect of the data imperfections. In fact, only a 10 per cent weighting was given to the revenue differentials, with the consequence that the first allocations for the 1974-75 financial year principally reflected expenditure needs.

The second allocations (for the 1975-76 financial year) were determined on much the same criteria and similar methodology. However, despite the experience of the first round of allocations and improvements to the data collection and analytical processes, the Commission still had substantial reservations about the data used for calculating the revenue differentials and again applied a weighting of 10 per cent to the figures.

These first two rounds of allocations determined by the Grants Commission firmly established a system of untied revenue grants from Commonwealth-raised funds for State local governing bodies. Constitutional niceties were preserved by the implicit use of Section 96 whereby amounts equal to the total grants for the municipalities in each State were paid to the respective States, on condition that they were passed-on as untied grants to the relevant local government authorities, in keeping with the recommendations of the Grants Commission.

What was of subsequent importance was that a pattern of relativities had been established by the two allocations and, indeed, a level of expectation raised by the recipients of the grants. While the Grants Commission might well have argued that the relativities were still very tentative,

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2 Financial Assistance for local governing bodies (1973), AGPS, Canberra.

3 Russell Mathews (1974), "Fiscal Equalisation for Local Government", in The Economic Record, Vol. 50, No. 131 (reprinted by the Centre for Research on Federal Financial Relations, The Australian National University, Canberra, Reprint Series No. 5).

4 Grants Commission, *op. cit.*

because of continuing, significant data imperfections and the still imperfect knowledge of each of the then 889 local government authorities in the six States, there was a growing general expectation by individual Councils that their base entitlements had been established by the allocations and henceforward individual allocations should increase roughly in line with overall funding increases. This was to have important implications for the State Grants Commissions when they assumed responsibility for determining the allocations.

## Local Government and the "Federalism Policy"[5]

Following the defeat of the Whitlam Labor Government in 1975, the general revenue grants arrangements for local government were caught up in the "Federalism Policy" of the new Coalition Government, which were to apply to State and local government funding arrangements. The Coalition, which had formerly been opposed to Commonwealth involvement in local government financial matters, now accepted the political realities of untied revenue funding for local government authorities and moved quickly to implement their own policies in relation to the program.

The new "Federalism Policy", as it applied to local government, provided for:

(i) a fixed percentage of personal income tax to be earmarked for local government;

(ii) a two-part allocation - a per capita component which might be weighted in some fashion and an equalisation or topping up component distributed on the recommendations of State Grants Commissions; and

(iii) the responsibilities of the Commonwealth Grants Commission for local government inquiries to be transferred to State Grants Commissions.

These policies were put into effect by the enactment of the Local Government (Personal Income Tax Sharing) Act 1976 and complementary amendments to the legislation governing the role of the Commonwealth Grants Commission by the enactment of the Commonwealth Grants Commission Act 1976.

An immediate repercussion of the Federalism Policy was that the Commonwealth Grants Commission was directed to desist from any further direct contact with local governing bodies and to cease all work on the allocations for the 1976-77 financial year, notwithstanding that this work was already well advanced.

## The Local Government (Personal Income Tax Sharing) Act 1976

The Local Government (Personal Income Tax Sharing) Act 1976 lays down the broad guidelines for the allocation of untied revenue grants to local government authorities in the six States, including a provision that each

5 Liberal and National Country Parties (1975), "Federalism Policy", Canberra, September.

State's entitlement to an allocation under the Act was contingent upon the States having, by 30 June 1978, established a Local Government Grants Commission in accordance with the parameters laid down in the Act (Section 6(3)). The effect of this provision was to require complementary State legislation to provide for the establishment of the respective State Local Government Grants Commissions and for the roles that they would be required to perform. Each State complied with this requirement by June 1978.

Only New South Wales had at the time a body in existence that could immediately take over responsibility for the allocation process. All other States made interim arrangements for determining the allocations for the 1976-77 financial year. However, because of the short time available to the State bodies in 1976 to undertake this new, and quite formidable role for most of them, and because of data and other information shortcomings that had been experienced by the Commonwealth Grants Commission, the State bodies sought and received considerable assistance from the Commonwealth Grants Commission. This included access to that Commission's working papers and to the preliminary work that had been undertaken by it on the 1976-77 allocations prior to the change in policy.

<u>Statutory Principles and Practices for Allocating Grants</u>

The 1976 legislation changed the general revenue grants arrangements of the Whitlam Labor Government to a revenue-sharing arrangement. Local government was allocated $140 million for 1976-77 and the proportion of personal income tax collected in the year that this represented, 1.52 per cent, became the base entitlement for future years. (Subsequent amendments to the legislation increased the proportion to 1.75 per cent for 1979-80 and 2 per cent for subsequent years up to 1985-86.)

The legislation stipulated that two basic conditions be observed:

(i) not less than 30 per cent of the total amount for a State for a year was to be allocated on a population basis which might also take into account size, population densities and other agreed matters (this is referred to as the Element A Entitlement or As-of-Right Entitlement); and

(ii) the remainder of the amount was to be allocated on a general equalisation basis to ensure, as far as practicable, that each local government authority was able to function, by reasonable effort, at a standard not appreciably below the standards of other local government authorities in the State, taking into account differences in the capacities of local authorities to raise revenue and differences in the cost of performing local government functions (see Section 6(2) of the Act).

As with the previous grants arrangements, the payments were to be made as unconditional grants. A further condition was that the total amount available to a State for a year for local government general revenue funding purposes had to be allocated in full amongst the local governing bodies in the State. This meant that the costs of operating the State Grants Commissions had to be fully met by the respective State Governments.

The legislation also contained some general provisions as to the membership of a Grants Commission, the manner in which the Commissions should operate and reporting requirements.

## Membership

Membership of the Commissions varied from State to State. Initially only one State, Victoria, had a full-time Chairman but Queensland subsequently also made the Chairman a full-time position. Numbers of members, including Chairmen, varied from three (Victoria, South Australia and Tasmania), to four (New South Wales), five (Western Australia) to six (Queensland). Queensland subsequently reduced the number of members to five. The difference in numbers reflect, as much as anything, differences in the areas of the respective States under local government, rather than the number of local government units to be examined.

## Procedures

All of the States Grants Commissions have now adopted similar procedures in fulfilling their statutory roles. These fall into four linked activities; data collection, inspections, allocation processes and reporting.

Data Collection: As previously indicated, the greatest problem confronting the Commonwealth Grants Commission when it was responsible for the allocation processes was the availability of reliable, accurate data that was comparable between the States. These problems were far from resolved when the State Grants Commissions took over the allocation role. However, one of the immediate benefits of the intra-State allocation process was that the vexed question of comparability of data between States was no longer an issue. Nevertheless, the availability of timely, reliable data and other information was still a problem and most of the States were forced to supplement data from established sources, such as the Australian Bureau of Statistics (ABS), with their own data collections. The Victoria Grants Commission has gone somewhat further than other State Commissions in that it has formal arrangements with the ABS for a single return of information that serves both the Census Act requirements for local government statistical information and the Victoria Grants Commission and a copy passed on to the ABS for its purposes. In return, ABS provides the Commission with a verified data tape, as well as other statistical information such as estimates of population and areas of local governing bodies in the State.

One of the side benefits of the data requirements of the State Grants Commission has been the very significant upgrading of local government statistics, in terms of quality of data and timeliness of publication.

Inspections and Discussions. All State Grants Commissions undertake regular visits to local governing bodies for discussions and inspections. For Victoria, which has by far the largest number of local government authorities (currently 210) the cycle of visits is five years. For New South Wales and Western Australia the cycle is four years and South Australia and Tasmania have adopted a three-year cycle. Queensland visits each municipality every two years for inspections and informal hearings. In addition to the three-year cycle of visits, the Tasmanian Grants Commission holds regional hearings each year in order to provide Councils that are not on the year's program of visits with the opportunity to present information to the Commission.

Allocation Principles. As previously mentioned, the Commonwealth legislation prescribes the broad framework of the allocation process that the State Grants Commissions are required to observe. There are two main components to the allocations:

(i) the Element A or As-of-Right component, and
(ii) the equalisation component.

Element A or As-of-Right Component. The legislation requires not less than 30 per cent of the total amount available for allocation in a year to be allocated on a population basis, but leaves open the way for the population figures to be weighted for area, population density or other matters that might be agreed between the Prime Minister and the Premier of a State (Section 6(2)(a)).

The minimum entitlements for New South Wales are based on 33.3 per cent of the total amount, with 87.5 per cent of this amount being determined by population and 12.5 per cent as an additional allowance to all Councils with a population density of less than twenty-five persons per square kilometre. For Victoria, the minimum entitlement is based on 40 per cent of the total amount, 85 per cent of which is determined by population and 15 per cent by area. For all other States the Element A entitlement is based on 30 per cent of the total amount. For South Australia, Western Australia (since 1984-85) and Tasmania the distribution is on a straight population basis. For Queensland the distribution is based on population, five-sixths, and area, one-sixth. Prior to 1984-85, Western Australia allocated up to 80 per cent of the total amount for the State on a weighted per capita basis, the weightings reflecting approximations of relative fiscal need within broad-banded groupings of local authorities determined by population density.

Of more significance than the differences between States in the bases for calculating Element A entitlements is the different treatment of the entitlements by the respective State Grants Commissions. The Commonwealth legislation is silent on this point, so it has been left to each of the State Grants Commissions to determine its own policy in this regard. The New South Wales, Victoria, South Australia and Western Australian Grants Commissions treat the Element A entitlements simply as base grant constraints. In other words, these four Commissions regard the Element A requirement simply as a device to ensure that each local governing body receives an allocation. The Commissions first calculate the fiscal equalisation entitlements for each local authority and then check that the entitlement so calculated is not less than the Element A entitlement. Where the fiscal equalisation entitlement falls short of the Element A entitlement, the relevant local governing body is allotted an amount equal to its Element A entitlement.

These Commissions have taken the view that the Element A entitlement already comprehends an element or elements of equalisation and to ignore this in the fiscal equalisation process would involve a degree of double counting. It is of interest that the New South Wales Grants Commission was threatened with a legal challenge on this issue by the Strathfield Municipal Council, which took the view that Commonwealth legislation required separate determinations to be made in respect of the two elements. The Commission satisfied the Council's concern about the issue by showing the two amounts separately in the schedule of recommendations. However, this was simply a change in presentation, not a change in procedure.[6]

The two remaining States, Queensland and Tasmania, determine the Element A entitlements as a separate exercise and then proceed with

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6 Local Government Grants Commission, New South Wales (1981), Report 1981/82 on Financial Assistance for Local Government, Sydney, pp. 16-17, paragraphs 2.24 to 2.28.

the allocation of the residual equalisation element as a separate and distinct exercise. In fact the Tasmania Grants Commission is only involved in recommending the distribution of the equalisation element; the per capita allocations are calculated by the State Treasury and the Local Government Grants Commission is advised of the residual amount available for the equalisation process.

As the Committee of Inquiry into Local Government Finance have pointed out in their Report (the Self Report), the approach used by Queensland and Tasmania reduces the amount available for equalisation to 70 per cent of the funds, whereas under the approach used by the other States, the whole amount is available for equalisation, except to the extent that Element A entitlements exceed equalisation entitlements.[7]

In the four States which treat Element A simply as a base grant constraint, Element A has played little part in the allocation process. In the 1985-86 allocations only five municipalities (three in New South Wales and two in Victoria) had their allocations determined by Element A entitlements. The Self Report supports the minimum entitlement concept for the treatment of Element A.

The Equalisation Component. The Commonwealth legislation requires the remaining amount to be allocated amongst local government authorities on a general equalisation basis. This is spelt out in the familiar terms of "ensuring, as far as is practicable, that each of those local governing bodies is able to function, by reasonable effort, at a standard not appreciably below the standards of the other local governing bodies in the State, being a basis that takes account of differences in the capacities of those local governing bodies to raise revenue and differences in the amounts required to be expended by those local governing bodies in the performance of their functions" (Section 6(2)(b)). Thus, there are two broad considerations for the State Grants Commissions to observe in the allocation process - capacity to raise revenue and the cost of services.

It needs to be said that fiscal equalisation principles and methodology are not widely understood and sometimes imperfectly understood even by those who claim to have some familiarity with the issues. This is not surprising as it is an inexact science and many of the principles and practices are not amenable to empirical testing. Therefore any grants distribution which requires the application of fiscal equalisation principles must, perforce, involve a significant element of judgment - judgment in relation to the choice of methodology, the choice of parameters, the choice of standards and in relation to the relevance of a mass of information.

On the other hand, each of the recipients of the grants invariably takes the view that their share of the total amount is a minimum share. Thus any downward revision of shares is likely to be queried and precise details of the reasons for a relatively smaller share of funds demanded.

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7 Report of the National Inquiry into Local Government Finance (the Self Report) (1985), AGPS, Canberra, pp. 101-3.

individual's rate burden was determined by reference to the unit value of rateable property owned or occupied by the individual. This suggested that the appropriate unit of comparison should be the value of rateable property.[9]

The use of per head values of rateable property discriminates against areas with low numbers of permanent residents but relatively high numbers of properties, e.g., holiday and resort areas where properties are occupied spasmodically throughout the year but fully occupied during holiday periods. The use of per head values of rateable property also discriminates against areas with low household occupancy rates, such as retirement areas where a high proportion of residents are likely to be on fixed incomes. Such discrimination was regarded as being inimical to the principles of fiscal equalisation and seen as a further justification for using property numbers instead of population in the comparisons of revenue-raising capacity.

Victoria and New South Wales therefore changed the basis for measuring revenue-raising capacity from per head values of rateable property to per property values of rateable property and South Australia changed to a mean of per head and per property values. In addition, the Victoria Grants Commission measures revenue-raising capacity for three main classes of property - residential, commercial and industrial, and rural and other - and weights each class of property for its contribution to the total value of rateable property.[10] This is justified because under the net annual value basis of valuation the parameters for assessing values varies between classes of property. For example, residential and rural properties are, by statute, assumed to have rental values equal to 5 per cent of capital improved values. On the other hand, rental values for commercial and industrial property are assessed in relation to current market rentals and are commonly 8.25 per cent of capital improved values in the Melbourne metropolitan area of Victoria (range 5.21 per cent to 13.86 per cent).[11]

Clearly a preponderance of commercial and industrial property within a local government area is an advantage for raising revenue and the Victoria Grants Commission believes that this advantage should be taken into account in comparisons of revenue-raising capacity. In addition, the weighting procedures modify the effects that size of holdings has on the measurement of revenue-raising capacity. This effect can be quite significant for smaller jurisdictions or for areas where, for example, for historical reasons, property sizes differ substantially from the norm.[12]

Other States have developed their own methodology for coping with the problems of measuring revenue-raising capacity. New South Wales allocates 30 per cent of the total funds to allowances for differences in revenue-raising capacity and divides the local governing bodies into four categories

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9 Moye, D.V. (1979), "Measuring Revenue-Raising Capacity of Local Government", paper delivered to ANZAAS, Auckland.

10 *Op. cit.*

11 See Report by the Victoria Grants Commission (1985), on The Prospective Financial Advantages of Restructuring Local Government in Victoria, Melbourne, pp. 32-44, June.

12 Details of the methodology used by the Victoria Grants Commission are given in the Commission's Annual Reports, particularly Appendix IV.

for this purpose. A standard is calculated for each category which is the weighted average per property value of rateable property in the top 50 per cent of the local governing bodies in each category.

The Queensland Grants Commission calculates the revenue component of the allocations by reference to an index which is the average of a notional rateable value, expressed as a percentage of total State notional value, and an index of income. The indexes of income are derived from different sources for urban areas and rural areas. For urban areas, the index is a reflection of relative average weekly earnings and for rural areas it is a reflection of the relative gross value of rural production. The average index for each local government area is then expressed as a proportion of the total of the indexes for the State and this proportion is then used to calculate the amount to be deducted from the expenditure differentials.

The South Australian Grants Commission calculates revenue standards from the weighted average of the top 25 per cent of local governing bodies in each of three categories. Both the standards and the allowances for revenue needs are the means of per head values of rateable property and per property values of rateable property.

Western Australia, until 1984-85, relied more upon the informed judgment of the Members of the Commission in determining the allocations rather than on mathematical calculations. The problems of measuring revenue-raising capacity in that State are exacerbated by the fact that different valuation methods apply in urban, rural, pastoral and mining areas. To overcome this, the Commission used five categories of property and calculated different standards for each property class. For rural and pastoral areas the figures were weighted for the gross value of rural production; in mining areas the lowest rate income in the category was taken as an indicator of revenue-raising potential.

The Tasmanian Grants Commission allocates equal weight to the revenue and expenditure components in allocating the equalisation element of the total amount available (70 per cent of the State's total allocation). Local governing bodies are categorised according to population and the standard tax base derived as a mean of the top 25 per cent in each category.

(A more detailed description of the methodologies used by the respective State Grants Commissions is contained in the Self Committee's Report, pp. 112-16.)

What is clearly evident from the foregoing cursory review of the methods used by the respective State Grants Commissions to measure revenue-raising needs for local governing bodies is the complexity of the problem. Also it is clear that the choice of methodology can, of itself, significantly influence the distribution of the allocations. The resolution of the methodological problems has figured prominently in the discussions at the annual conference of State Grants Commissions and the Victoria Grants Commission is undertaking a detailed investigation of an alternative approach to the fiscal equalisation task, which involves a return to the balanced budget approach that was formerly used by the Commonwealth Grants Commission in the assessment of Special Grants for claimant States. The difficulty is that none of the State Grants Commissions have the resources to undertake the detailed empirical testing of methodology that is essential to the resolution of the methodological problems inherent in the measurement of fiscal needs for a large number of small jurisdictions.

Measuring Expenditure Needs

The major difficulty confronting all of the States Grants Commissions in the initial years was the lack of reliable, comparative data for the range of functions undertaken by local government. Quite strenuous efforts have been made by the Commissions to overcome this problem, by improvements to data collection, by detailed physical inspections of each local government area in the respective States and by requiring detailed written submissions on particular aspects of each municipality. These difficulties have resulted in different approaches being adopted in the respective States to the assessment of expenditure needs; these are detailed in the Self Committee's report (pp. 116-22) and the main features are summarised below.

New South Wales distinguishes between needs and disabilities and allocates 30 per cent of the total available to disabilities and 40 per cent to needs. Disability factors are assessed by reference to a range of criteria reflecting the inherent characteristics of the respective areas and applied in the usual way to standard costs for each function. Disability factors are ranked from 0 to 10, there being no negative factors. Needs assessments reflect a number of characteristics, using objective data wherever possible but relying also upon submissions, evidence gained from inspections and the Commission's knowledge of the respective areas.

The Victoria Grants Commission uses strict effort-neutral methodology in assessing the expenditure component, which is the sum of needs and disability allowances. The standards are the modal levels of expenditure for each function and positive and negative factors (i.e., expenditure disadvantages and advantages) are assessed. Gross costs are used throughout and the gross assessed allowances discounted for State and Commonwealth grants. Explicit allowances are also made for the net cost of natural disasters. The Victoria Grants Commission does not make any arbitrary apportionment of the allocations to particular functions but, rather, allows natural weights to determine the relative levels of allowances.

Of the specified proportion allocated to the expenditure component, the Queensland Commission sets aside half for road needs, which are determined as each local government area's adjusted road length as a proportion of total adjusted road length. Adjusted road lengths are actual lengths adjusted by factors reflecting assessed cost differentials. A further 22.5 per cent is allocated to a range of human services, expressed as a weighted population index derived from a range of service indicators assessed by the Commission. There is no explicit needs consideration in the accepted sense, the Commission taking existing standards of service as a reflection of the perceived needs of the respective communities. A further 11 per cent is allowed for isolation, disabilities being assessed by reference to cost indexes supplied by the Public Works Department. The remaining 14 per cent is allocated to 'special disabilities' which are assessed on the basis of evidence submitted by the respective Councils.

The South Australian Grants Commission allocates 50 per cent of the total available to the expenditure component. As for Victoria, the assessment of expenditure needs is based on standard effort-neutral procedures, with each area's share of the amount allocated to expenditure needs reflecting its share of total assessed needs for the State as a whole. South Australia also uses data that includes specific purpose funds in the first instance and then eliminates the effect of these grants by discounting the assessed gross allowances.

As indicated previously, Western Australia substantially changed its allocation methodology in 1984-85 and has now adopted standard fiscal equalisation methodologies for determining the allocations. Prior to that, the distribution of the 20 per cent equalisation factor which was used to adjust the weighted per head allocations, largely reflected the collective judgment of the Commission. This exercise of judgment was substantially dependent upon systematic inter- and intra-category comparisons of a range of factors affecting the cost of services.

The Tasmanian Grants Commission apportions the expenditure component (50 per cent of the 70 per cent available for equalisation) between roadworks (17.5 per cent), administrative expenditure (3.5 per cent), human services (3.5 per cent), other property services (3.5 per cent) and the remainder (7 per cent) for tourism, isolation, growth and regional centre disabilities. Each segment comprises a weighted unit share; for roadworks this is based on a unit length of road and for administration it is based on per head relativities. For human services and other property services, 80 per cent is allocated by the weighted unit share and 20 per cent on a judgmental basis. The 7 per cent for other factors is allocated on a judgmental basis.

The foregoing brief and necessarily simplified summary of the methodology used by the respective State Grants Commissions is sufficient to indicate the wide divergence in approaches adopted by the Commissions in the fulfilment of their task of allocating general revenue grants to local government. The fact that such a wide divergence in procedures, which are ostensibly aimed at producing the same end result, has been allowed to develop is a reflection of the lack of interest by past Commonwealth Ministries in the allocation procedures and the distributions of grants that have resulted. In this regard it is noteworthy that each State's allocations and, by implication, procedures, have been approved by successive Commonwealth Ministers as conforming with the stated objectives of the legislation, notwithstanding the diversity of the procedures used in the allocation processes. To be fair, it is probable that, politically, the Commonwealth Ministers had little alternative but to approve the allocations; certainly it would be an impossible task, in a practical sense, for the Ministers' advisers to undertake any testing of the recommended allocations and therefore there would be no other option but to recommend their approval.

The wide divergence in procedures is also a reflection of the broad specification of fiscal equalisation contained in the current legislation which has allowed the respective State Commissions to each interpret the objectives of the legislation as they perceived them and devise their own methodologies accordingly. The Self Committee addressed the issue of methodology at some length and concluded that a degree of uniformity in the principles and practices of the respective Commissions was desirable. Their recommendations included, *inter alia*, that the Commonwealth "promulgate guidelines in respect of the general policies to be applied in determining grants for equalisation purposes" and "approve ... the general methodology adopted for this purpose by the local government grants commission in each State".[13] The Committee recommended a comprehensive set of guidelines for this purpose.[14] However, the Committee gave very little consideration to the effects of differences between the States in valuation practices in its examination of the patterns of allocations achieved by the respective State

13 The Self Report, *op. cit.*, pp. 314-16.

14 *Ibid.*, pp. 317 *et seq.*, also pp. XXIV-XXVI.

Commissions, nor did they address in any detail the effect that the choice of unit of measurement would have on the patterns of allocations. It is likely that differences in allocations arising from these two factors could overwhelm the effects of other methodological aberrations.

Reporting

Approval of the payments to the States of their entitlements under the legislation is subject to the Commonwealth Minister's receiving a declaration in writing from the responsible State Minister that the State Grants Commission's recommendations have been made in accordance with the provisions of the legislation. The legislation does not explicitly require the Commissions to make a report but copies of any report or recommendations of the State Grants Commissions are "to be laid before each House of the Parliament within 15 sitting days of that House after receipt by him (the Prime Minister) of the report or recommendations" (Section 10).

The State Acts include requirements for the respective Commissions to report annually to their Ministers. The Prime Minister's Department requires the States to provide enough copies of the Commissions' annual reports to enable each member of the Commonwealth Parliament to receive a copy.

Copies of the Reports are also provided to Members of State Parliaments, as well as to each Council.

The Self Committee was somewhat critical of the standard of reporting of the Grants Commissions, particularly regarding the explanation (or lack of explanation by some of them) of the methodologies employed in the allocation processes and the areas in which discretion is exercised.[15] The Committee recommended that, "at not more than three yearly intervals local government grants commissions should publish a comprehensive statement of their methodologies and procedures in their annual report". This proposal is clearly bound up with the proposals for a greater uniformity between the State Commissions in their allocation procedures. It is doubtful that, of itself, more detailed reporting of principles and practices will lead to a better informed public.

The experience of the Victoria Grants Commission is that, despite quite detailed reporting of its activities, local government representatives, including senior officers, take very little interest in the methodology of the allocation process. Councillors show less interest than officers, generally taking the attitude that it is the responsibility of the officers to understand these matters. Few of them have read the Commission's Annual Reports, five copies of which are sent to each Council.

In the absence of an informed public, it is very difficult to obtain objective responses to proposals for change; in the main, responses are couched in terms of what is the likely effect of a change on the allocations for the respective local governing bodies. The statement by the Commonwealth Minister, the Hon. Tom Uren, in his recent statement to Parliament, that "the principles under which the funds are to be distributed will be formulated by the States in consultation with local government and will be approved by me ..." is clearly fraught with practical difficulties.

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15 *Ibid.*, pp. 338-39.

## Outcome of the Self Committee Recommendations

The precise details of the Commonwealth's response to the Self Committee recommendations are unlikely to be known for some time but a broad indication of the directions they will take was given by the Hon. Tom Uren in a statement to Parliament on 10 April 1986. This indicated, *inter alia*, that

- there would continue to be a system of Commonwealth general revenue funding for local government, the allocations being determined by State grants commissions;
- the principal purpose of the allocations would be the achievement of horizontal equity but there would be a modest level of vertical equity;
- the methodologies employed by the respective State Grants Commissions would be subject to the approval of the Commonwealth Minister for Local Government and Administrative Services. The objective would be to achieve greater uniformity between the States, at the same time recognising that there are real differences in State local government systems which must be provided for by a flexible approach;
- a period of up to five years would be allowed for the phasing in of changes to allocations as a consequence of the adoption of the approved methodologies.

The statement appears to recognise the difficulties inherent in prescribing hard and fast rules for allocation processes that will always be subject to the exercise of judgment to a significant extent. It remains to be seen whether the final outcome will be substantially different from the patterns of distribution that have been achieved to date.

# 3 ISSUES IN LOCAL GOVERNMENT RATING*

N.J. THOMSON

## 1. Introduction

Recent emphasis in the study of Australian local government finance has been on revenue sharing, especially that provided from Commonwealth personal income tax receipts.[1] This chapter returns the emphasis to the principal source - and certainly principal "own-source" of local government revenue; namely the property rate. In aggregate, rates still account for about 46 per cent of total receipts (including borrowing) and 60 per cent of own-source revenue.[2] While these figures vary greatly from council to council the overall importance of rates as a source of revenue is such that despite the observation that "... few topics have been the subject of so many reports",[3] it is still fruitful to review the operations of this tax in raising revenue for local government. In particular, the chapter addresses the potential for increasing the **flexibility** of applying the rate and questions measures designed to restrict its imposition; particularly those restrictions imposed by higher levels of government.

Local government is an integral part of the public sector and the chapter begins by examining the rate in the light of the main fiscal functions of government. We see that in practical terms, the rate has a functional financing role that severely limits any distributional or stabilising role. As a prelude to the main discussion on providing some flexibility in the application of the rate we examine the basic features of the rate, especially in terms of its alleged weaknesses. Section 4 is devoted to measures to improve the flexibility of the rate while preserving its main strength - simplicity. Few taxes can rival the rate for thwarting the manipulations of tax experts who attempt to avoid and evade taxation. The chapter concludes that restrictions imposed upon the rate levying capacity of local government by higher tiers of government should only apply when it can be demonstrated that central legislators (and administrators) are more sensitive to the needs and taxing capacity of local property owners than those elected to make the local decisions. Much of the opposition to increasing the revenue-raising

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* This chapter summarises the main issues covered in the rating section of a discussion paper prepared for the Local Government Association of South Australia in November, 1985 entitled, "Local Government Revenue Sources". The views expressed (together with any unconscious bias through emphasis) are the responsibility of the author alone.

1 The most recent example is the Self Report, Commonwealth of Australia (1985), National Inquiry Into Local Government Finance, Australian Government Publishing Service (AGPS), Canberra, while earlier there was Local Government in Transition: Responsibilities, Finances, Management (1978), R.L. Mathews (ed.), Centre for Research on Federal Financial Relations, The Australian National University, Canberra (out of print).

2 Australian Bureau of Statistics (1985), State and Local Finance, Australia 1983-84, Canberra, Cat. No. 5504.0.

3 Else-Mitchell, R. (1978), "Local Government Finance: Commentary", in R.L. Mathews (ed.), *op. cit.*, pp. 79-90.

capacity of rates appears to relate to the traditional Australian opposition to **any** form of wealth tax. With death duties gone, residential property largely exempt land tax and the aged pension assets test, the inescapable local government rate appears to stand alone as a tax on individual wealth.

## 2. Fiscal Functions and the Rate

The general convention is to classify the fiscal functions of government under the following three headings.[4]

- the allocation function;
- the stabilisation function; and
- the distribution function.

Of the three, the allocative role dominates the revenue-raising and expenditure functions of local government. It does not have the capacity to effectively influence the distribution of individual private welfare, nor can it be more than a tool for the execution of stabilisation functions (e.g. job creation schemes) by higher tiers of government. Certainly local government, as part of the public sector, might be expected to complement the distribution and stabilisation policies of the other tiers of government, but its predominant function is to allocate resources away from the private sector to the perceived needs of the local public sector.

While it is sometimes tempting to attempt to distinguish between service to people and services to property, it is undoubtedly true that the great bulk of local government expenditure is on land-related property (roads, parks, recreation facilties).[5] We have already seen that the property tax (rates) yields most of the local government revenue. However, despite this dominance of the rate to local government, it remains as only 4 per cent of total tax revenue in Australia.[6] Its capacity to do more than serve as an allocative device is therefore extremely limited and to interfere with its revenue-raising potential in pursuit of the other fiscal functions of government might prove to be inefficient, particularly given the selective personal welfare and taxation measures available to other governments (especially the Commonwealth). That is, decisions have to be made at the margin about the trade-off losses in the tax's allocative function in pursuit of the other objectives of fiscal financing. In practice, the rate debate is usually in terms of the benefit (or "user-pays") justification for the tax and the capacity-to-pay (or distribution) objective.

## 3. Basic Features of the Rate

The rate, like any property tax, is a periodic tax applied to the assessed value of specified land-related (real estate) assets owned by an entity at a particular point in time. It is therefore, a form of wealth tax. When the rate revenue is applied to the provision of collective services for the benefit of a group in one region (e.g. local roadworks), the

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4 Musgrave, R.A. and P.B. Musgrave (1984), Public Finance in Theory and Practice 4th edn, McGraw-Hill Book Company, New York.

5 Self Report, *op. cit.*, Table 2.3, p. 9.

6 Australian Bureau of Statistics (1984), Taxation Revenue Australia 1982-83, Canberra, Cat. No. 5506.0.

benefit principle of taxation applies.[7] The "tax" element in the rate is then only the **excess** cost of the rate over the individual benefits enjoyed through the co-operative collective action embodied in the local government expenditure. Modifications of this most elementary form of collective action by a regional government to take account of ability-to-pay requires rules for redistribution which accurately reflect differences in individual taxpayer personal welfare - and this includes differences net of the intervention of other levels of government, including the central government. Some of the difficulties associated with making these judgments will be discussed later in this chapter. In the meantime, the following are fundamental aspects of the rate as a form of taxation:

(a) Valuation

The tax base can be measured in terms of its "improved" or unimproved' value. Both can be made to yield the same total revenue to a local government authority (LGA), but the distribution of the tax burden between ratepayers will vary according to the valuation method adopted so long as the extent of improvements varies from one piece of land to the next. Thus, while fulfilling the primary role of allocating resources from the private to the public sector, the choice of valuation will be influenced by a council's perception of the "desirable" distribution of the rate burden over the population of ratepayers. Opting for an unimproved valuation coupled with a conviction that the benefits of local government expenditure (e.g. roadworks) are distributed more in proportion to unimproved land values held by ratepayers than the value of land and improvements to that land suggests that ability-to-pay is of secondary consideration in apportioning the rate burden over the population of ratepayers. On the other hand, if locally-elected representatives become acutely aware of large differences in the value of improvements per unit of land and they relate this to differences in personal wealth (at least in the case of residential property) then they may opt for valuing for rates on an improved value basis.

The choice between a predominantly capacity-to-pay (improved basis) and a benefit-related base (unimproved) will depend very much upon the composition of property in the LGA. Uniform land use (e.g. for farming) may lead councils to opt for an unimproved valuation; diverse use, such as in urban areas, may lead councils to opt for an improved valuation of the tax base.

(b) Determining the Ultimate Incidence of Rates

The old complaint that rates only fall on property owners and not on tenants has long been laid to rest. In an unrestricted rental property market, any net tax component in rates will be passed on in the rent of tenants as well as being absorbed in part by the owners.[8]

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7 See Mowbray, M. (1984), "Fiscal Welfare and Local Government", in J. Halligan and C. Paris (eds), Australian Urban Politics: Critical Perspectives, Longman Cheshire, Melbourne.

8 The extent to which landlords are influenced by a tax on their property depends upon both the elasticity of demand for their rented property and the elasticity of their supply. If all LGAs impose the tax, the long-run equilibrium level of rents and supply of rented property will depend upon investment opportunities outside the local property market.

Of more interest is the ultimate incidence of rates levied on commercial (including rural and industrial) property. Producers that are price-takers have to absorb any rate increases and the long-term return on capital invested by these "price-takers" (e.g. exporters) in each LGA will depend upon the total cost structure (including rates) and the extent to which this is capitalised into price on the sale of these properties. Others may be able to pass on at least some of the rates (or rate increases) via the prices paid by consumers. In the long term, this implies that domestic consumers absorb a large component of local government property rates through increases in commodity price. This also has implications, not only for shifting some of the rate burden out of a particular council areas, but also the extent to which rates can therefore become an indirect form of consumption tax on Australian households.

(c) Some Criticisms (and Defence) of the Rate

The rate has been criticised on a number of grounds; the following criticisms would appear to be fairly representative.[9]

(i) Infrequent valuations may lead to serious inequities between ratepayers. Councils can always either increase the rate in the dollar or index all property values upwards by a uniform amount (based upon general changes in value in the LGA) to maintain a pre-determined level of (real) rate revenue, but this does not provide for differences in the rate of change of value between properties in the LGA. Furthermore, if councils choose to defer rate increases until a new valuation is carried out, and these are carried out at infrequent intervals, taxpayers view the local government rate with disfavour, relative to taxes that have grown steadily and without sudden jumps in their (nominal) value.

Resolution of the problem of infrequent valuation is an administrative problem that could be overcome by more frequent valuations. Certainly the Valuation Division of the South Australian Lands Department is moving rapidly towards annual valuations of most council areas and no doubt other States are becoming increasingly capable of meeting such an objective. This limitation of the application of the rate as a tax is less significant than the impact of the fiscal drag associated with income tax, but unfortunately for rates, it is more obvious to taxpayers (per dollar of revenue) than the fiscal drag of personal income tax.

(ii) The extreme visibility of rates is apparent, not only in the case of re-valuations, but through "lumpy", infrequent assessments (i.e. once a year) which prevent many ratepayers from paying this tax out of current income. Sales taxes, excise duty and even PAYE income tax payments are largely hidden in the flow of consumption and income. It would be interesting to be able to rank taxes per dollar (or $100) of tax revenue in terms of taxpayers awareness.

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9 See J. Howard (1985), "Local Government Revenue Raising", in the Self Report, Research and Consultancy Reports (2), AGPS, Canberra, p. 229 provides an alternative list; also A.R. Prest (1978), Intergovernmental Financial Relations in the United Kingdom, Research Monograph No. 23, Centre for Research on Federal Financial Relations, Distributed by ANUTECH, Canberra, p. 33.

While taxpayer consciousness is advantageous from the point of view of making the public sector accountable for its actions, there will be distortions in the legislated tax menu when taxpayers (and voters) do not have equal information about the incidence and effects of all taxes.

Similarly, by its very nature, local government provides representatives that are more accessible to taxpayers than are State or Commonwealth Members of Parliament. Again this is an advantage in accountability, but again it imposes political limitations upon rates that are not applicable to (an equal value of) other forms of taxation.

(iii) Rating discriminates against developing LGAs. On the face of it, it would appear that new and developing LGAs face heavier costs (and therefore rates) in establishing the capital embodied in the local public infrastructure. However, these development costs have to be met whatever form of tax is used to finance the public works. The property market would presumably capitalise these expected costs in the price of land in areas to be developed *vis-à-vis* already developed areas. Decisions have to be made about the intertemporal distribution of the financing burden (taxes and borrowing) and about the tax itself. These decisons will be influenced by the expected benefits to be enjoyed by future generations that are not capitalised into the present value of private land.

(iv) Rates do not recognise private indebtedness since they are levied on the value of title to property at a particular date. They are, therefore, a form of **gross**, not net wealth tax. This criticism focusses only on rates in terms of ability-to-pay. To the extent that rates reflect relative benefit from local government expenditure programs, the level of individual indebtedness is irrelevant.[10]

(v) Rates are regressive as against current household income. The kind of results shown in Table 6.2 (p. 151) of the Self Report should come as no surprise. It has long been known that the income elasticity of demand for housing is low.[11] Thus, with a proportional tax rate the amount of tax expressed as a percentage of household income will decline. In addition, the criticism can only be applied to householders as we have no evidence to identify the pattern of incidence on commercial ratepayers.[12]

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10 Furthermore, if local government services lead to improvements in property value, these capital gains are accrued by the owner regardless of the level of individual indebtedness.

11 See, for example, G. Carliner (1973), "Income Elasticity of Housing Demand", in Review of Economics and Statistics, Vol. 55, November. However, if public policy in Australia continues to exempt the residential home from the tax base (as with capital gains tax) the correlation between current income and residential property value could increase.

12 To the extent that business ratepayers pass on rates in price, rates become a form of consumption tax. Thus, with low (current) income households having a higher marginal propensity to consume than higher-income households, the regressiveness of the rate pattern will still apply.

However, as Prest asked,[13] why should the regressiveness of rates against current household income matter anyway? Local government rates are just one small part of government revenue and expenditure programs and the ultimate redistributing effect of a government's fiscal policy will depend upon the outcome of the total, not one part. More fundamentally, the criticism of regression relates to **current** income, not other measures like lifetime income. While specific welfare measures may focus on ways to allow those on low current incomes to pay the rate, it is just as valid to relate the pattern of incidence of the rate to lifetime income - which takes account of many property-rich, but income-poor retired people.

It seems therefore, that despite a general acceptance that rates as a form of tax are "unpopular", most of the criticisms levied against the tax can be answered in one way or another. Possibly the explanation is that **no** taxes are popular and the clear visibility of the rate and the accessibility of local legislators means that rates bear the brunt of much of the public aversion to taxes in general. Being so simple and visible, the rate is virtually impossible to avoid or evade - and this in itself may explain some of its unpopularity with certain classes of taxpayers.[14] Nonetheless, scope exists in the application of the rate in Australia to increase the flexibility of its impact, both over time, and between various classes of property use and ownership. These aspects of rate flexibility will be examined in the section that follows.

## 4. Increasing Rate Flexibility

Regardless of the absolute level of funds to be raised by rates to meet the expenditure needs of local government, the degree of flexibility in the distribution of the rate burden over the population of ratepayers depends upon the application of the following factors:

(a) valuation;
(b) minimum and maximum rates;
(c) exemptions;
(d) differential rating;
(e) the timing of rate payments; and
(f) welfare provisions.

Although it is convenient to deal with these aspects of rate flexibility under separate headings, they should not be regarded as mutually exclusive. For example, exemption from rates can be regarded as a welfare measure, as well as being the application of a special form of maximum rate (namely, zero). Similarly, properties may be differentiated for rating purposes, yet each category of differentiated property may carry with it some level of minimum (or maximum) rate. And, whatever is carried out under all the other headings, differences in valuation and timing of payments can be applied to each measure to further vary the pattern of the initial incidence of local government rates.

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13 A.R. Prest, *op. cit.*, p. 50.

14 Other property taxes, especially the land tax, can be avoided by splitting the nominal ownership to take advantage of minimum taxable values and the progression in the tax scales.

(a) Valuation

We saw in Section 3(a) above that an "unimproved" assessment of the tax base will increase the relative local government property tax burden on ratepayers who own land with the lowest value of improvements. On the other hand, the unimproved assessment does not serve to discourage investment and improvements on land - and in this sense, may be seen to be efficient. Councils therefore have a fundamental choice between equity considerations (if we are convinced that differences in private land and fix improvements ownership is a fair indicator of differences in private welfare) and those of efficiency in selecting a valuation system. This will make no difference to the total rate receipts, but will alter the distribution of the incidence between ratepayers.

Once the valuation system is selected, the only remaining flexibility in the application of the rate that can be built into the valuation system is to designate that specified categories of property should be valued in terms of their present (or "actual") use, rather than their development (or "future", or "potential" use).[15] If, for example, councils believe that there is a broad social value that justifies the loss of rate revenue implicit in valuing urban fringe farming land, or native vegetation land, or listed heritage property according to its actual use rather than potential use then they should be free to do so.

(b) Minimum and Maximum Rates

(i) A minimum rate can be justified on the grounds that every property in an LGA receives some minimum level of benefit from the services of local government.[16] In practical terms, it may be the only way for councils using an unimproved property value system to obtain rates of any significance from some ratepayers. In rural districts this might be the case for country town allotments (with or without rate differentiation) and in urban councils, for intensive use (e.g. home units) sites.

Whatever the other criticisms of rates on grounds that they are regressive in terms of current income, a minimum rate will also be regressive in terms of property ownership - and this will be seen by many as a clearly inequitable aspect of the rate. For example, Table 1 shows that with a minimum rate of $300 and a rate in the dollar of 1.5c, the effective rate of tax decreases as property value increases - at least for a range of ratepayers.

Intergovernmental financial relations have complicated the minimum rate further by the intervention of State governments who provide rebates for pensioners. Although we may personally deplore the action of councils that set their minimum rate on the basis of the State

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15 South Australian valuation legislation allows for the designation of certain categories of land use (e.g. rural and heritage) which is valued according to its actual use rather than its potential, or development value.

16 If we view the service as a simple straight line with benefits on the vertical axis (B) and property value on the horizontal axis (P) then the equation would be $B = A + bP$, with A the minimum benefit and b the increment in benefit with increases in property value.

government rebate (rather than their estimates of minimum benefit or the needs of a "resident tax")[17] their actions are perfectly rational, given a system of welfare support funded by one level of government for the payment of a property tax levied by another level of government. We shall be discussing welfare provisions in (f) below, but sufficient to say here that the integration of the minimum rate with a welfare grant signals the need for an income maintenance scheme for all categories of poor (whether property owners or not) and the abolition of piecemeal support.

Although we may believe that the need for a minimum rate could be reduced if all councils adopted an improved value tax base, its retention may be necessary to give councils the capacity (and flexibility) to levy what they regard as an adequate minimum charge on all ratepayers, especially for the public services which are collectively enjoyed regardless of the value of property owned (e.g. libraries, local health care and recreation facilities).

Table 1

INCIDENCE OF THE MINIMUM RATE: AN ILLUSTRATION

| Assessed Property Value<br>$<br>(1) | Rate Liability<br>$<br>(2) | Effective Rate of Tax<br>%<br>(3) |
|---|---|---|
| 5,000 | 300 | 6.0 |
| 10,000 | 300 | 3.0 |
| 20,000 | 300 | 1.5 |
| 30,000 | 450 | 1.5 |

(ii) A maximum rate, unlike the minimum rate that is expressed as an absolute dollar value, can be either a ceiling on the rate in the dollar that can be applied (rate "capping") or a limit to the percentage change (increase) allowed from one year to the next (as in New South Wales). Thus, apart from reducing the capacity of local government to increase own-source revenue (and therefore expenditure) via the property rate, a maximum rate may, over time, erode the relationship between differences in individual property value and difference in individual rate liability.

The New South Wales restriction on local government is, according to the 1984 legislation,[18] likely to erode differences in capacity-to-pay (in terms of differences in ratepayer property ownership) since the ceiling is on the rate of change on individual assessments. Market forces are unlikely to cause a uniform change in value across all properties (and classes of property) in an LGA, so that, in raising the requisite rate receipts, properties with low rates of value increase will bear some of the burden that would otherwise fall on properties increasing rapidly in value.

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17 See I.R. McPhail (1979), "An Overview of Differential Rating - An Address", in Differential Rating in Australia and New Zealand, AGPS, Canberra, p. 109.

18 See the Self Report, *op. cit.*, p. 84.

Apart from the potential inequity that rate ceilings impose between ratepayers in an LGA, they seriously inhibit the capacity (and therefore flexibility) afforded councils in rural and other areas, subject to wide fluctuations in economic prosperity. Without a rate ceiling, rural councils could, for example, strike a low rate in drought years, but levy a heavier rate when things improve. In other councils, some of the revenue-raising limits of the ceiling may be overcome by increasing reliance upon user-charges (fees) as a means of raising revenue. This, in effect becomes a backdoor means of applying a tax on property owners.

The imposition of a maximum rate by a higher tier of government denies the existence of democratic safeguards in local government. More than this, in selecting and setting a ceiling, the higher tier of government implies that it has a better idea of the needs and capacities of the local government electorate than those elected to councils. Given the relative visibility of the rate *vis-à-vis* other forms of taxation and the accessibility of local representatives relative to State and Commonwealth Members of Parliament, one could be excused for expecting that the fear would be that local government would tax too lightly, not that it would tax too heavily, and that higher-level intervention might be in terms of a minimum rate, not a maximum rate.

(c) Exemptions

Externally-imposed exemptions (for example, Commonwealth property under Section 114 of the Constitution) limit the rate-raising revenue of a number of LGAs, but only the internally-applied exemptions affect the flexibility afforded to local government to vary the local government rate, both in aggregate and between ratepayers. As we are confining this Chapter to the flexibility of the rate as a form of tax for local government we will not be discussing the question of exempt Commonwealth and State property.[19]

Exemptions allowed by councils themselves increase their capacity to influence the distribution of the rate within their LGA. Property will be zero rated because councils believe that the social benefit to the community at least equals the cost of rate revenue forgone. If we believe that the benefit may vary over time then concessions in the form of an annually approved grant (equal to the whole or part of rate liability) would be preferable to a zero rate.

(d) Differential Rating

Potentially, at least, differential rating offers local government the greatest scope for flexibility in the application of the rate. While leaving value untouched, the rate of tax can vary by whatever classification of property is deemed appropriate. The primary decision is the classification to be adopted; the secondary decision is the rate of tax to apply. The two major candidates are:

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19 The problem is discussed at some length in the Self Report, *op. cit.*, pp. 361-62 and the paper by Howard, *op. cit.*, pp. 169, 237-41 and 319. An important aspect of the problem missing from the Self Report is the potential that if we become more socialistic in our political economy, more of the resources that are presently private (and therefore rated) will be public (and exempt). At some stage we may have to legislate to address this aspect of rate exemptions in a more definitive manner than we do at the moment.

(i) to differentiate by class of taxpayer, or

(ii) to differentiate by property use.

Local government is very restricted in its ability to differentiate by class of taxpayer. Any welfare provisions they care to make depend upon the classifications applied by other levels of government; notably the Commonwealth. The business sector would be effectively classified according to land use, rather than the individual ratepayer, while even for the residential ratepayers, a household-by-household approach would be necessary, but even this may not detect rate evasion (through a nominee ownership scheme) or rapid changes in personal circumstances.

A "land use" classification could be restricted to the usual categories accepted by an outside "umpire" (such as the State Valuation Department, or State Planning Authority) and differential rating applied according to the elected council's own judgment of relative benefit (from council expenditures) and/or ability-to-pay of owners of the various categories of property. Furthermore, each could incorporate a separate minimum rate which again reflected the council's judgment about ability and benefit. Although grants may be a preferable source of subsidy, councils with differential rating also have the option of encouraging specific development (e.g. industrial) in their LGA by a differential rate that favoured that particular form of land used.

Finally it should be noted that differentiating rates by property use not only increase council flexibility, but increases the scope for local government to pass on more of the burden of rates to the Commonwealth Government. For if differential rating is used as a means of increasing the rate levy on commercial property (*vis-à-vis* residential) then a higher proportion of rate revenue receipts become an allowable deduction for the assessment of income tax liability and Commonwealth receipts fall accordingly.

(e) <u>The Timing of Rate Payments</u>

We saw earlier (Section 3(c)(ii)) that one of the criticisms levied at rates is the "lumpiness" of tax liability (especially when due annually) and this contributes to the visibility of the rate *vis-à-vis* other forms of taxation. There would be few ratepayers, business or residential who have the capacity to immediately pay their annual rates out of current disposable income.[20] Some would presumably be met from borrowing or savings. Rates therefore rank poorly per dollar of tax revenue when compared with PAYE personal income tax, sales tax, or excise duty in terms of the tax criteria of convenience of payment.

The solution lies in more frequent payments, despite the complaints of council accountants.[21] What councils choose to do about the cost of such a measure (in terms of foregone interest or extra administration) is really up to them. There will be costs and unless those who pay early are offered an inducement, or those who pay late carry a

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20 See, for example, the value of rate liabilities quoted in the Self Report, *op. cit.*, p. 150.

21 The case for the time payment of rates is developed further in M. Mowbray, *op. cit.*

penalty then there **will** be some redistribution between early and late ratepayers.[22]

(f) Welfare Provisions

As in the case of exempt property, local government, as part of the public sector, is free to offer its own concessions to those it judges to be in "need". However, the major problem for local government in increasing the flexibility of the application of the effective rate of its tax is in **identifying** those in need. Its primary source of reference is the classification provided by other levels of government (notably the Commonwealth) and in providing welfare assistance through the rate (as against expenditure programs) it must confine itself to ratepayers who are property owners. Offering welfare assistance to tenants through rate concessions to their landlords would seem to be a most insecure way of channelling public support to the needy, especially when other more direct measures (e.g. income support) are available through the public sector.

State governments already offer rebates to pensioners. Any **council** extension of this concession is therefore at the expense of other ratepayers, or, in the case of the price-increasing effects upon local goods and services, consumers. Some of these consumers may be worse-off in wealth/income terms than the rate concession recipients. Economic rationality suggests a deferred payment scheme - for State as well as local government concessions - to the asset 'rich' but income "poor" aged ratepayer. However the aged may have a different perspective of economic rationality and go through severe hardship to stay free of what they view as a debt.

Therefore the conclusion appears to be that local government has little scope to effectively vary private welfare through manipulations of the property rate. The tax measures that are possible compare poorly with the devices available to other levels of government (particularly the Commonwealth). Local government welfare functions might be better achieved through expenditure programs than through concessions confined to the rate.

## 5. Conclusion

Many of the criticisms of the rate *vis-à-vis* other forms of taxation relate to its wealth tax similarities. The fact that it cannot be avoided or evaded does not improve its popularity with a number of taxpayers. If the current mix of taxes in Australia is anything to go by, Australians do not like **any** tax that threatens their stock of wealth. Mention of a death duty, or even an effective capital gains tax (despite its income connotations) is considered to be politically dangerous by the major political parties.

Notwithstanding these attitudes towards taxes on private property, the rate remains the major tax available to local government. We have seen that,

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22 For example, a $400 annual rate liability deferred for three, six and nine months could require uniform quarterly payments of $104.59 if a 12 per cent p.a. rate is applied to the three $100 deferments of liability.

given acceptance of general competence powers for local government representatives, considerable flexibility can be built into the application of the rate. The adoption of rate differentiation by land use would provide councils with scope to influence the distribution of rate collections in their LGA. Similarly, providing for frequent periodic payments of rates would conform more closely with the time payment preference of income recipients.

Measures which restrict the general competence powers of local government representatives, apart from inhibiting revenue-raising powers, must restrict their flexibility in applying the rate to the population of ratepayers. In particular, the imposition of a maximum rate by a higher tier of government is an explicit denial of the democratic responsiveness of locally-elected representatives,[23] while at the same time implying that the higher tier of government is more sensitive than council members to the needs and capacities of the local electorate. Until there is general proof (as against case studies) that local government is unresponsive to the collective preferences of their electorate then everything possible should be done to free up the application of the rate by local councils.

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23 "... in small decentralised areas, politicians have to be more specific in their programs, and thus are more easily questioned on them by their constituents. In such situations, there is much greater chance that the wishes of the people are met than in the case of large centralised government" in Peter Groenewegen (1984), Public Finance in Australia: Theory and Practice 2nd edn, Prentice Hall, Sydney, p. 237.

# 4 COMMENTARY

Michael Gallagher

## Summation of Papers

I assume the purpose of this seminar is to exchange views on some current policy issues and to identify fruitful avenues of research related to local government finance.

None of the three papers specifically addresses a research agenda, though inferences can be drawn from them individually and collectively about useful research pursuits. I will return to this matter. Insofar as the papers address policy issues the treatment is partial, at least in two senses.

First, each considers a particular domain of the broad local government finance policy arena. Thomson's paper is confined to theoretical policy issues concerning the application of the property rate by individual councils. Moye's paper focusses on practical policy issues concerning the allocation of general purpose grants among councils by Grants Commissions in the States. Self's paper ranges across many mainly political-bureaucratic issues concerning local government financial and functional relations with the Commonwealth.

Second and not surprisingly, each author adopts value stances. All have something to say, though not always explicitly, about intergovernmental relations; and more about power-control than financial relations. Possibly because of the domain addressed it appears that Thomson is a localist, Moye a States' rightist and Self a centralist.

Thomson sees virtue in local government autonomy which he links to democratic principles. From this premise, at least as much as from his argument about rating, he appeals for the withdrawal of central (State and Commonwealth) restrictions on and interference with the exercise of locally-accountable rating discretion. State intrusions are particularly instanced as unwarranted, including pensioner rate rebates and ceilings on the permissible rate in the dollar or on annual percentage increases in rates. It is questionable, however, whether the distortions that he suggests are created by such impositions on local autonomy would, for instance, compel the New South Wales Government to ditch what it regards as its most popular policy in respect of local government.

Thomson also regards the property rate as a wealth tax of sorts and commends its wider, more flexible application by individual Councils. He sees the main strength of the rate lying in its relative unavoidability and the main weakness its visibility. He sees property rate revenue as having more of an allocative, functional financing role than a distributive or stabilisation role. It is curious, however, to use the fashionable language of wealth taxation with reference to the property rate without addressing local government boundaries which impede, for example, any transfer of revenues from the relative wealth on Sydney's north shore to poorer communities in the western suburbs.

Moye reflects, from a different perspective, on the diversity of local government rating practices as one among many complex factors which continually require the exercise of broad judgment by the State Grants Commissions in determining the allocation of untied grants to local Councils.

He demonstrates considerable divergence of practice among the Grants Commissions with particular reference to: the treatment of the as-of-right element in terms of the assignment of weights for area characteristics and its relation to the treatment of the equalisation element; the assessment of revenue capacity including the choice of valuation bases, units of measurement and standards; the assessment of expenditure needs and disabilities; the ratio of revenue to expenditure assessments.

Moye attributes this divergence to several factors, including: the persistence of data deficiences; the lack of specificity in legislation; the legacy of the early work of the Commonwealth Grants Commission, especially as it influenced State Commissions; and established patterns of relativities and expectations. On the grounds of complexity he condones the exercise of discretion in the hands of technocrats. On the one hand, he does not see evidence of local government interest in allocation procedures other than self interest in the outcomes such that local government participation in the establishment and review of allocation principles will cause problems. On the other hand, while commending the Government's rejection of the Self Report's recommendation for the Commonwealth to promulgate detailed allocation guidelines, he sees room always available for the Commissions to define methodological details in ways which significantly influence distributive outcomes. Moreover he has a jaundiced view of intended changes being realised: "It remains to be seen whether the final outcome will be substantially different from the patterns of distribution that have been achieved to date."

Self is inclined to limit the discretion or "paternalistic judgment" of the State Grants Commissions, presumably on the grounds that its exercise lacks transparency, consistency, objectivity and accountability. Like Thomson he values local autonomy but unlike Moye, who sees adherence to effort-neutral principles accommodating local choice, Self inclines to a mildly effort-positive approach particularly with regard to encouraging local government to provide human services. Like Moye, Self sees wide divergence of practice among the Grants Commissions and attributes this to lack of legislative clarity allowing broad scope for discretion. In particular he regards the PITS Act as allowing the purpose of the Commonwealth's financing of local government to be interpreted more in terms of vertical redistribution than horizontal equalisation. He presents the thrust of the Self Report as reforming the PITS arrangements so as to achieve more effective equalisation with greater consistency and uniformity across States.

Self is apparently dissatisfied with the Government's response to the report of the inquiry which he chaired. In the course of the bargaining required to obtain a useful decision, Self seems to regard the report as having been converted from wine to water. "What started out as a prospectus for some mildly radical reforms in the structure of financial support turned into a struggle to save the Commonwealth commitment to local government", he writes, and asks: "is the end product merely a process of elaborate negotiation and bargaining which costs a great deal but has few visible end-effects?" Self in harmony with Moye: "was it all worth it"?

Response to Papers

My response is also partial in that it addresses only some points of linkage between the three papers and the Government's response to the Self Report. It also reflects a particular view of policy formulation in the bureaucratic field: a view which sees policy formulation as a process of negotiation wherein the challenge is to capture the maximum degree of logical coherence out of the realms of practical constraints and political compromises. This challenge is particularly exacting when the negotiations concern intergovernmental financial and power relations.

From this perspective, the national inquiry into local government finance was worth the resources devoted to it, which incidentally greatly exceeded the official financial cost of it. Notwithstanding the polemic and uncertainty it may have generated, it made a valuable contribution to knowledge and the consultative process. It stimulated a government response to questions of financial and administrative arrangements of some complexity and much contention. And it resulted in the repeal of the Local Government (Personal Income Tax Sharing) Act 1976 and the introduction of a Bill for the Local Government (Financial Assistance) Act 1986.

The Government had previously broken the nexus between the funding level of the program and tax receipts, rendering the PITS Act irrelevant insofar as it provided for a tax sharing arrangement for local government. The Government was in receipt of a comprehensive report which called for reappraisal of basic elements of the current program. With the Government pursuing a tighter mid-term fiscal policy, cut-out or wind-back options commanded attention. In the event, the Government rejected those options and decided to continue a fully Commomwealth-funded program of assistance for local government.

The 1985-86 funding level, adjusted upwards to allow wider coverage in the Northern Territory and at the same per capita level as for the States, was adopted as the program funding base of $540.9m. The Government decided to escalate the base in 1986-87 and 1987-88 by the CPI or the increase given to the States for their general purpose assistance, whichever is the greater, and in all subsequent years on at least the same basis as for the State grants. In all the circumstances the outcome of the struggle over dollars is very favourable to local government. While it represents abandonment of tax-sharing principles and moderation in the notion of local government autonomy embedded in those principles, it provides a new order of certainty and stability in Commonwealth support for local government and potentially gives a new form of expression to the concept of local government partnership in the Federation. The new Act provides for local government to be treated no less favourably than the States in terms of periodic increments to the funding base of the general purpose financial assistance program.

There are several important implications which flow from the new arrangements. Under the PITS arrangements local government was entitled to a share of tax receipts virtually independent of pressures on or changes in fiscal policy. Under the new arrangments, Commonwealth general purpose expenditure on local government will be subject to such pressures and changes. Self has commented on the suggestion that the fortunes of local government will be tied more closely to the bargaining ability of the Premiers. As Self sees it, local government will have its weak bargaining position in Canberra strengthened by having the Premiers acting automatically on its behalf. But I cannot see local government getting its dollars by default, without effort and without scrutiny by both the Commonwealth and the States. It will be interesting to see what expressions of mutual interest emerge between the States and local government, but I cannot envisage local government relinquishing its relative independence in bargaining. To the contrary, I expect local government will monitor State budgets more closely and will take a more active and realistic interest in national macroeconomic settings and especially Commonwealth fiscal policy.

It should come as no surprise that the arguments, especially at the Commonwealth level, about whether and to what extent the Commonwealth should continue to fund local government substantially crowded out debate about how any future program should best be organised - the questions that most concern Moye and Self. It is interesting in this regard that discussion of other than the threshold financing issues occurred mainly within the local government interest sector broadly defined, including the Commonwealth Office of Local Government, the State departments of Local Government and local government representative bodies, with varied input to each of these from the State Grants Commissions.

However formative the engagement of allocation questions by local government bodies and State departments of local government, however steep the learning curve for them, a new interest has been awakened and there will be increasing participation in allocative decision making by parties directly interested in the development of local government. The Self Inquiry set this process in train. The new Bill will reinforce it. For instance, the Bill requires the States to formulate principles for allocation of grants among councils, for local government to be consulted on the development of the principles, for the Commonwealth Minister to approve the principles after being satisfied that they accord with the purposes of the legislation, for the States to report in detail at least every three years on the methods used in applying the principles and for local government to participate in periodic reviews of the program. Moye may regard much of this as opening a Pandora's Box. It will certainly result in the lids being taken off the black boxes of technical assessment and in the exercise of discretion being opened to the region of public accountability.

The foregoing I suggest puts a gloss on Self's textbook interpretation of the political outcome of his inquiry's proposals: that a weak Commonwealth department of local government, requiring full State support in order to beat off strong Commonwealth co-ordinating departments, traded off those reform proposals which were likely to meet strong State resistance. The interpretation has limited validity. I am not sure what weakness and strength mean in the bureaucratic context, especially when matters of functional expertise are involved. To test the Self interpretation we should identify those proposals of the Inquiry which attracted State opposition and those which were rejected by the Commonwealth. I will not include for this purpose the Government's decision on changes to inter-state relativities which went further than the recommendations of the Inquiry and attracted varying State responses.

State opposition focussed on Inquiry recommendations 7, 8 and 9 and on the proposed allocation guidelines to be promulgated by the Commonwealth. Incidentally, local government supported the former but agreed with the States in opposing the latter. Recommendations 7 and 8 addressed alleged State substitution of Commonwealth funds for their own support of local government.

Given the ambivalence of evidence and argument provided by the Inquiry on this matter, the recommendations were heavy-handed and were rejected unanimously on the grounds of impracticability.

Recommendation 9 addressed rate-pegging, or more accurately in Thomson's language, limitations on rate increases. It applied only to New South Wales. While all Commonwealth departments opposed the practice in principle they were all in agreement that local government in a State should not be penalised in terms of withdrawal of Commonwealth general purpose grants if the State chooses to limit rate increases. Moreover, the matter was regarded as fundamentally one for political resolution between local government and the State concerned.

The proposed guidelines were rejected on numerous grounds but principally because they were prematurely detailed, inflexible and intrusive. Advice from the Grants Commissions suggested problems of practicability and politically intolerable redistributive consequences, especially with immediate concurrent implementation. The reservations placed by the Grants Commissions on the indicative outcomes gave additional cause for concern. No one could be confident of the actual consequences and in that light it was considered irresponsible to promulgate guidelines in ignorance of their effects. It was the consultation with local government bodies and State departments of local government that shaped the Commonwealth response. Broad agreement was reached that the primary purpose of the program should be defined in legislation in terms of horizontal equalisation to average standards. It was also agreed that every council should continue to receive a grant and that the amount provided for this purpose should be specified in legislation on the understanding that per capita entitlements should be unweighted in order to reduce scope for double counting of disabilities.

Even so, caution was advised as to timing of such changes in order to allow adequate time for councils to adjust to the new arrangements. Consequently, the legislation provides for phasing-in over a five-year period. With the exception of some unconvincing details, then, the principal recommendations of the Self Report were adopted in terms of funding principles, allocation purposes, transparency and accountability of decision making. The new arrangements provide for evolutionary reform.

To sum this up, the Commonwealth response to the Self Report represents a rejection of the various "pure" philosophical positions depicted by the three papers for this seminar. The outcome reflects a negotiated compromise between these positions, providing logical coherence of purpose and opportunity for development. Interventionist centralism is rejected. Unconstrained States' rights are rejected. Unaccountable technocratism is rejected. Local government autonomy is redefined in terms of partnership.

I said at the outset that the papers suggested items of a research agenda. Thomson's paper indicates the need for a more comprehensive approach to research on local government rating. Moye and Self indicate gaps in our working knowledge of rating policies. Such research would benefit local councils and State Grants commissions.

From a Commonwealth perspective basic research is needed if the program of general purpose support for local government is to be properly evaluated. The chief issue is whether the funding level is adequate for program objectives to be achieved. This issue will emerge again when the program is reviewed.

Given the experience of negotiation over the Self Report, the thrust of the reforms and the comments made in the three papers, there is one over-riding topic that warrants research in the broad sense. That is the nature of the power relations expressed in intergovernmental financial arrangements. There is, I believe, something of a hiatus between approaches to finance provision on the one hand, and financial allocation on the other hand and a glaring gap in terms of attention to the politics of both.

# 5 COMMENTARY

Peter Groenewegen

The three papers on local government finance presented today are nicely integrated since they all deal with aspects of vertical and horizontal imbalance in the context of financial relations between Commonwealth and local governments. By and large they exclude matters associated with the more fundamental relationship between State and local government. The papers are also timely since local government remains the "Cinderella" of the research interests of Australian public finance academics, and any additional information on this subject is always welcome. Although in the past, I have myself laboured in the area of local government finance - presumably the reason why I was selected to act as substitute commentator in place of Mr Walls by our Acting Director - I have not kept up this interest, a failing on my part undoubtedly reflected in my comments. However, as a teacher and textbook writer in Australian public finance, I greatly welcome the three papers and the information they contain, and in addition the report on local government finance prepared under the chairmanship of Professor Self because the data provided will pay dividends for many years to come.

As I see it, the unity in subject matter of the papers presented, arises from the fact that they all address aspects of fiscal imbalances insofar as these affect local government finance. Professor Self addresses both the vertical and horizontal aspects of this problem in his informative paper when pointing out that Commonwealth revenue transfers to local government have had both vertical and horizontal (equalisation) considerations as their objectives. Norm Thomson addresses rating, one potential factor influencing vertical fiscal imbalance in local government finance. The other major source of funds, local government borrowing, is largely left out of the picture. In any case, it would have required a fourth paper if the changes which have recently taken place in the Loan Council were to be fully considered. Mr Moye, in a paper from which I personally benefitted most, addresses mainly the horizontal imbalance aspects of the problem. The state local government grants commissions are required to tackle the equalisation aspects in their determination of grants to individual local government unit when distributing the revenue paid by the Commonwealth Government to the various states for that purpose.

In this, the expenditure side of local government finance has received relatively little attention, though neither Professor Self nor Mr Moye ignore it entirely in their discussion. Hence the first part of my comments is addressed to the missing friends at this seminar: expenditure and borrowing considerations. In the second part of my comments I want to address specific questions and remarks to the individual paper givers. My strategy is therefore to cover some sins of omission and not only points on which I would like more clarification.

## Expenditure and Local Government Functions

Professor Self draws attention at the start of his paper to a feature of Australian local government which I always find embarrassing when lecturing on fiscal federalism theory in public finance classes, that is, local government's relative insignificance in terms of public expenditure functions. The functions assigned to local government in Australia are so small and so property-owner oriented, that it is difficult to see the relevance of the

Tiebout model as a theory of local goods supply in the Australian context, or, more generally, to see Australian local government as a significant case of decentralisation in the provision of public goods.

The slow speed with which Australian local government has moved into new fields, including the human services area to which Professor Self draws attention in his paper, is quite notorious. This raises the question as to why Australia has not followed the United States pattern in decentralising public goods provision to a far greater extent. Can this be explained by the huge disparities in size (area and population) which are so characteristic of Australian local government units and which are far greater than those experienced elsewhere? Or is the answer to some extent to be found in Russell Mathews' suggestion that planning community and economic services in the larger cities should be conducted on a metropolitan-wide basis hence creating *de facto* regional units between the states and local government as presently constituted. In short, as I see it from the expenditure side, Australian decentralisation practice in the allocational branch of public goods supply fits very badly into the conventional layer-cake federalism model.

This raises also a question about the appropriateness of general revenue assistance as the form Commonwealth grants to local government should take. If there is only a slow move to the important human services at the local level (an unsatisfactory outcome in Professor Self's view) then would "tied" or specific purpose grants with their "seed" function aspect not be more appropriate to encourage such activities. This line of argument raises some doubts about the universal superiority of general revenue assistance grants, a presumption which seems to underly the views of both the Self Committee and Mr Moye's paper.

<u>Some Questions in Local Government Borrowing</u>

It is clearly not appropriate in this context, and in any case I do not have the necessary skills, to raise general issues on local government borrowing. I may, however, be permitted to raise the following general questions which are of relevance to the contents of the papers presented.

1. How much capital outlay of local government should be financed from borrowing rather than current revenue sources including general revenue grants? In local government as elsewhere the tax/borrowing choice arises and needs to be addressed in the vertical fiscal imbalance context. It is worth noting in this connection that over recent periods, rates have grown sufficiently in aggregate to cover current outlays of local government.

2. How restrictive is current Commonwealth policy in relation to local government borrowing? Should we look to the behaviour of the State borrowing authorities (such as the New South Wales Treasury Corporation) which have been set up for this purpose? It is unfortunate that very little information on such authorities is as yet available. In addition, to what extent can the rather generous revenue assistance provided by the Commonwealth be seen as a compensation for reduced borrowing potential by local government, given that one of the established effects of these grants appears to have been reduced local government borrowing?

3. How much "revenue disability" can be assigned to small authorities borrowing as a result of disadvantages in credit access, loan raisings

and so on, and to what extent is this addressed by the new State authorities co-ordinating local loan raisings within their jurisdictions as "mini-Loan Councils"?

Perhaps this last question is more one for Mr Moye in the context of his concentration on equalisation matters, but I am curious about the current principles of local borrowing transferred to the States on which the information obtainable from Budget Paper No. 7, Chapter III is no longer sufficient to provide clear answers.

Some Questions Addressed to Specific Paper Givers

Let me finally raise some brief questions of the three individual paper givers, all of them rather fragmentary but, I hope, not incoherent.

1. Mr Thomson on rates

First on incidence of local government rates, I would draw Thomson's attention to the alternative incidence analysis presented by D. Mair ('Towards a Kaleckian theory of the short period incidence on the property tax', Government and Policy, Volume 2, 1984, pp. 117-34) which supports his contention that rate incidence on commercial property behaves more like an excise than a tax on capital, the conventional result. This has important implications for the regressiveness of rates overall, on which not only Thomson but also the Self Committee, made a number of remarks.

Second, in his espousal of greater use of differential rating for local government, what costs does Thomson see in terms of reduced simplicity and anti-avoidance properties of the local rate?

Thirdly, what sort of variations in distributional consequences arise if Unemproved Capital Value (UCV) and site value were replaced by Improved Capital Value (ICV) as the universal local government tax base and is there any statistical evidence available on this?

Finally, to what extent can local rates be seen as a specific form of wealth tax, and to what extent is it more appropriate to describe them as a tax on factor use (when they fall on commercial property) or a consumption tax associated with the consumption of housing services?

Referring back to my own work on taxable capacity of local government in New South Wales for the 1960s and early 1970s, I am interested to see that the view I then expressed - namely, that local government makes insufficient use of its tax base - seems to be endorsed by both Thomson and Self.

2. Self on Commonwealth assistance to local government

Here I need to apologise even more strongly for the fragmentary nature of the questions on this very interesting and informative paper.

First, how solid is the evidence for limited economies of scale in public goods provision and what are the implications of such a finding for cost disability calculations?

Secondly, could Self more fully explain the "bottom-up view" of equalisation grants in terms of needs rather than the quite different fiscal capacity equalisation which informs the work of the Commonwealth Grants Commission?

Thirdly, do the rising inequalities in respect of fiscal capacity in local government finance which Self notes arise mainly from the revenue side?

Finally, to what extent is it accurate to describe the potential legislative outcome of the Self Committee recommendations as a Department of Treasury and Finance defeat when those departments did succeed in greatly curtailing the growth of Commonwealth financial assistance to local government by replacing personal income tax sharing with a two per cent real increase or, what may in practice turn out to be even less generous, following the growth of general revenue assistance to the States?

<u>Mr Moye on State Local Government Grants Commissions</u>

I have only a few questions of Mr Moye. I learnt a great deal from his paper since I always find it difficult to be well-informed about practices in other States, without taking a great deal of time and effort. His paper provides much useful comparative information in an easy to understand way and I value it for this reason as well as others.

First, a question on the index of taxable capacity or revenue disability index. How fruitful in this context is the income measure applied by Queensland - if I have understood this point in his paper correctly (a measure originally supported by Department of Urban and Regional Development in its submission to the Grants Commission in 1973) - as compared with indexes based on the rateable value such as rateable value per rate payer, per resident rate payer or relative to aggregate rateable property?

Secondly, how far advanced is research on estimating the consequences of different criteria in valuation and units of measurement with respect to the grants payable to individual local government units and their ranking in terms of fiscal capacity disabilities. When I did my own research on an aspect of this for New South Wales, my findings suggested that different criteria did affect ranking and size of grant to a marked extent.

# 6 COMMENTARY

A.R. Prowse

I propose to comment on the papers in the reverse order of presentation.

Whatever category of political philosophy Mike Gallagher might think Mr Thomson falls into, I liked the Thomson paper. It is a clear paper directed at important questions. Since I have no particular disagreements with what is said there I take the opportunity to ask him to comment (and Professor Self if he would wish to) on a very important question that is not dealt with. Mr Thomson says that in Australia we do not levy rates at anything like sufficiently high levels. The question therefore is: to what extent should revenue raised by rates be increased? and a second question is: should uniformity in rate revenue performance among local government authorities be sought, and if so how?

Mr Moye's very informative reference document on the procedures of his State's Local Government Grants Commission serves as a natural lead in to what is being called the Self Report. Frankly, I liked Professor Self's paper better than I like his Report, though there are some good things in the Report with which I think most of us here would agree. On the most basic issues, however, I do not think that the Report's recommendations are sustained.

I come to the consideration of these very basic issues from the useful experience of a long stint in the Commonwealth Treasury - including a period as head of the division in charge of Commonwealth/State financial relations and the Loan Council; a further period in an international economic and financial organisation; and most recently a briefer period in a State Treasury.

The period in the Commonwealth Treasury extended back to the early seventies, through the previous Federal Labor government, during which the program of Commonwealth assistance to Local Government had its genesis. Despite what has been asserted by one of our speakers today, I do not think there was ever a sustained and objective analysis which established that the Commonwealth is, in effect, better placed to understand the requirements of local government than are the States. After all, local government is in the formal legal sense a creation of the State legislatures. The stronger argument is that the program was conceived essentially for political objectives directly reflecting the political circumstances of the time. Moreover, the efforts by the Commonwealth to make a direct and detailed input into local government activity, where the State Governments are responsible and must necessarily be involved, has created a very inefficient overlapping of functions with the State Governments. The efficiency objective is surely in favour of absorbing the Commonwealth financial provision for local government into the general financial provisions to the States.

I recall that as an academic economist I saw federation as a problem; a problem for macro-economic management. I do not recall certainly that I had entirely overcome that position when I came to work in the Commonwealth service, though it was certainly being rectified after some years in Canberra. I now believe that the maintenance of the federation and the federal structure is utterly important. Its preservation in good working order should perhaps be the country's highest objective. To an important degree that is a philosophical position, just as Commonwealth intervention in local government reflected largely a philosophical and political position.

from more conventional norms in normative economic analysis, fiscal equalisation is actually inconsistent with them. There is an argument offered by Buchanan that generates a case for fiscal equalisation on the grounds of general horizontal equity - the claim is that horizontal equity requires that a person who pays the same local (or state) taxes should receive the same public services. Now several things should be said about this principle. First, it presupposes a rather centralised view of a federal order. We would not, for example, expect a Frenchman who pays $5,000 in tax to receive the same level of services as an Englishman who pays $5,000, even though both France and England belong to the EEC (and NATO). Yet a federalist might feel that the EEC (or NATO) is a better model for an ideal federal order - since it involves sovereign entities coming together for specific purposes - than the UK model of devolved central powers. Second, fiscal equalisation may well generate inefficient location choices: if there are economies of scale in local service provision, one might not want to provide equal services to all citizens independent of their location. Third, fiscal equalisation is bound to involve an inefficient public-private good mix in poorer jurisdictions; under all but highly implausible assumptions a poorer jurisdiction will not want <u>average</u> quality street-lighting if it has profoundly inadequate levels of private shelter, food and clothing. Other things equal, residents of poorer jurisdictions can be predicted to want to trade off a little public goods quality for a little extra in private goods consumption.

Of course, one might argue that the real motivation for fiscal equalisation is precisely that it redistributes to the poor - a traditional individual-egalitarian argument. But then the question is whether, and under what circumstances, fiscal equalisation is a more effective means of achieving that end than more conventional instruments of redistributive policy such as welfare payments. I can contrive an argument that might justify such a claim, but I have never seen it presented in the fiscal federalism context and have never seen any reference to the empirical findings that would be required to support it. Moreoever, if this <u>were</u> the implicit reasoning, there would be nothing to be said for fiscal <u>equalisation</u> *per se*; there would be every reason to expect poorer jurisdictions to receive amounts <u>larger</u> than average service provision.

I recognise of course that any attack on the principles of fiscal equalisation is much broader than the local government issue. In particular, it raises doubts about the normative justification for the Grants Commission's methodology - something that the Self paper (and Report) seems to accept as authoritative. The broadness of my queries, however, does not inhibit me in the slightest. I like to have <u>reasons</u> for policy arrangements. Fiscal equalisation has become something of a sacred cow in the intergovernmental relations area: it is entirely unclear to me that it deserves to be so.

## 2. David Chessell

I would like to begin by referring to two points made by Professor Self in his remarks. First, in looking ahead, Professor Self maintained that local government's responsibilities should grow, especially in the provision of human services. This view was based on the following arguments:

(i) local government should assume more welfare and recreational responsibilities.

I question, however, whether this is a sensible area for greater local government involvement. The Tiebout model of local government expenditures was referred to earlier. If citizens ever vote with their feet, they will do so in response to marked differences in the levels of welfare provided among municipalities. This suggests that an extension of services from present arrangements to meet these needs would best be met from higher levels of government and provided on a uniform basis across the nation;

(ii) there is likely to be a switch from institutional to community care.

Without necessarily disagreeing with that prognosis, it seems to me that it could be handled through agency arrangements with local government, as already occurs in a number of areas. This would inflate the recorded outlays of local government but would not involve an effective increase in their responsibilities (other than as a delivery unit for programs initiated at the State or Commonwealth level); and

(iii) we should decentralise to the grass roots.

Apart from prejudging the issue, this argument begs the question of whether we should decentralise to the State or the local level. Bearing in mind that many of the functions carried out by local government in other countries are carried out at the State level in Australia, this argument does not appear to involve a clear presumption in favour of an expansion of local government.

Second, I was most interested in Professor Self's complaints about there being too much State intervention in the affairs of local government. Mr Prowse has referred to the constitutional basis for that state of affairs. Professor Self, who appears to have undergone a conversion on the road from Queanbeyan to the Australian National University, went on to say that, as a result of the intervention by the States, he is now advocating that general revenue assistance to local government should, in future, be shared between the Commonwealth and the States. Naturally I am pleased that he has now seen the light! My only regret is that this final position came too late for inclusion in the Self Inquiry report. I was not convinced by Professor Self's argument that a matching arrangement was not feasible at present because it would have weakened the desire for more equalisation. The issue of the source of funds for the program seems to me to be largely separate from the issue of the distribution of those funds among local governments. It is unlikely that the States would suddenly wish to scrap their own Local Government Grants Commissions if matching arrangements were adopted.

Professor Groenewegen spent some time in his remarks discussing the borrowing arrangements for local government. Under the Global Approach for borrowings by authorities, government-owned companies and trusts that was adopted by Loan Council in June 1984, Loan Council determines annual aggregate global limits for authority borrowings for each State. It is then a matter for each State Government to divide each State's global limit among its authorities, including local government authorities. Consequently, this aspect of the operation of the Global Approach does not attract attention in Budget Paper No. 7 (although aggregate data on local authority borrowings in each State are shown) but State publications may throw some light on the matter.

The other question about the borrowing arrangements raised by Professor Groenewegen was why relative borrowing needs were not taken into account in the equalisation process. The same issue arises in the context of the States' equalisation arrangements which are based on State Budget recurrent transactions. While not necessarily arguing for a widening of the equalisation processes to include capital items it is clearly no longer tenable to rely on the distribution of the State government borrowing program as meeting these needs as that distribution has remained unchanged for many years.

The comments by Professor Brennan about the rationale for fiscal equalisation struck a particularly sympathetic cord with me. I was going to ask him, given his admission that he did not understand the rationale for fiscal equalisation among local governments, whether he understood the rationale for fiscal equalisation among the States because I share his puzzlement. However, he has answered that in the negative. Instead, let me conclude by making the obvious logical extension of Professor Brennan's point. If there is no rationale for fiscal equalisation, then judging by the Self Committee's findings, the basis for a Commonwealth program of direct financing of local government is very flimsy indeed.

3. Cheryl Saunders

I am tempted to follow up the question raised by Bert Prowse, about the justification for general revenue grants from the Commonwealth to local government. Although several alternative bases are suggested in the papers I do not find any of them compelling. In view of the time constraints, however, I will resist temptation and confine myself to questions on some narrower issues which I will direct to three of the speakers.

First, I have two questions for Mr Gallagher.

1. He referred in his commentary to lack of accountability as a problem of the PITS arrangements which would be overcome by the new legislation. Would he identify more precisely the accountability problems of the PITS scheme and the ways in which they are overcome in the Local Government (Financial Assistance) Bill 1986?

2. Clause 9 of the Bill requires principles for the purposes of allocating the amounts of financial assistance amongst local governing bodies to be formulated by each State in consultation with local government, and forwarded to the Commonwealth Minister for approval. If the Minister does not approve the principles he is empowered to substitute his own. The principles would appear to be a form of delegated legislation, but there is no requirment in the Bill that they be tabled in or even notified to the Parliament. Does Mr Gallagher anticipate criticism of the Bill in this form from the Senate Standing Committee for the Scrutiny of Bills?

My next question is for David Moye.

The new Bill requires consultation by a State with local government in the State for the purposes of development of the guidelines and periodic review of the scheme. In my experience it is very difficult to identify representatives of a constituency as varied and diverse as local government. It follows that it is very hard to consult with local government in anything other than a token way. Another clause in the Bill, which I assume is directed to a similar end, requires at least two members of each Local Government Grants Commission to be or have been associated with local government. Would he comment on how these provisions in the legislation are likely to work in practice?

Finally, a question for Professor Self. The Bill ties the increase in local government financial assistance grants to the increase in State general revenue and general purpose capital assistance. I assume that the latter refers to the capital grant component of the State Loan Council allocations. If this is correct, is it consistent with the recommendations of the Inquiry? What rationale underlies the nexus between local government general revenue assistance and State capital assistance?

## 4. R.H. Scott

I would like to suggest that some thought might usefully be given to the origins of the rating system and property valuation.

I would like to suggest that they are both inherited systems - inherited from older countries and now applied in very different circumstances to those in which they were originally developed.

The modern practice of rating arose, I submit, when property services were new and the values of properties receiving them were enhanced by them. Property ownership was also probably allied with incomes in the higher ranges of wide income differentials. It must have seemed fair enough in times past elsewhere to put a charge on the benefitted properties and their owners.

It is quite different here now.

The spread of home-ownership - high in Australia - has spawned a different relation between wealth and income in relation to housing. Moreover, that and other influences have introduced considerable variability into the housing-wealth income relationship over individual life-spans.

At the same time, the spread of local government services has quite altered the relation between serviced and unserviced properties; the unserviced property is now the exception from the general rule, not the serviced property. Serviced properties are not advantaged over the majority; unserviced properties are disadvantaged (and public benefits exceed private).

The original rationale for rating seems to me at the least suspect if not absolutely inapplicable today. It has been seriously undermined by the spread of local government and home ownership. A new rationale is therefore needed if rating is to remain unchanged; mere convenience is no lasting substitute for principle.

There are more specific disadvantages in rating. Some arise from rating and valuation practices and add to an uneven incidence of the burden of rates. Others arise from lack of uniformity in valuation concepts and rating bases and raise further questions of equity. Important advances have been made in the development of valuation concepts but they have not gone far enough nor been uniformly adopted; much remains to be achieved. The importance of these matters can easily be overlooked, and often is.

Altogether, there are good reasons to keep open the question of the suitability of property rating as a major source of finance for local government today.

If the question is to be kept open, implications for research follow and I suggest there are two aspects of possible research to be taken into account.

Economics, in its origins, was a system of deductive logic; it still retains that basic structure and useful insights might be gained (and should certainly be sought) from a review of rating in terms of pure theory and in terms of the effects to be expected from it in different circumstances, identifying, in particular, circumstances on its introduction and subsequent changes in them. The importance of the latter, in a changing world, can hardly be exaggerated; it can often best be shown up by an examination of origins.

Measurement is popular now in a way it never was before in economics. There is, first, the measurement of simple quantities and changes in them and then the measurement of relationships, whether changeable or stable. Both kinds of measurement can provide useful confirmation (or illumination) of logical deductions or even more usefully, refutation of them. In either case, theoretical analysis must (normally) precede measurement in order to show where it is needed and what it might mean. (Measurement for its own sake is not likely to be rewarding: the nature of theory in the social sciences - and economics in particular - leaves little opportunity for discovery of new aspects of the world by search and measuring, especially by comparison with opportunities in the physical sciences.)

It follows that a discovery of unutilised rating capacity available to local governemnts in Australia may have a pragmatic importance in the context of Australian institutional arrangements but, on its own, no more than that. The discovery would have application on a valid basis only if theory showed first that rating was both just and efficient (or more efficient, perhaps, than some other measure). Has the question been adequately addressed?

## 5. R.C. Madden

It was suggested that there are few areas for research work in local government finance. On the contrary, I think there are numerous fruitful areas for those interested. Let me name just two: first, the measurement of revenue capacity; and second, of particular interest to the Northern Territory, equalisation issues between traditional municipal councils and Aboriginal communities in varying states of development.

The view has been expressed by some States, reflecting Peter Emery's views in the Self Report, that the Commonwealth should withdraw from the field and include its assistance for local governments in States' general revenue assistance. This has been the catchcry for many areas of so called 'States' constitutional responsibility', including health and education. I consider this view simplistic. The States have largely ignored local governments' concerns for generations. Functions have been centralised in State Government "quangos", with consequent reduced local community representation. Despite States' claims, government in most parts of Australia is relatively highly centralised with State Governments and their bureaucracies showing inadequate sensitivity to local concerns. In these circumstances, a Commonwealth role, with general minimal standards and conditions, may well be justified.

Before States' claims for absorption of local government assistance can be taken seriously, there must be some formulation of appropriate States' policies to devolve power over local services back to local authority and influence. I should add that the same arguments apply to States' grants. There must be an unwritten contract that States will not depart too far from national standards of service. If they diverge dramatically, they must expect Commonwealth withdrawal of general purpose funds and replacement with specific purpose funding. The prevention of this intervention is in States' (and Territories') hands.

Turning to revenue, one can only be struck by the lack of attention given to land taxes in current Australian debate on wealth taxes. The split between State Governments (land tax), quangos (water rates) and local government (rates) probably contributes to this lack of attention. Together, significant revenue is gained through these mechanisms and they have corresponding equity implications. The general exclusion of owner occupied housing, but not rented housing, from land tax, seriously affects horizontal equity, and adds to the economic efficiency distortions introduced through the capital gains tax and assets tests provisions. This matter should certainly be added to the research program in local government finance (and federal financial relations).

## 8 RESPONSE TO COMMENTS

D.V. Moye

First, I would like to make my position clear about the question of comparability between the State Grants Commissions in the methodology used in the allocation processes. I support the notion of the Commissions using generally comparable allocative procedures, particularly if these procedures are based on what the Victoria Grants Commission is doing! In fact the Self Committee Report gave a considerable degree of support to the methodology used by the Victoria Grants Commission.

But the main problem is getting the methodology right, especially with regard to how to measure revenue-raising capacity. A lot more work needs to be done to resolve these methodological problems but the State Grants Commissions are not well enough resourced to undertake the detailed testing that is required. The Commissions have very limited staff to call upon and what they have are generally drawn from the lower ranks of the public service. They have had little or no knowledge of fiscal equalisation principles and methodology when first appointed to positions and there has been a considerable training period before they are able to contribute to methodological development in any significant way. In fact there is a singular lack of personnel within State public services who have an understanding of fiscal equalisation matters. Again, the Self Committee commented on the meagre resources of the respective Grants Commissions.

It is not too different in local government circles either and it is very difficult to get any worthwhile response to questions of principle or methodology. Most are more concerned with the outcome for their municipality - will the proposed change mean more or less money for their municipality? It is very difficult to get an objective response to any proposed changes. Neither local government staff nor elected representatives show any great interest in fundamental equity considerations.

This has relevance for the proposed consultation procedures in the new legislation that Dr Saunders has drawn attention to and must raise doubts about the usefulness of the consultation processes. Who after all is to represent local government in these processes? Bodies such as the Municipal Association of Victoria must, of necessity, represent the broad spectrum of "winners" and "losers" from any changes in principles and methodology and are therefore compromised with regard to any contribution they might make.

Also, one must question the necessity for further consultation with local government about principles. We have just concluded a very detailed inquiry into these issues which are comprehensively documented in the Self Committee Report. It is very doubtful whether further consultation with local government is going to help very much in the circumstances.

This raises another issue in relation to the membership of the State Grants Commissions to which Dr Saunders also referred. For the most part the members have been drawn from local government itself, either from the administrative side or the elected side, or both. While this might seem to satisfy the perception that local government ought to be represented on the Grants Commissions, and the new legislation preserves this requirement, it is not clear that persons drawn from local government have the technical capabilities necessary to cope with the complex issues of fiscal equity. This perhaps accounts for some of the differences between the States in the methodologies used by the respective Grants Commissions, particularly the rule-of-thumb approaches that some have used in the past. What is really needed on the State Grants Commissions is persons with knowledge of or capacity for understanding fiscal equalisation principles and contributing to the development of improved techniques for measuring fiscal needs. An understanding of local government is a secondary consideration and the necessary knowledge can be acquired without too much difficulty.

On the question of rating levels that was raised by Mr Prowse, it is of some relevance that the range of rating levels in Victoria is from about 5.5 cents in the dollar to about 16.5 cents on a Net Annual Value (NAV) basis. The mode is about 11 cents NAV. This seems to suggest that there is significant scope to increase rate effort to at least the modal level for those municipalities on lower rates. Also there is no evidence of any great ratepayer dissatisfaction in areas with higher rates. The most populous municipality in Victoria provides the widest range of services with a rate level significantly below the modal level and it could be inferred from this that there is scope for increased rating effort by local government. This also raises questions of efficiency and cost-effectiveness which are currently being addressed in the restructure processes under way in Victoria.

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