University of New England

School of Economics

Why Does Australian Local Government Endure Chronic Financial Stress?

by

Brian Dollery, Lin Crase and Joel Byrnes

No. 2005-19

Working Paper Series in Economics

ISSN 1442 2980

http://www.une.edu.au/febl/EconStud/wps.htm

 ISBN 1 86389 969 3

Why Does Australian Local Government Endure Chronic Financial Stress?

Brian Dollery, Lin Crase and Joel Byrnes**

Abstract

Existing funding of local government systems in Australia has been falling relative to other tiers of government for the past thirty years with various adverse consequences, especially local government infrastructure decline. This paper seeks to explain this phenomenon by drawing on two theoretical strands in the political economy literature; the Australian theory of local government failure and the Wittman (1989; 1995) model of democratic efficiency. Three explanations are assessed: a traditional public finance perspective, Australian local government failure, and the institutional efficiency of democratic preference revelation. A secondary aim of the paper is to evaluate the consequences of the Wittman model for the local government failure paradigm.

Key Words: Comparative efficiency; federalism; finance; local government.

** Brian Dollery is Professor of Economics and Director of the UNE Centre for Local Government at the University of New England. Crase is Senior Lecturer in the School of Business at the Albury/Wodonga campus of La Trobe University. Joel Byrnes is a post-graduate student in the School of Economics at the University of New England.
Contact information: School of Economics, University of New England, Armidale, NSW 2351, Australia. Email: bdollery@une.edu.au.

1. INTRODUCTION

Together with its famous older cousin market failure, the phenomenon of government failure now forms an integral part of the lexicon of modern policy analysis. However, local government failure remains a largely neglected member of the same family, perhaps because this lower tier of government typically controls fewer resources than its more august counterparts and generally remains 'a creature of statute' of central or provincial government. Despite this neglect, an embryonic literature nevertheless does exist on local government failure in Australia. At the conceptual level, Dollery and Wallis (2001) have developed a generic taxonomy of local government failure suited to Australian institutional circumstances, which was later extended by Byrnes and Dollery (2002) and Dollery (2003). In empirical terms, Byrnes and Dollery (2002) also applied this typology to Australian local government with some explanatory success[1].

A notable feature of contemporary Australian local government is the ongoing financially straitened environment in which it operates. Two dimensions of the problem are particularly salient. In the first place, local government revenue as a proportion of national income has been falling relative to other tiers of Australian government for the past 30 years (Johnson 2003). For example, Access

[1] It has also been applied to South African local government, a system with an analogously narrow 'services to property' range of functions comparable to Australian local government, with promising results. See Buthelezi and Dollery (2004).

Economics (2004) has calculated that the share of the national tax take accruing to local government has declined from just over 6% in 1970-71 to 4.28% in 2003-04. Similarly, as a proportion of total Commonwealth tax revenue, the value of Commonwealth Financial Assistance Grants (FAGS) will have fallen from 1.18% in 1993-94 to just over 0.77% in 2007-08 on current Budget estimates (Spokes 2005). Moreover, available evidence indicates that both state and Commonwealth governments remain reluctant to increase the revenue of local government through inter-governmental grants, other transfer payments, or tax sharing arrangements. Indeed, the Commonwealth government's response to the Final Report of the Commonwealth House of Representatives Standing Committee on Economics, Finance and Public Administration (2003), entitled *Rates and Taxes: A Fair Share for Responsible Local Government,* largely rejected its recommendations for greater funding and invited local government to do more to resolve its own problems (Australian Government 2005).

Secondly, because of local government's lack of constitutional recognition, confirmed by the people in the 1988 federal referendum on the issue, property rates are still the only tax that can be levied by Australian councils. Furthermore, even this source of income is heavily regulated by state and territory governments, as perhaps best exemplified by the ongoing imposition of 'rate-pegging' in NSW. However, when state governments do permit latitude in striking a rate, councils typically shy away from using the opportunity to substantially increase revenue with large rate rises. In addition, organized local government generally cautions its members to impose only modest rate increases. For example, the recent South Australian local government inquiry into financial sustainability warned that 'ramping up rates revenue should be the last resort' (Financial Sustainability Review Board 2005, 5). It would thus appear that not only are higher tiers of government in Australia unwilling to provide more financial assistance to municipal councils, but that local government itself is hesitant to use its only taxing power to remedy its fiscal plight.

But why should this be the case? After all, representative organizations in the local government sector often point to the purported fact that local communities want more services from local councils and are concerned at the inability of these councils to deliver additional services. Indeed, organized local government in Australia seldom allows an opportunity to pass without reminding state and Commonwealth governments, and anyone else prepared to listen, that municipal systems across the country are under chronic financial stress. For instance, in an appeal typical of its kind, Councillor Paul Bell (2005, 1), President of the Australian Local Government Association (ALGA), called on local government 'to exert pressure on all state and federal governments for fair funding, fair treatment and formal recognition'. Moreover, 'we must press home the need for fair funding [and] we must build momentum for a new funding deal for local government' since 'we need access to growth funding that reflects the increasing costs and demands faced by councils'.

The primary objective of this paper is to consider this question by evaluating the embryonic Australian literature on local government failure in the light of the theory of political market efficiency advanced by Donald Wittman (1995) in his *Myth of Democratic Failure.* In essence, it is argued that Australian voters want to constrain local government funding and that political institutions in Australia have efficiently transformed these preferences into public policy at the federal, state and local government levels. A secondary aim of the paper is to ponder the implications of this argument for the theory of local government failure.

The paper itself is divided into five main sections. Section 2 briefly considers trends in Australian local government finance to establish the fact that its proportion of the national tax take has fallen compared with state and Commonwealth governments. Section 3 provides a synoptic discussion of the theory of local government failure, focusing on the Australian strand of this literature. Section 4 outlines Wittman's (1989; 1995) 'invisible hand' theory of efficient democratic markets and its central implications for Australian local government failure. Section 5 seeks to explain continuing financial austerity in terms of traditional public finance, the Australian theory of local government failure and the Wittman model. The paper ends with some brief concluding remarks in section 6.

2. AUSTRALIAN LOCAL GOVERNMENT FINANCE

Australian local government has four primary sources of revenue: Rates; user charges and fees; interest income, dividends, interest on grants and subsidies, and fines; and grants and subsidies from state and Commonwealth government. Crase and Dollery (2005, 21) have made the following observations regarding trends in local government sources of income since the mid-1970s: 'User-charges have shown the most rapid expansion (13% p.a.), followed by other revenue (11% p.a.), financial assistance grants (10.8% p.a.), municipal rates (9.4% p.a.) and revenue from the state government (6.6% p.a.)'.

Property taxes in the form of rates represent the sole taxation power of Australian local government and they accounted for almost 38% of total revenue in the fiscal year 2003-04 (ALGA 2005). However, unlike consumption taxes, corporate taxes, or personal income tax, municipal rates are calculated on land values have comparatively slow and discontinuous rates of growth. Constraints imposed by higher tiers of government, like rate pegging in NSW, also exacerbate this slow growth.

The second most significant source of revenue is fees and user charges, which have grown from 13% of total revenue in the 1970s to slightly in excess of 30% in 2003-04 (ALGA 2005). Crase and Dollery (2005) have shown that municipal fees and charges have been rising as a percentage of total income compared with other sources of revenue, including rates. They observed that ‘it is plausible that the expanded usage of charges as a revenue source is accounted for by the shortfall in grant income from the states and, to a lesser extent, income derived from municipal rates’. The recent South Australian local government inquiry appears to support this argument (Financial Sustainability Review Board 2005).

The third major source of revenue is ‘other sources of revenue’ that include interest income, dividends, interest on grants and subsidies and fines. In total, this income amounted to about 20% of local government revenue over the fiscal year 2003-04.

Finally, the fourth revenue stream is intergovernmental transfers, particularly in the form of FAGS from the Commonwealth government, which now comprise some 12% of total local government revenue. The primary reason for the fall in the proportion of local government revenue derived from FAGS resides in the fact that the real value of these grants is adjusted on the basis of the Consumer Price Index (CPI), which increases more slowly than Commonwealth government tax receipts and GST payments to the states. To some extent, the decline in income from aggregate grants and subsidies has been partly offset by the recent Commonwealth *Roads to Recovery (R2R)* program. However, the Department of Transport and Regional Services *2002-03 Local Government National Report* (2003) calculated that it had still not fully compensated for the fall in other intergovernmental transfers.

3. LOCAL GOVERNMENT FAILURE

Government failure can be generically defined as the inability of a public agency (or agencies) in a given tier of government in a federal system of multi-tiered government to achieve allocative and productive efficiency. Various taxonomies of government failure have been developed. Although the notion of government failure extends at least as far back as Adam Smith, possibly the earliest contemporary typology of government failure was developed by O'Dowd (1978) who argued that there are three types of government failure: 'inherent impossibilities', 'political failures' and 'bureaucratic failure'. By contrast, Dollery and Wallis (2001) developed a more recent taxonomy of government failure in which they identified three main forms of public sector failure: legislative failure, bureaucratic failure, and rent seeking. However, the most comprehensive modern typology consists of a fourfold classification advanced by Weisbrod (1978) that embraced legislative failure, administrative failure, judicial failure and enforcement failure. In his classic text *Markets or Governments* (1989), Charles Wolf also made a significant contribution to this taxonomic literature with his theory of 'non-market failure'.

In contrast to the substantial public choice literature on the problem of government failure in state and federal governments (Mueller 2003), comparatively little effort has been expended on government failure at the municipal level. Nevertheless, theorists have developed at least three taxonomic approaches to local government failure. British scholars Bailey (1999) and Boyne (1998) have both advanced typologies of local government failure premised on the belief the problem of government failure is less apparent at the local government level compared to state and central governments. By contrast, Dollery and Wallis (2001) have argued that the phenomenon of government failure is likely to be more widespread in local governance and have produced a fourfold taxonomic classification of local government failure based on this proposition.

Byrnes and Dollery (2002) extended this typology in the context of the Australian political milieu. They argued that government failure is more acute at the local level than in higher spheres of Australian government. Five main propositions underpinned their argument: 'voter apathy', 'asymmetric information and councillor capture', 'iron triangles', 'fiscal illusion', and 'political entrepreneurship'.

3.1 Voter Apathy

Public choice theory holds that, in general, voting by citizens in political elections is an irrational activity since the voting process itself is costly to the individual voter whereas the benefits associated with voting to that voter are negligible. After all, the act of voting involves various expenses in terms of both time and money while the vote of a single individual has virtually no effect on the outcome of elections (Aldrich 1997). Five reasons seem to contribute to higher voter apathy at the local level (Dollery and Wallis 2001). Firstly, in many local government systems, voters do not perceive periodic municipal elections as politically significant events because local governments activity is so severely constrained by state and national governments. Secondly, even where local government elections occur along political party lines, with the associated informational benefits for voters, many candidates do not have a party affiliation or party affiliations may in any event be much weaker than at higher levels of government. Thirdly, local government elections often receive inadequate scrutiny from the media. Fourthly, 'because of their lower public profiles and complicated interface, governance and management roles are often confused in the eyes of many citizens, who cannot readily distinguish between elected representatives and professional public servants, making it difficult to assign responsibility for previous policy outcomes' (Dollery and Wallis 2001, 57). Finally, it is comparatively difficult to establish accountability in local governance due to the influence of other tiers of government.

3.2 Asymmetric Information and Councillor Capture

This problem arises from the existence of principal-agent relationships between bureaucrats and politicians, and between politicians and voters. Dollery and Wallis (2001) identified four factors based on agency theory and economic theory of bureaucracy that may contribute to the emergence of an agency problem. Firstly 'since the hands-on nature of their jobs means managers are bound to be much better informed than councillors, it seems likely that by manipulating the asymmetry of information to their advantage, managers can capture councillors and thereby achieve the policy outcomes they desire' (Dollery and Wallis 2001, 61). Secondly, unlike state and central government politicians, local government representatives generally do not have access to political advisers, who may assist in filtering information received from professional managers. Thirdly, difficulties arise from 'agenda control' exercised by well-informed bureaucrats. Finally, selective behaviour can affect municipal outcomes. Wintrobe (1997, 251) described selective efficiency as a means by which ‘bureaucrats control their master’s choices by being efficient at the things they want to do, and inefficient at those they do not’.

3.3 Iron Triangles

Derived from the public choice theory of rent seeking, the theory of iron triangles refers to the formation of tripartite colluding associations (or ‘triangles’) that seek to influence the share of a council’s budget devoted to particular programs. Byrnes and Dollery (2002) identified three factors that suggest that the problem of ‘iron triangles’ will be felt more acutely at the local government level. In the first place, due to acute asymmetry of information at this level between managers and their typically part-time elected masters, as well as the tendency for local governments to rely upon standing committees to oversee their operations, interest groups can readily identify councillors with powers over certain municipal functions and form alliances with them. Secondly, since a relatively high percentage of tax revenues are fixed and do not vary much with the consumption of local public services, interest groups have an incentive to attempt the redistribution of service provision in their favour. Thirdly, owing to the horizontally fragmented nature of local governments, iron triangles might be expected to have a more significant impact on policy making, since small local governments will attract less media and voter scrutiny.

3.4 Fiscal Illusion

Fiscal illusion refers to the possibility that the costs and benefits of government may be consistently misconstrued by the citizenry of a given fiscal jurisdiction. Of the five generic forms of fiscal illusion that have been identified by economists, two may apply especially strongly to local government: the ‘fly-paper effect’ and ‘renter illusion’. The flypaper effect describes the hypothesized tendency for categorical lump-sum grants from federal to state and local governments to increase public expenditure by more than an equivalent increase in income from other sources. It would seem that voters misperceive intergovernmental grants as ‘gifts’ to their jurisdictions and overlook the fact that their tax liability rises correspondingly at a higher level of government. By contrast, renter illusion relies on the assumption that since the primary revenue of local government is derived from property taxes, only those who own property and are thus directly levied will correctly estimate the tax-price of local public goods. Because local government is heavily dependent upon rates, it is thus far more susceptible to this form of fiscal illusion.

3.5 Political Entrepreneurship

The argument here is that the inefficient use of resources by political entrepreneurs to capture the attention of voters may lead to systematic allocative inefficiencies in local government (Byrnes and Dollery 2002). Thus, 'councils can be conceived of as breeding grounds for political entrepreneurs to not only capture the attention of political party officials at higher levels of government, but also of prospective voters in federal and state seats' (Byrnes and Dollery 2002, 57). Three factors may explain the greater magnitude of political entrepreneurship at the local government level. Firstly, since local government is typically the lowest level of government in a federation, with a large number of elected representatives, the proportion of political entrepreneurship is likely to be higher at this level than any other tier. Secondly, due to the high degree of voter apathy and comparative lack of interest by the media in local government, an ambitious municipal politician may embark on expensive eye-catching projects to become known to voters. Finally, since national and provincial jurisdictions are typically larger in area and population than local government wards, political entrepreneurs may need to provide public goods that have a benefit region much larger than that of the local government area they represent.

4. CASE FOR LOCAL GOVERNMENT DEMOCRATIC EFFICIENCY

Following Caplan (2005, 2), the political economy literature on the comparative social efficiency of competitive markets and democratic polities may be classified into four major schools of thought. Table 1 illustrates this observation with leading exponents of these idealized positions employed as elucidatory examples.

Table 1: Markets and Democracy

	Democracy	
Markets	*Works*	*Fails*
Work	Wittman	Friedman
Fail	Galbraith	Lenin

Donald Wittman's (1989; 1995) theory of 'democratic market efficiency' can thus be contrasted with alternative perspectives on the comparative efficiency of economic markets and political markets. In particular, his model can be distinguished from the government failure paradigm since it holds that political markets are efficient in the sense that they maximize aggregate wealth through time in an analogous fashion to well-functioning markets.

Wittman's (1989; 1995) work derives from a long tradition in economic theorizing on politics that characterizes democratic institutions as a system of exchange relationships between voters, politicians, bureaucrats and interest groups each behaving in accordance with the simplifying *homo economicus* postulate

(Mueller 2003). Thus, individuals trade votes for benefits from the political process, politicians seek votes to win elections, bureaucrats desire budgets, and interest groups engage in rent-seeking. Both the Chicago school and public choice scholars have focused on the limitations of the politics as a socially efficient exchange mechanism, identifying numerous shortcomings in this welfare-reducing 'visible foot' process, and contrasted it unfavourably with the welfare-maximizing 'invisible' hand of markets. This line of inquiry has resulted in the emergence of the modern theory of government or non-market failure, including local government failure. In essence, stylized assumptions about political actors have formed the basis for this bleak view of the consequences of political exchange. For example, voters are presumed to be rationally ignorant, politicians possessed by short time horizons, political bargaining rendered difficult by high transactions costs, and so forth.

To a large extent, Wittman (1989; 1995) departs from this tradition by attacking its assumptions concerning political actors. For instance, he has observed that 'behind every model of government failure is an assumption of extreme voter stupidity, serious lack of competition, or exceptionally high negotiation/transfer costs', but caustically added that while 'economists are very suspicious of similar assumptions regarding economic markets', this 'scepticism should be carried over to models of government behaviour' (Wittman 1989, 1421).

Indeed, the approach adopted by Wittman turns these assumptions upside down by arguing that democratic markets have most of the qualities associated with efficient economic markets. For example, he contends that 'voters make informed judgements and democratic markets are competitive' (1995, 192). In general, voters therefore are rational and well informed, elections highly competitive processes, public bureaucracies relatively efficient in the provision of well-defined public goods, and political bargaining costs comparatively low. The implications of these presumptions are then applied to a wide range of political phenomena, including electoral market competition, legislative markets, bureaucratic markets, and the market for regulation. The result is an 'invisible-hand' theory of efficient democratic markets that maximize social welfare in aggregate[2].

Although Wittman does not directly address the problem of the efficiency of local government political markets and the associated potential for local government failure, it is nonetheless clear that his model undermines its foundations in much the same way as it does for higher levels of government. Consider the expanded taxonomy of Australian local government failure advanced by Byrnes and Dollery (2002). For example, from a Wittman perspective, voter apathy could quite easily be explained in much the same terms as these writers as

---

[2] Wittman is not without critics. Most attack either his economic reasoning or his neglect of empirical evidence (see, for example, Rowley (1997), Lott (1997), and Caplan (2005)).

the outcome of an informed view that because local government is so severely circumscribed by state government legislation and so carefully monitored by state government agencies, it is rational for voters to pay it relatively scant attention. After all, most Australian state and territory Departments of Local Government not only conduct annual performance appraisals of local government, but also maintain 'watch lists' of poorly performing councils on an 'at risk' basis. Furthermore, they employ an inspectorate that vigorously investigates allegations of malpractice. It can be argued that local government is already closely scrutinized and accordingly 'voter apathy' may thus represent a rational course of action, given current opportunity costs.

Much the same line of argument can be brought to bear on 'asymmetric information and councillor capture', 'iron triangles' and 'political entrepreneurship'. In other words, public suspicion surrounding the efficacy of the internal workings of municipal councils has been made manifest through the efficient absorption of public preferences by elected state government politicians and transformed into tight state government legislation and vigilant oversight mechanisms. Mistrust and wariness on the part of local government voters have thus successfully spawned state government institutions that play a 'watchdog' role over municipal affairs. An efficient political process has therefore engendered efficacious political institutions precisely because of public scepticism over the ability of local authorities to conduct their affairs effectively.

'Fiscal illusion' can also be explained using the Wittman model. In a federal system of government in an advanced economy, the three tiers of government deliver a vast array of public goods and services and finance these activities with a complex mix of various direct and indirect taxes, fees and charges, and intergovernmental transfers. It is thus not at all surprising that even informed and rational voters find it impossible to adequately gauge whether or not they receive 'value for money' from local government service provision. In the absence of this knowledge, and with full awareness that vigorous competition between political parties in a Westminster system ensures that state and Commonwealth government expenditure and revenue-raising programs are subject to more intense scrutiny than hundreds of fragmented local government entities, it is not unexpected that voters might want to place limits on the spending and funding behaviour of councils. This kind of argument can explain the close control exerted over local government finance in Australia. For instance, the fact that all state governments have regulated rate increases at some time, and rate pegging still continues in NSW, can be ascribed to the efficient transformation of voter preferences for this kind of supervision into political practice. Much the same can be said for the 1988 referendum result in which constitutional recognition of local government was resoundingly rejected. Voters simply did not want to grant greater powers to local government and thereby remove some of the state government financial constraints over local government. An analogous argument can account for the proliferation of hypothecated funding of specific local government activities, such as the Commonwealth *Roads to Recovery* program. Electors are satisfied when additional finances are tied to designated projects and monitored by public agencies representing higher tiers of government. However, general purpose grants permitting expenditure discretion on the part of councils might no enjoy public support.

5. EXPLANATIONS FOR LOCAL GOVERNMENT FINANCIAL CONSTRAINTS

We have shown that local government revenue growth is constrained relative to state and Commonwealth governments and, even when permitted to do so, local councils are reluctant to increase rates to remedy the situation. The primary objective of this paper is to attempt to answer the question of why this should be the case.

5.1 Public Finance Arguments

At least three plausible explanations can be identified. In the first place, the most obvious argument is to ascribe the ongoing financial austerity experienced by municipal councils to technical features of current financial arrangements in the Australian federal system. This represents a conventional public finance approach pursued in formal reports and inquiries into local government finance in Australia. For instance, in its report *A Fair Share*, the ALGA (2005) specifies the declining real value of FAGS relative to council costs over time as the fundamental source of fiscal stress in local government. It suggests that the solution resides in linking Commonwealth government revenue transfers to local government to a fixed percentage of Commonwealth taxation to provide municipalities with an adequate 'growth tax', or alternatively, the method of indexing FAGS could be adjusted to bring them into line with cost escalation in local government rather than simply the much more general CPI. Moreover, the ALGA has also called for more initiatives along the lines of the present *Roads to Recovery Program* to fund specific activities.

Another strand often pursued in this general line of argument revolves around the proposition that the only taxing power available to Australian local government is neither a fully fledged 'growth tax' nor can councils set property taxes without frequent state government regulation or at least heavy oversight. For instance, with respect to the ‘growth tax’ dimension of the argument, exponents of a ‘technical’ or public finance approach contend that although the Commonwealth government derives much of its own income from taxes based on revenue elastic sources that grow in proportion to national income, or even faster than Gross Domestic Product, such as consumption taxes, corporate tax and personal income tax, the same is not true of a land value tax like rates. Indeed, while in the very long run, the real value of rate income should approximate, or even exceed most common price indexes, as land values rise relative to other goods and services, administrative features of rating systems in Australia mean that rates typically lag behind property values because land values are only assessed at periodic intervals. Given that periods of rapid price increases typically characterize Australian real estate markets, this lag may translate into significant amounts of foregone rate income.

Furthermore, in addition to the problem of these time lags, public finance approach advocates point to state government interference in the process of striking a rate, which ranges from the extreme of rate-pegging in NSW to intermittent intervention by other state governments, such as the freeze on rate increases in Victoria in the immediate aftermath of the structural reform program in the 1990s. Since intervention of this kind always limits the extent of rate rises, it serves to artificially constrain local government income, sometimes by a substantial amount.

A related argument marshalled by advocates of the technical school focuses on rate exemptions often enjoyed by state governments, churches, educational institutions, and similar organizations. In general, these exemptions stem from state government legislation rather than local council generosity and thus amount to a further impost on the capacity of local government to finance its activities through rate collection.[3]

The conventional public finance approach also typically emphasizes cost pressures on local government generated by other tiers of government in the Australian federation. In essence, this argument is based on 'cost shifting', where state and Commonwealth governments oblige councils to extend, improve, create, or take over functions without adequate (or sometimes even any) financial compensation. The Hawker Report and other recent documents have highlighted the importance of this problem. A variant of this argument emphasizes the hidden and rising costs associated with compliance to an escalating avalanche of state and territory government regulation and reporting requirements.

[3] It has been argued that the growth of local government fees and charges relative to council rates demonstrates that Australian local government is seeking to overcome constraints on rates as a source of income by shifting at least some of its 'tax effort' into user charges, fines, etc. See, for instance, Crase and Dollery (2005).

The Financial Sustainability Review Board (2005) Report entitled *Rising to the Challenge* adds three further arrows to the bow of the conventional public finance perspective on fiscal stress in Australian local government. Firstly, fiscal austerity can be attributed to 'past policies responsible for service levels and standards in excess of those which could be sustainably funded by councils themselves' (p.2). In Chapter 11, the authors of the Report contend that, at least in South Australian local government, councils fail to define service standards properly, do not review these standards, and suffer rising per capita service costs as a consequence. Secondly, 'deficiencies in asset management practices and associated depreciation and asset valuation policies' (p.2) play an important contributing role to financial stress. Indeed, the Financial Sustainability Review Board (2005, 91) found that 'the primary area of contention seems more about actually identifying the condition of a council's infrastructure assets, and how they need to be maintained and renewed in a manner that enables them to meet the legitimate needs of the community'. Finally, the Board argued that a widespread 'reluctance to borrow' to fund infrastructure worsened the financial plight of South Australian local authorities.

5.2 Australian Local Government Failure Arguments

A second explanation for the ongoing financial austerity experienced by Australian local government can be sculpted from the existing embryonic literature on Australian local government failure. If government failure is indeed both more pervasive and more acute in local government than at the state and Commonwealth government levels, as writers such as Dollery and Wallis (2001), Byrnes and Dollery (2002) and Dollery (2003) contend, and this failure is recognized by policymakers in these other tiers of government, then it is not surprising if these policymakers and their political masters display an increasing reluctance to fund local government as this realization dawns. After all, factors like 'voter apathy', 'asymmetric information and councillor capture', 'iron triangles', 'fiscal illusion' and 'political entrepreneurship' are hardly likely to inspire confidence that monies provided to councils will be effectively expended. Moreover, this kind of explanation can account for the increasing reliance on direct hypothecated funding along the lines of the *Roads to Recovery Program*, which not only earmarks grants to specific projects, and is thus amenable to close scrutiny, but also does not contain any 'automatic' recurrent funding in the same way as FAGS.

As we observed earlier, an explanation based on local government failure derives from the conventional government failure paradigm in contemporary policy analysis. A key premise underlying this school of thought stresses the comparative disadvantages of government agencies relative to market mechanisms as methods for efficiently allocating scarce resources between alternative ends. The theory of local government failure simply extends this argument to government institutions by maintaining that state and central governments hold a comparative advantage over municipal government in the effective delivery of public services and the prudent use of the public purse.

5.3 Democratic Efficiency Arguments

A third explanation for the chronic under-funding of Australian local government can be adduced from the Wittman (1989; 1995) model of democratic efficiency. It has been argued that while this theory of political market efficiency shares the assumptions as the Australian theory of local government failure, including 'voter apathy', 'asymmetric information and councillor capture', 'iron triangles', 'fiscal illusion' and 'political entrepreneurship', it inverts their significance for the efficient operation of Australian democracy. Thus, instead of stigmatizing Australian government as comparatively inefficient because of these characteristics, this view holds that the political system as a whole will respond efficaciously to electoral pressure by developing institutional mechanisms to cope with these features of municipal governance. For instance, following this logic 'watchdog' institutions will form an agency relationship with local government voters to demystify fiscal illusion by monitoring council revenue and expenditure decisions on behalf of voters. Since effective monitoring of this kind requires specialist knowledge and resources, the law of comparative advantage prescribes that aggregate welfare will be higher if this task is undertaken by a few dedicated organizations rather than many citizens. It is thus rational for voters to entrust these kinds of organizations with this mission.

In other words, well-informed median voters induce higher tiers of government in the Australian federation to create agencies to scrutinize local government systems precisely because these voters are aware of the limitations of the local government political process. The effective operation of monitoring agencies serves to reduce the transaction and other costs associated with ensuring that local government uses scarce resources efficiently and thus represents a welfare enhancing policy response to the desires of informed electors.

This public choice line of argument can account for the endogenous nature of existing institutional arrangements that oversee local government funding in Australia, such as the Commonwealth Grants Commission, the state and territory local government grants commissions, the federal National Office of Local Government, the various state Departments of Local Government, and associated agencies, taken as given by the public finance approach. Moreover, it can also explain why the absolute volume of funding received by Australian local government restrains it to a continuing state of financial austerity. The argument here relies on the assumption that the individual preferences of informed median voters are efficiently translated into public policies[4]. Since public policy by state and Commonwealth governments for the past thirty years has severely constrained local government funding, in terms of the efficient political markets perspective, this implies that median voters desire this state of affairs. Similarly, the unwillingness of particular councils to increase rates when they are allowed the flexibility, suggests that the same process occurs in municipal political markets. In sum, Australian local government is chronically poor because median voters want it to be chronically poor!

6. CONCLUDING COMMENTS

The major aim of this paper is to explain the continuing financial stress experienced by Australian local government by invoking *inter alia* the theory of political market efficiency advanced by Wittman (1989; 1995). This process has spawned three contending explanations for the phenomenon of financial austerity in Australian local government: Traditional public finance arguments that emphasize institutional arrangements for funding local government; the Australian

[4] This kind of argument is reminiscent of Armen Alchian and Harold Demsetz' (1972) dictum that 'what is, is efficient'. Like much economic and political science reasoning, it is obviously not in the classical Popperian mould of conjecture and refutation and development through a process of hypothesis falsification.

literature on local government failure that focuses on the perceived inadequacy of municipal councils and their comparative disadvantages relative to other levels of government; and Wittman's theory of democratic inefficiency that relies on the efficient transformation of individual preferences into public policy funding decisions.

The public finance argument seems to satisfactorily explain the mechanics of how local government continues to experience financial stringency and inadequate funding. But this account begs the question of why these arrangements persist through time despite clear evidence of the problems that inadequate funding have wrought, especially in under-investment in vital local infrastructure. In other words, it cannot explain why higher tiers of government have allowed the funding problem to persist and even intensify.

Secondly, while the Australian model of local government failure can account for the reluctance of state and Commonwealth governments to provide sufficient finance to local government on grounds of its comparative disadvantages in spending these funds in a socially optimal manner, it seems to lack a convincing justification for why the existing flow of monies continues, albeit at an inadequate rate. After all, if local government is a 'statutory creature' of state legislation, and policymakers can thus accordingly modify the role of local government, or even abolish this tier of government, then why are substantial funds still channelled to municipal councils through the grants process? However, two caveats appear to mute this line of criticism. Firstly, it must be added that increased reliance on direct hypothecated grants that can be readily terminated does seem to indicate a change in approach to accommodate perceptions of local government failure. Secondly, reform measures, like heightened performance monitoring by state and territory governments through the publication and evaluation of key performance indicators, etc., and structural change, could be argued to represent an effort by policy makers to address local government failure.

Thirdly, the efficient political market model can explain both the existing mix of oversight and funding institutions that control the financial circumstances of Australian local government as well as its chronic financial stress. Unlike the public finance approach that takes the existing institutional milieu as exogenously given, the Wittman model sees it as an efficient organizational method of minimizing the transaction and other costs involved in monitoring local government behaviour. In addition, the financially straitened municipal environment represents the effective translation of median voter preferences into political reality. Voters thus do not want to fund local government any more than at present.

Finally, a subsidiary aim of the paper is to consider the implications of the Wittman model for the modest extant literature on the theory of local government failure in Australia. It has been argued that both these theoretical perspectives share common assumptions regarding local government in the form of the extended taxonomy developed by Byrnes and Dollery (2002), but draw diametrically opposite conclusions. In contrast to the Australian local government failure paradigm, which sees councils as endemically under-funded because they are inefficient, the efficient political market theory holds that voters are not prepared to pay for more local government expenditure. How can this impasse be resolved? It would seem that empirical resolution of the issue is possible, at least in principle, by determining what voter preferences really are.

REFERENCES

Access Economics. 2004. *Commonwealth-State Funding: An Assessment of Reform Proposals.* Canberra: Commonwealth Government.

Alchian, A. and H. Demsetz. 1972. 'Production, Information and Economic Organization.' *American Economic Review* 62(5): 777-795.

Aldrich, J.H. 1997. 'When Is It Rational to Vote?' In *Perspectives on Public Choice,* ed. D.C. Mueller. Cambridge: Cambridge University Press, 137-152.

Australian Government. 2005. *Government Response to the Report of the House of Representatives Standing Committee on Economics, Finance and Public Administration.* Canberra: Commonwealth of Australia.

ALGA [Australian Local Government Association]. 2005. *Federal Budget 2005-06: Towards a Fair Share*. Canberra: ALGA.

Bailey, S.J. 1999. *Local Government Economics.* Basingstoke: Macmillian.

Bell, P. 2005. 'President's Message'. *ALGA News,* 7 October, 1.

Boyne, G.A. 1998. *Public Choice Theory and Local Government*. Basingstoke: Macmillan.

Buthelezi, A. and Dollery, B.E. 2004. 'An Exploratory Analysis of Local Government Failure in South Africa.' *Studies in Economics and Econometrics* 28(2): 91-105.

Byrnes, J. and Dollery, B.E. 2002. 'Local Government Failure in Australia: An Empirical Analysis of New South Wales.' *Australian Journal of Public Administration* 61(3): 54-64.

Caplan, B. 2005. 'From Friedman to Wittman: The Transformation of Chicago Political Economy.' *Econ Journal Watch* 2(1): 1-21.

Crase, L. and Dollery, B.E. 2005. 'A Critical Note on Local Government Charges in Australia: Have We Lost Sight of How to Fund Public and Merit Goods?' Unpublished paper presented to the *34nd Conference of Economists,* University of Melbourne, 28 September, 2005.

Department of Transport and Regional Services. 2003. *2002-03 Local Government National Report.* Canberra: Commonwealth of Australia.

Dollery, B.E. 2003. 'Local Government Failure.' In *Reshaping Australian Local Government: Finance, Governance and Reform,* eds B.E. Dollery, N.A. Marshall and A.C. Worthington. Sydney: University of New South Wales Press, 212-228.

Dollery, B.E. and Wallis, J.L. 2001. *The Political Economy of Local Government: Leadership Reform and Market Failure.* Cheltenham: Edward Elgar.

Financial Sustainability Review Board. 2005. *Rising to the Challenge.* Adelaide: South Australian Local Government Association.

House of Representatives Standing Committee on Economics, Finance and Public Administration. 2003. *Rates and Taxes: A Fair Share for Responsible Local Government (Hawker Report).* Canberra: Commonwealth of Australia.

Johnson, A. 2003. 'Financing local government in Australia.' In *Reshaping Australian Local Government: Finance, Governance and Reform*, eds B.E. Dollery, N.A. Marshall and A.C. Worthington. Sydney: University of New South Wales Press, 37-63.

Lott, J. 1997. 'Donald Wittman's *Myth of Democratic Failure.*' *Public Choice* 92(1/2): 1-13.

Mueller, D.C. 2003. *Public Choice III*. Cambridge: Cambridge University Press.

O'Dowd, M.C. 1978. 'The Problem of Government Failure in Mixed Economies.' *South African Journal of Economics* 46 (3): 360-370.

Rowley, C.K. 1997. 'Donald Wittman's *Myth of Democratic Failure.' Public Choice* 92(1/2): 15-26.

Spokes, D. 2005. 'Financial Sustainability of Local Government.' Unpublished paper presented to the *Trans-Tasman Roundtable on Local Government Finance,* University of Technology, Sydney, 30 September, 2005.

Weisbrod, B. 1978. 'Problems of Enhancing in the Public Interest: Towards a Model of Government Failures.' In *Public Interest Law,* eds. B. A. Weisbrod, J. F. Handler and N. K. Komesar. London: University of California Press, 30-41.

Wintrobe, R. 1997. 'Modern Bureaucratic Theory.' In *Perspectives on Public Choice*, ed. D.C. Mueller. Cambridge: Cambridge University Press, 429-454.

Wittman, D. 1989. 'Why Democracies Produce Efficient Results.' *Journal of Political Economy* 97(6): 1395-1424.

Wittman, D. 1995. *The Myth of Democratic Failure: Why Political Institutions Are Efficient.* Chicago: University of Chicago Press.

Wolf, C. 1989. *Markets or Governments.* New York: MIT Press.