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Local Government Failure: Why Does Australian Local Government Experience Permanent Financial Austerity?

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Funding of local government systems in Australia has been falling relative to other tiers of government for the past 30 years with various adverse consequences, especially the decline of local government infrastructure. This paper seeks to explain this phenomenon by drawing on two relatively new theoretical strands in the political economy literature; the Australian theory of local government failure and the Wittman 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 implications of the Wittman model for the local government failure paradigm.

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

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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 tailored to suite 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 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 intergovernmental 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*, made no offer of additional funding and invited local government to do more to resolve its own problems (Australian Government 2005).

Secondly, property rates are still the only tax that can be levied by Australian councils. Furthermore, even this source of income is sometimes regulated by State and Territory governments, as perhaps best exemplified by the ongoing imposition of 'rate pegging' in NSW. However, where 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, for the most part as a result of local political pressures. Moreover, the recent independent 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 organisations 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, organised 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

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

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. The next section 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. The third section provides a synoptic discussion of the theory of local government failure, focusing on the Australian strand of this literature. The fourth section outlines Wittman's (1989, 1995) 'invisible-hand' theory of efficient democratic markets and its central implications for Australian local government failure. The fifth section 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.

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 2003–04 fiscal year (ALGA 2005). The key factor in assessing rates as a source of revenue is that they are calculated as a 'rate-in-the-dollar' applied to property values. Consequent upon the recent property boom, property values have increased considerably, but local government has not generally taken full advantage of the associated potential for increasing rate revenue, for reasons that this paper will explore. By contrast, State governments have used rising property values to increase income through land taxes and stamp duties. It can thus be argued that rates could have been a 'growth tax' for local government in the same way as consumption taxes, corporate taxes, land taxes, stamp duties, and personal income tax have become growing sources of funds to the Commonwealth and State governments.

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, 5) 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 observe 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 2003–04 fiscal year (Crase and Dollery 2005).

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. FAGS deriving from the Australian government are paid through the States in the form of either general-purpose grants or local road grants and amounted to a total of $1501 m over the 2003–04 fiscal year (DOTARS 2005). As a proportion of aggregate local government income, FAGS have been falling (Crase and Dollery 2005). The primary reason for this fall is 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. In addition, local government costs rise faster than the CPI, largely because they involve labour-intensive services closely linked to wage increases. 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 (DOTARS) *2003–04 Local Government National Report* (2005) calculated that it had still not fully compensated for the fall in other intergovernmental transfers.

Local Government Failure

Government failure can be defined as the inability of a public agency (or agencies) in a given tier of government in a multi-tiered system of government to achieve its intended economic efficiency and equity objectives. Various taxonomies of government failure have been developed in order to understand the phenomenon. Although the idea of government failure extends at least as far back as Adam Smith, an early current typology of government failure was constructed by Michael O’Dowd (1978) that embraced three generic types of government failure: ‘inherent impossibilities’, ‘political failures’ and ‘bureaucratic failure’. More recently, Dollery and Wallis (2001) developed a taxonomic breakdown of government failure containing three main categories: legislative failure, bureaucratic failure, and rent-seeking. However, Burton Weisbrod (1978) has composed perhaps the most complete contemporary typology containing a fourfold classification comprising administrative failure, enforcement failure, judicial failure and legislative failure. In his pioneering text *Markets or Governments* (1989), Charles Wolf also made a significant contribution to this taxonomic literature with his theory of ‘non-market failure’.[2]

In contrast to the substantial public choice literature on the problem of government failure at the State and federal spheres of government (Mueller 2003), comparatively little effort has been expended on government failure at the municipal level.

[2]The discussion in this section of the paper draws on Dollery and Wallis (2001) and Dollery (2003).

Nevertheless, theorists have developed at least three taxonomic approaches to local government failure. Bailey (1999) and Boyne (1998) have both advanced typologies of local government failure drawn from the British experience and premised on the belief that the problem of government failure is less apparent at the local government level relative to State and central governments. In stark contrast to these scholars, Dollery and Wallis (2001) have argued that the phenomenon of government failure is likely to be more widespread in local governance. They produced a fourfold taxonomic classification of local government failure based on this proposition.

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

Voter Apathy

A central proposition of public choice theory holds that, in general, electoral voting represents an irrational act since the voting process itself is costly to the individual voter whereas the benefits to the voter derived from voting are negligible. It is argued that 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 involving large numbers of voters (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 view municipal elections as politically significant events because local government activity is controlled largely by State and national governments. Secondly, even where political parties contest local government elections, with the attendant informational benefits for voters, many candidates are not affiliated to political parties. Moreover, where party affiliation exists, it is often much weaker than in higher spheres of government. Thirdly, local government elections often receive inadequate attention from national and State media, especially in metropolitan areas, although local media scrutiny in provincial areas may be intense. 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 owing to the strong influence of higher tiers of government.

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) have 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 can assist in assessing 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) defines selective efficiency as a technique 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'.

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) identify three factors that suggest that the problem of 'iron triangles' will be felt more acutely at the local government level. In the first place, owing to acute asymmetry of information at this level between managers and their typically part-time elected masters, as well as a possible tendency for local governments to rely upon standing committees to oversee their operations, interest groups might be able to easily 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. 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.

Fiscal Illusion

Fiscal illusion refers to the prospect 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 fly-paper effect describes the hypothesised 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 a major revenue source for 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 often reliant on rates to a substantial degree, it may thus be more susceptible to this form of fiscal illusion.

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). If political entrepreneurship is indeed significant in local government, then three factors could 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 absolute number of political entrepreneurs is likely to be higher at this level than any other tier. Secondly, due to a potentially high degree of voter apathy and comparative lack of interest by the media in local government, especially in metropolitan settings, an ambitious municipal politician could 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 to capture public attention.

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 idealised positions employed as elucidatory examples.

Table 1 represents a highly stylised heuristic method of differentiating between four possible schools of thought on the relative efficacy of 'markets' (as exchange processes) and 'governments' (as hierarchies) as methods of organising economic and social activity. As perhaps best exemplified by the work of Milton Friedman, the Chicago School sees markets as relatively efficient allocative institutions compared with public agencies and political processes. By contrast, the socialist tradition, represented by Lenin in Table 1, sees market activity as not only economically wasteful but also inevitably inequitable, with public ownership and control of resources a superior method of social decision making. Moreover, this view on markets is echoed in Leninist perception that a single dictatorial proletarian party is preferable to competing political parties in the political arena. The Keynesian approach, epitomised by the views of American economist Kenneth Galbraith, sees markets as inherently unstable and in constant need of the 'visible hand' of government intervention to prevent periodic depressions.

Donald Wittman's (1989, 1995) theory of 'democratic market efficiency' can thus be contrasted with these three alternative perspectives on the comparative efficiency of economic markets and political markets. In particular, his model can be

Table 1. Markets and democracy

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

distinguished from the government failure paradigm since it holds that political markets are efficient in the sense that they maximise aggregate wealth through time in an analogous fashion to well-functioning markets.

Wittman's (1989, 1995) work derives from a long tradition in economic theorising on politics that characterises 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 have contrasted it unfavourably with the welfare-maximising '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, stylised 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, and political bargaining rendered difficult by high transactions costs.

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 adds caustically 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 judgments 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 maximise social welfare in aggregate.[3]

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 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

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

voters to pay it relatively scant attention. After all, all Australian State and Territory Departments of Local Government not only collect comparative material on local councils, but also publish this and other information on local government. In NSW, the largest local government system in the country, the Department of Local Government also maintains a 'watch list' of poorly performing councils on an 'at risk' basis. Furthermore, the Department employs an inspectorate that vigorously investigates allegations of malpractice. It can be argued that local government is thus already closely scrutinised by State government agencies and 'voter apathy' may therefore 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, it can be hypothesised that 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, especially in the case of NSW. Mistrust and wariness on the part of local government voters may thus have successfully spawned State government institutions that play a 'watchdog' role over municipal affairs. An efficient political process could therefore have 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. It is hypothesised here that 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 may thus not be at all surprising that even informed and rational voters may find it difficult to gauge adequately whether or not they receive 'value for money' from local government service provision. In the absence of this knowledge, and with possible awareness that vigorous competition between political parties in a Westminster system can ensure that State and Commonwealth government expenditure and revenue-raising programs may be subject to more intense scrutiny than hundreds of fragmented local government entities, it can plausibly be argued that voters might want to place limits on the spending and funding behaviour of councils.

If it is accepted, 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 form of supervision into political practice. Although many alternative explanations have been advanced to account for the 'No' result, much the same can be said for the 1988 referendum result in which constitutional recognition of local government was resoundingly rejected. It can be argued that 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 could account for the rise in the proportion of tied grant funding of specific local government activities, such as the Commonwealth 'Roads to Recovery' program, although it must be stressed that untied grants still easily exceed the proportion of tied grants. Electors may be satisfied when additional finances are tied to designated projects and monitored by public agencies representing higher tiers of government.

By contrast, general-purpose grants permitting expenditure discretion on the part of councils may enjoy less public support.

Explanations for Local Government Financial Constraints

We have sought to show that local government revenue growth is constrained relative to State and Commonwealth governments and, even when permitted to do so, local councils seem 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. Three general lines of argument can be identified, as described in the following subsections.

Public Finance Arguments

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 not a fully fledged 'growth tax' and 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 through the 'rate-in-the-dollar' relationship to property values, administrative features of rating systems in Australia mean that rates typically lag behind property values because land values are assessed only at periodic intervals. Given that periods of rapid price increases typically characterise Australian real estate markets, this lag may translate into significant amounts of forgone rate income. However, a caveat must be added to this argument: it is likely that the effects on council revenue of administrative time lags may be less than the impact of the reluctance of councils to exploit opportunities offered by the 'rate-in-the-dollar' system to increase rates.

Furthermore, in addition to the problem of these time lags, advocates of the public finance approach 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 constrain local government income artificially, 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 organisations. 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.[4]

The conventional public finance approach also typically emphasises 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 emphasises the hidden and rising costs associated with compliance with an escalating avalanche of State and Territory government regulation and reporting requirements.

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.

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

[4]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).

levels, as writers such as Dollery and Wallis (2001), Byrnes and Dollery (2002) and Dollery (2003) contend, and this failure is recognised by policy makers in these other tiers of government, then it is not surprising if these policy makers and their political masters display an increasing reluctance to fund local government as this realisation dawns. After all, if they have empirical validity—suggested by the empirical work of Byrnes and Dollery (2002)—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 expended effectively. Moreover, this kind of explanation can account for the increasing reliance on direct tied 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 above, 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]

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 same 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 stigmatising 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 organisations rather than many citizens. It is thus rational for voters to entrust these kinds of organisations with this mission.

In other words, well-informed median voters may induce higher tiers of government in the Australian federation to create agencies to scrutinise local government systems precisely because these voters are aware of the limitations of the local

[5]For this argument to hold, empirical support must be found for the contention that higher tiers of government enjoy an efficiency advantage in the provision of *local* services. At present no such published evidence exists in Australia. This argument therefore remains conjectural.

government political process. The effective operation of monitoring agencies may serve 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 may be able to 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.[6] Since public policy by State and Commonwealth governments for the past 30 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![7]

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 emphasise institutional arrangements for funding local government; the Australian 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. Although these three competing conceptual arguments present potentially plausible explanations for local government austerity in Australia, it must be stressed that much more empirical work is necessary to buttress conjectural arguments of this kind and enable us to definitely discriminate between them on the basis of evidence.

The public finance argument seems to satisfactorily explain the mechanics of how local government continues to experience financial stringency and inadequate

[6]This kind of argument is reminiscent of Armen Alchian and Harold Demsetz's (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.

[7]An anonymous referee has pointed out that this argument is weakened by the fact that grants and other income accruing to local government from higher tiers of government represent only a relatively small proportion of local government total funding. Moreover, the referee noted that it is possible that voters want all levels of government in Australia to be relatively 'poor' and not only local government. But because local government suffers from a combination of a highly visible tax and the greatest measure of policy and oversight influence by higher tiers—and competes with State governments for an overall share of property taxes—its financial constraints are most obvious to voters.

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 policy makers can thus modify the role of local government accordingly, 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 organisational method of minimising 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. But, as we noted above, this represents only one of many empirical issues that require urgent attention.

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