Putting a Cap on Community:

The Economic and Social Consequences of Victoria's Local Government Rate Caps Policy

By Dan Nahum

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Contents

Summary

Especially in times of crisis, governments have a responsibility to maintain and expand their provision of essential services and protections – for both economic and social reasons. This responsibility has never been clearer than during the ongoing COVID-19 pandemic. Australians in all states count on their governments, at all levels, to play a leading role in rebuilding a stronger, healthy society in the aftermath of this unprecedented catastrophe.

In Victoria, about 50,000 local government employees work in a wide range of different services and occupations, and their work is essential to the wellbeing of the communities they serve. Local government workers' wages strengthen the financial situations of businesses and governments, through the taxes they pay and the consumer spending they undertake. Policies which restrict local governments' ability to raise revenues and invest them in local services have negative effects on broader economic activity, and hence on revenue flowing back into government budgets.

Rates on property are the largest single source of revenue to local governments in Victoria. Of total Victorian local government revenue in 2019-20 ($11.7 billion), rates accounted for $5.6 billion or almost half.

Since 2016-17, the Victorian state government has capped the amounts local governments can collect from their ratepayers. There are numerous arguments against this policy. It is pro- rather than counter-cyclic: it becomes more restrictive rather than less when the overall economy slows (since the inflation indices to which the rate cap is tied tend to slow when the economy is weak). The rate caps also embed a dynamic of self-fulfilling fiscal restraint and austerity, applying the brakes to recovery and growth. It is a one-size-fits-all, blunt instrument, which paid no heed to the budgetary positions of individual councils when it was introduced; and it has compounded any revenue shortfalls since. It accentuates risk and uncertainty for local government workers; since councils have lost control of their rates revenue, their ability to budget for longer-term enterprise agreements has been compromised. Councils have reacted by hiring workers on a casual basis or through labour hire firms, to the detriment of job quality and stability. Less than half of Victorian local government workers enjoy permanent, full-time employment.

Furthermore, the rate cap redistributes the cost of local government services from property owners towards other residents, through revenue sources (like user fees) which are unrelated to an individual or household's capacity to pay. Finally, the rate

cap is anti-democratic: it takes decision-making about budgets and service levels that should rest with local governments and voters, and passes it to a different level of government.

The argument that services will be improved if local governments are 'fiscally disciplined' by the state government is not only counterintuitive but also refuted by empirical data. The historical evidence indicates that major shortfalls in service delivery were experienced when rate caps were previously imposed in Victoria in the 1990s. And this time around, the rate caps are having similarly negative effects: with visible reductions in service provision, and smaller and rural councils reporting financial distress.

Far from 'protecting' ratepayers (that is, residents), rate caps hurt them, in several different ways: through compromised service delivery, through lower levels of employment and/or wages amongst residents employed in the local government sector, through higher fees collected through other revenue tools (such as user fees), and through lower expenditures flowing back into the private sector. We calculate that **the rate caps have reduced employment in Victoria (counting both direct local government jobs, and indirect private sector positions) by up to 7425 jobs in 2021-22.** They have also **reduced GDP by up to $890 million in 2021-22.** The costs of suppressed local government revenues, and corresponding austerity in the delivery of local government services, will continue to grow with each passing year if the policy is maintained.

Victoria's rate cap policy has inhibited a normal trend of expanding and improving local government services in line with population growth, rising living standards, and economic expansion. For economic, social, and democratic reasons, therefore, we recommend the abolition of the Victorian rate cap policy. Instead, local governments should be empowered once again to establish their own rates in accord with the democratically-expressed preferences of their residents.

Introduction: The Value of Local Government Jobs

Local governments, and the services they provide, are important economic and social enablers. They provide essential services for public safety, economic efficiency, and community cohesion. Local governments provide services such as road planning and maintenance, home and aged care, waste disposal, libraries, childcare, school crossing supervision, maternal and child health, the State Emergency Service, and environmental management. As we rebuild after the COVID-19 pandemic, a resilient, capable, dedicated and respected local government workforce will continue to be a critical asset in Australia's economic and social recovery.

Despite Victorians' clear reliance on public service delivery, the state government has capped local government rates collections since 2016-17. Growth in average local government rates is limited by an amount determined by Victoria's Local Government Minister, on the basis of advice from the state's Essential Services Commission. Usually that recommendation reflects the Commission's forecast level of consumer price inflation, but it can be adjusted on the basis of various factors.[1] Arbitrarily restricting public service delivery and public sector employment, just at the time Victoria needs more public services (not less), is a major policy mistake. And at the everyday, grassroots level in Victorian communities, problems have begun to emerge with reductions in service provision, and smaller and rural councils reporting financial distress (Dollery, 2021).

The people employed to deliver local government services in Victoria provide numerous vital economic and social functions. They produce essential services. They contribute directly to output and incomes, and their subsequent tax payments and consumer spending strengthen the financial situations of businesses and governments alike. Income tax and GST are just two of the channels through which the incomes of local government workers, along with the incomes of the businesses and jobs they support through their spending, reappear on governments' own accounts. Restricting

[1] For 2021-22 the recommended cap of 1.5% reflects the average CPI growth experienced over the previous five years. The Commission recommended this approach given the high level of uncertainty regarding forecast inflation given the dramatic impacts of the COVID-19 crisis (see Essential Services Commission, 2020a).

local government outlays therefore has a perverse effect in restricting revenue flows back into the Victorian government's own budget.

Regional Victoria depends particularly on the public sector workforce. In smaller towns and communities, local government is a crucial source of decent, socially valuable jobs, performed by well-qualified people, earning (and spending) decent incomes in their communities. Local government employment – and the wages paid to local government workers – thus translates into vital income and spending power in local regions and businesses.

Given the stimulatory effect of local government expenditure, it is therefore puzzling and concerning that the Victorian state government continues to impose restrictive and arbitrary caps on the overall rates revenue of local governments in Victoria. This seems especially perverse given that the Victorian government doesn't itself save any money through the imposition of the policy. Furthermore, the rate caps are imposed in aggregate across each local government area, and hence do not even ensure that any given ratepayer will have their rates held to the same growth rate as implied by the cap. The rates paid by individual ratepayers instead depend on the valuation of their property relative to property price valuations across their respective local government area. So the system provides no certainty to individual ratepayers regarding the increase they can expect in their own specific rate payments.

Rates are the largest single source of revenue to local governments in Victoria. Of total Victorian local government revenue in 2019-20 ($11.7 billion), rates accounted for $5.6 billion (or almost half). Imposition of the rate cap amounts to a 'fiscal straitjacket', impinging on the ability of local governments to employ workers and deliver needed services. It is economically and socially counterproductive for governments to impose measures that arbitrarily restrict the scope of the services that government delivers, its breadth of capability, and its performance. Various forms of austerity have been imposed by various governments in Australia over the last generation, including the imposition of staffing caps, wage caps, or caps on overall costs, always based on the simplistic assumption that smaller government and/or smaller deficits will translate into improved economic performance.[2] While the local government rate caps are different in form, at a macroeconomic and social level they perform a similar function: embedding a dynamic of self-fulfilling fiscal restraint, even austerity, and applying the brakes to recovery and growth.

[2] For more detail and critique of these policies, see Nahum, 2020; Henderson & Stanford, 2019; Henderson, 2018; Henderson & Stanford, 2017.

And the argument that services will somehow be improved and delivered more efficiently if local governments are 'fiscally disciplined' by the state government lacks credibility. It is contradicted by empirical evidence of shortfalls in service delivery when rate caps were previously imposed in Victoria in the 1990s (for a review, see Dollery, 2021; we will also elaborate on this evidence below). So there is clear evidence that residents lose in several different ways: through compromised service delivery, through lower levels of employment and/or wages amongst residents employed in the local government sector, through higher costs for other forms of local government revenue (like user fees), and through reduced economic activity in the private sector (as a result of reduced business sales to local councils, and reduced consumer spending by local government workers).

Initially, Australia's relatively successful effort in restraining spread of COVID-19 underpinned relatively resilient economic and employment conditions as the pandemic unfolded. But that enviable situation did not last: failures to implement an effective quarantine strategy and quickly roll-out vaccines have left Australia vulnerable to renewed waves of COVID-19 contagion (including the more dangerous new variants). At time of writing, much of the country's population and economy (including much of Victoria) were just emerging from another period of lockdowns, which imposed a painful burden on Australian households, communities, and jobs. We are at a fragile moment, and public services – perhaps most critically at local government, which provides the services most directly connected to Australians' day-to-day lives – are more essential than ever to our collective health and well-being. Policies of fiscal austerity like local council rate caps make our economy and society less resilient, and delay or prevent the expansion of social and physical infrastructure that will help us weather the rest of this pandemic, and whatever next crisis follows. And because local governments' access to funds from sources other than rates is more limited than their state and federal counterparts – they have fewer fiscal levers at their disposal, and it is harder and more expensive for them to borrow – rate capping has hobbled local governments' efforts to respond to the COVID-19 crisis with appropriate measures.

In this unprecedented time, the expansion of public services (and the continuation and security of employment for the people who provide those services) is a more desirable option than fiscal restraint. This paper will review the negative direct and indirect economic and social consequences of rate caps, and propose alternative policies that would allow Victoria's local councils to fulfil their full potential in helping lead the state out of this pandemic.

The first major section of this paper reviews the operation and history of the current Victorian rate caps. Section II considers their effects on local government revenue.

Section III reviews empirical data attesting to the size and importance of the local government sector. Section IV of the paper produces a quantitative estimate of the Victorian local government sector's footprint in the broader economy, including upstream linkages experienced through the inputs purchased by local governments (supply chain), and downstream benefits flowing from consumer spending supported by local government employment. These linkages also generate an important positive feedback loop flowing back into government revenues. Section V reviews the especially important impacts of local government activity and employment in non-metropolitan Victoria. Section VI considers the impacts of rate caps on workers, employment conditions, and collective bargaining. In Section VII, the paper models the impacts of rate caps on employment and economic growth in Victoria, by estimating two counterfactual scenarios in which rate caps are absent (and instead councils had been able to expand their rates revenue in line with historic experience). This modelling indicates that **the imposition of rate caps has reduced employment by as much as 7425 positions in 2021-22 – including direct (local government) and indirect (upstream and downstream private sector) jobs,** relative to what employment would have been if rates revenue had been uncapped. The impact to GDP under these assumptions implies a **reduction in 2021-22 of as much as $890 million**.

The paper concludes by recommending that local government rate caps are removed. This would restore decisions over rates back into the purview of local government: the level at which these decisions democratically belong. Not all LGAs in Victoria are the same, or have the same needs or capacity to pay, and artificially restricting the activity of all councils with a blunt, one-size-fits-all fiscal restraint is counterproductive, both economically and socially. The appropriate location of democratic oversight for the both the rates levied by local governments, and the way in which that revenue is subsequently spent, is within those individual communities themselves – so they can best reflect the priorities and preference of the people who live and vote in them.

I. Local Government Rate Caps in Victoria: Their Operation and History

Victoria's 79 local and regional councils have been operating under the state government's rate caps policy since 1 July 2016 (Victorian Government, 2019).[3] Rates are the largest single source of local government revenue (accounting for 47.4% of total local government revenues in 2019-20, down from a peak of 50.9% in 2013-14).[4]

Each year the Minister for Local Government sets a cap on rate increases based on advice from the Essential Services Commission (ESC). The ESC's recommended cap is based on its forecast of inflation, usually a weighted average of expected consumer price and wage price inflation.[5] The implementation of the rate cap is also overseen by the ESC. The decision must be made by the Minister by 31 December each year to apply to rates in the following financial year. Councils report that this timing is problematic in attempting to plan ahead into future financial years. The timing pressure is all the more intense given that individual councils' appeals for variations to the rate cap – known as 'exceptions' – must be lodged by 31 January.[6] Not only is this a considerable length of time before the following year's rate cap is to be imposed, but it

[3] Rate capping in Victoria had briefly been introduced from 1996 to 1999 by the Kennett government. There is evidence that during that period, councils responded by deferring spending on social spending and capital programs such as roads maintenance and renewal. These shortfalls had negative consequences for safety and amenity (Dollery 2021; Donaldson, 2016), and their consequences lasted in some cases for years.

[4] Author's calculations from ABS (2021a) Table 332. User charges/sales of goods and services comprise 17% of local government revenue, and grants from state/territory governments comprise 10%. There is a separate, small line item for 'State government capital grants'. The ABS also identifies an 'Other revenue' category comprising 24% of revenue, raised through income such as public enterprises and fines, and assistance through the Natural Disaster Relief and Recovery Arrangements.

[5] For 2021-22, reflecting the uncertainty regarding future inflation in the context of the COVID-19 pandemic, the ESC's recommended cap was based on a five-year historical average of CPI. In the initial years of the rate cap system, the ESC included an 'efficiency factor' within its recommended rate cap: a homogenous, across-the-board reduction in the cap *below* its estimate of forecast inflation. Since 2018 the ESC has excluded this factor. 'Efficiency dividends' have been applied elsewhere in Australian public sector settings and amount to a simple, indiscriminate, across-the-board cut in expenditures, service delivery, and potentially employment (Henderson and Stanford, 2019).

[6] We note that for 2021-22, the cut-off date for application for exceptions was 31 March 2021.

is also a time of year when operations in many organisations, public and private, are at their lowest capacity.

The rate cap applies to a council's average rate revenue per property (ESC, 2020b). A council's aggregate rates income must not increase annually by more than the rate cap set by the Minister for Local Government, *adjusted* for changes in the number of rateable properties in the LGA.[7] Therefore, the total amount of revenue raised by a local government from rates may well exceed the rate cap figure if the number of rateable properties increases – and across Victoria, this has been the case in many councils (and for the state as a whole). Aggregate rates revenue has thus expanded at a faster rate than implied by the cap (ESC, 2021a). Conversely, if the number of rateable properties in an LGA were to shrink, that would also be reflected in that local government's rate cap calculation, resulting in total rates revenue growing more slowly than the cap.

However, changes in the rates paid on any individual property depend on changes in the value of that property, relative to the overall trend in property prices in their community. Therefore, a particular property's rate increase might exceed the rate cap in any given year. This is because redistributions in relative property values across the LGA will result in a redistribution of rates payments across property owners. Valuations are performed by independent valuers. Under this system, local governments do not get more revenue than the rate cap policy allows, even if property values across a particular LGA rise: the average rate take is capped by the rate cap itself. Redistribution between individual properties reflects changes in relative property valuations: in these instances, some ratepayers will experience an increase of less than the rate cap, while others will experience an increase of more than the rate cap. But the *average* rates collected by local governments per rateable property cannot exceed the rate cap unless that council is granted an exemption by the ESC (see below, and also Yarra Ranges Council, 2021; City of Port Phillip, 2021).

The annual rate caps imposed under this policy (since its reintroduction in 2016-17) are reported in Table 1, and compared to growth over the same time in nominal GSP per capita in Victoria. In most years GSP growth per capita exceeded the rate cap. The exception was during the recession associated with COVID-19 – but that will be offset by an expected strong recovery in GSP once COVID restrictions are lifted. Over the long run, this means that relative to the growth in the state economy, local government rates have eroded. The rate cap policy thus implies a relative shrinkage in local government revenues – at a moment in history when Victorians clearly need more

[7] In the case of some councils, different rates may also apply for different types of properties. For example, commercial rates may differ from residential rates.

services and protection from all levels of government, not less. (The relative erosion of rates could be offset by revenue from other sources, which we will consider below.)

Table 1 Rate caps by financial year, Victoria		
Financial year	**Rate cap**	**GSP per capita growth (current prices)**
2021-22	1.5%	7.7%[1]
2020-21	2.0%	-3.2%[1]
2019-20	2.5%	-1.1%
2018-19	2.25%	3.0%
2017-18	2.0%	2.7%
2016-17	2.5%	4.7%
Source: Essential Services Commission (2021) 'Annual council rate caps', ABS (2020a), *Australian National Accounts: State Accounts*, *2019-20*, Table 1. 1. Forecast from Victorian State Budget 2021/22 (Overview, p.4), based on real GSP plus CPI inflation less population growth.		

By applying the same cap across all local governments, the rate cap is a blunt instrument which fails to account for several important considerations: including the budgetary starting positions of individual councils when the policy was first applied in 2016-17 (an effect worsened by the compounding effects of any shortfall in subsequent years), the backlog of infrastructure needs experienced in many councils, and the need for funding for new projects and expansions to service offerings.

Under the rate cap policy, councils may apply to the ESC for rates increases above the cap if they can demonstrate a need. But a Victorian parliamentary committee which examined rate caps noted the variance approval process is "cumbersome," and there is significant evidence it "is not working satisfactorily" (Donaldson, 2016).

In 2019-20, just two local councils applied for and received exemptions. Just three councils received rate cap exemptions in 2020-21. For the 2021-22 financial year, no councils applied for variations (ESC, 2021b).

The Legislative Council has released four reports into the current rate capping policy, which included public submissions processes (Parliament of Victoria, 2017). The last was released in June 2017.[8]

Among the recommendations contained in these reports were the following:

[8] Plans for a fifth and final report were superseded by a Parliamentary Committee on the matter which resolved not to produce a report, in the context of the dissolution of the Victorian Parliament ahead of the 2018 election.

- The minister should announce the rate cap earlier than December and publish the reasons for setting the cap at a particular rate.
- The Essential Services Commissioner should refine the guidelines for rate cap variation applications based on feedback from local councils.
- Support should be provided for smaller rural councils that wish to apply for a rate cap variation but lack the resources or staff to make an application.
- The Essential Services Commissioner should investigate the most effective and simple way for rate cap variation applications to be submitted.

The Municipal Association of Victoria (2019) argues that rate caps are anti-democratic, in that local governments constitute an elected tier of government, whose autonomy in identifying their own priorities and setting their own budgets should be respected by other levels of government. Previous rate capping in Victoria during the 1990s, under the Kennett government, resulted in ongoing investment and maintenance shortfalls for local governments (Municipal Association of Victoria, 2019). Such shortfalls produce compromised community safety, inconvenience, and economic inefficiency. And certainly, underinvestment in services and infrastructure hampers the ability of councils to deliver new projects and initiatives – to the detriment of the communities in which those local councils operate. Those consequences are clearly emerging under the current rate cap policy, as well. The Municipal Association of Victoria (2019) reports both a worrying shortfall in capital investment by local councils, and councils opting out of discretionary community services due to budget constraints. The inevitable result of this arbitrary restriction on the ability of local governments to provide needed services and infrastructure, and mobilise the resources required to pay for them, will be continued degradation of local infrastructure, services, and quality of life.

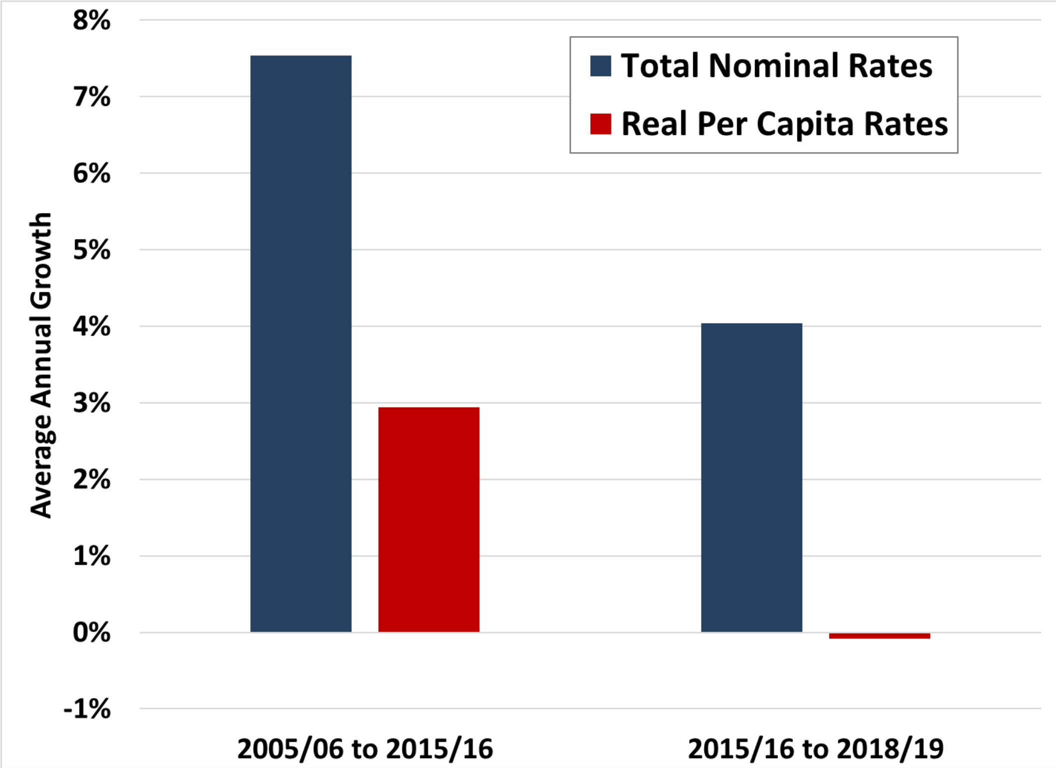
II. The Effects of Rate Caps on Local Government Revenues

The reintroduction of rate capping was strongly opposed by local governments in Victoria (Municipal Association of Victoria, 2019), and has been described as “onerous” and “costly” for local governments (Parliament of Victoria, 2017; Donaldson, 2016). While costs to councils are increasing (partly as a result of state government cost-shifting to the local government sector, as described below), state government rate caps impede local governments’ ability to raise revenue to offset higher costs – including to compensate for cost-shifting from the state level.

In the context of ABS (2021a) data on operating statements for the local government sector, 'Taxation revenue' equates to the tax components of municipal rates (i.e. general rates as well as small amounts of metropolitan improvement rates). Other charges invoiced via rates notices (e.g. water, sewerage & garbage services) are classified by the ABS as ‘Sales of goods and services’. The 'Other revenue' line item in the ABS data includes physical assets acquired below fair value (including from developers), and cash contributions from developers in lieu of asset contributions. Streams such as fines (e.g. parking, animal control etc) are also included in this category. These distinctions are important in examining trends in the mix of local government revenue in the presence of the rate caps.

The immediate and direct impact of the rate cap policy has been to drastically slow growth in local government rates revenue. As illustrated in Figure 1, in the decade prior to the introduction of this policy, local government rates revenue grew at an average annual rate of just over 7.5%. Since the rate caps were imposed, however, growth in the core revenue source for local government has been cut almost in half: to an average of just 4% per year.

Figure 1. Local Government Rate Growth, Victoria, 2005/06 to 2019/20



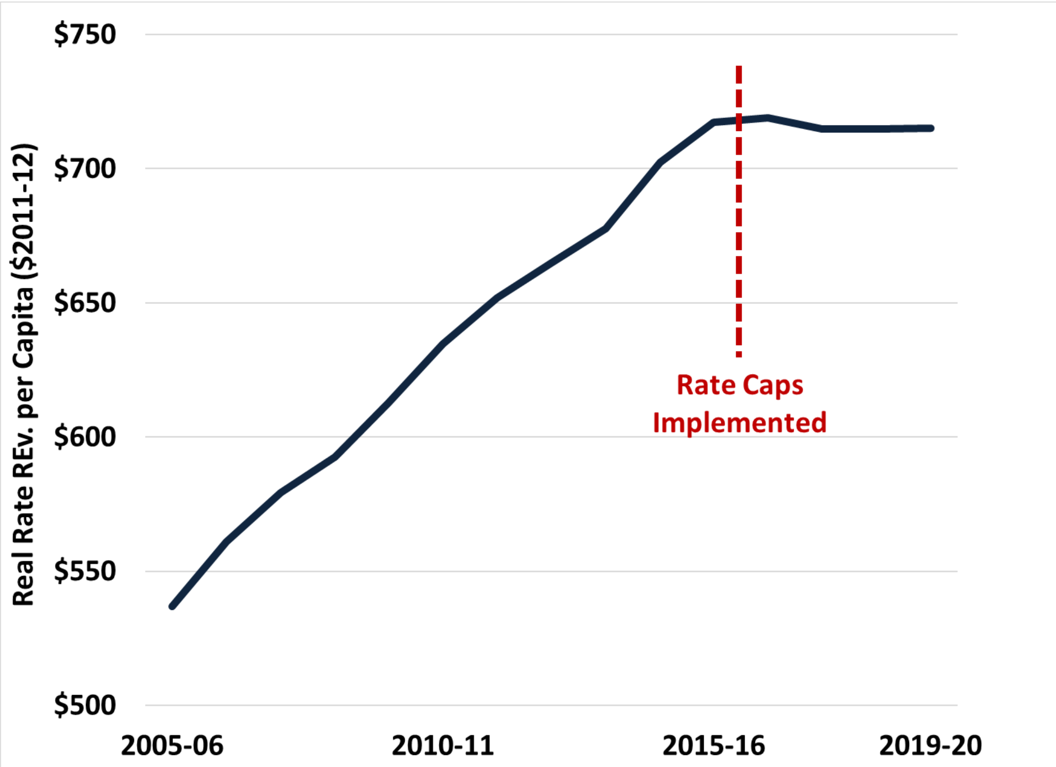
Source: Author's calculations from ABS (2021a) Government Finance Statistics, Table 332, ABS (2021b) *Consumer Price Index*, and ABS (2021c) *National, State and Territory Population, September 2020*.

As a result of the slowdown in revenue growth, this most crucial source of revenue to fund local government services has not even kept up with the combination of population growth and ongoing inflation in Victoria. In real per capita terms, the revenue base of local government has been frozen for four years under the cap policy: in fact, real per capita rate revenue has declined somewhat since 2015/16, the last year before imposition of the caps. This drives ongoing restrictions on local governments' ability to provide goods and services to their communities – at a time when the COVID-19 pandemic, and other economic, social and environmental challenges, demands more from government, not less. In contrast, during the decade prior to the rate caps, real per capita revenue from rates grew at a modest but steady pace (of under 3% per year). That facilitated local government efforts to expand services and infrastructure, to keep up with Victoria's rapid economic and community development. Even when local governments' revenue base was expanding, it could not be argued that local services and infrastructure were fully adequate: more investments and services and infrastructure were clearly needed. But freezing the most important source of local government revenue has made matters far, far worse – as attested by the congestion, decay, and inadequacy of services so visible in many communities in

Victoria. The deliberate goal of the rate cap policy was to forcibly constrain local government revenue and hence spending. Figure 1 confirms that it has done exactly that.

The sudden and dramatic impact of the rate caps on the local government rates base is illustrated in Figure 2. Years of modest but steady growth in the revenues which support local services suddenly ran into a wall in 2016/17, with the implementation of the caps. The real per capita revenue base for local government has been frozen (and in fact slightly declined) since then. That may have been precisely the motivation for this policy in the eyes of its advocates.[9] But residents of Victorian communities are left to wonder why this sudden imposition of fiscal restraint was implemented, and what the implications will be for the quality of local services and infrastructure, and the fairness of Victoria's tax system.

Figure 2. Real Per Capita Rates Revenue, Victoria, 2005/06 to 2019/20.

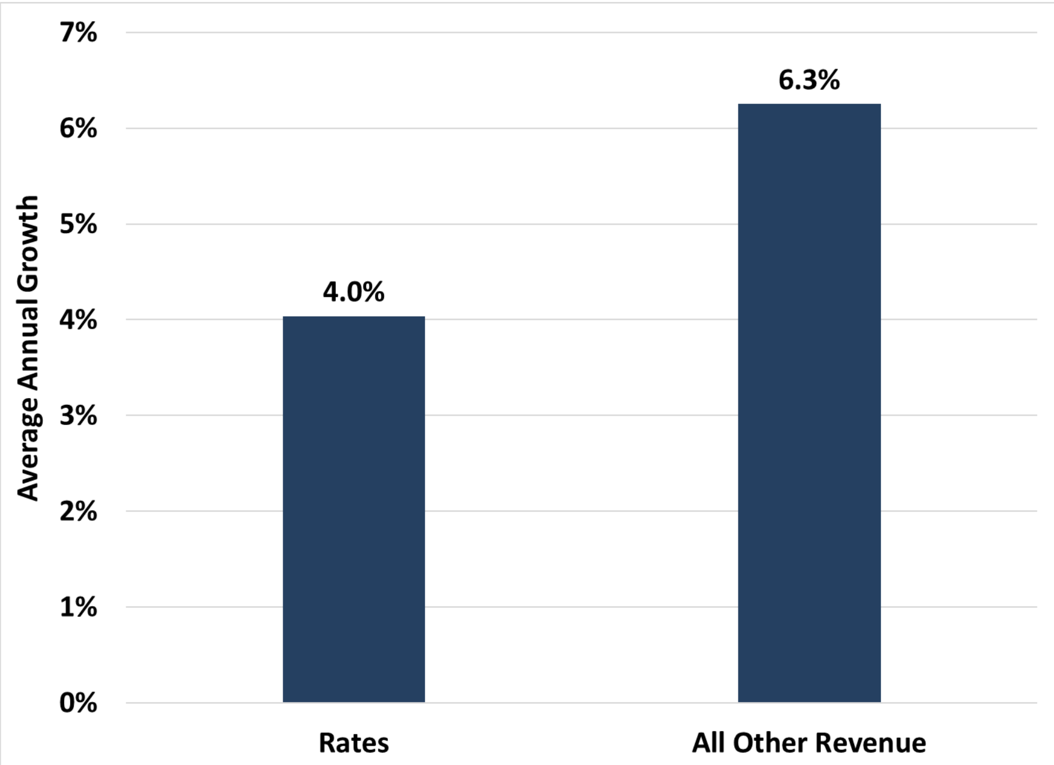


Source: Author's calculations from ABS (2021a) Government Finance Statistics, Table 332, ABS (2021b) *Consumer Price Index*, and ABS (2021c) *National, State and Territory Population, September 2020*.

[9] Indeed, the Victorian Essential Services Commission's review of rate caps approvingly presented a figure very similar to Figure 2 as evidence that the system had 'worked.' See Essential Services Commission (2021a), p. vii.

On the matter of fairness, because of the cap on rates revenue, local governments have been compelled to turn to other sources of revenue to try to meet the pressing needs they face in their communities. This has resulted in a restructuring of local government revenue away from rates, and toward other sources of revenue – including sources that are less efficient, and less fair. Figure 3 indicates that the growth of revenue from other sources (including user fees, fines, interest income, and grants from other levels of government) has grown by over 6% per year since the rate cap policy came into effect. That is more than twice as fast as growth in those other revenues before the cap. So the imposed restrictions on rate revenue have resulted in a growing reliance on those other revenue sources. It is not that Victorians are paying less for local government; it is that they are paying through alternative channels, which in many cases are less efficient and fair.

Figure 3. Rates and Other Revenue Sources, Local Government, 2015/16 to 2019/20



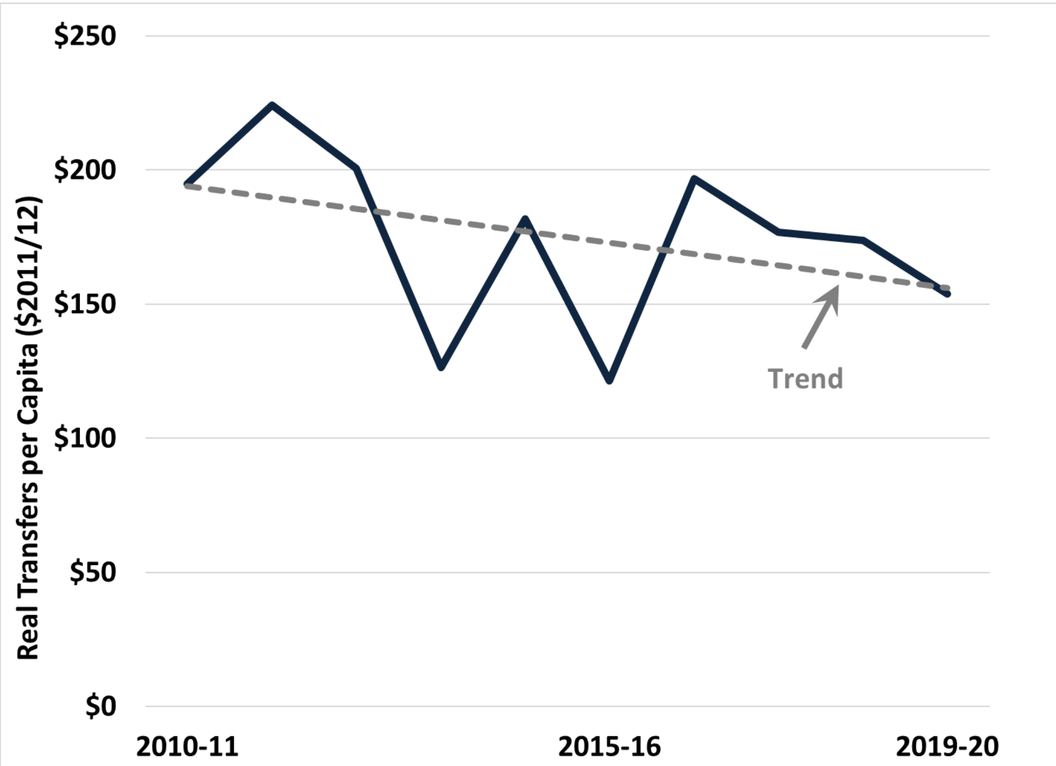
Source: Author’s calculations from ABS (2021a) *Government Finance Statistics*, Table 332.

As a result of the redistribution of local government revenue-raising from rates to other streams of revenue, the share of total local government revenue generated by rates has declined in this period. In 2015/16, local governments received almost half (49.5%) of total revenues from rates. That share declined by 4 percentage points by 2018/19. The share of rates in total local government revenue rebounded partially in

2019/20, mostly because of COVID-related declines in other sources of revenue. This is a temporary change in the relative importance of rates revenue. Once the pandemic is over and the economy re-opens, the observed trend toward shrinking relative reliance on rates, and corresponding expansion of other revenue sources, will almost certainly recommence.

It is important to note that state transfers to local government have not expanded to fill the revenue void created by the artificial restrictions on rates revenue. Current and capital transfers from other levels of government (mostly the state level) fluctuate considerably from year to year, based on specific events (including natural disasters) and announcements (such as major infrastructure projects). Nevertheless, the longer-run trend on these transfers (measured in real per capita terms) has been stagnant or declining, as indicated in Figure 4. Thus even though local governments' revenue capacities have been hamstrung by an arbitrary cap imposed by the state government, the state level has not assisted local councils in addressing the resulting revenue ramifications.

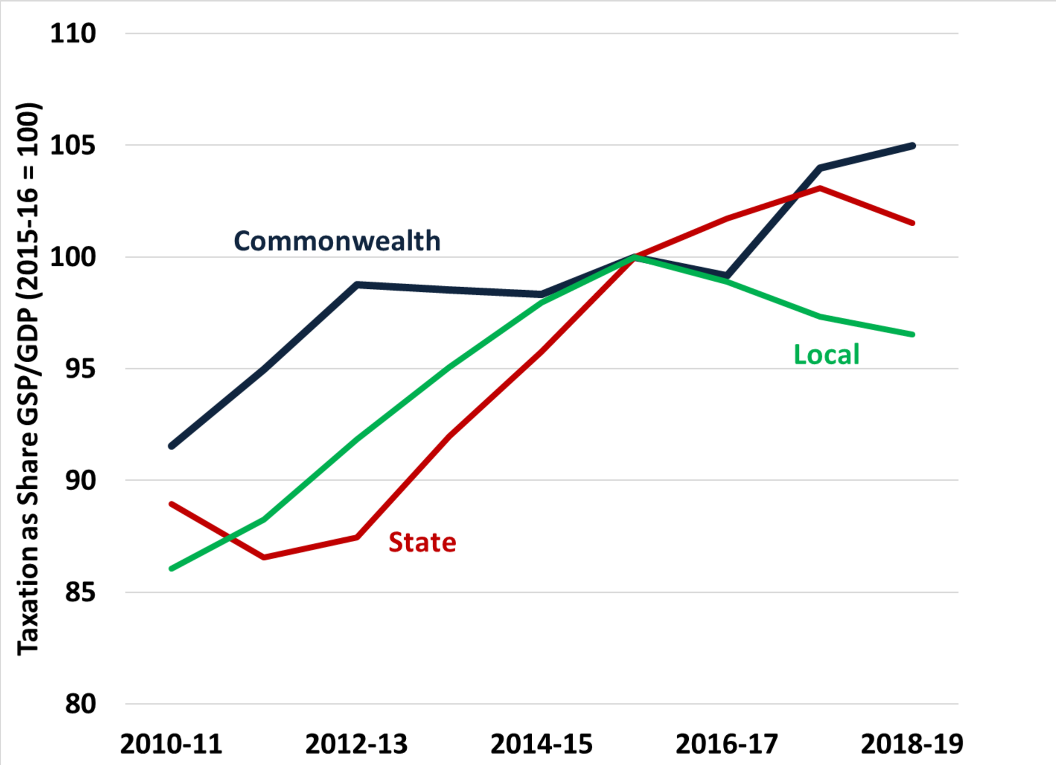
Figure 4. Current and Capital Transfers to Local Government, Victoria, 2010/11 to 2019/20.



Source: Author's calculations from ABS (2021a) Government Finance Statistics, Table 332, ABS (2021b) *Consumer Price Index*, and ABS (2021c) *National, State and Territory Population, September 2020*.

To further confirm the receding size of local government rates revenue, in contrast to the taxation powers of other levels of government, we have constructed indices of taxation relative to measures of total economic output. We measure rates revenue and state taxation revenue as a share of Victorian GSP; and we measure Commonwealth tax revenue as a share of national GDP. The indices are benchmarked at 100 for each data series in 2015-16 – just before the introduction of the Victoria rate cap. Figure 5 shows that tax revenues for all three levels of government increased after 2010 relative to the underlying economy.

Figure 5. Tax/Output Ratios by Level of Government, 2010/11 to 2018/19.



Source: Author's calculations from ABS (2021a) *Government Finance Statistics*, various tables, ABS (2021d) *National Accounts*, and ABS (2020a) *State Accounts*.

The rise in the tax ratio was especially rapid for state taxes after 2012. After 2015/16, however, when the rate caps were imposed on Victorian local government, the trend lines diverged. Both state and Commonwealth tax revenues continued to increase relative to GSP or GDP over the subsequent years.[10] But the relative importance of local government rates revenue began to recede: with the index of tax to GSP falling

[10] Victoria state revenue fell as a share of GDP during 2019-20 due to the impacts of the COVID-19 pandemic.

by about 4 percentage points.[11] Ratios of tax to GSP or GDP have been obviously disrupted by the impacts of the COVID-19 pandemic on both the numerators and the denominators of those ratios. Local government rates rebounded modestly in 2019/20 relative to GSP (mostly because GSP declined dramatically, while local rates – which were set before the pandemic – were stable), but were still lower than in 2015/16 when rate caps were imposed. And that rebound in the rates/GSP ratio will be reversed quickly as the Victoria economy recovers after the pandemic.

The comparisons illustrated in Figure 5 provide useful political insights, as well as economic ones. The tax base of all levels of government in Australia was increasing steadily relative to the underlying economy before 2015. This reflects several factors – not least being the demands of Australians for high-quality public services from all levels of government. There is no evidence in this history that local government rates were somehow 'out of control,' and needing some external supervision to stop them from increasing further. Indeed, in proportional terms the tax base of the state government was expanding even faster – and the tax base of the Commonwealth was also growing. For one level of government in the constellation of Australian democracy to arbitrarily restrict the capacity of another level of government to raise sufficient revenue to fulfil its duties, *even while that same higher level of government continued to increase its own tax collections*, seems both counterproductive and strikingly hypocritical.

THE SHIFT TOWARD REGRESSIVE SOURCES OF LOCAL GOVERNMENT REVENUE

As noted above, a particularly counterproductive effect of the rate cap is that local governments have been pushed to replace foregone rates revenue from other sources. However, those alternative sources are less progressive, and in most cases more costly to collect and administer. Local rates are, in effect, a wealth tax: collecting a larger share of revenue from households with more valuable properties. In fact, rate payments on property owners are one of the only forms of wealth taxation remaining in Australia. The principle of progressive taxation (including property-based local government rates) is intended to ensure that wealthier Australians contribute more fulsomely to public services.

The rate cap policy interferes with this potentially progressive outcome. As the ESC (2021a, p. 5) notes: "In the first four years of rate capping, the average annual increase

[11] Local government rates increased from 1.04% of GSP in 2010/11 to a peak of 1.21% in 2015/16. Under rate caps it declined to 1.16% of GSP by 2018/19.

[in rates] dropped to zero per cent (in inflation-adjusted terms)". In response, local governments have naturally looked to other sources of revenue, which are not progressive (and in some cases are regressive) since they are unconnected to the wealth or income of taxpayers. For example, the 'Other Revenue' item in Victorian local government operating results (ABS 2021a, Table 332) includes a variety of revenue streams such as fines (for example, parking fines and animal control). These revenues are not related to a resident's income, assets, or ability to pay, and hence are more regressive in their incidence. Yet under the rate cap policy, they have increased as a share of total local government revenue.

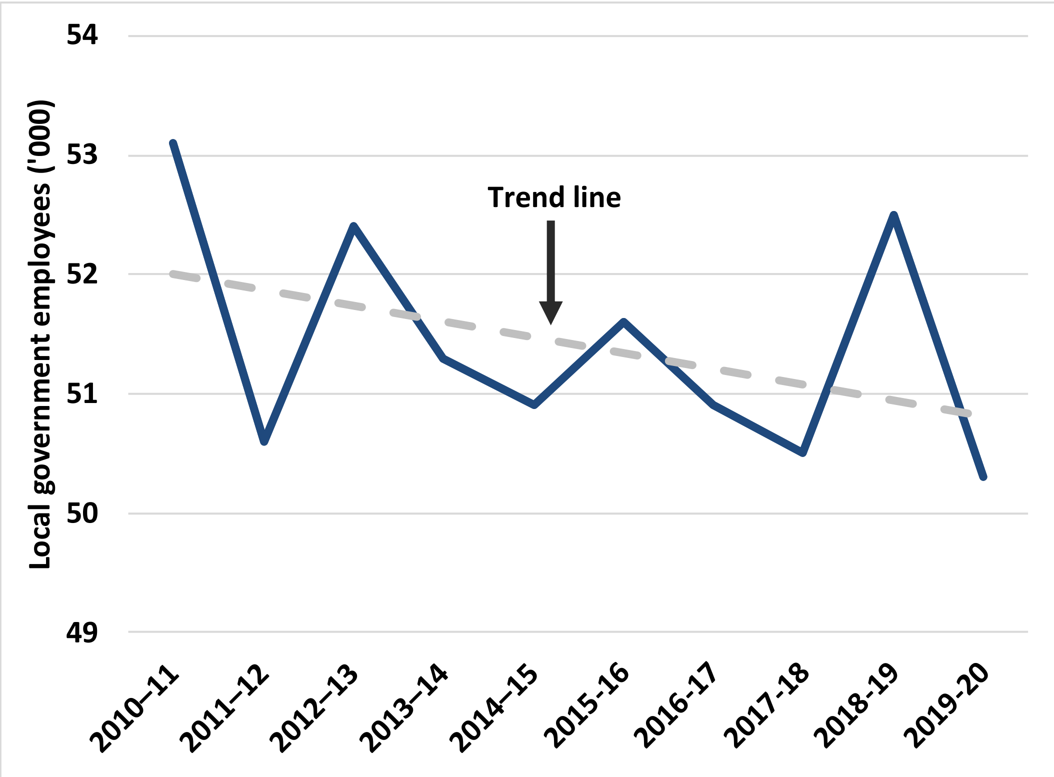
Moreover, collecting such revenues is less efficient than rates from a governance and organisational perspective: fines, for example, require the engagement of local government workers to monitor and penalise infractions.

Since the rate cap policy was introduced, total local government revenue (from all sources) has been stable as a share of nominal GSP. That represents a change in trajectory from the pre-rates-cap period, when local government revenues increased modestly relative to GSP. Nevertheless, it indicates that Victorian local governments have responded to the rate caps by mobilising alternative sources of revenue to offset the decline in relative rates revenue that resulted from the caps. The costs of local government service provision have thus shifted towards other revenue sources that tend to be less fair, collected without reference to each taxpayer's ability to pay. From a social equity perspective, it would be preferable for a greater proportion of local government revenue to be raised from wealth-based rate payments, not a smaller one.

III. The Size and Importance of the Local Government Workforce

The aggregate local government workforce in Victoria is a significant employer in its own right, directly employing roughly 50,000 staff (ABS, 2020b), doing the essential work of keeping communities safe, functional and livable. However, as shown in Figure 6, the number of local government staff in Victoria has been stagnating, and even slightly declining – despite the expanding state population and its growing need for local government services. There were about 3000 fewer local government workers in 2019-20 (50,300) than 8 years earlier.

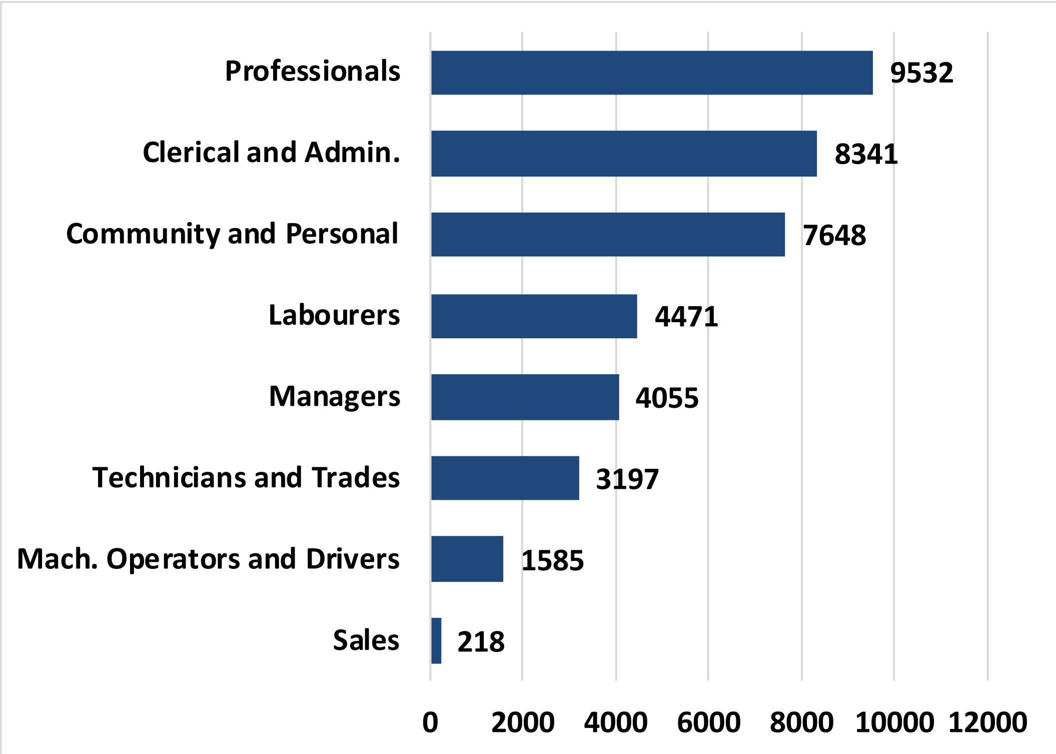
Figure 6. Local government, total workforce, Victoria, 2010-11 to 2019-20



Source: ABS (2020b), *Employment and Earnings, Public Sector, 2019-20.*

The most recent detailed occupational breakdown for the local government workforce in Victoria can be drawn from 2016 Census data (ABS, 2018), illustrated in Figure 7. Over two-thirds of the state's public servants fall into three broad occupational categories: professionals, clerical and administrative staff, and community and personal services workers. The remaining third consist of labourers, managers, technician and trades workers, and operators and drivers.

Figure 7. Local government workers by occupation, Victoria, 2016



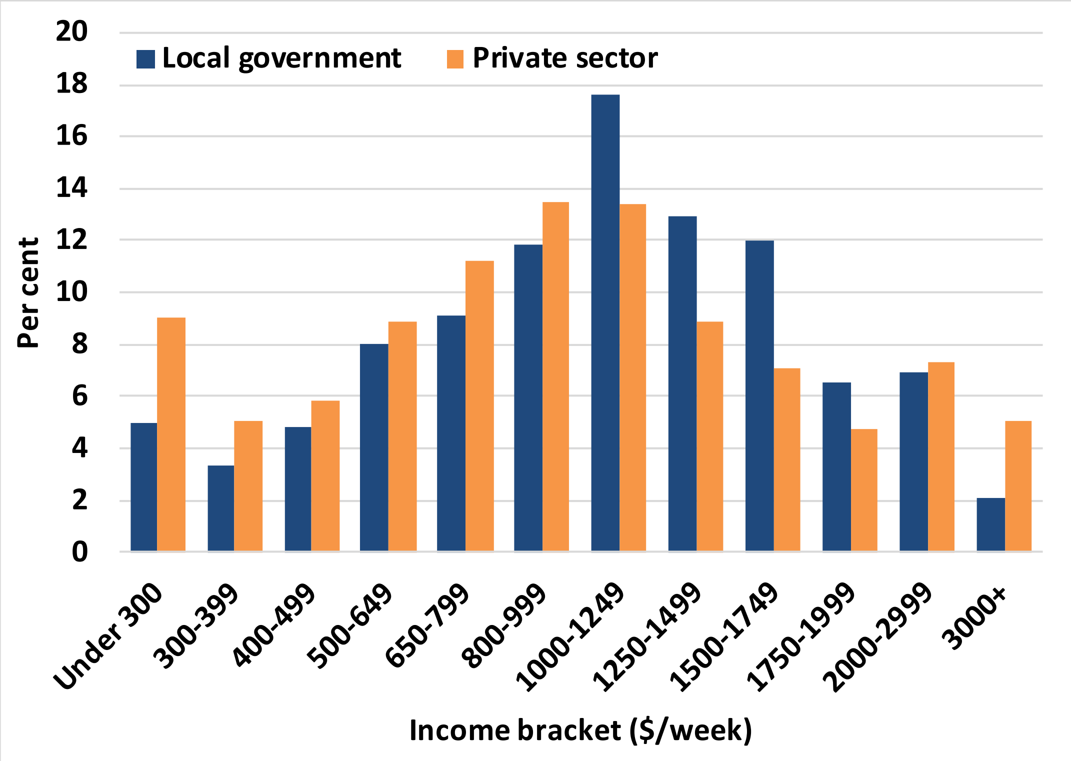
Source: ABS (2018) Census *TableBuilder, 2016*.

Victoria's local government workforce consists of well-trained people, doing decent, widely respected, and important work. Local government employment is also an important source of decent, middle-class jobs. Figure 8 shows the distribution of earnings for Victorian local government workers, compared to their counterparts in the private sector:

- The median income – the midpoint of the earnings distribution – of local government workers is in the $1000-$1249 per week category, while for private sector workers it is in the $800-$899 category.
- Public sector incomes are distributed far more equally than in the private sector. Almost twice as many private sector workers earn incomes at the bottom of the distribution (under $300 per week; 9.0%) than is the case for local government workers (5.0%). And more than twice as many private sector workers fall in the top bracket of the income distribution (more than $3000 a week; 5.0%) compared to local government workers (2.1%). The number of decent middle-income jobs in the private sector is proportionally small.

- In contrast, the local government workforce is more concentrated in the middle of the income distribution, supporting the existence of decent, middle-income jobs.

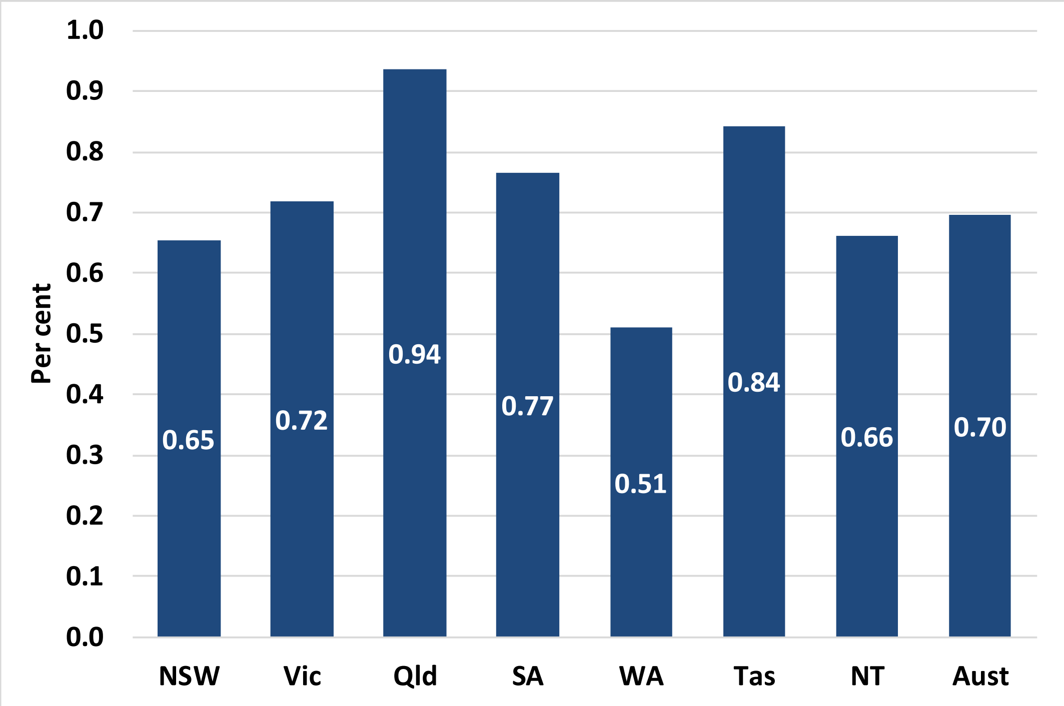
Figure 8. Proportion of Victorian local government and private sector workers by income category, 2016



Source: Author's calculations from ABS (2018) *TableBuilder, 2016*.

Figure 9 shows local government wage costs as a proportion of gross state product, demonstrating two important points. Firstly, Victoria's local government wages bill is on par with overall Australian aggregates. Secondly, local government wages are very small relative to gross state product: less than 1 per cent. The vital basic services and infrastructure provided by local governments are provided by this workforce, in return for compensation accounting for less than 1 per cent of economic output. Given that the work these workers perform is essential to the everyday health, safety, and functioning of our communities (not to mention making them more interesting and attractive places to live, thanks to amenities like parks and libraries), they represent good value for money.

Figure 9. Local government wages, proportion of gross state product, 2019-20



Source: Author's calculations from ABS (2020b) *Employment and Earnings, Public Sector, Australia, 2019-20*, and ABS (2020a) *Australian National Accounts: State Accounts*, Table 1. Data for ACT is not available, as there is no distinction between local and territory government functions in this jurisdiction.

One final important consideration is the effect of local government employment as a source of high-quality jobs for women workers. Across Victoria, at the time of the 2016 Census, over three-fifths (61.0%) of council workers were women (ABS, 2018). It logically follows that fiscal restraint directed at local government employment or wage levels will impact women workers disproportionately. This puts the rate caps policy directly at odds with the Victorian government's own stated commitment to improve gender equity in the state. For example, the current Inquiry Into Economic Equity For Victorian Women has reinforced the importance of improving gender equity in the workplace, addressing unequal pay, and examining barriers to women's workforce participation (Department of Premier and Cabinet, 2021). In this regard, the rate cap policy of the Victorian government is misaligned with the goals of gender equity.

IV. The Economic Footprint of Local Government Services

Local government activity and employment supports the economy in many different ways. The following section of the report describes the spillover benefits of public service delivery for private sector industries, considered in two broad categories of effect: ‘upstream’ linkages and ‘downstream’ linkages. We then summarise the total economic impact (considering both direct and indirect effects) of local government spending.

UPSTREAM LINKAGES AND SUPPLY CHAIN PURCHASES

To deliver their designated services, public sector agencies purchase billions of dollars of supplies, services, and inputs from businesses across a wide range of industries. Those purchases therefore constitute an important market for private sector businesses which serve this supply chain. We call these impacts the ‘upstream’ spin-off benefits of public service production. They extend through the entire supply chain of goods and services industries which sell output to public service organisations. These upstream benefits are especially important in smaller regional communities, where public services are vitally important economic anchors (discussed further below).

We develop an estimate of the scale of these upstream supply chain linkages based on Australian Bureau of Statistics (ABS) data regarding input-output linkages between various industries in Australia’s economy. The ABS database breaks down input purchases for over 100 different industries. To capture the relative mix of overall input purchases across these various service functions, we use a proxy production sector consisting of the input-output classification ‘Public administration and regulatory services’. While the total production sector of local government in Victoria includes activities beyond this industry, most of the services provided by Victorian local government employees fall within it, or are very similar to it – and hence their input purchases can be described similarly.

We scale this proxy sector to match the level of total activity undertaken within Victorian local government, based on the relative size of total direct employee compensation.[12] Using this approach, we estimate the total input purchases made by local government services in Victoria.

We estimate that in 2017-18 (most recent data), those input purchases amounted to over **$2 billion** worth of Australian-made goods and services.[13] Victorian local governments make significant purchases of goods and services from every major category of the economy: from agriculture and minerals through to manufactured products, utilities, construction, and the full range of services industries. Table 2 summarises the estimated composition of these input purchases.

Table 2
Upstream Jobs Supported by Victorian Local Government 2017-18

	Input purchases ($m)	Supported Jobs
Agriculture	5.0	25
Mining	20.3	14
Manufacturing	61.1	135
Utilities	167.1	135
Construction	351.8	924
Wholesale/Retail	63.5	124
Hospitality	34.4	336
Transport	128.7	458
Information/Telecoms	128.9	262
Finance, Insurance and Real Estate	481.3	1520
Professional and Technical Services	449.1	2146
Business Services	300.7	2852
Other Services	40.4	416
Total Input Purchases	**2232.3**	**7612**

Source: Author's calculations from ABS (2020c) *Australian National Accounts: Input-Output Tables, 2017-18*, ABS (2020d) *Australian Industry, 2018-19*, and ABS (2020b) *Employment and Earnings, Public Sector, Australia, 2018-19*, as explained in text. Includes Australian-made inputs only.

[12] On this basis, we estimate that in 2017-18 local government services in Victoria accounted for 6.5% of the total national output of this industry category.

[13] The input-output data used to generate this estimate includes only domestically-produced inputs; imported
intermediate products are reported separately in the ABS dataset.

Those businesses in the public sector's supply chain in turn must employ their own workforces to produce those goods and services. On the basis of average job-output ratios in the various industries which supply the public sector, we can estimate the number of jobs in each sector which depend on supply chain purchases by state public service providers. We estimate that over **7600 additional jobs** in 2017-18 depended on the purchases of the myriad of inputs required to deliver local government services to Victorian residents.

The biggest suppliers in dollar terms to Victorian local government include business services, professional and technical services, and the broad finance, insurance and real estate sector. But there is no major segment of the state's economy which does not receive some significant incremental business as a result of these supply chain purchases arising from local government activity.

One important caveat is that this analysis covers first-round input effects only. But all the inputs to Victorian local government shown above also have their own inputs, purchased from private sector businesses. This reflects subcontracting, procurement, and other purchases which suppliers to local government in turn make from their own suppliers. As a result, the total economy-wide effects of Victorian local government are in fact larger than those shown above. Given these linkages, it is clear that when local government is constrained by arbitrary restraint policies (like the rate caps), it hurts private sector suppliers throughout the economy.

DOWNSTREAM LINKAGES AND CONSUMER SPENDING

Another category of economic benefit generated by the activity of local governments, and the employment of local government workers, is experienced through the incremental consumer expenditure of workers employed in local governments. This includes both spending by direct employees of local governments, as well as the 7600-plus jobs supported upstream in the supply chain described above. The payment of incremental wages and salaries to these workers results in an added 'downstream' stimulus to thousands of businesses providing the full range of consumer goods and services: from restaurants and tourism, to retail and home-building, to transportation and personal services.

These spillover effects of public sector direct and indirect employment on downstream consumer spending are particularly important during periods of broader economic weakness. Today, with Australia still seeking a full recovery from the COVID-19 pandemic, the consumer spending of those employed directly and indirectly in the provision of public services constitutes a vital stabilising anchor for local, state and national economies. The Victorian government's rate cap will exacerbate this weakness.

Table 3 Downstream Impacts, Victorian Local Government Workers 2017-18	
Wage and Salary Income ($m) Local Government Workers <u>Workers in Input Industries</u> Total	 $3118.0 <u>$474.8</u> $3592.8
Share Spent on Australian-Made Goods & Services	51.3%
Additional Consumer Spending ($m)	$1843.1
Average Jobs Content (jobs per $m)	6.7
Supported Downstream Jobs	**12,349**
Source: Author's calculations from ABS (2021d) *Australian National Accounts: National Income, Expenditure and Product, Dec 2020*, ABS (2020c) *Australian National Accounts: Input-Output Tables, 2017-18*, ABS (2020d) *Australian Industry, 2018-19*, and ABS (2020b) *Employment and Earnings, Public Sector, Australia, 2019-20*, as explained in text.	

The wages and salaries paid to workers who directly deliver local government services in Victoria totalled over $3 billion in 2017-18.[14] And in 2017-18, roughly $475 million in additional wages and salaries were paid to the over 7600 workers employed in the broader public sector supply chain (described in Table 2 above; ABS 2021d).[15] On average in Australia, consumers spend almost two-thirds of their income on final consumption spending (after deducting taxes and personal savings; author's calculations from ABS 2021d, Table 20). Expenditure in Australia on average encompasses an import penetration ratio of around 18%; that is, just under one dollar of every five is spent on imported goods and services (author's calculations from ABS 2021d, Table 3). This implies that just over 50 cents of each dollar in incremental personal income are spent on Australian-made goods and services.[16] Therefore, the $3.6 billion in incremental employment income generated by Victorian local

[14] The local government employment and compensation data utilised in this section is from ABS (2020b). We use 2017-18 data from that publication for comparability with the upstream supply-chain impacts described above.

[15] We derive this estimate on the basis of the upstream employment described above and average weekly wages for all employees in 2017-18.

[16] More precisely, 82.2% (domestic expenditure share) of 62.3% (average expenditure propensity) equals 51.3% (average propensity to spend on domestic production).

government and its supply chain translates into an additional $1.8 billion in incremental consumer spending on the whole range of Australian-made goods and services. Based on average employment ratios across all produced goods and services in the economy, this consumer spending supports an additional 12,300 jobs. These downstream linkages are summarised in Table 3.

COMBINED EMPLOYMENT IMPACTS

Finally, Table 4 summarises the combined employment impacts arising from the Victorian local government sector, its upstream linkages (through the whole range of supply industries), and downstream linkages (through the equally broad range of consumer goods and service industries). In total, we estimate that **more than 70,000 positions are supported, directly and indirectly, by the Victorian local government sector**. In addition to the 50,500 direct jobs in the local government sector in 2017-18, there were almost 20,000 more positions supported in private sector activities: on the basis of upstream supply chain purchases and downstream consumer spending of local government workers and those working in the supply chain. This is summarised in Table 4.

Table 4 **Combined Employment Impacts of Victorian Local Government** **2017-18**	
A. Direct Employment in Victorian Local Government	50,500
B. Upstream Employment in Supply Chain	7612
C. Downstream Employment in Consumer Industries	12,349
D. Total Employment (A + B + C)	**70,461**
Source: Author's calculations from ABS (2021d) *Australian National Accounts: National Income, Expenditure and Product, Dec 2020*, ABS (2020c) *Australian National Accounts: Input-Output Tables, 2017-18*, ABS (2020d) *Australian Industry, 2018-19*, and ABS (2020b) *Employment and Earnings, Public Sector, Australia, 2019-20*, as explained in text.	

The combination of upstream and downstream spillover effects thus considerably magnifies the total employment effects arising from public service provision. **For every 10 jobs in the Victorian local government sector, there are another 4 jobs supported**

in private businesses through the combination of upstream and downstream linkages described above.

Note that this analysis considers only the first-order flow of demand through both the upstream supply chain and the downstream consumer spending relationships. But those first-order impacts will in turn generate similar upstream and downstream spending effects: such as the subsequent supply chain purchases by firms which are themselves suppliers to public sector organisations, and the downstream consumer spending of people in consumer industries who are employed as a result of the spending of public servants. For this reason, the spillover job effects noted above underestimate the ultimate impact of local government sector activity and employment.

The above analysis is conservative for another reason as well: we have used data throughout our analysis from 2017-18 to match the latest available input-output data from the ABS. Current expenditure totals would be larger.

PUBLIC SECTOR INCOMES AND GOVERNMENT REVENUES

There is another self-defeating effect arising from artificially limiting government expenditure. At every stage of the flow of production and income through the economy, incomes and expenditure are taxed. When employment or wages decline (whether in the private or the public sector), governments also experience a reduction in their own tax revenues. As a result, public sector austerity – whether through suppression of public sector wages, or reductions in public sector employment – produces an economic ‘blowback’ on governments’ own revenues.

Most obviously, public sector employment generates its own stream of tax revenues: income taxes on wages and salaries (often collected at relatively high marginal tax rates), payroll taxes, and GST on public sector workers’ own purchases. Additionally, the incomes generated by the upstream supply chain purchases of public service agencies, and the consumption spending of public sector workers, in turn underpin more tax revenues.

It seems especially ironic for a state government to limit its own revenues by intervening to impede the ability of a different level of government to raise taxes and spend them on public services. A government which seeks to suppress public sector wages or downsize public programs – as the rate cap does, albeit via a different level of government – must take account of the impact of that austerity back onto its own revenues.

Overall, public sector austerity will have an inevitable and significant effect on state tax revenues (experienced both directly, and indirectly via transfers from the Commonwealth). After all, state governments in Australia collect close to 15 cents of each dollar of GDP: consisting of roughly 9 cents of own-source revenue and 6 cents in the form of fiscal transfers from the Commonwealth level of government.[17] . Expressing this idea in converse terms, the Victorian state government, to an important degree, receives a benefit in the form of public revenue through the positive feedback loop of public expenditure. This could in turn supplement its own ability to fund local government, and/or reverse the cost-shifting to local government discussed above.

[17] Author's calculations from ABS, 2021d, Table 19.

V. The Regional Importance of Local Government Employment

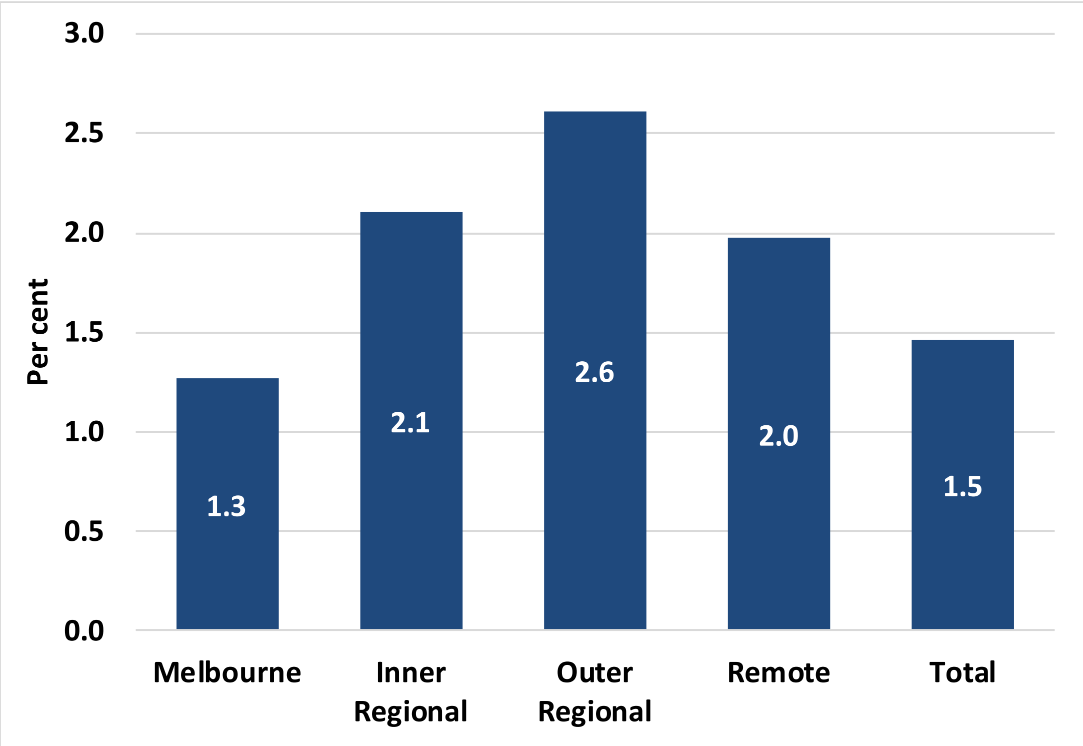
Local government is an important and outsized employer of choice in regional Victoria. At the time of the 2016 Census, almost one-third of Victorian local government workers were based outside Melbourne, despite the fact that less than a quarter of Victorians lived in those same areas. While the state government is also an important employer in the regions, the prevalence of local public sector employment makes the importance of this work in the regions especially clear.

Additionally, public sector jobs often constitute some of the few attractive positions in regional and remote Victoria available for well-educated, mobile, younger workers. Stagnation in local government hiring and compensation, therefore, has a doubly negative impact on regional and remote communities struggling to maintain their viability.

Figure 10 shows that Melbourne has the lowest proportion of local government workers, as a proportion of all workers, of any Victorian geography, at 1.3%. In outer regional Victoria, there is twice as large a proportion of local government workers (2.6%), but all other parts of Victoria substantially exceed Melbourne (with inner regional at 2.1% and remote at 2.0%).

That said, the proportion of local government workers in relation to the total workforce should also be kept in perspective: only 1.5% of the state's workforce overall are employed in local government. Given the vital role that local governments play in the basic functionality of our communities, this represents a high social return on investment. This small segment of our workforce functions as a crucial social and economic enabler throughout our economy and society. And since labour markets in regional and remote Australia are underutilised at the best of times, an arbitrary imposition on a source of good-quality employment during a fragile economic recovery is counterproductive. Instead, governments at all levels should affirm and support public sector employment, and fulfil their responsibilities to the communities they represent.

Figure 10. Victorian local government workers as a proportion of all workers, by remoteness category, 2016



Source: Author's calculations from ABS (2018) *TableBuilder, 2016*.

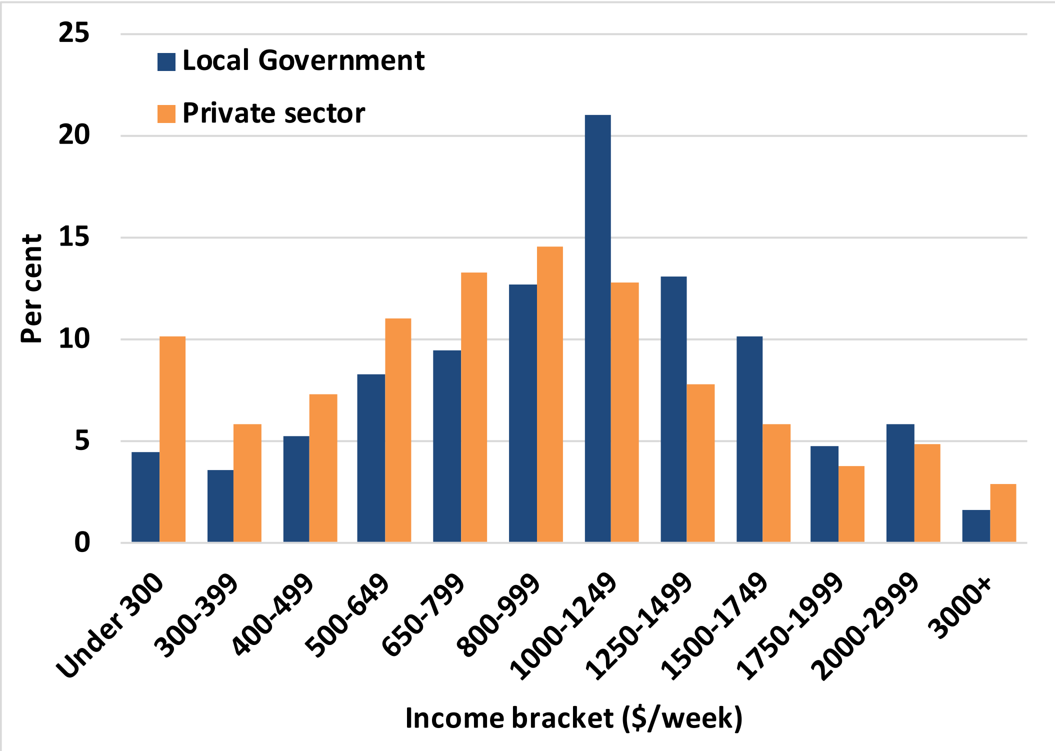
It is important to note the contrast between patterns in weekly pay in the non-metropolitan local government sector and the comparable private sector (again based on 2016 Census data). This data demonstrates a similar pattern to the earnings data for the whole of Victoria (illustrated in Figure 8 above): local government is an important source of *high-quality, middle-class* jobs. Figure 11 shows the distribution of earnings for Victorian local government workers in regional communities, compared to their counterparts in the private sector:

- The median income – the midpoint of the earnings distribution – of local government workers is in the \$1000-\$1249 per week category, while for private sector workers it is in the \$800-\$899 category. Recall that these are earnings that are, to a significant extent, ploughed back into the regional economies where they are earned.
- The distribution of earnings for private sector workers is far more polarised than for local government workers. The private sector has, proportionally, more than twice as many workers earning very little (under \$300 per week), but also more earning very high incomes (more than \$3000 a week). In contrast, the local government sector has a strong tendency towards the

middle of its income distribution, with workers clustered in a broad band of decent, middle-income jobs.

These statistics tell an important story. The private sector workforce in regional Victoria is polarised between a large number of low-wage, low-quality jobs, and a small group of very high income earners. The number of decent middle-income jobs is proportionally reduced. In contrast, the local government workforce reflects an earnings distribution dominated by high-quality middle-income jobs. These jobs are occupied by well-trained workers, for whom public service is one of the only options for good-quality work in these regional communities.

Figure 11. Proportion of Victorian local government workers by income category, non-metropolitan areas, 2016



Source: Author's calculations from ABS (2018) *TableBuilder 2016*.

A large body of research now confirms the importance of socioeconomic equality and the broader economic resilience it engenders (see, for example, Australian Council of Social Services, 2018; Wilkinson and Pickett, 2009). Public sector employment – generally stable, decently-remunerated work – provides an important buttress against broader social and economic inequality (Henderson and Stanford, 2019). The local government sector workforce is a source of economic resilience and purchasing power for regional Victoria. It is a mistake for the state government to impose arbitrary limits on this source of stable, regional employment – especially given the sector's strong representation of women workers.

Census data also confirm that local government workers in regional communities are more highly qualified than their private sector counterparts. Table 5 shows that almost half of local government workers in non-metropolitan Victoria have a university qualification (46.7%). In contrast, only 27.4% of the private sector workforce in non-metropolitan Victoria have a university qualification.

These findings further emphasise that local government jobs, frequently requiring post-school qualifications, attract qualified people to, and retain qualified people in, regional Victoria. This is good for aggregate incomes and economic resilience in these communities. And since there are fewer attractive private sector positions in the regions than in Melbourne, any externally-imposed limit on public sector hiring and employment can reasonably be expected to add more pressure on this well-qualified section of the labour force to move out of the regions and towards Melbourne.

Table 5
Highest Educational Attainment, Non-Metropolitan Victoria
Share of Employment, 2016

	Postgrad/ Grad. Dip./ Grad. Cert.	Bachelor	Advanced Dip./Dip.	Cert III & IV	Years 10 and above	Cert I & II	Years 9 and below
Victorian local government	10.1%	18.6%	18.0%	24.9%	23.9%	0.1%	4.4%
Private sector	4.6%	12.1%	10.7%	29.7%	36.7%	0.1%	6.1%

Source: Author's calculations from ABS Census (2018) *TableBuilder 2016*.

VI. The Effects of Rate Caps on Services and Service Workers

The broader employment and economic benefits resulting from the provision of public services extend into virtually every sector of the Victorian economy. As demonstrated above, in addition to the wages and salaries paid to local government public sector workers, the provision of these services also entails spending billions of dollars per year on supplies and services produced by a wide range of other businesses and sectors. These purchases extend and multiply the economic impact of public services on the broader state and national economies.

Typically, the goal of governments during an economic downturn is to spend more to counter prevailing economic weakness. This occurred at both the federal and state government levels during the COVID-19 crisis. Spending initiatives include the very substantial JobKeeper and JobSeeker COVID supplement programs at the Commonwealth level, and numerous initiatives at the Victorian government level -- including the $2.7 billion Building Works package (Department of Health and Human Services, 2020), the $500 million Working for Victoria fund for displaced workers, payroll and land tax deferrals, support for First Peoples' businesses, support for commercial tenants and landlords, and others (Global Victoria, 2021). Australia also embraced a strongly countercyclic approach to economic crisis during our successful and internationally-praised response to the Global Financial Crisis.

However, the rate caps policy undermines this countercyclic approach to macroeconomic management – which should guide the decisions of every level of government. This is of particular concern in the context of the economic recovery from COVID-19, the most sudden and harsh economic downturn since the Great Depression. During such downturns, the rate of inflation typically decreases as households – with wage earners newly unemployed, working fewer hours, or unsure of their continuing employment – defer spending. Businesses typically respond by lowering prices, or at least deferring increases. Under these circumstances, the economy tends to experience lower inflation or even *deflation*. However, Victoria's rate cap is tied to expectations of inflation, and hence local government revenues reflect and reinforce this deflationary tendency, rather than offsetting it. Thus, the rate cap policy exacerbates economic contraction rather than counterbalancing it.[18] This contributes

[18] In this respect they are similar in effect to 'balanced budget' rules. See Nahum (2020) for an examination of the macroeconomically limiting effects of such rules in the Queensland context.

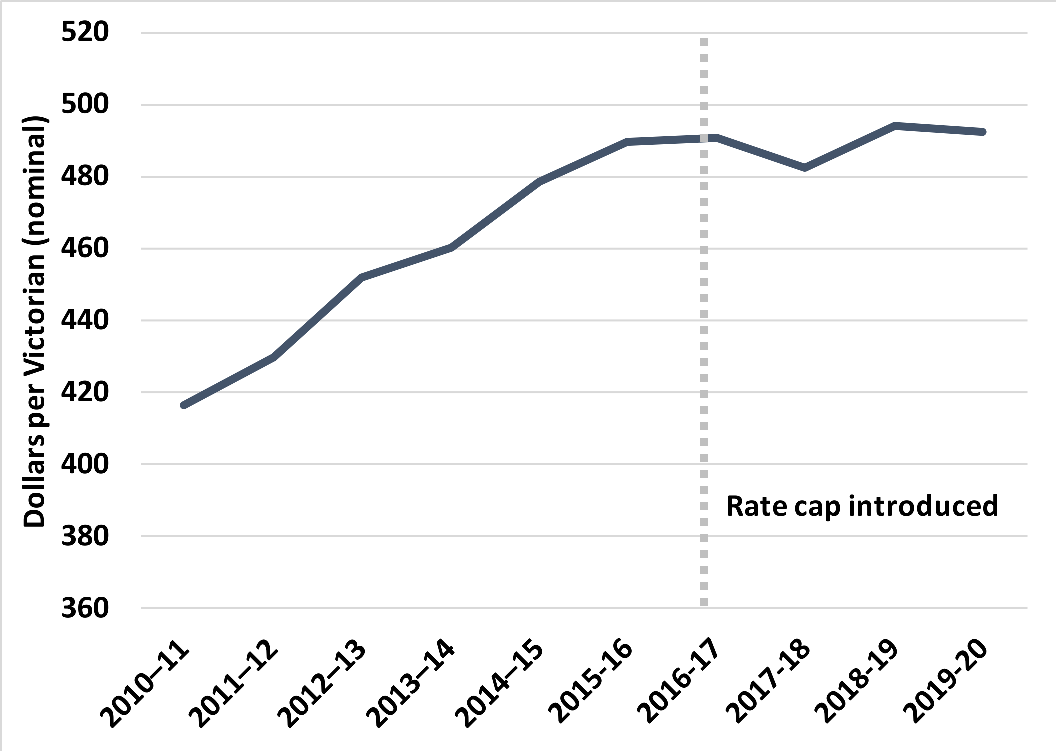
to lower expenditure, reduced consumption, slower recovery, and – completing the vicious cycle – lower wages and employment in the private sector (with commensurately lower expenditure arising from that sector). By the same token, during periods of strong economic growth inflation rates typically increase. Under the rate cap policy, this implies more revenues (and hence more spending capacity) for local governments, at the time when the economy needs it relatively less intensely. Tying the ability of governments to raise revenue to expectations of inflation is thus a pro-cyclical policy that amplifies economic fluctuations.

Rate capping, and in particular the annual timing of rate cap announcements, also presents additional difficulties for local governments in the negotiation of enterprise agreements for local government workers. Because multi-year enterprise agreements must be negotiated in the context of yet-to-be-announced annual rate caps, local governments manage risk by keeping their workforces precarious: employed on casual or short-term contracts. These staff can then be made redundant as shifting budgetary constraints demand. However, this 'flexibility' – shifting budgetary risk onto the backs of local government workers – is a false saving: there are many hidden or semi-hidden costs associated with it. Apart from the loss of institutional expertise and the productivity of workers in insecure jobs lagging well behind that of permanent staff, the administrative and organisational burden of cycling through workers is costly – especially for smaller organisations, like many local governments.

This administrative and productivity drag helps explain Drew and Dollery's (2015) finding that from 2009 through 2013 (prior to the rate cap policy), Victorian local councils delivered their services more efficiently (measured by greater service delivery per dollar of input) than those in rate-capped NSW (where rate caps have been in place since 1977). In other words, councils have been shown to be *more efficient* when not grappling with the consequences of rate caps – and the employment precarity they engender. Even the conservative Commonwealth government recently recognised a similar reality, conceding that the hiring and retention of ongoing public servants is more efficient than the wide-scale churn of contractors that has characterised Commonwealth employment practices in recent years (Dingwall, 2021). This finding that rate caps result in *less* efficient and effective service delivery is also supported by Temple (1996), who found that in the US context, rate capping reduced outlays on local services more than on local administration. This makes intuitive sense: if funds are tight and uncertain, the staff who administer funding (and thus services) will simply employ, procure, contract, and deliver less.

Figure 12 shows that since the rate cap was introduced, overall local government wage costs per Victorian have flatlined in nominal terms: at about $490 of local government wages per Victorian per year. In real (inflation adjusted) terms, local government sector wages per Victorian have been declining. It is hard to see how local governments could maintain their service offerings in the context of this austerity.

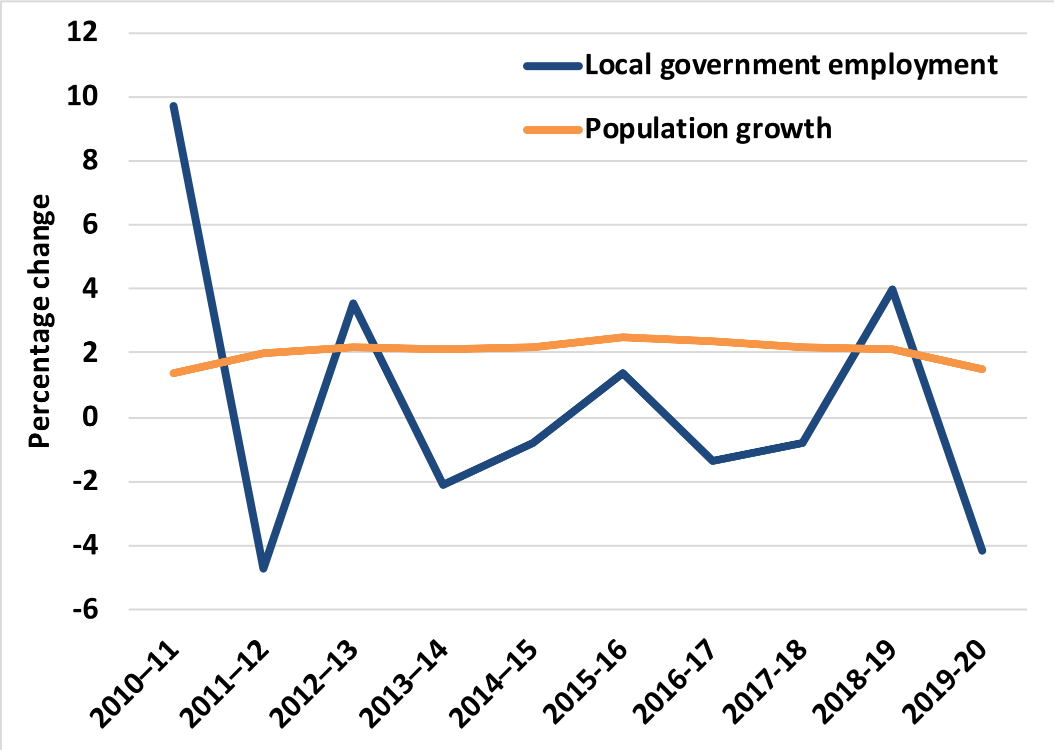
Figure 12. Local government wages per Victorian, 2010-11 to 2019-20



Source: Author's calculations from ABS (2020b) *Employment and Earnings, Public Sector, Australia, 2019-20*, and ABS (2021c) *National, State and Territory Population, September 2020*, table 'Population – states and territories'.

The trend towards fewer local government workers – in both absolute and per capita terms – is particularly concerning in the light of Victoria's strong population growth over that period. Victoria's population grew by over 20% from 2010-11 to 2019-20, while local government employment declined 5.3%. Moreover, there was considerable volatility in staffing levels over the decade (in part because of the rate cap policy's negative impact on local governments' ability to plan ahead). Staffing levels declined in six of those years, and exceeded population growth (roughly 2% per year) in only three. Figure 13 shows this volatile employment over time. Typically as a society becomes more well-off and complex, one expects government service offerings to expand in step, and hence for public sector employment to increase. It is concerning that in the case of Victorian local government, the opposite has occurred.

Figure 13. Annual percentage change in local government workforce and population, Victoria, 2010-11 to 2019-20



Source: Author's calculations from ABS (2020b) *Public Sector Employment and Earnings, 2019-20*, and ABS (2021c) *National, State and Territory Population, September 2020*.

It is difficult to reconcile reasonable, grassroots community demands for improved service levels (as described, for example, in Butler, 2021) with reductions in staffing in both overall and per capita terms. There is no reason that communities in a wealthy state such as Victoria should not enjoy improvements in community safety and amenity over time. And given that Victoria is growing in both population and GSP, local government investment – including in staffing – needs to keep pace, at the very minimum.

Since the introduction of rate caps, recorded wage rises per worker in the local government sector have also declined. Prior to the introduction of rate caps, they averaged 4.7% per year. After the introduction of the caps, they have average 2.9% per year since. [19] Local government wages lagged behind consumer price inflation in both

[19] Note that these changes over time are moderated not only by agreed wage outcomes, but also by the mix of staff at particular levels and with particular duties. That is to say, if the staffing profile of local government has become more senior over the period – perhaps as junior roles have been outsourced to labour hire – that will have resulted in the wage result skewing upwards. It is *not* the case that this

2017-18 and 2018-19.[20]. In other words, local government workers' spending power has gone backwards in real terms.

ENTERPRISE BARGAINING OUTCOMES

The ESC (2021, p. 34-36) agrees that since the introduction of the rate caps, average salary increases for local government workers have decreased. In 2013-14, the growth in employee costs per worker[21] and average salary increases were both above three per cent, higher than both the Victorian public sector wage price index and the consumer price index. In other words, at that time, local government workers' material standard of living was improving in real terms. However, even prior to the introduction of rate capping (in both 2014-15 and 2015-16), growth in local government employee costs per person dropped below the Wage Price Index. This is evidence that employee costs were not 'out of control' prior to the introduction of rate capping. Following the introduction of wage capping from 2016-17 onwards, growth in the sector's employee costs per person fell still lower, trending close to the consumer price index. Annual increases under enterprise agreements also trended closer to the consumer price index – and well below the Victorian state public sector wage price index. This analysis is summarised in Figure 14.

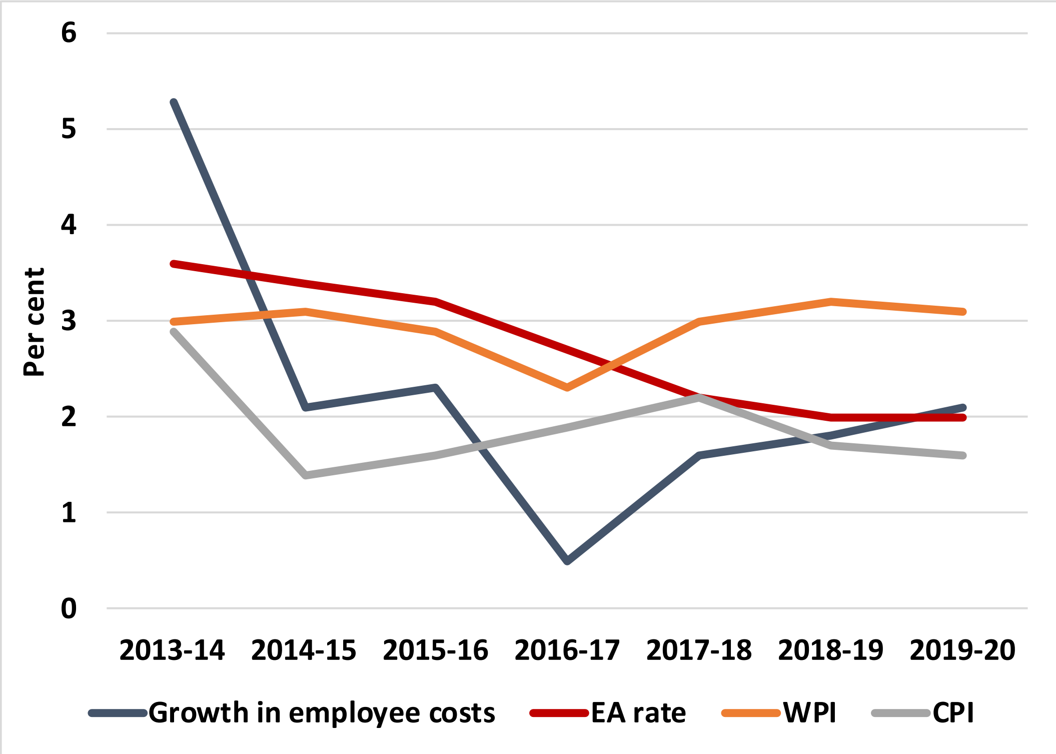
With Australia and Victoria already experiencing slow growth and stagnant wages (notwithstanding a fragile, still-uncertain economic recovery from COVID-19), the Victorian government should be unequivocally encouraging greater public sector employment and wage rises, as a lever to improve macroeconomic and labour market outcomes, quite aside from benefits to community safety and amenity. In this context, the ESC's expressed view (ESC 2021a) that the rate cap policy is working 'as intended' (evidenced by its effect in suppressing local government wages) suggests the policy is poorly conceived to begin with.

average result implies that individual workers were necessarily receiving annual pay increases in the order of 4.7% per year prior to the wage cap.

[20] Author's calculations from ABS, 2020b, and ABS, 2021e, Tables 1 and 2.

[21] Defined as wages, superannuation, and leave entitlements of permanent and casual staff, but not external contractors.

Figure 14. Growth in local government employee costs per person compared to average increases under enterprise agreements (EA rate), Victorian public sector Wage Price Index (WPI) and Consumer Price Index (CPI)



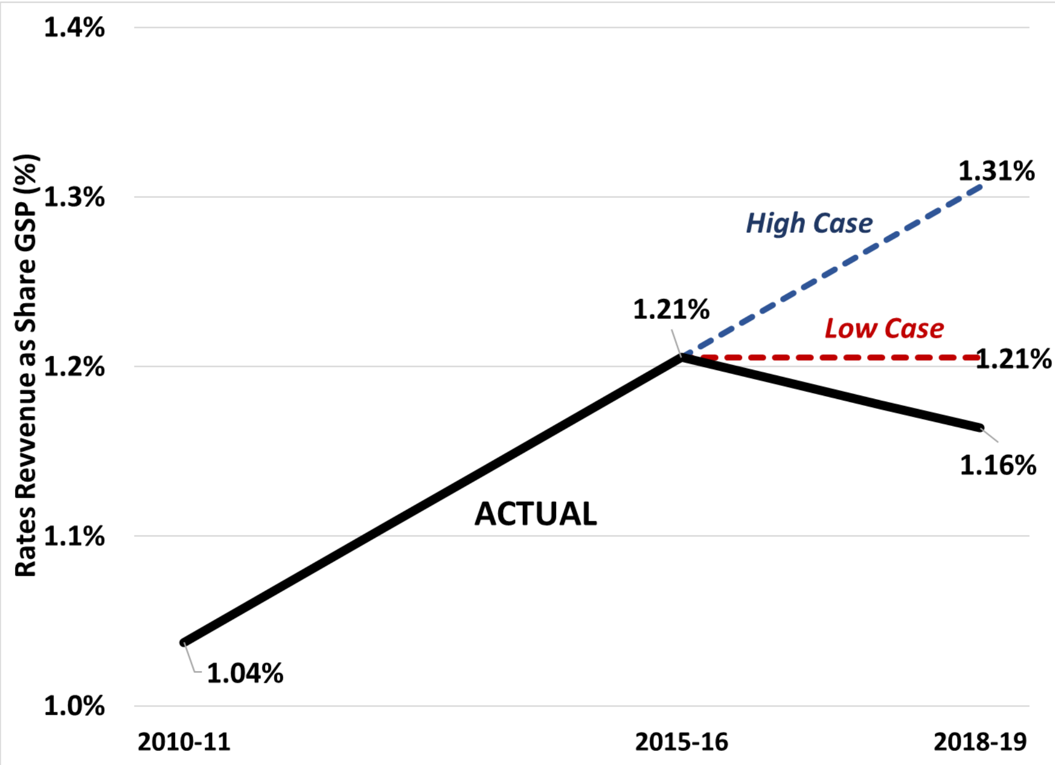
Source: Reproduced from ESC (2021), page 36.

Data supplied by the Australian Services Union from the most recent round of Victorian local government EBAs shows that 20.2% of Victorian local government workers were employed casually – with another 34.4% employed part-time. That is over half the local government workforce that are employed in a configuration other than conventional, full-time employment. And additionally, these figures don't account for outsourcing or contracting out of work to labour hire companies. All of this confirms that the rate cap policy has had a negative impact on both the quantity and quality of local government employment, and by extension on the quantity and quality of services delivered by those workers.

VII. The Impacts of Rate Caps: Two Simulations

As described above, the main effect of the Victorian rate cap policy has been to suppress the growth of local government rates revenue, relative to the growth of other macroeconomic and fiscal variables – including GSP, incomes, and even the tax revenues collected by other levels of government. In this section, we simulate the potential effects on local government revenues, and hence local government employment and service provision, if the rate caps had not been in place.

Figure 15. Local Government Rate Revenues: Actual and Counterfactual Scenarios



Source: Author's calculations from ABS Government Financial Statistics, various tables, National Accounts, and State Accounts.

We provide two counterfactual simulations of what could have happened to local government rates revenue in the absence of the rate caps. As noted above, total rates revenue had grown modestly but steadily for several years, measured as a share of GSP, before the imposition of the caps in 2015-16. Remember, tax revenues for other levels of government were also increasing relative to GSP or GDP (as illustrated in

Figure 5 above). Then, with the rate caps in place, local government rates revenue began to shrink, falling from 1.21% of state GSP to 1.16% by 2018-19 (the last full financial year before the COVID-19 pandemic[22]). A simplified illustration of this reversal in local government's most important revenue source is provided in Figure 15.

The decline in rates revenue has been associated with a corresponding decline in local government employment (especially relative to Victoria's growing population) and service delivery. Without that cap, we can imagine two potential counterfactual outcomes for rates revenue (again measured as a share of GSP): it might have continued growing at the modest but steady pace demonstrated before the imposition of the caps, or it might have simply stayed at the level reached when the caps were introduced. Those two scenarios are also illustrated in Figure 15, labelled "High Case" and "Low Case," respectively. In this section we consider, on the basis of the analysis provided above of the direct and indirect economic impacts of local government spending, on overall state employment and GSP. To provide an up-to-date macroeconomic context for these simulations, we apply the counterfactual revenue shares illustrated in Figure 15 to an estimate of Victorian GSP for the current financial year (2021-22), generated by extrapolating historical growth rates to pre-COVID actual data; in this manner, as well, we normalise the results to control for the dramatic but ultimately temporary impacts of the pandemic on Victorian macroeconomic and fiscal conditions.

The difference between actual rates revenue as a share of GSP in 2018-19, and the two counterfactual scenarios, is reported in Table 6. Applying those "revenue gaps" against our normalised estimate of Victoria state GSP in 2021-22, generates an estimate of the extra revenue that local governments would have received in the absence of the rate caps. In the low case, local governments would have received an additional $218 million in 2021-22; in the high case, the revenue increment is much larger, an estimated $745 million.

Next, we assume that local governments spent that additional revenue in line with conventional practice. Over the last decade, spending on local government staffing (to provide direct services) accounted for just under half (47%) of all local government revenues. We assume that broad labour share of local government activity is maintained, and that the additional labour spending is allocated to new hiring to expand services, compensated at the same average levels as existing staff.[23] This new

[22] Because of the dramatic impacts of the pandemic on macroeconomic and fiscal variables, we choose this pre-COVID benchmark as the starting point of our simulations.

[23] This assumption is conservative, because in practice new employees would typically earn somewhat lower wages and salaries than existing staff. We estimate 2021-22 average compensation for local government workers by extrapolating 2018-19 actual data on the basis of previous compensation

spending supports close to 1500 new local government employees in the low case, and over three times as many (near 4900) in the high case. This new hiring would underpin an important expansion of local government service delivery, at a time when Victorians are more dependent on safe, healthy, liveable local communities than ever. However, even the larger increment to employment in the high case scenario represents an increase in staffing of less than 10%. That is barely sufficient to restore total local government employment in the state to its levels in 2010 – and leaves it much smaller relative to population or total employment in the state.

The wages earned by those new local government employees are quickly recycled into the economy through their tax payments and consumer spending. Utilising the finding (described above) that slightly over half of personal incomes are subsequently spent on Australian-made consumer goods and services (after deducting income tax payments and purchases of imported goods), this results in an expansion in consumer spending of between $50 and $180 million per year, and the creation of between 350 and 1200 new jobs in downstream consumer industries.

The remaining 53% of incremental local government rates revenue would be spent on other inputs and purchases, further supporting the expansion of local government services. We assume that those purchases are distributed across the local government sector's supply chain, in similar proportions to its existing input purchases (described above in Table 2). After deducting an assumed margin for import purchases, this results in additional spending by local governments on Australian-made inputs of between $95 million (low case) and $325 million (high case). That, in turn, support additional employment in those supply industries of between 325 (low case) and 1100 jobs (high case). Of course, the earnings of those workers are also recycled into tax payments and downstream consumer spending. The additional increment of consumer spending (of between $10 and $35 million) supports the creation of an additional 70 to 235 jobs in consumer goods and services industries.

Through all of these channels of spending and re-spending, the additional revenue base provided by the uncapping of local government rates facilitates an expansion in hiring and other activity that flows through both the local government supply chain and downstream consumer spending activities. Table 6 summarises these far-reaching effects. The combined increase in spending on Australian activity (through the direct employment of new local government workers, and indirect spending on both input purchases and downstream consumer goods and services) ranges between $260

trends. If incremental revenues were spent on higher compensation in addition to new hiring, the result would be smaller direct employment increases, but the downstream and macroeconomic impacts would be similar to those described here.

million (low case) and $890 million (high case). This can be broadly interpreted as an increase in underlying economic activity or GDP – although many other interactions would also occur as these additional local government revenue and expenditures were put into motion.[24] The total increase in employment (direct and indirect) resulting from the uncapping of local government rates (and resulting expansion of local services) would range between 2175 jobs (low case) and 7425 jobs (high case).

Table 6
Results of Uncapped Rates Revenue Simulations

	Low Case	High Case
Assumed Rates Revenue Share (%GSP)	1.21%	1.31%
Difference from 2018-19 Actual	0.04%	0.14%
Estimate of Normalized GSP (2021-22, $b)	$523.4	$523.4
Additional Rates Revenue ($m)	$218.0	$745.6
Labour Spending (47%):		
Additional Labour Spending ($m)	$102.5	$350.4
Additional Direct Employment	1427	4880
Additional Downstream Spending ($m)[1]	$52.6	$179.8
Additional Downstream Employment	352	1204
Non-Labour Spending (53%):		
Additional Input Purchases ($m)[1]	$94.8	$324.0
Additional Upstream Employment	323	1105
Additional Upstream Wage Income ($m)	$20.2	$68.9
Additional Downstream Spending ($m)[1]	$10.3	$35.4
Additional Downstream Employment	69	237
Total:		
Additional Spending ($m)	$260.2	$889.5
Additional Employment	2172	7426

Source: Author's calculations as described in text.
1. On Australian-made goods and services, net of assumed import share.

By any measure, therefore, it is clear that the arbitrary suppression of local government rate revenues, and resulting austerity in local government hiring and service delivery, is undermining Victoria's economic performance. Removing that arbitrary restriction, and restoring the democratic authority of local governments to collect and spend tax revenues in line with the expressed preferences of their constituencies, would result in stronger employment and growth. Most importantly, it

[24] A full-fledged macroeconomic or general equilibrium simulation would portray other effects such as higher-order indirect effects on Tier 2 suppliers, changes in consumer spending by ratepayers, impacts on business investment, and others. Such an exercise is beyond the scope of this paper.

would also result in stronger and healthier communities – at a moment in history when those priorities are more obvious than ever.

Conclusion and Policy Implications

The local government sector delivers socially vital services on an aggregate budget that constitutes a small sliver of Victoria's gross state product. The state government's arbitrary suppression of that modest budget, through its rate caps policy, has many consequences: it impedes planning, undermines employment (particularly ongoing, secure employment), and damages program delivery. However, it also has a more insidious effect of removing democratic decision-making that should be apportioned to those who live in a particular LGA – and placing it with a different level of government altogether, on a one-size-fits-all basis. This fails to recognise the diversity of the local government experience across Victoria, where differing geographies and demographic challenges pose differing requirements.

We have also noted the perverse and pro-cyclical impact of constraining rates to expected inflation – especially during a recession. Under the rate cap policy, as inflation falls (as typically occurs during a downturn), the capacity of local government is restricted – to plan, employ, and deliver. This is precisely the opposite of what a counter-cyclical government response to negative economic conditions would demand.

It is clear from the above analysis that the Victorian government's rate caps have resulted in a reduction in local government service provision, lower staffing levels and wages, and more precariously employed workers. Previous research has examined these effects in the New South Wales[25] and Victorian contexts, as well as overseas, including the US (see Dollery, 2021 for a review). This literature supports the assertion that rate capping negatively affects staffing levels, service delivery, and infrastructure maintenance. These aren't 'efficient outcomes', either for ratepayers or in an abstract economic sense. Simply put, they are missed opportunities.

Far from 'protecting' them, the Victorian government's rate capping policy has affected ratepayers and other residents negatively. The delivery of local government services is impeded. And for the private sector, the cap suppresses potential demand for businesses in both the upstream (inputs) and downstream (consumer expenditure) sectors. And we have shown that at the macroeconomic level, tying government spending to inflation indices exerts a pro-cyclical effect on economic growth –

[25] Recall that rate capping has been in place in NSW since 1977 – albeit with rules that make it easier for a council to apply for an exemption than in Victoria. That provision came into effect into response to official reports on the effects of rate capping (see Dollery, 2021).

especially damaging when the economy remains fragile after the COVID-19 crisis. This is no time to put a brake on services, employment or wages, at any level of government.

We recommend that the Victorian government's rate cap policy is abolished altogether.[26]

Local councils are democratically accountable to ratepayers and residents. A 'one-size-fits-all' approach to determining rates growth is all the more counterproductive given the wide variety of circumstances experienced by local government, such as differing infrastructure needs (construction, upgrades and maintenance) and the different revenue baselines at the time the rate caps were imposed (leading to compounding effects, as councils with lower revenue relative to their needs prior to the imposition of rate caps have fallen increasingly behind).

Local government spending and employment per capita (proxies for service provision) have both declined since the cap system was introduced. Furthermore, the evidence suggests that externally-imposed rate caps don't serve their stated purpose of making local government service delivery 'more efficient'. Dollery's (2021) survey of experiences both here and overseas suggests that rate caps do not achieve this aim, instead simply starving the community of services.

The economic effects of the rate caps would be damaging at any time, but this is especially the case at this fragile moment in Australia's economic recovery from the COVID-19 crisis. Allowing local governments authority to collect as much revenue as is consistent with the expressed preferences of their constituents, would facilitate more service delivery and more employment. This would translate into a more robust rebound in consumer spending, which in turn will assist in the propulsion of private sector employment and investment. All of these effects would be especially beneficial in reinforcing Victoria's economic recovery from the pandemic.

[26] This is consistent with Dollery's (2021) 'first-best' policy recommendation.

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