



FUNDING OF LOCAL GOVERNMENT IN IRELAND

SUBMISSION TO THE DEPARTMENT OF THE ENVIRONMENT, HERITAGE AND LOCAL GOVERNMENT

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PREPARED WITH THE ASSISTANCE OF



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1. Foreword

The Funding of Local Government

The recently published statement on prices and costs by the National Competitiveness Council confirms the widely held belief that Ireland is an expensive location for both business and consumers. The Chairman of the Council in his overview, states that improving Ireland's international cost competitiveness should become a priority for Government. It highlights that decisions made by Government, its agencies and regulators have contributed adversely to inflation. It is timely that the Minister for the Environment, Heritage and Local Government should request submissions on the funding of local government in Ireland, as local government costs, be they in respect of rates or services provided are a major contributor to the excessive increase in the cost base for Irish businesses.

In his preface to the first progress report of the Tourism Action Plan Implementation Group, Mr. John Travers, Chairman, states that "many of the factors that have undermined the competitiveness of Irish tourism lie outside the direct control of the industry itself". The general rate of inflation, at a level many times higher than that of the countries with which Ireland competes for visitors, has raised input costs for the tourist industry at a rate of increase well above that of its competitors. Increases in input costs are inevitably reflected in the cost of tourist products and services. The tourist industry itself is continually examining all the costs over which it has control and in making this submission, it is requesting the Government to look seriously at funding local government in Ireland in a more equitable manner which will adequately fund the necessary activities of local authorities and at the same time ensure that the business sector is not penalised.

Major rationalisation to increase efficiency and reduce costs is now a priority for all industries. It is a greater priority for tourism, as the Irish economy is built on a low direct tax model with high levels of indirect taxation. This economic model puts us at a serious disadvantage to our competitors who operate in an economic model with higher direct taxes and lower indirect taxes. In these economies prices appear to be cheaper, although the disposable incomes of their citizens appear to be lower. In a country such as Ireland which has a higher level of disposable income, the prices in these countries appear more attractive and ours more expensive. Tourism and the export sector are most vulnerable to this economic reality.

In this submission, we suggest that local authorities look for efficiencies in carrying out their operations in the same way as businesses do. We believe that the Government should recognise the nature of the services provided and fund them in an appropriate manner. Services such as water, waste collection, planning fees, and recreation facilities etc., that are provided directly to households and/or business premises should be paid for by user charges. Charges should be based on full cost of recovery by the local authority and should be based on the level of use of the relevant services. The basis of these charges should be open and transparent. On the other hand, community based services such as the provision of parks; libraries and street cleaning should be funded by a local income tax that is applicable to all taxable entities, including business and individuals. We propose that this local tax should replace the current system of property rates. We suggest in our submission, that this tax should be collected through the normal income tax and corporation taxation system. We estimate that a corporation tax rate of about 2.25% on profits would provide similar funding to the current rates system and the replacement of the current personal tax rates with “national” rates of 18% and 38% (standard and higher rates respectively), couples with a 2% and 4% standard and higher rate of local income tax would fund local government adequately. Given the buoyancy in current income tax and corporation tax receipts, it is our view that it would not be necessary to increase the current overall rates of taxation but merely to fund the local authority from the natural increases from these sources. The proposed system has a strong “ability to pay” element; removes many anomalies in the existing system and is equitable and transparent.

The Irish Hotels Federation, which represents over 1,000 hotels and guesthouses throughout the country who have over the years borne more than their fair share of the burden of funding local authorities, earnestly urge the Minister of the Environment, Heritage and Local Government and his cabinet colleagues, to take on board the recommendations made in this submission. By doing so, the Government will make a substantial contribution to increasing the competitiveness of Irish businesses in vulnerable industries like tourism, and help our competitiveness in International markets.

A handwritten signature in black ink, appearing to read "Richard Bourke".

Richard Bourke
President

2. Background to the Submission

The Irish Hotels Federation is the representative body of the Irish registered hotel and guesthouse sector.

The Federation membership includes 852 hotels and 486 guesthouses that provide a total of over 48,000 bedrooms. The members employ in excess of 57,000 people.

The members interact with local authorities in many ways, directly and indirectly, such as through:

- ***Directly Supplied Services***
 - Water and waste water services
 - Waste management services, in some regions
 - Planning applications and planning control
 - Fire safety and inspections, and

- ***Local Authority Activities Impacting on the Hotel and Guesthouse Sector***
 - Road maintenance and upkeep
 - Economic planning and local tourism projects
 - Environmental controls, pollution measures etc,
 - Recreation and Amenities, parks, local environment, etc.
 - Waste management, especially street cleaning.

There is much interaction and the sector is also a major contributor to local government funding. Active local government is of major importance to the sector.

The Minister for the Environment, Heritage and Local Government has commissioned a review of the funding of local government with a view to developing a sustainable funding system for local government in the medium to long term

Submissions have been invited from interested parties and the Irish Hotels Federation now submits its views and proposals on behalf of its members

3. Summary and Key Points

Overview of the Current Position

Local Government current expenditure in Ireland has been increasing at an average rate of 12.5% over the last four years, driven mainly by the operating and maintenance demands of the infrastructure investment under the National Development Plan. With projected high levels of investment in the national infrastructure, coupled with the payment of benchmarking awards, prospects are for continuing high growth levels in local authority expenditure in future years.

The Local Government Fund, comprising motor tax revenues and an Exchequer contribution, was launched in 1999 as a key source of local government funding. However, despite an underlying buoyancy of close to 5% per annum, and three increases in motor tax rates since 2000, the Fund has provided money for a substantial increase in non-national roads expenditure, but as is demonstrated in our submission, the Fund has made no real contribution to other areas where local authority expenditure has increased.

With the central Government contributions constrained by fiscal policy, and with little direct contribution from the domestic sector, the brunt of funding the increases in local authority expenditure has fallen on the commercial sector through a combination of rates and user charge increases.

At present, we estimate that the commercial sector provides almost 40% of local authority day-to-day funding through rates, user charges and levies. In contrast, excluding rents and loan repayments made by local authority housing tenants and home borrowers, the domestic sector makes a contribution of about 6% of local government funding needs.

There are substantial inequities within the rates system, in that the system does not recognise the ability of different forms of enterprise to generate substantially different levels of revenue and profits from properties.

Our Proposals

Our proposals for consideration by the Review Group are that:

- **A system of funding local government through a combination of**
 - **A local income tax**
 - **User charges for services where the levels of use can be determined, and**
 - **Central government funding for specific, typically social purposes**

should be considered strongly for adoption.

Charges on both domestic and commercial users should fund services such as water and sewerage and waste collection and disposal. Local services such as parks, libraries and street cleaning, should be funded by a local income tax levied on incomes of all sectors, commercial and households. Social services such as adapting homes for the elderly or disabled should be funded by central Government, while specific activities, where local authorities act as agents, such as disbursement of Higher Education Grants, should be funded by the relevant Government Department.

Models for such a system exist in other EU countries. The proposed system meets the key criteria of equity, ability to pay, promoting efficiency in the use of services and strengthening of local democracy, as well as addressing the shortcomings in the current funding system.

- **The new funding system should be complemented by radical proposals to provide better value-for-money, by, for example:**
 - **Amalgamating small local government units such as towns and boroughs with Counties to generate improved economies of scale,**
 - **Generating operational efficiencies such as the establishment of financial shared service centres for financial accounting and reporting or outsourcing housing loan administration, and**
 - **Removing the financial distortions that arise from the existing treatment of local authorities in respect of VAT.**

4. Scale and Nature of the Irish Hotel and Guesthouse Sector

4.1 Sector Overview

- **Membership**

The Irish Hotels Federation represents the registered hotel and guesthouse sector in Ireland. The sector comprises 852 hotels with 42,912 bedrooms as shown below, in addition to 486 guesthouses providing over 5,300 bedrooms. The hotel sector in 2003 is broken down as follows:

<u>Grade</u>	<u>No.</u>	<u>Rooms</u>
5 Star	21	2,899
4 Star	84	7,386
3 Star	316	20,082
1 & 2 Star	245	5,026
Other	<u>186</u>	<u>7,519</u>
	852	42,912

- **Visitor Numbers**

6.4 million visitors came to Ireland in 2003, generating €4.1 billion of foreign earnings.

- **Revenues**

Hotels in Ireland sold over 9 million roomnights in 2003, generating almost €2 billion in turnover as follows

<u>National Hotel Turnover</u>		<u>2003</u>	
Room nights		9,051,000	
Average Room Rate		€ 88.73	
Total Room Turnover	€ 803,095,230		41%
Food Sales	€ 595,465,732		30%
Beverage	€ 401,547,615		21%
Other	€ 158,660,277		8%
Total Turnover	€ 1,958,768,854		100%

Source Failte Hotel Review 2003 and Horwath Bastow Charleton Hotel Industry survey 2004

- **Employment**

Employment in the hotel sector was just over 57,000 as detailed below

Employment Numbers (2003)				
	Permanent		Seasonal	Total
	Full Time	Part Time		
Hotels	35,365	13,573	5,227	54,165
Guesthouses	2,039	531	309	2,879
	37,404	14,104	5,536	57,044

Source Failte Employment Survey 2003

Hotels are the largest employer in the tourism sector, generating a total payroll of the order of €600 million annually

- **Economic Impact**

Hotels make a major economic impact in Ireland by

- Underpinning national efforts to continue to expand tourism and increase foreign earnings
- Putting some 87% of their revenues back into the Irish economy through wages, food, beverage and other purchases
- Sustaining some 29,000 jobs in supplier and support companies
- Distributing tourism benefits across all regions

4.2 Key issues facing the sector

International competition for tourists has been intensifying for some years, but the recent expansion of the EU has drawn a substantial of tourists, particularly central Europeans, towards that region and has greatly increased the pressure on the Irish tourist product to maintain its competitiveness.

Ireland is gaining a reputation as a high cost tourist destination, but the sector suffers from high cost inputs in labour, food and drink and high levels of indirect taxation and levies, including local authority rates and levies.

The nature of the hotel industry is that it has a high level of fixed costs, including premises, building maintenance, facility costs such as insurance, heat and light, core staff, etc. This makes the hotel sector particularly vulnerable to visitor number changes.

The key impact of both central and local Government regulation and local government taxation on the hotel and guesthouse sector is to exacerbate the fixed cost characteristics of the industry, for example;

- Rates paid to local authorities are a fixed charge, incurred annually, that are based on notional property values and that bear no relationship to the size or scale of the business or its ability to pay. A small accountancy or legal firm can generate over €1 million in fees from an office of 100 sq. m., whereas a 40-bedroom hotel that would generate a similar amount of bedroom income pays substantially more in rates.
- Effluent Discharge licences are fixed charges imposed by local authorities that are increasing at a substantial rate, and that bear no relationship to the service provided. The major impression is that such licences are priced on a “what we think they’ll pay” basis
- Liquor licences have to be paid for annually

- Certain fire inspection charges are a fixed cost and again appear to fixed on the basis of what the service provider needs to raise by way of revenue rather than reflecting the cost or value of the service provided, and
- Failte Ireland registration fees.

It is the view of the hotels sector that the current system of local government funding places a disproportionate burden on the commercial sector in general and that the rates system penalises the accommodation providers relative to others in the commercial sector.

Our submission contains proposals for spreading the burden more equitably, a major requirement of any system that is intended to provide a medium and long term solution to local government funding.

5. Local Government in Ireland – Overview and Salient Features

5.1 Trends in Local Government Funding

The focus of our submission is on the future and the recent past, however, it is useful to identify the key trends of recent decades to show how we have come to the current position in the funding of Local Government.

In summary, the key developments have been:

- In 1978, dissatisfaction with the domestic rates system in Ireland had reached the level where the Government decided that instead of reforming the rates system, it would transfer the liability for paying rates from households to the Exchequer. Subsequently, in 1982, agricultural rates were judged to be unconstitutional, and so, with the loss of significant amounts of rates funding, a substantial level of funding from Central Government was required. This was provided under the Rate Support Grant and in 1983, Local Government was funded primarily by Central Government as shown in the following table. The contribution from commercial rates was 12% of local authority expenditure.

Local Government Funding - 1983

○ Central Government Funding	65%
○ Commercial Rates	12%
○ Charges	23%

- The 1980s were a period of economic slowness in Ireland, with Governments working within tight financial constraints. In 1983, the powers of local authorities to charge for services were widened and later, the Government removed the “cap” on commercial rates. These decisions are reflected in the changed structure of Local Government funding, which by 1995 showed a shift from Central Government funding to charges and particularly to commercial rates, the latter more than doubling its contribution to the funding needs.

Local Government Funding - 1995

○ Central Government Funding	41%
○ Commercial Rates	26%
○ Charges	33%

- In 1997, the powers of local authorities to charge the domestic sector for water and sewerage were abolished, and as was the case with the “abolition” of domestic rates, much of the resultant funding gap was taken up by Central Government, this time through the Equalisation Fund and the Local Government Fund. However, it was merely a case of Central Government replacing a large portion of the revenues lost through the abolition of water charges. The contribution from commercial rates rose further.

In 1998, Local Government Funding was as follows:

Local Government Funding - 1998

○ Central Government Funding	45%
○ Commercial Rates	27%
○ Charges	28%

- The National Development Plan 2000 –2006, has been the primary driver of recent developments in local government activity levels. The plan provides for significant increases in expenditure on roads, wastewater infrastructure and public sector housing. In addition, major developments in waste management, including recycling initiatives and diversion of waste from landfill meant greater costs in that area. In 2003 Local Government is funded as follows.

Local Government Funding - 2003

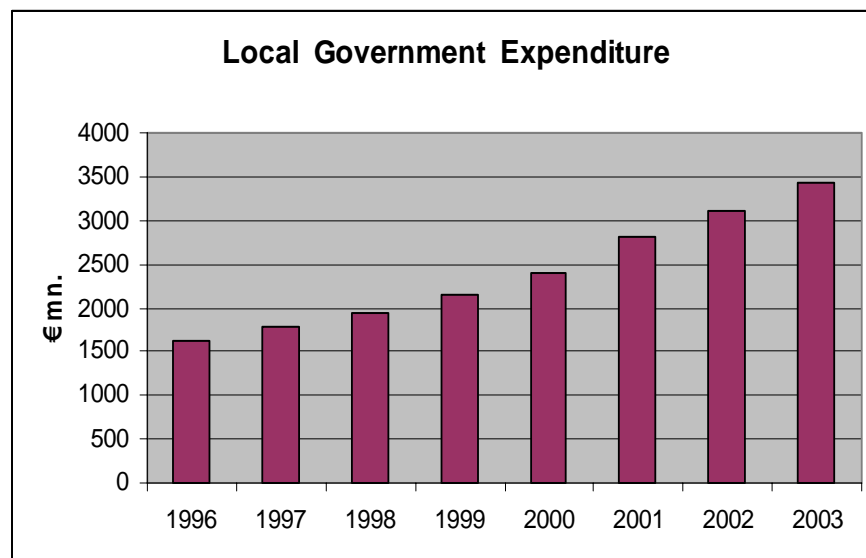
○ Central Government Funding	44%
○ Commercial Rates	24%
○ Charges	32%

The impression that one might take from this table is that over the past five years the funding of Local Government has seen a shift from commercial rates to service charges, with Central Government maintaining its level of support. However, with domestic water and sewerage charges having been abolished, and given that most Local Authorities have ceased the collection and disposal of domestic waste, the bulk of user charge increases has fallen on the commercial sector, as will be discussed in more detail later.

In summary, the key trend in Local Government funding in Ireland over the past quarter of a century has been a succession of retreat from raising income from the domestic sector, followed by an initial reliance on Central Government funding and then a gradual shift of the burden to the commercial sector, both through increases in the commercial rates burden and latterly through substantial increases in service charges. This has led to the situation where in our view, the burden of Local Government funding is not shared equitably, and where there is an undue reliance on the commercial sector in general, and on the hotel and guesthouse sector in particular.

5.2 Trends in Local Government Expenditure and Receipts

Local Government expenditure has risen inexorably in Ireland in recent years, and is estimated at €3.423 billion in 2003. The rise is as shown in the chart below.

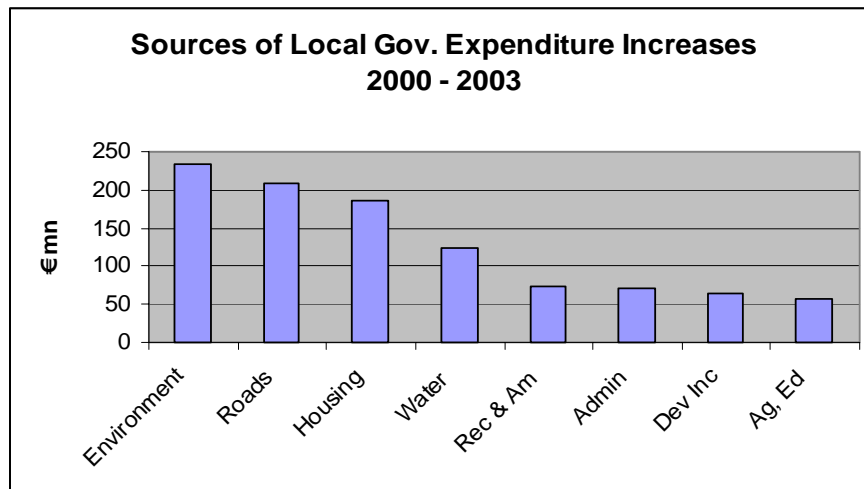


Between 2000 and 2003 alone, the increase in money terms has been € 1.02 billion, (from € 2.40 billion to € 3.42 billion). This equates to a gross increase of 42.4%, substantially ahead of the overall increase in the cost of living over the same period of 13.6%. The average annual increase in local authority expenditure since 2000 in real terms, i.e. after allowing for inflation, has been 8.8%.

The main sources of expenditure increases since 2000 have been in four Programme Groups in particular. These are

- The Environment Programme Group, which is composed primarily of waste management and the Fire Service
- The Roads Programme Group, primarily made up of expenditure on non-national roads
- The Water Provision and Sewerage Programme Group, which is self-explanatory, but which has been driven by substantial capital investment in new wastewater treatment plants, and
- The Housing Programme Group, where the provision of social housing and the expansion of loan schemes to assist buyers in affordable housing and other initiatives, has led to increased expenditure.

The relative contributions of these sectors to the overall increase in local authority expenditure are shown in the following chart.



Each of the four main contributors to the increased expenditure is discussed in the following section.

- **The Environment Programme Group**

The two key areas where expenditure has increased in this Programme Group are Waste Disposal and the Fire Protection Service.

Waste disposal expenditure has more than doubled in the last four years, driven by substantial changes in our waste management services and infrastructure. Receipts, driven by the requirements of the Polluter Pays Principle, have more than kept pace with expenditure, though a deficit still remains.

Waste Disposal	2000	2003
Expenditure € mn	170.5	368.0
Receipts € mn	113.9	305.3
Deficit € mn	56.6	62.7

In relative terms, the gap between expenditure and receipts has virtually halved, from 33% of expenditure in 2000 to 17% in 2003. Most local authorities have now ceased their domestic waste collection services, therefore much of the receipts are not gained from households, but are now collected through landfill charges. The commercial sector accounts for some 70% of waste that is landfilled with local authorities, and it is clear therefore that much of the increased receipts are collected from the commercial sector.

We have no issue with the principle of paying for a service provided, however, we point out that:

- Landfill charges are substantially higher in Ireland than in other countries. Charges in Ireland are generally well in excess of €100 per tonne, before the imposition of the landfill levy of €15 per tonne, whereas landfill charges in Scotland are of the order of €35 per tonne. In short, landfill is seen as an opportunity to generate required revenues with little or no recognition of the cost of the service provided.
- Industry and Commerce make substantial contributions to recycling initiatives through schemes such as REPAK, and therefore through charges, rates and REPAK subscriptions, commercial interests make a major contribution to the new waste management infrastructure.

Expenditure on the Fire Service has grown as follows:

Fire Service	2000	2003
Expenditure € mn	160.0	227.3
Receipts € mn	43.9	74.0
Deficit € mn	116.1	153.3

There is a substantial deficit on the provision of the Fire Service that has to be funded from general income. Much of the existing receipts are derived from the commercial sector through Fire Inspection charges.

- **The Roads Programme Group**

The National Development Plan provided for a substantial increase in expenditure on non-national roads.

Roads	2000	2003
Expenditure € mn	517.4	677.3
Receipts € mn	384.2	502.7
Deficit € mn	133.2	174.6

The Local Government Fund was established in 1999 to provide money for

- Non-national Roads
- Local authority general purposes, and
- Specific initiatives.

The fund is made up of the proceeds of motor tax plus an Exchequer contribution. In the following table we show that the fund increased by €233 million over the period 2000 to 2003, but that €155 million of this was diverted to specific purposes, primarily the roads programme. In practice, the substantial increase in non-national roads expenditure promised under the NDP has been funded primarily through a diversion of funds within the Local Government Fund rather than new funding provided by the Exchequer.

		2000	2003
Motor Tax	€mn	496	640
Exchequer Contribution	€mn	362	451
Total	€mn	858	1,091
General Purposes	€mn	540	618
Diverted to Specific Purposes	€mn	318	473

The fund has been increased by a combination of buoyancy in the national vehicle fleet of close to 5% per annum in recent years, added to motor tax rate increases. Although the fund increased by €233 million over the period from 2000 to 2003, the amount that has been diverted to non-national roads and other purposes has risen by €155 million, while the amount provided to general purposes has risen by just €78 million. In fact, when inflation is taken into account, the funding provided to local authorities for general purposes from the local government fund has increased by a mere €5 million in real terms since 2000.

- ***The Housing Programme Group***

The key activities in this Programme Group, namely the provision of local authority housing and various loan schemes to assist people to buy their own houses, operate at virtually a break even between expenditure of €350 million and receipts of €340 million

In practice, this programme is now financed almost totally by local authority tenants and borrowers through payment of housing rents and repayment of housing loans.

- ***The Water Supply and Sewerage Programme Group***

Expenditure and receipts for water supply and sewerage have been as follows:

Water Supply and Sewerage	2000	2003
Expenditure €mn	246.2	332.7
Receipts €mn	106.6	178.6
Deficit €mn	139.6	154.1

In summary, expenditure on providing water and wastewater services has risen by €86.5 million and receipts have risen by €72 million.

The domestic sector does not pay for water provision or sewerage services. Data from various sources such as the ESRI indicates that Domestic/Non domestic water use in Ireland is of the order of 50%/50%. On this basis, the non-domestic sector can be seen to be paying the full cost of its water provision, while the domestic sector is funded from central sources.

- **Summary**

In summary, the foregoing analysis shows that the major portion of charges in the areas of waste, water provision and sewerage falls on the commercial sector. In the area of housing, current expenditure is almost completely funded by local authority tenants and borrowers. Increased expenditure in other programme groups, such as roads, has been funded by a diversion of funds from existing sources to specific purposes.

In the annual publication of the local authority estimates, the Department of the Environment, Heritage and Local Government shows that for 2003, the estimated expenditure of €3,423.9 million was to be funded as follows:

	<u>€mn</u>	<u>%</u>
Central Government Grants	890	26
Local Government Fund	618	18
Charges for Services	1,091	32
Commercial Rates	836	24
Other	<u>- 12</u>	<u>--</u>
	3,423	100

However, if one analyses the source of local authority receipts in 2003 by source, one would conclude that the funding of local government shows a breakdown as follows:

	<u>€mn</u>	<u>%</u>
Central Government / LGF	1,496	44
Commercial Sector	1,306	38
Housing Tenants / Borrowers	400	12
Domestic Sector	<u>221</u>	<u>6</u>
	3,423	100

In calculating this breakdown, we have attributed the receipts under programmes 1.1 (Provision of Social Housing) and 1.2 (Assistance to Persons Housing Themselves) to housing tenants and borrowers. We have attributed water and sewerage charges to the commercial sector, together with an apportionment of parking, waste disposal, planning fees and fire service charges. The main sources of the income attributed to the domestic sector are the Recreation and Amenity programme group and waste charges in the Dublin Region.

While there is some degree of estimation in the analysis shown above, the differences between the sources are so substantial that the key thrust of the analysis is valid.

It may be argued that the domestic sector contributes to local government funding through the local government fund and through central taxation. We note that

- In 2003, out of an estimated €31.6 billion of tax revenues, income tax was €9.3 billion and corporation tax was €5.0 billion. The Exchequer draws revenue from a wide range of other taxation sources.
- Of the €1,496 million provided from central government, €640 million was provided by way of motor tax, which forms part of the Local Government Fund. There are no official statistics on the sources of motor tax, but with substantial numbers of cars owned by the commercial sector and also recognising that goods vehicles are subject to substantially greater annual motor taxes than private cars, we estimate that commercial sector pays a substantial portion, and possibly up to half the motor tax collected.

In conclusion, it is evident that the commercial sector pays substantial contribution to local government funding through rates, charges and the central taxation system, and that the domestic sector, other than local authority tenants and house loan borrowers, pays a substantially smaller contribution.

5.3 The Future

The historic rate of growth in local government year-on-year expenditure is likely to continue, and possibly increase in future years, particularly given

- The increasing pressure on the government and local authorities to address the issue of affordable housing and provide more assistance to first time buyers
- The continuing increase in expenditure on non-national roads. A substantial increase may arise when the results of a non-national roads study that is underway are available
- The continued development of new wastewater treatment infrastructure. A €5 billion programme was announced by the Minister earlier this year, and this will give rise to increased operating and maintenance costs
- The continuing development of waste management infrastructure, including recycling initiatives, external treatment and new landfill sites. New regional waste management plans are being developed and there may be additional costs implications from these plans which are to be launched in early 2005, and
- The funding of additional benchmark awards, which the minister has stated will be €120 million in 2004 and for which no central government funding is being provided.

Staff costs, and the growth in staff costs, are an issue of some concern. CSO data show that local government staff costs have risen by 10.4% annually since 2000, arising from

- An increase in local authority staff numbers from 30,900 to 35,000 in the period 2000 to 2003
- Restructuring as part of the better local government programme, and
- Pay increases, including bench marking

However, it is a concern that the staff number increases have occurred over a period when

- Many local authorities have ceased operations such as waste collection
- Some authorities, such as the Dublin authorities, have secured substantial efficiency increases in a number of key operating areas
- Many authorities have outsourced operations such as housing maintenance and road maintenance, and
- Major new plants have been provided under Public Private Partnership arrangements.

In short, there has been a very questionable increase in local government employment.

- ***The Funding of Future Expenditure***

The prospects for local government expenditure are that, given a continuation of historic growth rates that are in turn driven by infrastructure investment, coupled with the significant impact of benchmarking, it will approach €4 billion in 2004. We estimate that after allowing for a modest increase in inflation, local government current expenditure will see an increase of the order of €500 million over 2003.

In respect of the various sources of funding that are relied on at present, the underlying buoyancy in the national vehicle fleet, added to the 5% increase in motor tax rates effective from January 1, 2004 should provide an additional €65 million euro in 2004.

Buoyancy in the commercial rates base is of the order of 3% to 4% at present, and were this to continue into 2004, it will provide an additional contribution from rates of some €33 million before any increases in the rate in the euro.

It is not possible to derive detailed estimates of increases in receipts from housing tenants, house loan borrowers or the general domestic sector for 2004, but if historic trends continue these will provide an additional €120 million euro, resulting in a situation as follows:

	€ Million
Expenditure increase 2004 over 2003	<u>500</u>
Less: additional LGF Receipts	65
Less: Rates Buoyancy	33
Less additional Housing, Domestic receipts	<u>120</u>
Balance to be funded	282

This is a serious funding gap. The total funds that would be provided by increasing water charges, waste charges and commercial rates at the current rate of inflation, i.e. 2.5%, would come to €34 million. Increases of the scale of 10%, four times the rate of inflation would not provide even half of the additional funding required.

As noted previously, the Local Government Fund, which was announced in the late-1990s, put in place in 1999, and proposed as a long term solution to local government funding, has been overtaken by the demands of the National Development Plan and has not made the expected contribution to local authorities general funding needs. The Fund was to provide a buoyant source of revenues for both non-national roads works as well as a central fund that would provide some level of equalisation between authorities with substantial resources and those with relatively less resources. These funds were to be provided by way of general purposes grants.

The contribution made by the Fund to “general purposes” has grown from €540 million in 2000 to €618 million in 2003, a nominal increase of €78 million, but an increase of just €5 million in real terms. By contrast, in the same period, the rates levied have grown by 42.4 % to €336 million and income from user charges has grown by 58.4% to €1.09 billion. However, as shown previously, the bulk of user charges have fallen on the commercial sector.

Apart from waste collection charges in the Dublin region, private households make no direct contribution to local authority funding, except through charges for occasionally used services such as planning applications, swimming pool use, etc. In fact, the major direct contribution made by any group of households to local authorities is the rental income paid by local authority tenants.

In the absence of increased Exchequer funding, particularly the failure to provide for benchmarking awards, it is clear that the continued expansion of local government expenditure will result in disproportionate increases in commercial rates, levies and demands, and charges for water, waste disposal and other services used by the commercial sector, unless a different approach to funding is taken.

5.4 Summary of Issues with the Current Funding Structure

We have noted previously that, with the exception of local authority tenants and service charges in Dublin, the non-commercial sector makes very little direct contribution to local authority funding. The commercial sector pays for services that are priced at least at full cost recovery levels, and in some instances, appear to be at levels greater than a full cost recovery basis.

In individual local authorities, rates are treated as the “balancing figure”. When the expenditure estimates are completed, and central Government and Local Government Fund moneys have been taken into account, the final decision made by many Councils is what level of rates will be demanded from the commercial sector to fund services, additional activities or investment that is intended more for the benefit the population in general than the commercial sector. This situation has arisen because since the removal of the Ministerial “cap” in late 2002, rates increases are in practice the only substantive source of discretionary funding available to local authorities. Hence, many local or community initiatives promoted by local politicians, rely on funding from the commercial sector.

As illustrated above, buoyancy, or the propensity for tax and service charge income to increase as economic growth continues, is of the order of 3% to 4% per annum for the existing sources of local government funding. Clearly this is not sufficient to fund the levels of growth seen in recent years, which in real terms have been of the order of 8.8% per annum, and in actual terms would be in excess of 10% per annum when inflation is provided for.

It is in this context that we make our proposals.

6. Principles for Funding of Local Government

6.1 Basic Principles

We suggest that the basic principles for funding of local government should be that:

1. The system should be equitable, i.e. the beneficiary should pay for the service being provided, and payment should be related to the level of benefit obtained or the extent of use of the relevant service.
2. Within the context of the previous point, ability to pay should be an important element of any equitable funding system.
3. The nature of funding should be related to the nature of the service provided.
4. Local representatives should be accountable to the local electorate for their stewardship. If local government is to be truly effective, then it follows that a meaningful portion of the finance for those services should be raised from the electorate.
5. Any financing system should be practical, transparent and easy to understand.
6. Any source of finance should provide a revenue yield that justifies the cost of administering the system.
7. There should be some degree of local variability to reflect the preferences of the local electorate.
8. Any new system should be compatible with the national tax system.
9. Any new system should be acceptable to taxpayers.
10. The system should promote efficiency on the part of service providers and service users

6.2 Options

The options for funding of local government can realistically be reduced to a small number of options, though in practice there may be many variations under each option.

The basic options are firstly, whether local government should be funded mainly from central sources or local sources.

The central source of funding, which would be largely a grant driven system or the diversion of a particular stream of central government revenues, often suffers from the difficulties of determining what is an adequate level of expenditure at local level as well as engendering a “democratic deficit”, i.e. where there is no relationship between local representatives and the electorate. On the other hand, a central system is beneficial where there is a large disparity between the needs and resources of the different local authorities, as funding can be more appropriately distributed. This is one of the benefits of the existing Local Government Fund.

Local funding can be carried out either by way of charges for services, based on levels of use or consumption, and local taxes. In the case of local taxes, the options are taxes on:

- Income
- Expenditure, and/or
- Property.

We understand that taxes on expenditure are not a realistic option in the context of the existing VAT regime. We also note that the Irish electorate has a particular aversion to taxes on property, where property is defined so as to include the family home. Given that:

- The levying of water charges on the domestic sector would raise something of the order of €160 million, which is substantial but is not sufficient to resolve the 2004 funding shortfall
- The existing sources of local government funding have buoyancies of the order of 3% to 5% per annum, which is far short of what is required to meet projected needs, and

- The Department of Finance projections for Income Tax and Corporation Tax for 2004 and 2005 as shown in the 2003 Budget papers show buoyancies of the order of 6% and 7% per annum.

We conclude that serious consideration should be given to replacing the existing commercial rates and the Local Government Fund with a form of local income tax, levied on both the corporate and non-corporate sectors.

Models for such forms of taxation that include local variability are to be found in other EU countries.

We believe that a system based on a substantial portion of the required funding being provided from local sources, that includes both charges for services to households as well as commercial users and that includes a form of local tax based on profits and taxable income should be considered for the future of local authority funding.

7. Proposals for change

We propose that

1. Government should recognise the nature of the services provided and fund them in an appropriate manner

In principle:

- Services provided directly to households and/or business premises should be paid for by user charges – this applies to services such as water provision, waste collection, planning fees, recreation facilities, etc. Charges should be based on full cost recovery by the local authority; should be related to the level of use of the relevant service, and the basis for charges should be open and transparent.
- Community based services such as the provision of parks, libraries, street cleaning, local contribution to road maintenance, etc., should be funded by a form of local taxation, applicable to all taxable entities, including business and individuals. In our view, the “ability to pay” criterion would be best met through a form of income-based local taxation, covering both businesses and individuals.
- Social services such as social housing and assistance to elderly and disabled people to adapt their houses should be funded through a combination of rental income from tenants and central government funding.
- Finally, “agency” services such as the disbursement of higher education grants and VEC pensions should continue to be funded through direct grants from the relevant Government Department.

Implications

The implications of this proposal are that

1. In respect of service charges, all users of services, including water, would pay a charge related to the extent to which that service is used.

The current “deficit” on water and sewerage services is €154million and is largely attributable to the lack of user charges payable by the domestic sector. This “deficit” equates to a charge of the order of €140 per annum per household connected to the public water system. A key attribute of domestic charges is that they promote efficiency on the part of the users. Studies by the ESRI indicate consumption reductions of the order of 5% where volume related charges are in effect. User charges meet several of the criteria outlined previously, including equity, promotion of efficiency and raising substantial amounts of revenue.

2. The existing rates system should be replaced by a system of local taxation that in the case of commercial enterprises should be based on profitability and not property valuations. In the case of individuals, a local income tax should be levied on taxable income.

A key issue with the current rates system is that it has inbuilt inequities and fails the “ability to pay” criterion. Ireland has seen a substantial increase in the services sector in recent years, both professional services and personal services. As a result, the revenues and enterprise profitability that can be generated from properties can vary substantially. In the case of revenues, turnover per square metre per annum can be in the range of

- €1,000 per sq. m. per annum for hotel rooms, to
- €8,000 per sq. m. p.a. in certain high volume retail outlets, to
- €10,000 per sq. m. p.a. in professional services.

In our view, the current valuation system does not recognise the wide variations in revenue or profit that can be generated by different types of business and thus the burden of rates falls disproportionately on businesses such as hotels and guesthouses where, in many cases, city or town centre locations are required, but where revenues per sq. m. are inferior to many other types of business.

In the context of annual corporation tax receipts of €5 billion and income tax receipts of €9 billion, a local income tax would need a share of about 14% of the sum of these taxes at present rates. This is comparable to the levels seen in other countries such as Denmark.

A local income tax should have scope for local variability, in order to allow public representatives to be accountable to the local electorate. Such variability should be within limits defined by central Government. The amount collected within each local authority should be split into two parts, one to provide an equalisation fund to assist authorities where incomes are relatively low, and one part to be retained by the authority raising the revenue.

The major benefits of disposing of the existing property tax, rates; the returning of “ownership” of the motor tax revenues to the Exchequer, and their replacement by a local income tax is that

- The electorate will see a link between their representatives and what they are paying for local services through variations in local income tax rates
- The funding system will have a substantial “ability to pay” element
- Irish people have shown a tendency to object to property tax based systems in favour of income related schemes
- An income based system will expand the local authority funding base, by including non-rate payers such as unregistered accommodation providers and other non-subscribers to local government such as owners of investment properties.

2. *Improve efficiency of Service Delivery*

In our view

- There is scope for rationalisation and achieving economies of scale, such as by merging Town Councils and Boroughs with the relevant County Councils
- There should be scope for increased use of Shared Resources, e.g. financial shared service centres, centralising driving licence issuance, centralised or outsourced housing loan administration, IT systems support
- Redefining the roles of County Tourism Boards and County Development Boards to make them more effective and relevant.

Implications

Administration costs within local authorities totalled €807 million in 2003. This is the accumulation of the administration costs in each programme group, plus the financial administration costs shown in Programme Group 8. We appreciate that these costs include non-pay elements, as well as design and supervisory engineers whose costs in respect of capital projects may be recovered through charges on those projects.

However, it appears to us that there are significant cost saving opportunities such as shared service centres than are well proven in the private sector and that should be developed in local government.

In particular, boroughs and towns incur administration costs of €79 million per annum, in an overall expenditure of €255 million. Much of that expenditure involves the purchase of services from the relevant County Council.

In our view, the continuance of borough and town councils as separate entities raises serious value for money questions and amalgamation of these bodies with the counties merits serious consideration.

We believe that a programme of rationalisation in administration costs designed to reduce expenditure by € 80 million is feasible.

3. *Remove Financial Distortions by Implementing the 6th VAT Directive*

In Ireland, the Government has not implemented the provisions of the 6th VAT directive in its entirety, and consequently for many services, local authorities are not recognised as taxable entities and are not registered for VAT. The situation is different in the U.K. and other EU Member States, where in respect of certain services that could be deemed to be commercial, the local authorities are required to register for VAT.

The failure to require local authorities to register for VAT has two negative impacts.

Firstly, the authorities provide water and sewerage services, and are unable to recover VAT on their inputs, thereby increasing the costs of these services to the commercial sector.

Secondly, VAT is a cost to local authorities, and comparing options such as outsourcing with internal operations, VAT costs can distort the comparisons and, from a national perspective, promote sub-optimal decisions.

4. *Extending the Contributing Net*

The proposals for a local income tax provided previously will ensure that many that are not currently contributing to local government, including unregistered accommodation providers, self catering accommodation, investment property owners etc., would make a fair contribution to local government.

5. *Transparency*

Local authorities should deliver on the cost and performance benchmarks that were promised as part of Better Local Government and provide evidence of cost effective performance

Appendix 1

Overview of Local Income Tax Model

- ***Future Levels of Funding Required***

To illustrate how the proposed local income tax would operate, we firstly assess the levels of funding required. In our submission we concluded that local government current expenditure in 2004 would be of the order of €500 million greater than 2003, if historic growth trends are maintained. This gives a funding need of €3,924 million, in round terms.

- ***Impact of Implementing Charges for Services Provided***

Implementation of our proposal that all directly supplied services should be charged for would provide something of the order of an additional €340 million, as shown below:

	<u>€mn</u>
Existing Income from Charges	1,091
Add Domestic Water Charges	155
Housing Tenants/Borrowers	120
Waste Charges	<u>65</u>
Total	1,431

- ***Motor Tax Receipts***

Motor tax receipts at € 640 in 2003 are closely matched to current expenditure on non-national roads of €677 million in that year. Given the continued need for road maintenance and restoration expenditure, we are of the view that road tax should be treated as it has been historically, i.e. dedicated for use in road maintenance and restoration works only. In 2004, given the level of buoyancy that exists and the recent increase in motor tax rates, motor tax receipts should provide about €700 million in 2004.

- **Funding of Local Government**

Taking the items above into account, the funding of local government would then be as follows:

	<u>€mn</u>
Funding Required	3,924
<i>Funded by:</i>	
User Charges	1,431
Motor Tax	700
Local Income Tax	<u>1,793</u>
Total	3,924

- **Corporate Sector**

The corporate sector is estimated to provide €836 million by way of rates in 2003. Allowing for buoyancy and increases in rates in line with inflation, this should reach something of the order of €890 million in 2004.

Corporation tax is projected to raise some €5,000 million in 2004 (according to the 2003 Budget papers). For the purposes of illustration, taking that this is based on a tax rate of 12.5%, (i.e. ignoring for the purpose of this discussion that “passive” income is taxed at a higher rate) then a 2.25% Local Income Tax Rate would raise some €900 million, which would almost equate to the Rates collected.

In practice, the corporate sector could be assessed on a local income tax rate of 2.25% in addition to the national corporation tax rate, and this local tax rate would be in lieu of commercial rates.

- ***Personal Sector***

Personal income tax receipts are estimated to provide €9,300 million in 2004. Allowing for local corporation income tax receipts of €900 million, the personal income tax sector will be required to provide €893 million to fund local government adequately in 2004.

This amount equates to some 9.6% of the estimated income tax receipts for 2004, and could be provided by local income tax rates of a 2% standard rate of local income tax and a 4% higher rate of local income tax.

However, the key difference is that whereas in the case of the corporate sector the local income tax is additional to the current levels of corporation tax – because the local income tax is a replacement for commercial rates – in the case of personal incomes, the local income tax is a share of the existing tax receipts. In practice, the national income tax rates would be 18% and 38% for the standard and higher rates respectively, supplemented with possibly a 2% and 4% standard and higher rate of local income tax.

Models used in other European countries would permit for some variation around these levels, potentially within a range of 0.5%, thus allowing the local variability that would provide the link between the electorate and their representatives and allow for local determination of local spending levels.

- ***Variations on the Model***

In our submission, we proposed that certain activities of local authorities, generally social welfare and related activities should be funded by central Government and/or relevant Government Departments. For example, higher education grants or VEC pension moneys may continue to be provided by the Department of Education.

In this case, the rates of personal local income tax suggested above may be reduced substantially, possibly by half, giving local income tax rates of a 1% standard and a 2% higher rate. The commercial income tax rates would be unchanged. The funding of local government may then be as shown overleaf:

	<u>€mn</u>	<u>%</u>
Funding Required	3,924	
<i>Funded by:</i>		
User Charges	1,431	36
Motor Tax	700	18
Specific Government Grants	450	11
Local Income Tax	<u>1,343</u>	<u>34</u>
Total	3,924	100

Percentages do not add to 100 due to rounding

- ***Equalisation***

We appreciate the need for equalisation – a process whereby funds can be distributed from relatively well-off councils to councils that do not have a sufficient population or local income base to provide the required levels of funding for their requirements. The issue of equalisation could be addressed by the establishment of a centrally controlled fund, to which a proportion of each local authority’s income tax would be transferred and distributed using an allocation process similar to the existing Needs and Resources model.