

COMMONWEALTH GRANTS COMMISSION

Review of The Operation of the Local Government (Financial Assistance) Act 1995



June 2001

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The Report

A volume of working papers was prepared for this Report.

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The Hon John Fahey MP
Minister for Finance and Administration
Parliament House
CANBERRA ACT 2600

Dear Minister

As members of the Commonwealth Grants Commission appointed under the *Commonwealth Grants Commission Act 1973*, we respond in this report to terms of reference received from you in a letter dated 1 June 2000, for a review of the *Local Government (Financial Assistance) Act 1995*.

Yours sincerely

A G Morris, Chairman

K W Wiltshire, AO, Member

L J Early PDM, Member

H A Rolfe, Member

M Nicholas, Acting Secretary

21 June 2001

TERMS OF REFERENCE

MINISTER FOR FINANCE AND ADMINISTRATION

1 June 2000

Mr Alan Morris
Chairman
Commonwealth Grants Commission
Cypress Court
5 Torrens Street
CANBERRA ACT 2612

Dear Mr Morris

I refer to letter from Senator the Hon Ian Macdonald dated 30 May 2000 which I have received in relation to the proposed review of the *Local Government (Financial Assistance) Act 1995*.

Senator Macdonald has asked that I formally convey these terms of reference to you so as to facilitate the commencement of the review of the *Local Government (Financial Assistance) Act 1995*.

Yours sincerely

JOHN FAHEY

**TERMS OF REFERENCE FOR THE REVIEW OF THE
LOCAL GOVERNMENT (FINANCIAL ASSISTANCE) ACT 1995**

The review under Section 17 of the *Local Government (Financial Assistance) Act 1995* will examine and report on:

- a) the effectiveness of the current arrangements under the Act to achieve the purposes of the Act and the goals in providing the grants that are referred to in Section 3 of the Act;
- b) the appropriateness of the current National Principles and, in particular, the retention of or variations of the minimum grant for the general purpose component in Section 6 of the Act;
- c) the consistency with the National Principles of the methodology and policies used by each of the State and Territory Grants Commissions in distributing funds to councils;
- d) As required by Section 17 of the Act, the review shall also examine and report on:
 - (i) the effectiveness of the arrangements under this Act in relation to ensuring that the allocation of funds for local government purposes is made on a full horizontal equalisation basis as mentioned in paragraph 6(2)(a); and
 - (ii) the impact of the Act on the raising of revenue by local governing bodies and on the assistance provided by the States to local governing bodies; and
 - (iii) the implications of any changes in the functions or responsibilities of local governing bodies; and
 - (iv) the eligibility for assistance under this Act of bodies declared by the Minister under Section 4 to be local governing bodies.

The Review will not address the interstate distribution of the general purpose and local road grants or the quantum of funds available under the Act.

CONTENTS

TERMS OF REFERENCE.....	v
CONTENTS	vii
MAIN FINDINGS.....	ix
CHAPTER 1.....	1
REVIEW OF THE LOCAL GOVERNMENT (FINANCIAL ASSISTANCE) ACT 1995	1
<i>What The Commission Was Asked To Do.....</i>	2
<i>How The Commission Conducted The Review</i>	3
<i>Structure Of The Report.....</i>	4
<i>Acknowledgements.....</i>	5
CHAPTER 2.....	6
LOCAL GOVERNMENT IN AUSTRALIA	6
<i>Local Government Finance</i>	8
Revenue	9
Outlays	10
CHAPTER 3.....	11
THE EFFECTIVENESS OF THE CURRENT ARRANGEMENTS	11
Overview	11
The Current Arrangements	12
<i>Purpose 1 – Financial Capacity.....</i>	13
<i>Purpose 2 – Equitable Level Of Services</i>	14
Horizontal Equalisation.....	15
Should the Language of Horizontal Equalisation be Retained?.....	17
Effort Neutrality	19
Other Grant Support	19
The Minimum Grant	20
<i>Purpose 3 – Certainty Of Funding</i>	23
<i>Purpose 4 – Efficiency And Effectiveness.....</i>	25
<i>Purpose 5 – Aboriginal Peoples And Torres Strait Islanders</i>	26

Contents

<i>Goal 1 — Transparency And Accountability</i>	28
<i>Goal 2 — Consistency Of Methods</i>	29
<i>Local Roads Funding</i>	31
<i>Conclusions</i>	32
CHAPTER 4	35
FUTURE DIRECTIONS	35
Overview	35
The Modified Arrangements	35
<i>Distributing The Per Capita Pool</i>	36
<i>Distributing The Local Roads Pool</i>	38
<i>Distributing The Relative Need Pool</i>	39
<i>Consistency And Flexibility</i>	43
<i>Transparency And Accountability</i>	44
<i>Transitional Arrangements</i>	44
<i>Conclusions</i>	45
CHAPTER 5	47
OTHER ISSUES	47
<i>Eligibility</i>	47
<i>Changes In Local Government Finance over Time</i>	48
Local Government Revenue	49
<i>Changes In Local Government Functions And</i> <i>Responsibilities Over Time</i>	52
Implications	54
<i>The Escalation Process</i>	56
<i>Announcing Grant Allocations And</i> <i>Determining Grant Pool Adjustments</i>	57
<i>Ministerial Responsibility</i>	58
ATTACHMENT A	60
THE EXISTING NATIONAL PRINCIPLES	60
ATTACHMENT B	62
THE PROPOSED PURPOSES AND NATIONAL PRINCIPLES	62
ATTACHMENT C	64
ACQUITTAL AGAINST THE TERMS OF REFERENCE.....	64

MAIN FINDINGS

The terms of reference for this review asked us to examine and report on:

- the effectiveness of the current arrangements for achieving the purposes and goals of the Act;
- the appropriateness of the current National Principles — in particular, whether the minimum grant arrangement should be retained or varied;
- the effectiveness of the current arrangements in ensuring that assistance is allocated on a full horizontal equalisation basis;
- the consistency of Local Government Grants Commissions' (LGGCs') policies and methods with the National Principles;
- the impact of the Act on revenue raising by local governing bodies (LGBs) and on the provision of assistance to them by States;
- the implications of any changes in the functions or responsibilities of LGBs; and
- eligibility for assistance under the Act of bodies declared by the Minister to be LGBs.

Effectiveness of the Current Arrangements, including the National Principles

The Act aims to provide financial assistance for local government to meet three underlying intentions:

- to provide all LGBs with at least a minimum level of assistance;
- to provide funding to contribute to the costs faced by LGBs in maintaining their local roads; and
- to provide relatively greater financial assistance to those LGBs which are relatively more disadvantaged compared with other LGBs because they face greater costs in providing services or because their ability to raise revenue is more limited.

In broad terms, the current arrangements have led to a distribution of funds in line with these intentions.

Main Findings

The Act sets out five purposes. Six National Principles have been developed to guide LGGCs in allocating the assistance to achieve those purposes. The purposes, our interpretation of them and the associated National Principles are:

- Financial Capacity, which is about ensuring that every LGB receives a share of the financial assistance provided by the Act. It is supported by the Minimum Grant and the Identified Road Component Principles;
- Certainty of Funding, which aims to ensure certainty of funds to the local government sector;
- Equitable Level of Services, which aims to ensure that relatively greater funds are provided to LGBs which, because of their greater costs of providing services or because of their more limited ability to raise revenue, are more relatively disadvantaged than other LGBs. The Horizontal Equalisation, Effort Neutrality, Other Grant Support, Aboriginal Peoples and Torres Strait Islanders and Minimum Grant Principles all bear on this purpose;
- Efficiency and Effectiveness, which aims to improve the efficiency and effectiveness of LGBs; and
- Aboriginal Peoples and Torres Strait Islanders, which relates to improving the provision of services by LGBs to Indigenous people and has an associated Aboriginal Peoples and Torres Strait Islanders Principle.

The Financial Capacity purpose is being achieved. The Minimum Grant Principle, which is well understood and correctly applied by LGGCs, ensures that each LGB receives a minimum of 30 per cent of their population share of the General Purpose pool. All LGBs with roads responsibilities also receive a share of assistance from the Local Roads pool, in accordance with the Identified Road Component Principle.

The provision of at least a minimum level of assistance to all LGBs reflects one of the underlying intentions of the Commonwealth. This intention should continue to be implemented, but expressed in the form of a Per Capita grant to ensure that every LGB receives a share of assistance. The current rate of this assistance (30 per cent) should be retained.

The Certainty of Funding purpose is also being achieved. The Act includes an escalation process that provides for growth in the level of funds to the local government sector for the duration of the Act.

The Equitable Level of Services purpose is described in terms of horizontal equalisation, as far as practicable. The definition of horizontal equalisation in the Act, the language of the Act, and the limited amount of funding indicate the purpose is about providing additional assistance to disadvantaged LGBs. As such, it is broadly being achieved. However, the language of the Act and of the associated Horizontal Equalisation National Principle should be revised. In particular, the term horizontal equalisation should be

replaced with ‘relative need based on equalisation principles’ because this more clearly reflects the Commonwealth’s intentions and what is being, and can be, achieved. It would also avoid using the language of horizontal equalisation in a different way from its use in the allocation of Commonwealth general revenue assistance to the States.

The Minimum Grant Principle conflicts with the Horizontal Equalisation Principle because minimum grants and equalisation grants are funded from the same pool. As the minimum grants are not distributed on an equalisation basis, they reduce the assistance available to meet the Commonwealth’s equity objective.

Implementation of the Horizontal Equalisation National Principle requires LGGCs to make comprehensive assessments covering all areas of local government expenditure and revenue, all influences that might affect the expenditure required and the revenue raised, and to assess both relative advantages and relative disadvantages. Some changes in the methods of LGGCs are required to better implement the intent of this National Principle.

The Effort Neutrality and the Other Grant Support Principles are integral aspects of any distribution of untied grants on the basis of equalisation principles or relative need. The Other Grant Support Principle is not consistently interpreted or implemented by LGGCs, with implications for LGB grants. The Principles are appropriate for an untied grant arrangement on equalisation principles, but the language of them could be improved to make the concepts better understood.

The Efficiency and Effectiveness purpose attempts to impose conditions on the allocation of the financial assistance. This is not an appropriate purpose for an Act that distributes untied assistance on equalisation principles. It should be removed from the Act.

The Aboriginal Peoples and Torres Strait Islanders purpose attempts to direct LGBs to spend part of their assistance on improving services to Indigenous people. It is inconsistent with the untied nature of the assistance being distributed and should be removed. However, the associated Aboriginal Peoples and Torres Strait Islanders Principle should be retained even though conceptually it is not required in a grants distribution process based on relative need. This Principle should be strengthened to make it explicit that relative need requires an assessment of the impact of Indigenous people on the expenditure requirements and revenue raising capacity of LGBs.

We think that the National Report needs to take on a much stronger monitoring role in this area. It should monitor and report on:

- the extent to which LGGCs’ assessment methods recognise the needs of Indigenous people; and
- the performance of LGBs in providing services to Indigenous people (performance measures should be developed for this purpose).

Main Findings

The Act also identifies two **goals of the Commonwealth** in providing the financial assistance. They are to:

- increase the transparency and accountability of the allocation of funds by LGGCs; and
- promote greater consistency in the methods used to allocate equalisation grants.

Transparency and accountability are not defined in the Act. We think transparency is about LGBs being able to understand how their grant has been calculated and accountability is about LGGCs providing information to assist that understanding further. Improvements in these areas are required. LGGCs should provide more and clearer information in their annual reports and the National Report should provide commentary on the different approaches of the LGGCs.

The consistency goal described in the Act relates to consistency in the methods used by LGGCs to allocate funds. There are many differences between LGGCs in the areas of expenditure and revenue covered by their assessments, the range of influences on expenditure and revenue levels assessed and the methods of measurement. Such differences are to be expected given the differences in the circumstances of LGBs both between and within the States. LGGCs require the flexibility to adopt methods that best reflect their circumstances.

The consistency goal should focus on the consistency of LGGCs' methods with the National Principles. Changes in LGGCs' assessment methods are required to achieve consistency with the Relative Need, Other Grant Support and Aboriginal Peoples and Torres Strait Islanders Principles.

The Identified Road Component Principle is appropriate because it is consistent with the intent of the Act and provides guidance to LGGCs on how to allocate their Local Roads grants.

Improving the Arrangements

The operation of the Act would be improved if the Commonwealth's intentions in providing its assistance were clearer and more transparent, with a clearer relationship between the purposes and the funds provided. We think this could be achieved if there were:

- a Per Capita pool to provide every LGB with a share of the assistance;
- a Local Roads pool to contribute towards LGBs' costs of maintaining their local roads; and
- a Relative Need pool to improve equity by providing additional assistance to the more disadvantaged LGBs.

Every LGB would receive a fixed per capita share from the Per Capita pool. Every LGB that has a road responsibility would receive funding from the Local Roads pool. Only relatively disadvantaged LGBs would receive funding from the Relative Need pool. As part of the changes, a purpose should be drafted for the Act to outline the Commonwealth's intentions in providing the assistance from each pool.

Transitional arrangements. The changes to the proposed three pool arrangement will not alter the total amount of assistance available or the allocation to the States. However, requiring LGGCs to amend their assessment methods to make them more consistent with the National Principles is likely to change the current distribution of grants to LGBs within States. A five year transitional period would be appropriate to enable LGGCs to modify their methods and LGBs to adjust to the changes in their grants.

The National Report should play a much stronger monitoring role. Areas that it should monitor and report on include:

- the extent to which LGGCs' assessment methods and approaches are consistent with the National Principles;
- the extent to which LGGCs are modifying their equalisation assessments to deliver greater stability in annual grants;
- the extent to which LGGCs' assessment methods recognise the needs of Indigenous people;
- assessing the performance of LGBs in providing services to Indigenous people;
- the extent to which LGGCs explain how individual grants have been calculated and provide sufficient information to enable LGBs to calculate them if they wish; and
- the effectiveness of the proposed transitional arrangements.

Impact on Revenue Raising and the Provision of State Assistance

Since the introduction of the Commonwealth's financial assistance grants in 1974–75, local government revenue from all sources has grown on average by 10.1 per cent per annum. Revenue from local government taxes and charges was about the same proportion in 1997–98 as it was in 1974–75. The introduction of Commonwealth assistance appears to have had little impact on local government revenue raising effort at the national level.

State assistance to local government has increased absolutely in real terms over the same period. However, the rate of increase has been less than the rate of increase of other sources of local government revenue. State assistance has declined in relative importance from about 15 per cent of local government revenue in 1974–75 to 7 per cent in 1997–98.

Main Findings

Implications of Changes in Functions and Responsibilities

Local government functions and responsibilities have expanded over the period since 1974–75. Analysis of local government expenditure over the period 1961–62 to 1997–98 shows that the composition of services being provided by local government has changed markedly over the last 30–35 years. Local government is increasingly providing human services at the expense of traditional property-based services (particularly roads).

Some changes are the result of the changing priorities of local government, others are imposed on them by other spheres of government. The general broadening of local government functions has implications for local government finances.

Eligibility for Assistance

The Act provides the Commonwealth Minister with the capacity to declare bodies that are providing local government-type services, but are not LGBs under State legislation, to be eligible to receive financial assistance grants. 40 of the 730 LGBs eligible to receive grants under this Act are declared LGBs. These arrangements are working well and should be retained. The Act should be amended to allow:

- (i) either the Commonwealth or State Minister to initiate a declaration — but require both to agree to it; and
- (ii) the Ministers to revoke an existing declaration, provided both agree.

CHAPTER 1

REVIEW OF THE LOCAL GOVERNMENT (FINANCIAL ASSISTANCE) ACT 1995

1. On 1 June 2000, the Chairman of the Commonwealth Grants Commission (the Commission) received terms of reference from the Minister for Finance and Administration asking the Commission to review the operation of the *Local Government (Financial Assistance) Act 1995* (the Act). This was in response to a request from the Commonwealth Minister for Regional Services, Territories and Local Government. A copy of the terms of reference is at the front of this report.

2. Under the Act, the Commonwealth provides financial assistance grants through the States¹ to local governing bodies (LGBs)². The Act sets out the Commonwealth's purposes and goals in providing this assistance. This assistance is provided in two parts — a General Purpose grant and a Local Roads grant — both of which can be spent as the LGBs choose.

3. The General Purpose grants are distributed between States on an equal per capita basis and the Local Roads grants on an historical basis³. The Act states that the intrastate distribution of these grants is to be determined by the Local Government Grants Commission (LGGC) in each State.

4. In making recommendations on the distribution of the General Purpose and Local Roads grants to LGBs within their State, the LGGCs are guided by a set of National Principles, a copy of which is in Attachment A.

5. The National Principles are guidelines to assist the LGGCs to implement the Commonwealth's purposes. They were developed after extensive consultation with State Ministers and officials and representatives of Local Government Associations. They were

1 References to 'States' include the Northern Territory unless otherwise stated. Although the ACT receives a share of assistance under the Act, it has no separate local government sector. This review does not have any grant distribution implications for the ACT.

2 'Local governing bodies' is the term used in the Act to define those bodies eligible for financial assistance grants. It includes mainstream councils as well as other bodies established under or by State legislation, and bodies declared to be local governing bodies by the Commonwealth Minister on the advice of the State Minister.

3 The States' fixed shares of the road grant were inherited from the previous (tied) program. The grants under the *Roads to Recovery Act 2000*, announced in November 2000, are not to be distributed under this Act and this review has not included any analysis of that process.

agreed at the April 1995 Local Government Ministers' Conference and came into effect in October 1995. They were designed to establish a more nationally consistent approach to distributing Commonwealth assistance among LGBs.

6. This chapter outlines:
 - (i) the requirements of the terms of reference;
 - (ii) how the review has been conducted; and
 - (iii) the structure of the report.

WHAT THE COMMISSION WAS ASKED TO DO

7. The terms of reference specified the issues the Commission was to examine, and those it was not to examine. In general terms, they asked us to consider:

- (i) whether the current arrangements achieve the Commonwealth's purposes and goals as set out in the Act;
- (ii) the appropriateness of the National Principles;
- (iii) whether the methods and policies of the LGGCs are consistent with the National Principles; and
- (iv) a range of other issues specified in Section 17 of the Act, dealing with:
 - eligibility for assistance;
 - changes in the functions or responsibilities of local government; and
 - the impact of the Act on local government revenue raising and State assistance to local government.

8. The terms of reference expressly precluded us from examining:
 - (i) the amount the Commonwealth makes available for local government; and
 - (ii) the interstate distribution of that amount.

9. Many participants said that the two excluded issues were the most important aspects of local government funding and expressed disappointment that they would not be addressed in the review.

10. In this respect, some said the financial assistance grants had not kept pace with the growth in Commonwealth taxation revenue, and that this had made it difficult for local government to fund its services and maintain its infrastructure. Others pointed out that the funding fell well short of what would be required to fully equalise all LGBs.

11. Many claimed that distributing the General Purpose grants between States on an equal per capita basis was inconsistent with a requirement that LGGCs distribute the grants between LGBs on a horizontal equalisation basis. They pointed out that LGBs in different States were being equalised to different standards. Some particularly questioned the appropriateness of the interstate distribution of the Local Roads grants⁴.

12. Consistent with the terms of reference, this report does not address these matters.

HOW THE COMMISSION CONDUCTED THE REVIEW

13. The review was conducted in two parts. In the first phase, we sought the views of all parties with an interest in the review. We did this by:

- (i) issuing a Discussion Paper encouraging interested parties to provide written submissions;
- (ii) holding meetings with Commonwealth and State agencies, Local Government Associations, LGBs and other interested parties, to discuss their views; and
- (iii) issuing a draft report.

14. We received more than 150 written submissions⁵ and held conferences in each State capital and nine regional centres across Australia. We met with relevant Commonwealth and State agencies, including the National Office of Local Government and each of the LGGCs. About 45 per cent of all LGBs contributed to the review, by making a submission or by meeting with us, or both.

15. Commission staff visited each LGGC to collect information and discuss the methods used to distribute funds.

4 On 30 November 2000, the Deputy Prime Minister and Minister for Transport and Regional Services, commented on the interstate distribution of the Local Roads grants in the Second Reading Speech for the *Roads to Recovery Bill* in the House of Representatives. He said: 'In the Roads to Recovery Program the government has recognised that the historical methodology for allocating funding between States and Territories contains inherent anomalies. Therefore we have rectified this by establishing a fairer allocation based on historical precedents, length of local roads and population.'

5 A list of the LGBs that met with us or made a written submission to us is reproduced in Attachment A of the working papers associated with this report.

16. A draft report was produced to inform participants of our preliminary thoughts on the issues. An accompanying technical volume presented some of the analysis undertaken as part of the review.

17. In the second phase of the review we sought reactions to our draft report. We did this by:

- (i) holding a conference in Canberra; and
- (ii) encouraging interested parties to provide written submissions.

18. Representatives of relevant Commonwealth, State and Local Government agencies, including the National Office of Local Government and each of the LGGCs, attended the conference. We received a further 50 written submissions after the conference⁶.

STRUCTURE OF THE REPORT

19. The remaining chapters of the report are as follows.

- Chapter 2 provides background information on the local government sector in Australia.
- Chapter 3 considers the current grant arrangements and provides our views on whether they have achieved the Commonwealth's objectives.
- Chapter 4 sets out our thoughts on what changes might be considered to better achieve the Commonwealth's objectives.
- Chapter 5 considers other issues such as the roles and responsibilities of the Commonwealth, the States and LGGCs; eligibility of LGBs; and funding arrangements.

20. Commission staff have prepared a volume of working papers. The volume discusses technical aspects of LGGCs' practices and presents analysis undertaken as part of this review, but does not hold any recommendations.

⁶ A list of the LGBs that made a submission or attended the conference is reproduced in Attachment A of the working papers associated with this report.

ACKNOWLEDGEMENTS

21. We acknowledge the assistance provided by Commonwealth, State and Local Government agencies.

22. We also acknowledge the ready participation, openness and hospitality of the LGBs and individuals we met during our consultations. Their contributions have been invaluable in helping us to understand and consider the issues.

23. We also acknowledge the dedication and professionalism of the staff of the Commission who worked on this review.

CHAPTER 2

LOCAL GOVERNMENT IN AUSTRALIA

1. During this review, many participants emphasised the extent of differences in local government both between and within States. This chapter provides some background on local government in Australia and looks at some of the differences.

2. Constitutionally, local government is the responsibility of the States. States provide the legislative framework in which LGBs operate, and oversee their operations. Historically, local government expenditure requirements have exceeded the revenue available from their own sources. Prior to 1974, the States were the main source of additional financial assistance for local government.

3. In 1974, the Commonwealth introduced a program of untied financial assistance through the States to local government. The reasons cited by the Commonwealth for providing this financial assistance were to ‘make the third tier of government a genuine partner in the (Federal) system and to give local government access to the nation’s finances’¹. Subsequent Commonwealth governments have maintained and extended the program of financial assistance for local government.

4. The *Local Government (Financial Assistance) Act 1995* is the most recent in the series of Acts passed by the Commonwealth Parliament to provide untied financial assistance to local government. In 2000–01, financial assistance grants under this Act will provide local government with over \$1.3 billion. On average, this is almost \$70 per capita but, reflecting the diversity of local government, the amount individual LGBs receive varies from about \$20 per capita to over \$7100 per capita.

5. The LGBs covered by the Act include the mainstream councils established under State local government legislation, as well as a range of other bodies. The latter group, which includes indigenous community councils, comprises bodies which are either established under other State legislation, or ‘declared’ to be LGBs by the Commonwealth Minister under Section 4 of the Act.

¹ The Hon Gough Whitlam, Prime Minister, Second Reading Speech, *Grants Commission Bill 1973*, House of Representatives, 17 May 1973.

6. Although there are many similarities in local government between States, there are also major differences in form, governance and responsibilities². For instance:

- a major source of revenue for local government in all States is taxes on properties (municipal rates) but the basis upon which the rate is calculated varies between States;
- water supply and sewerage is a local government function in Queensland, Tasmania and rural New South Wales, but a State responsibility elsewhere; and
- LGBs in Victoria, Queensland, Western Australia and Tasmania cover virtually the whole of the State, whereas there are large unincorporated areas in New South Wales, South Australia and the Northern Territory.

7. The operating base of local government in Australia is diverse. For instance, even for mainstream councils:

- population varies from around 150 for Murchison Shire (Western Australia) to over 833 000 for Brisbane City Council (Queensland);
- area varies from 2 square kilometres for the Shire of Peppermint Grove (Western Australia) to 378 533 square kilometres for East Pilbara Shire (Western Australia);
- population density varies from 3 people per 1000 square kilometres for Menzies Shire (Western Australia) to 7280 people per square kilometre for Waverley Council (New South Wales); and
- the length of local roads varies from 9 kilometres for the Shire of Peppermint Grove to 5427 kilometres for Buloke Shire (Victoria).

8. This diversity reflects differing circumstances, differing opportunities and responses, and differing choices.

9. State Local Government legislation imposes few, if any, limitations on what services LGBs can provide. To a significant extent, what individual LGBs do is a function of their policy choices.

10. LGBs in Australia have moved from providing a limited range of mainly property-related services to a much broader range of services. In introducing the *Local Government (Financial Assistance) Act 1986*, the Commonwealth Minister for Local Government and Administrative Services observed that ‘from the early 1970s, local government has evolved from authorities dealing with roads, gutters, drains and garbage to

² A more detailed analysis of differences in services by State is in Attachment C of *Performance Measures for Councils — Improving Local Government Performance Indicators*, Industry Commission, 1997.

increasingly sophisticated multi-factional and multi-functional authorities dealing with human and community services.’³ The range of services they now provide is extensive and includes:

- engineering services (roads, bridges, footpaths, drainage);
- community services (aged care, child care, fire prevention and fire fighting);
- environmental services (waste management, environmental protection);
- regulatory services (buildings, restaurants, animals); and
- cultural services (libraries, art galleries, museums).

11. In 1999–2000, there were 730 LGBs receiving financial assistance grants under the *Local Government (Financial Assistance) Act 1995*. Although only 20 per cent of them were in urban areas⁴, over 60 per cent of Australia’s population lived in those areas. A further 15 per cent of LGBs were in regional centres, 45 per cent in rural areas and 20 per cent in remote areas. About 100 LGBs served discrete Indigenous communities in Queensland, Western Australia, South Australia and the Northern Territory.

12. There are large differences in the range of services provided by LGBs in capital cities, metropolitan areas, regional centres, rural communities and remote areas. There are also large differences in how they raise revenue and their capacity to do so.

LOCAL GOVERNMENT FINANCE

13. Local government, as a sphere of government, is small financially and its relative importance has been declining. Although local government outlays have grown in real terms since 1961–62, the growth has been slower than the growth in Commonwealth and State outlays. In 1961–62 local government was responsible for 8 per cent of total government outlays but, by 1997–98, its share had declined to 5 per cent.

14. We have analysed aspects of the revenue and outlays of mainstream councils for the period 1961–62 to 1997–98. This analysis is in response to two issues covered by the terms of reference — the impact of the Act on local government revenue raising and State assistance, and changes in local government roles and responsibilities. Our findings are in Chapter 5. The rest of this chapter looks at differences between States in local government revenue and outlays in 1997–98. Data are available for later years but they are

3 The Hon Tom Uren, Member of Parliament, Second Reading Speech, *Local Government (Financial Assistance) Bill 1986*, House of Representatives, 2 May 1986.

4 Our categorisation of LGBs into urban, regional, rural and remote is the Australian Classification of Local Government.

on an accrual basis and not comparable to the data for earlier years. Although we have not included the accrual data in our analysis, we have looked at it and it would not lead us to change any of our conclusions.

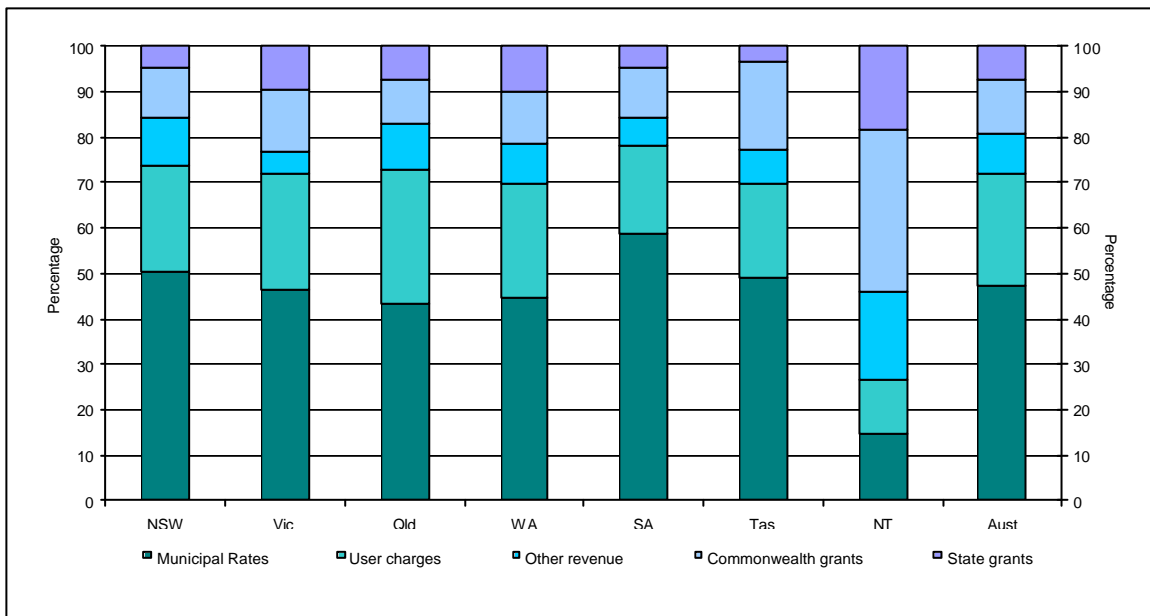
Revenue

15. Figure 2-1 shows differences between States in the sources of local government revenue in 1997–98. For all States except the Northern Territory, municipal rates (contributing on average 47 per cent of revenue) and user charges (about 25 per cent) were the main sources of revenue. Commonwealth and State grants contributed 19 per cent of revenue.

16. The local government financial assistance grants provided under the Act are a substantial share of total Commonwealth and State grants. They contribute around 10 per cent of local government revenue. The Commonwealth also provides some specific purpose payments direct to local government. In 1997–98, they represented 2 per cent of revenue.

17. There is broad similarity in the proportion of local government revenue contributed by rates and user charges in all States except the Northern Territory. With its greater prevalence of non-rateable land, local government in the Northern Territory has a much lower reliance on rates and a much greater reliance on grants.

Figure 2-1 LOCAL GOVERNMENT REVENUE SOURCES, 1997–98



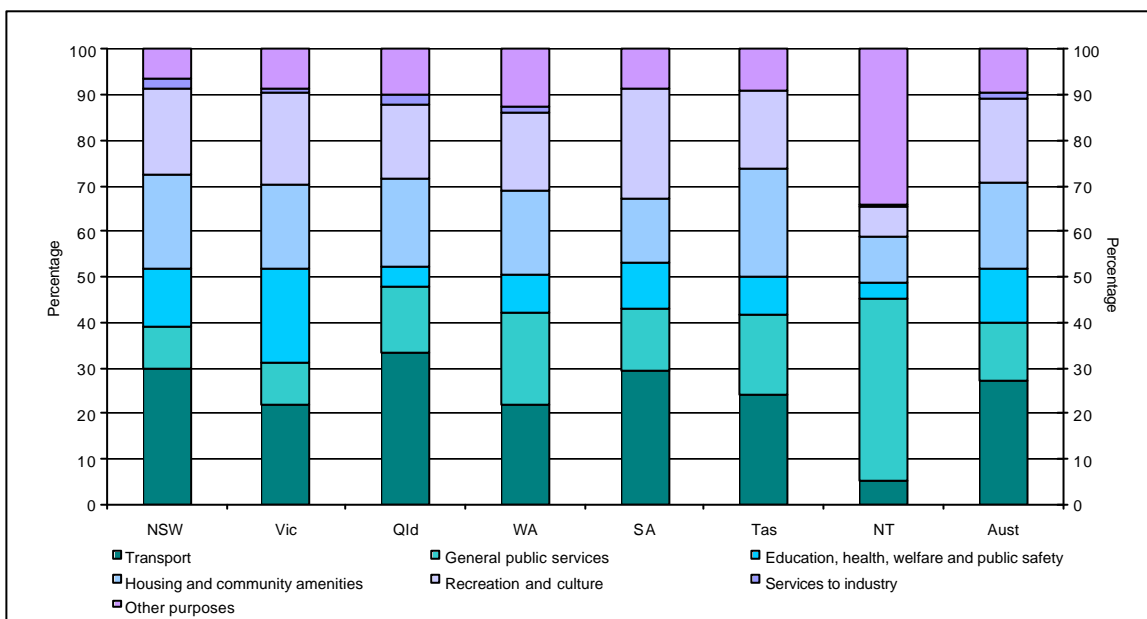
Note: Figures for the Northern Territory include municipalities, community councils and association councils.
 Source: Australian Bureau of Statistics (ABS) Government Finance Statistics, 1997–98, unpublished data.

Outlays

18. Figure 2-2 shows the different spending patterns of local government in each State in 1997–98. There were large variations between States in the services provided. For most States, expenditure on transport (mainly local roads expenditure) was the largest outlay (contributing on average around 27 per cent of outlays). Expenditure on housing and community amenities (about 19 per cent) and recreation and culture (about 19 per cent) were the next highest outlays. The Northern Territory had a very different pattern of expenditure from all other States⁵.

19. Differences among the other States are most marked for expenditure classified as ‘education, health and welfare’ and ‘housing and community amenities’. Local government in Victoria spends 21 per cent of its outlays on education, health and welfare while in Queensland it spends only 4 per cent. In Tasmania, local government spends 24 per cent of its outlays on housing and community amenities while in South Australia it spends only 14 per cent.

Figure 2-2 LOCAL GOVERNMENT OUTLAYS, 1997–98



Note: Figures for the Northern Territory include municipalities, community councils and association councils.

Source: ABS Government Finance Statistics, 1997–98, unpublished data.

5 This is partly because the ABS Government Finance Statistics for the Northern Territory include data from the Indigenous Community Governments. Their pattern of expenditure is very different from the pattern of expenditure of mainstream councils in other States.

CHAPTER 3

THE EFFECTIVENESS OF THE CURRENT ARRANGEMENTS

Overview

1. This chapter addresses the requirements in the terms of reference to examine and report on:

- the effectiveness of the current arrangements for achieving the purposes and goals of the Act; and
- the appropriateness of the current National Principles.

2. We have concluded that the underlying intentions of the Commonwealth in providing untied financial assistance¹ under the Act are to provide:

- a share of its financial assistance grants to all LGBs;
- a contribution to the costs faced by LGBs in maintaining their local roads; and
- relatively greater financial assistance to those LGBs, which, because of their greater costs in providing services or because of their more limited ability to raise revenue, are relatively more disadvantaged than other LGBs.

3. The Act also seeks to promote transparency and accountability and to improve the consistency of the methods used to allocate this financial assistance among LGBs.

4. We think the current arrangements have, in broad terms, led to a distribution of funds which is generally in line with the Commonwealth's intentions. All LGBs receive a share of the General Purpose grants, Local Roads grants are provided, and relatively more disadvantaged LGBs, overall, receive a greater share of assistance.

¹ Untied assistance is unconditional and LGBs are free to decide how to spend it.

5. Some improvements can be made to clarify the way in which the Commonwealth's intentions are implemented and to make the current arrangements more effective. They relate to:

- providing a clearer link between the purposes and the instruments that are being used to achieve them;
- the way disadvantage is assessed and funds are distributed;
- the consistency of the assessment methods used by LGGCs; and
- the transparency and accountability of the LGGCs' assessment processes.

The Current Arrangements

6. The Act specifies a range of elements that form the current arrangements. Section 3 sets out the objectives of the Commonwealth in relation to its financial assistance. It says that there are five *purposes* (Section 3(2)) and two *goals* (Section 3(4)).

7. To help achieve these purposes and goals, Section 3(5) provides for:

- the development of *National Principles* to guide the allocation of the funds to LGBs within a State;
- the making of a *National Report* to the Parliament each year, reporting on the operation of the Act; and
- an assessment of the performance of LGBs in the *National Report*.

8. The financial assistance consists of two *pools of funds* (General Purpose and Local Roads funds), the interstate distributions of which are fixed². The intrastate distribution of the pools is guided by six National Principles. Five relate to the distribution of the General Purpose pool and one to the distribution of the Local Roads pool.

9. The Act also describes a process for determining the annual increase in each pool.³ The same process is applied to each pool so that both pools grow at the same rate.

10. In this chapter, we take each purpose and goal outlined in the Act and:

- set out our interpretation of it;
- discuss which aspects of the current arrangements are relevant to achieving it;

2 Section 9 mandates the distribution of the General Purpose pool on an equal per capita basis. Section 12 mandates the distribution of the Local Roads pool on an historical basis.

3 Sections 9 and 10 describe the escalation process to apply to the General Purpose pool, and Sections 12 and 13 describe the process to apply to the Local Roads pool.

- discuss the appropriateness of the National Principles that directly relate to it;
- discuss how the LGGCs have interpreted and implemented the requirements of the Act and the National Principles; and
- indicate whether we think the purpose/goal has been achieved.

11. Although none of the existing five purposes relate specifically to roads funding, we discuss roads funding in this chapter as if it were a separate purpose.

PURPOSE 1 — FINANCIAL CAPACITY

12. The first purpose for which financial assistance is provided is ‘to improve the financial capacity of local governing bodies’.

13. The Act does not say what this means. It could refer to the financial capacity of each LGB or the financial capacity of the local government sector (the LGBs as a whole).

14. The 1994 Review of the previous Act⁴ interpreted this purpose as referring to the financial capacity of each LGB. It concluded that each LGB should receive a share of the financial assistance because:

- there is a mismatch between local government expenditure responsibilities (totalling \$12.1 billion in 1997–98) and revenue-raising powers (totalling \$9.5 billion in 1997–98) — this mismatch is called vertical fiscal imbalance; and
- the Commonwealth decided to address the vertical fiscal imbalance by providing financial assistance grants to local government rather than by giving it a new revenue-raising power.

15. While we do not necessarily agree with the arguments of the 1994 Review, we think the natural reading of the Act supports this view and that it should be interpreted in this way. During our review, there was a clear consensus among LGBs that this purpose is about ensuring that every LGB receives a share of the financial assistance grants.

16. There are two National Principles that relate to this purpose.

- The Minimum Grant. The Act requires that each LGB receive at least a minimum level of assistance from the General Purpose pool — 30 per cent of its per capita share of the General Purpose pool.

4 Australian Urban and Regional Development Review, *Financing Local Government, A Review of the Local Government (Financial Assistance) Act 1986*, Discussion Paper Number 1, Melbourne, 1994, p14.

- The Identified Road Component. The Act requires that the Local Roads pool be distributed on a road needs basis — every LGB with responsibility for local roads receives some assistance⁵.

17. The LGGCs have implemented these Principles in a way that ensures that each LGB receives a share of the General Purpose and Local Roads pools. They have, therefore, improved the financial capacity of each LGB and we conclude that this purpose has been achieved.

PURPOSE 2 — EQUITABLE LEVEL OF SERVICES

18. The second purpose for which financial assistance is provided is ‘to improve the capacity of local governing bodies to provide their residents with an equitable level of services’.

19. Although ‘equitable level of services’ is not specifically defined in the Act, Section 6 requires funds to be distributed, ‘as far as practicable on a full horizontal equalisation basis’, but subject to each LGB receiving a minimum grant. Section 6(3) of the Act defines full horizontal equalisation as being an allocation of funds that:

- ensures that each local governing body in a State is able to function, by reasonable effort, at a standard not lower than the average standard of other local governing bodies in the State; and
- takes account of differences in the expenditure required to be incurred by local governing bodies in the performance of their functions and in their capacity to raise revenue.

20. The 1994 Review said the Commonwealth’s notion of equity was that ‘Poorer communities or those where services are more expensive to provide are seen as more deserving of Commonwealth funds’, and that this concept of equity was encapsulated by the concept of horizontal equalisation. Most LGBs agreed that this purpose is about horizontal equalisation.

21. We have interpreted this purpose as being about providing relatively greater financial assistance to those LGBs, which, because of their greater costs in providing services or because of their more limited ability to raise revenue, are more relatively disadvantaged than other LGBs.

5 A very small number of LGBs, for example Silverton and Tibooburra in New South Wales, do not have responsibility for roads.

22. Three National Principles relate to this purpose:

- Horizontal Equalisation;
- Effort Neutrality; and
- Other Grant Support.

23. A fourth Principle, the Minimum Grant, conflicts with this purpose and acts as a constraint on the achievement of horizontal equalisation. Since every LGB in a State must receive a minimum grant from the General Purpose pool, the amount of assistance available for equalisation is reduced.

Horizontal Equalisation

24. The wording of the Horizontal Equalisation National Principle repeats the wording of the Act⁶. There are a number of difficulties in interpreting the purpose and associated Principle. The most obvious are:

- (i) the contradiction in the language between ‘full horizontal equalisation’ and ‘as far as practicable’;
- (ii) the contradiction between equalising LGBs and only bringing the disadvantaged LGBs up to the average; and
- (iii) the contradiction between full horizontal equalisation and the minimum grant.

25. These contradictions imply that the Act itself recognises that full horizontal equalisation is not possible and that the Commonwealth’s intentions in providing assistance under this purpose are:

- to provide additional assistance to only those LGBs that are relatively disadvantaged; and
- to contribute to a reduction in the extent of their disadvantage (but not to provide sufficient assistance that would remove all of their disadvantage).

26. We have concluded that, because the Act recognises that full horizontal equalisation cannot be achieved, it is clear that its intention is to provide assistance to the relatively disadvantaged LGBs.

⁶ The National Report says that this Principle is in the existing legislation and is included for the balance and completeness of the National Principles.

27. The LGGCs are generally distributing funds in line with this intention. However, there are some aspects of their implementation of the intention which we think can be improved and which would make the arrangements more effective. If the purpose and Principle more clearly expressed the Commonwealth's intention, we think that the LGGCs would be better able to understand what was required and be better able to implement it.

28. The Horizontal Equalisation Principle requires the LGGCs to 'take account of differences in the expenditure required by those local governing bodies in the performance of their functions and in the capacity of those local governing bodies to raise revenue'. We think the natural reading of this Principle is that it requires LGGCs to estimate:

- (i) how much it would cost each LGB to provide the standard⁷ level of services for each of the services provided by LGBs; and
- (ii) how much revenue they could raise from each source of revenue available to LGBs.

29. To correctly assess these costs and revenues, the LGGCs are required to undertake a comprehensive assessment of needs. By comprehensive we mean an assessment of:

- each area of expenditure and revenue — most LGGCs restrict this to recurrent expenditures and revenues and, given the difficulties of measuring capital needs, this is sensible;
- a proper assessment of the influences that affect the cost of providing services or the capacity to raise revenue of LGBs — this requires an assessment of all influences including the needs of all population groups; and
- both relative advantage and relative disadvantage for each service and revenue — if relative advantage and disadvantage are not measured it will not be possible to correctly determine the overall disadvantage of one LGB relative to the others.

⁷ The term standard has a specific meaning in an equalisation context. Generally, it means the State average per capita experience. However, in some cases an LGB does not need to provide a certain service (for example, an airport). In these cases, the LGB's cost of providing the standard service would be zero.

30. An LGB's financial capacity would be below average (that is the LGB would be disadvantaged) if, after considering all relevant services and sources of revenue, its assessed costs exceeded its assessed revenue by more than the State average amount.⁸

31. LGGCs are not comprehensively assessing needs. They do not assess all areas of expenditure and revenue, they do not assess all of the influences that affect the cost of providing services or the capacity to raise revenue, and some of them do not assess relative advantage⁹ and relative disadvantage. These aspects of their practices are not consistent with a proper assessment of relative needs and would not, therefore, be consistent with delivering equalisation outcomes.

Should the Language of Horizontal Equalisation be Retained?

32. While the Act talks about lifting those LGBs which have a financial capacity that is below the average (disadvantaged LGBs) up to the average, it is silent about the treatment to apply to those LGBs which have a financial capacity that is above the average (advantaged LGBs). There has been no suggestion that the Act intended their advantage to be reduced. The definition of horizontal equalisation in the Act implies, therefore, that there will be two groups of LGBs — those with an above average financial capacity and those with a below average financial capacity. This is not our understanding of, nor the natural meaning of, equalisation.

33. Equalisation is about providing each government with the same financial capacity to provide services as every other government. To be consistent with that interpretation, LGGCs would have to equalise all LGBs. The only way that this could be done, would be for:

- (i) the relatively advantaged LGBs to contribute funds to the relatively disadvantaged LGBs; or
- (ii) sufficient assistance to be provided to bring all LGBs up to the financial capacity of the most advantaged LGB.

8 In more detailed terms, calculating an LGB's financial capacity would require assessments of:

- (i) what it would cost it to provide the standard level of service, for each service provided by LGBs;
- (ii) how much it would raise if it applied the standard rate of tax or charge, for each tax or charge raised by LGBs;
- (iii) how much of its expenditure need is financed by grants from the Commonwealth and/or State; and
- (iv) the difference between its total assessed costs under (i) and its total assessed revenue under (ii) and (iii) — its assessed per capita shortfall before the distribution of the Commonwealth's assistance.

An LGB would be relatively disadvantaged if its assessed shortfall exceeded the State average shortfall.

9 Some LGGCs place a floor on their expenditure assessments. This means they do not assess expenditure advantage.

34. In circumstances where LGBs are not required to contribute funds to other LGBs, equalisation could only be achieved if the Act provided sufficient assistance to bring all LGBs up to the financial capacity of the most advantaged LGB. It doesn't and, clearly, this is not the intention of the Act.

35. In these circumstances, we do not think it is appropriate to call the process described by the Act as horizontal equalisation. Different language is required. The process described by the Act is about assessing relative needs, with the assessment of those needs being based on equalisation principles. The language of the Act should be amended to make the real intention of this purpose clear. We think the expression of horizontal equalisation should be removed from the Act.

36. Most participants accept that full horizontal equalisation cannot be achieved. Nevertheless, they strongly supported the retention of the concept in the Act. They said:

- it is a long-standing key element in Australian inter-government financial relations that is understood by most and removing it would cause confusion for LGBs;
- there is no reason to abandon the objective simply because it cannot be achieved in practice;
- the current objective was to '**improve** the capacity of local governments to provide equitable services' and that is achievable; and
- the main reason full horizontal equalisation cannot be achieved is the lack of funding. To address this failure by changing the terminology would be a negative, albeit pragmatic, response.

37. Overall, we have concluded that the intent of the Act is to reduce the disparities among LGBs by providing assistance to those relatively more disadvantaged. It also requires that an equalisation approach be adopted in measuring relative disadvantage. We have also concluded that:

- (i) the Horizontal Equalisation National Principle cannot be achieved and should be replaced by a concept that more clearly reflects this intention;
- (ii) the Act needs to make it clear that its equity objective is to deliver equalisation grants only to the disadvantaged LGBs; and
- (iii) LGGCs are generally delivering outcomes that are consistent with this intention. But to better capture the financial capacity of LGBs, some of their practices have to change because they are inconsistent with equalisation principles.

38. In the next chapter we discuss a concept of relative need based on equalisation principles as a means of more appropriately describing the Commonwealth's equity objective.

39. During the review, there was considerable discussion about the degree of equalisation that was being achieved and some parties asked us to estimate it. There are different approaches to measuring the extent of equalisation being achieved and these give quite different answers. It is not clear that any approach is particularly meaningful. But even if it were clear, the terms of reference do not ask us to examine this issue and doing so would inevitably raise issues associated with the size of the pool which we were explicitly told not to examine. Therefore, we have not undertaken this analysis.

Effort Neutrality

40. In general terms, the Effort Neutrality Principle says that the policies of an individual LGB should not affect the grant it receives. Under equalisation principles, an LGB should receive more financial assistance if, for reasons beyond its control:

- it incurs higher than average per capita expenditures in providing services; or
- it raises lower than average per capita revenue.

41. The Effort Neutrality Principle operates to ensure that an LGB does not receive additional assistance if, through its own decisions, it caused the higher than average expenditure (for example, by choosing to provide a higher quality service) or the lower than average revenue (for example, by choosing to apply lower charges or to offer higher rate exemptions). The grant distribution process should not reward (or penalise) LGBs for the choices they make about what services to provide or what level of taxes to raise.

42. The LGGCs are implementing this Principle in the way intended.

43. We have concluded that this is an appropriate Principle for an Act that aims to apply equity principles in distributing untied assistance.

Other Grant Support

44. Equalisation principles require an assessment of how much each LGB is able to raise from all of the revenue sources available to it. The Other Grant Support Principle requires LGGCs to treat other grants — whether provided for general or special purposes and whether provided by the Commonwealth or the State — like any other source of revenue and to take them into account when assessing the overall financial capacity of each LGB. Omitting grant assistance would not be consistent with a comprehensive assessment of needs. In the assessment of each LGB's financial capacity, this Principle should be applied to minimum grants and Local Roads grants provided under this Act, as well as to any other grants.

45. Implementing the Other Grant Support Principle requires LGGCs to include in their assessments, all expenditure LGBs incur in providing services and to treat all of that expenditure in the same way. Parts of the expenditure should not be treated differently simply because they are financed by a grant from the Commonwealth or State. Omitting expenditure would not be consistent with a comprehensive assessment of needs.

46. At present, LGGCs implement this Principle in different ways. For example, some of them exclude the expenditure financed by grants and the grants themselves from their assessment processes. This approach is not consistent with a comprehensive assessment of needs and it will not provide an accurate assessment of an LGB's overall financial capacity if the factors that influence its capacity to raise revenue differ from those that influence the level of expenditure it must incur. This suggests that the language of the Principle is not sufficiently clear. We think it should be improved to make the concept easier for LGBs to understand and for LGGCs to implement consistently.

47. If all LGGCs were to implement the Other Grant Support Principle in this way, there would be grant distribution effects. These effects could be large. Table 3-1 shows the effect of treating the Local Roads grants in this way.

48. The size of these effects suggests some transitional arrangements could be required if the Other Grants Support Principle is applied consistently by all LGGCs. This issue is discussed in the next chapter.

Table 3-1 ESTIMATE OF THE EFFECT OF APPLYING THE OTHER GRANT SUPPORT PRINCIPLE TO LOCAL ROADS GRANTS

		NSW	Vic	Qld	WA	SA	Tas	NT
Change in Grants	(\$m)	42.9	15.7	10.4	0.0	0.3	0.0	0.0
Total Grants	(\$m)	411.3	299.4	235.9	146.0	91.1	42.7	18.1
Percentage Change	(%)	10.4	5.2	4.4	0.0	0.3	0.0	0.0

49. We conclude that:

- (i) the Other Grants Support Principle is an essential element of the equalisation principle and, therefore, is an appropriate Principle for the Act's equity purpose;
- (ii) it is not being consistently implemented by LGGCs and that is impacting on equalisation outcomes;
- (iii) the language of this Principle is not sufficiently clear and it should be improved to make the concept easier for LGBs to understand and for LGGCs to implement consistently.

The Minimum Grant

50. The terms of reference ask us to consider:

- the appropriateness of the Minimum Grant Principle; and
- whether it should be retained or varied.

51. Minimum grants were introduced in the 1976 Act and they have been retained in subsequent Acts. In the 1976 Act, the grants were a minimum of 30 per cent of the State pool¹⁰. In the 1986 Act, the arrangements were specified in the same terms as the current Act. An LGB is entitled to receive, as a minimum, 30 per cent of its per capita share of the General Purpose pool. All LGGCs have provided minimum grants at that rate.

52. Many reasons were given by participants to this review in support of the concept of minimum grants, including:

- they are a means of implementing the Commonwealth's intention that every LGB receives a share of the assistance;
- they reflect a form of equity because they ensure every LGB receives some financial assistance;
- the grants address the narrowness of local government's tax base;
- they are a long standing element of the financial assistance scheme;
- they can encourage LGBs to provide new services;
- they come at little cost to other LGBs;
- they provide stability and a safety net against the possibility of errors in LGGCs' assessments; and
- they encourage all LGBs to participate in, and have an interest in, the process.

53. However, some participants noted that the minimum grants were one of the constraints that prevent the Commonwealth from achieving horizontal equalisation because they:

- give some LGBs more assistance than their horizontal equalisation assessment would warrant, thereby placing them in an above average financial position; and
- reduce the assistance available for horizontal equalisation purposes, so that disadvantaged LGBs receive less assistance than their horizontal equalisation assessment would warrant.

54. When funded from a single pool, minimum grants act as a constraint on the extent to which equalisation principles can be implemented. However, they have been a feature of the arrangements since 1976, and they are the means by which each LGB receives

10 One difference in the 1976 Act was that these grants were distributed on a weighted per capita basis. LGBs' populations could be weighted by area or population density.

a share of the General Purpose pool, which we accept is one of the Commonwealth's objectives. For these reasons, we have concluded that the minimum grant arrangements should be retained.

55. We have examined the implications for achieving horizontal equalisation of increasing and decreasing the level of funds used to provide minimum per capita grants. Table 3-2 provides an estimate of the assistance required to finance a minimum per capita grant at different rates¹¹. The table also shows this amount as a share of the General Purpose pool and how many LGBs would receive only the minimum grant¹² — other LGBs would receive their equalisation grant.

Table 3-2 FINANCING A CHANGE IN THE LEVEL OF THE MINIMUM GRANT

		Minimum grant rate					
		0%	10%	20%	30%	40%	50%
Amount required to finance the minimum grant	\$m	0.0	21.2	43.8	74.7	127.7	179.0
Share of General Purpose pool	%	0.0	2.5	5.1	8.7	14.9	20.9
Number of minimum grant LGBs	No.	72	81	84	94	106	118

56. Reductions in the rate of the minimum grant have only a small effect on the grants of LGBs that receive more than the minimum. Reducing the rate from 30 per cent to 20 per cent would increase the assistance going to 'non-minimum grant' LGBs from the current level of \$805 million to \$835 million (a 4 per cent increase). Reducing the rate to 10 per cent would raise that figure to about \$858 million (a total increase of 6 per cent). Removing the minimum grants would increase the figure to \$880 million (a total increase of 9 per cent). We do not think these gains justify a decrease in the minimum grant.

57. Any increase in the rate of the minimum grant would require an increasing share of the General Purpose pool to finance it. Increasing the minimum grant rate from 30 per cent to 40 per cent (an increase of one third) requires a 70 per cent increase in funds. Increasing the rate from 30 per cent to 50 per cent (an increase of two thirds) requires a 140 per cent increase in funds. The extra funds required to finance higher minimum grants

11 As the minimum grant rate increases (decreases) the associated per capita grant increases (decreases). For example, the 30 per cent rate translates to a per capita grant of about \$15. A 20 per cent rate would translate to a per capita grant of about \$10. For each minimum grant rate, the amount required to finance the minimum grant arrangement was calculated by first identifying which LGBs were minimum grant LGBs and then by applying the relevant per capita grant to the number of people located in these LGBs. A minimum grant LGB was an LGB with an equalisation assessment less than the relevant per capita grant. The existing LGGCs' equalisation assessments were used for each of these calculations.

12 That is, at each rate level, how many LGBs have an equalisation assessment less than their minimum grant assessment. As the rate level increases, the minimum grant for every LGB increases and the number of LGBs that satisfy this criterion increases.

would come from reducing the grants to ‘non-minimum grant’ LGBs (that is, further reducing the extent to which equity can be improved). Increases in the minimum grant rate would also increase the volatility of the grants to non-minimum grant LGBs. This would not be consistent with the Commonwealth’s intentions and we see no justification for it.

58. In summary, we have concluded that:

- (i) each LGB should receive a minimum per capita grant; and
- (ii) a change in the uniformly applied 30 per cent rate for that grant is not warranted.

59. However, we think this funding arrangement could be made clearer. In Chapter 4, we recommend replacing the minimum grant with a universal grant — a per capita grant provided to every LGB. These grants would be financed from a separate pool which would be funded with what would have been, under the present arrangements, 30 per cent of the State’s General Purpose pool.

PURPOSE 3 — CERTAINTY OF FUNDING

60. The third purpose for which financial assistance is provided is ‘to improve the certainty of funding for local governing bodies’.

61. The meaning of this purpose is not clear.

62. The Department of Territories and Regional Services (DoTRS) said the Certainty of Funding purpose was about providing certainty of ongoing funding for the local government sector. The 1994 Review agreed, saying that ‘From time to time, the Commonwealth has also attempted to improve the certainty of local government receipts, though more at the aggregate State level than at the level of individual councils’. If this interpretation is accepted, the elements that deliver this outcome are:

- the Act’s guarantee of General Purpose and Local Roads grants (Section 9 and Section 12 respectively); and
- the escalation arrangement for each (Sections 9 and 10 and Sections 12 and 13 respectively).

63. The escalation process specifies that the level of assistance should increase in line with population and the Consumer Price Index (CPI), but gives the Commonwealth (in special circumstances) the power to vary the rate of increase. Except for one year, the pool has been increased to maintain real per capita funding.

64. Overall, we think that the natural reading of this purpose refers to the certainty of ongoing funding for the local government sector. As a consequence, we have concluded that the current arrangements have been effective in achieving this purpose.

65. Local government interprets this purpose as being about stability of grant allocations from year to year. They raised instability of grants as a matter of real concern because of the practical difficulties of managing budgets from year to year and the difficulty of adjusting to downward changes in revenue. They said greater importance should be given to ensuring stability of grant allocations and many suggested that a National Principle aimed at stability should be introduced.

66. Grant instability is an inherent feature of equalisation grants. The source of this volatility is:

- changes in the circumstances of individual LGBs¹³; and
- LGGCs introducing changes in assessment methods¹⁴.

67. All of the LGGCs are conscious of the need for LGBs to have a degree of stability in grant allocations from year to year. They employ a range of measures to reduce instability (for example, averaging of assessments, phasing in assessments, capping increases and collaring decreases etc). We think these are sensible arrangements which respond to real world concerns that LGBs face in managing their budgets.

68. Stability is not compatible with the Horizontal Equalisation Principle — stability means that LGGCs depart from their horizontal equalisation assessments. However, the ‘as far as practicable’ qualification in the Commonwealth’s equity purpose recognises there are practical limits to the implementation of horizontal equalisation assessments. One of those limits could be preventing disruptive movements in grant allocations. This provision provides LGGCs with the capacity to adjust grant allocations, on occasions, so that disruptive movements from year to year do not eventuate. We think that LGGCs should continue to be allowed to exercise their discretion in deciding the weight to be given to the competing objectives of stability and equalisation.

13 Grant distribution processes based on relative need (equalisation) determine an individual LGB’s grant by comparing its circumstances with the circumstances of all other LGBs. This means that an individual LGB’s grant can change even though its own circumstances do not — its grant could change because of a large change in circumstances of another LGB.

14 LGGCs continually review their assessment methods and if a change is needed, they will introduce it in the following year. LGGCs said that they adopt this approach because:

- it gave them the flexibility to quickly adapt to the on-going changes in the circumstances of LGBs in their State;
- it avoided the possibility of very large changes that might arise if all assessment methods were changed at the same time; and
- they did not have the resources to conduct major reviews of methods.

69. Getting the right balance between stability and equalisation is a matter of judgement. It would be appropriate for the National Report to initiate discussion on:

- the methods LGGCs use to constrain grant changes;
- how much these methods are constraining the equalisation outcomes; and
- whether there should be any limit on the extent to which these arrangements can be used.

PURPOSE 4 — EFFICIENCY AND EFFECTIVENESS

70. The fourth purpose for which financial assistance is provided is ‘to improve the efficiency and effectiveness of local governing bodies’. This purpose was introduced into the Act following the 1994 Review.

71. The Act does not define efficiency or effectiveness. Some guidance on the meaning of efficiency can be obtained from the 1994 Review, which talked about allocative efficiency (the optimum allocation of resources in the marketplace) and administrative efficiency (producing services at the lowest cost¹⁵). Effectiveness is about how well programs meet their objectives. Measuring effectiveness is difficult because it requires an examination of service outcomes and, most likely, would involve surveying users.

72. Most participants agreed that improving the efficiency and effectiveness of LGBs was worthwhile. However, many had concerns about whether efficiency or effectiveness can be measured and queried the relevance of this purpose to a grant distribution system that provides untied (unconditional) grants. We agree with the latter concern.

73. The Act does not provide an instrument that would increase grants for those LGBs that improve either their efficiency or their effectiveness. Nor has any LGGC introduced methods that redirect grants because of improvements in efficiency or effectiveness. Such an approach would be inconsistent with the concepts of effort neutrality and equalisation.

74. The Effort Neutrality Principle says that the policies of an individual LGB should not affect the grant it receives. It would be inconsistent with this Principle if an LGB’s grant were to be related to the level of efficiency at which it operated.

15 In its broader sense this would include structural efficiency, that is, the optimal number of LGBs and the optimal spatial distribution of their administrative centres.

75. The Act requires the National Report to include an assessment of the efficiency of the performance of LGBs. When the Act was initially presented, it was intended that a range of national performance measures would be developed to assist this assessment. However, these indicators have not been developed.

76. Our conclusions are that:

- this is not a relevant purpose for an Act that distributes untied grants through a predominately needs based distribution process; and
- the current arrangements have not been effective in achieving it.

PURPOSE 5 — ABORIGINAL PEOPLES AND TORRES STRAIT ISLANDERS

77. The fifth purpose for which Commonwealth financial assistance is provided is ‘to improve the provision by local governing bodies of services to Aboriginal and Torres Strait Islander communities’.

78. This purpose is about:

- (i) ensuring that the needs of Indigenous people are appropriately recognised; and
- (ii) ensuring LGBs improve the services provided to Indigenous people.

79. The arrangements that relate to this purpose are:

- (i) the Aboriginal Peoples and Torres Strait Islanders National Principle; and
- (ii) the requirement in Section 16(3)(c) of the Act for the National Report to include an assessment of the performance of LGBs in providing services to Aboriginal and Torres Strait Islander communities.

80. The wording of the purpose, the associated National Principle and the requirement for the National Report have created some confusion about whether they relate to all Indigenous people or only those in discrete communities. The language of the National Principle requires LGGCs to allocate financial assistance in a way that recognises the needs of Indigenous people within the area served by each LGB. We think this is the Commonwealth’s intention and we have interpreted the purpose as referring to all Indigenous people.

81. Whether this purpose has been achieved depends on whether:
- (i) LGGCs recognise the needs of Indigenous people¹⁶ and whether the LGGCs measure those needs comprehensively; and
 - (ii) LGBs deliver services which address those needs.

82. Not all LGGCs recognise the needs of Indigenous people in their assessments. Those that do, do not measure the needs comprehensively. Many LGBs do not deliver services which specifically address those needs and those that do, do not appear to do so because of the additional funding provided by LGGCs. In fact, many of the LGBs were unaware of this purpose and its existence appears to have had little, if any, effect on whatever decisions they have made on the level of service provided to Indigenous people. Finally, the National Report does not adequately assess the performance of LGBs in providing services to Indigenous people because the performance measures necessary for this purpose have not been developed. Therefore, we have concluded that the Commonwealth's intention in specifying this purpose is not being achieved.

83. Conceptually this purpose is not consistent with equalisation principles (because it would make the grant an LGB received dependent on its policies) or the untied nature of the assistance provided by the Act. Some participants have argued that tying some of the funds would be a way of directing assistance to Indigenous need. We do not see this as appropriate because it would be inconsistent with the whole structure of the financial assistance grants arrangements and, in general, would only direct small amounts towards the needs of Indigenous people.

84. Equalisation assessments should reflect differences in the demand for services by Indigenous people, the cost of providing services to them and the capacity to raise revenue from them — regardless of whether they live in a discrete community or in a mainstream community. Evidence suggests that this is not being adequately or consistently implemented. For that reason, we think a specific National Principle should be retained. Since the evidence also indicates that LGGCs implement this Principle in different ways, we think the language of the Principle is not sufficiently clear and should be improved. The Principle would be strengthened if the language made it explicit that all the needs of Indigenous people must be reflected in LGGCs' assessments.

85. We also think that the requirement in the Act for the National Report to include an assessment of the performance of LGBs in providing services to Indigenous people should be retained. The National Report should inform the Commonwealth on whether the LGGCs' assessments are recognising the needs of Indigenous people and whether LGBs are providing services which address these needs. The Commonwealth together with the States and Indigenous organisations should work to develop the performance measures necessary for this assessment, apply them and publish the results in the National Report.

¹⁶ That is, they recognise these needs in their assessments of the higher demand for services, the higher costs of providing services and the reduced capacity of LGBs to raise revenue.

86. One aspect of the current arrangements that has been more effective in addressing the needs of Indigenous people is the Act's eligibility provision (Section 4(2))¹⁷. Under that provision, many discrete Indigenous communities have been declared to be LGBs, which has increased the flow of funds to them and the services they can provide.

87. Overall, we have concluded that:

- (i) the Aboriginal Peoples and Torres Strait Islanders purpose should be removed because it is conceptually inconsistent with arrangements which provide for the distribution of untied grants; and
- (ii) the Aboriginal Peoples and Torres Strait Islanders Principle should be strengthened to make explicit that the needs of all Indigenous people must be reflected in the assessments of the LGGCs; and
- (iii) the National Report should:
 - report on whether the LGGCs' assessments are recognising the needs of Indigenous people; and
 - provide an assessment of the performance of LGBs in providing services to Indigenous people, using performance measures developed by the Commonwealth, in conjunction with the States and Indigenous organisations.

GOAL 1 — TRANSPARENCY AND ACCOUNTABILITY

88. The first of the goals established by the Act is 'to increase the transparency and accountability of the allocation of funds to local governing bodies'.

89. In the context of a grant distribution process, we think that transparency is about LGBs being able to understand how their grants have been calculated and accountability is about LGGCs providing sufficient information to allow an LGB, if it chooses:

- to verify its grant allocation;
- to understand why its allocation has changed from its previous level;
- to understand why it differs from the grant allocation of a neighbouring or similar LGB; and
- to understand the key drivers of its grant allocation.

17 This section allows the Commonwealth Minister to declare bodies that provide local government type services to be LGBs and eligible to receive assistance under the Act.

90. The views of parties to the review indicate that this goal has only been achieved to a limited extent. The efforts of LGGCs to provide information to LGBs vary considerably. In general, LGBs say they do not understand the grant allocation process and the LGGCs do not provide sufficient information. Further improvements in transparency and accountability can be achieved and would improve LGBs' understanding and acceptance of the process.

91. Improving accountability requires both the National Report and the LGGCs to provide more and clearer information. As a minimum, we think LGGCs' annual reports should provide information on:

- the grant outcomes of all LGBs in the State;
- the expenditure and revenue assessments of all LGBs in the State; and
- the key drivers of LGGCs' expenditure and revenue assessments.

92. The formal mechanism in the Act for increasing the transparency and accountability of the process is the requirement that the National Report include an assessment of the methods used by LGGCs in making their recommendations. To date, the report has mostly confined itself to describing LGGCs' methods. Understanding of the process would be improved if it provided commentary on the LGGCs' approaches, explained how those approaches relate to and satisfy the National Principles, and analysed the influences on and trends in grant outcomes across LGBs and States.

GOAL 2 — CONSISTENCY OF METHODS

93. The second goal is to promote 'consistency in the methods by which grants are allocated to achieve equitable levels of services'. However, our terms of reference imply a broader interpretation, in that they ask us to examine the consistency with the National Principles of the methods and policies of LGGCs.

94. If this goal is interpreted narrowly, then consistency would be defined in terms of uniformity of LGGCs' assessment methods. This is the interpretation DoTRS used in its submission. It said the National Principles were introduced to bring consistency to the methods and policies of the LGGCs, but they had not done so because LGGCs implemented them in non-uniform ways. It asked the Commission to consider the feasibility of developing a standard framework that could be adopted by all LGGCs. If consistency is defined in this way, we agree that the many differences in LGGCs' assessment methods would indicate that the intention of the Act has not been achieved.

95. If the goal is interpreted more broadly, consistency would be defined in terms of consistency with the National Principles, which reflect the Commonwealth's intentions in providing its assistance. This is the interpretation we think is appropriate. We

think the focus of consistency should be consistency of a LGGC's assessment methods with the National Principles rather than conformity with the assessment methods of other LGGCs. The language of the Act should be changed to make it clear that this is the intention of this goal.

96. The only mechanism relating to this goal is the requirement for the National Report to include an assessment of the methods used by LGGCs in making their recommendations. As indicated earlier, the National Report has largely confined itself to describing LGGCs' methods, with very little assessment of them. In addition, an LGGC is not compelled to change a method if the National Report concludes it is inconsistent with the National Principles.

97. We have concluded that the LGGCs are consistently implementing the Minimum Grant and Effort Neutrality Principles. However their approaches are often inconsistent with other National Principles. For example:

- (i) Horizontal Equalisation. The assessment methods that LGGCs use to measure relative needs are not always consistent with horizontal equalisation in that:
 - they do not make an assessment of all expenditures and all revenues;
 - when they do make assessments, some do not assess both the cost advantages and disadvantages; and
 - some do not make assessments of all the influences on the level of expenditure required to provide standard levels of services.
- (ii) Other Grant Support. LGGCs implement this Principle in different ways, which often do not achieve the intent of the Principle.
- (iii) Aboriginal Peoples and Torres Strait Islanders. Some LGGCs assess some needs for the additional costs of providing services to all Indigenous people, others do not.

98. These different approaches affect grant distribution outcomes and the extent to which the Commonwealth's objectives are achieved. We think greater consistency of methods with the National Principles can be achieved and should be required. For example, greater consistency can be pursued in terms of:

- (i) the range of influences assessed, including the assessment of needs associated with the provision of services to Indigenous people;
- (ii) the application of equalisation principles, including more comprehensive coverage of expenditures and revenues of LGBs in the assessments and assessments of both cost advantages and disadvantages for each service; and
- (iii) the application of the Other Grant Support Principle.

99. Greater consistency with the National Principles in these areas can be achieved without detracting from the ability of each LGGC to assess needs in ways that reflect the circumstances of LGBs in their State.

100. We have concluded that:

- (i) consistency of methods is about ensuring the methods and policies of LGGCs are consistent with the National Principles rather than achieving uniformity of LGGCs' methods and policies;
- (ii) the language of the Act should be amended to make the intention of this goal clear;
- (iii) some of the practices of LGGCs are not consistent with the National Principles; and
- (iv) greater consistency of LGGCs' practices can be achieved without detracting from their capacity to design assessment methods that adequately reflect the circumstances of LGBs in their State.

LOCAL ROADS FUNDING

101. The 1990 Special Premiers' Conference agreed that Commonwealth grants to local government for local roads would be untied. The 1986 Act was amended and a second pool introduced from July 1991. The 1994 Review recommended against absorbing these grants into the General Purpose pool.

102. The current Act retains the separate Local Roads pool¹⁸ but none of its purposes or goals specifically relate to the distribution of that pool. The only mention of local roads in the Act is in Section 14(2)(c)(ii)¹⁹. The Act's explanatory memorandum confirms that Sections 12 to 14 relate to the provision of untied local roads funding.

103. The process of providing assistance for roads under the Act is complex:

- (i) roads funding is provided to LGBs from two pools (the General Purpose and Local Roads pools);
- (ii) the distribution of each pool to individual LGBs is different (because different assessment methods are used); and

18 This is additional assistance provided under Section 12 of the Act.

19 It says that the distribution of Section 12 payments should be in accordance with any subsequently developed National Principle that relates to expenditure on local roads by LGBs.

- (iii) the Other Grant Support Principle requires that the amount of Local Roads grants should be taken into account when assessing the equalisation grant each LGB should receive — although not all LGGCs comply with this requirement.

104. The processes for distributing grants to LGBs on the basis of relative need could be simplified and made more understandable if the Local Roads pool was combined with the equalisation component of the General Purpose pool. One pool would mean road expenditure would receive the same treatment as any other expenditure of LGBs. It would also mean only one assessment of road needs would be required.

105. To move in this direction would, however, raise important issues going beyond our terms of reference. Since the Act's methods of calculating the interstate distribution of the General Purpose and Local Roads grants are different, the introduction of a combined pool implies a change in the allocation of the total amount of funds between States. Therefore, we have not taken this issue any further.

106. Moreover, the overwhelming majority of LGBs and LGGCs supported a separate Local Roads pool²⁰, primarily because they considered that a separate pool reflected the special significance of roads to local government.

107. We have concluded that a separate Local Roads pool should be retained and, as a specific purpose is not currently defined, one should be introduced in the Act to clarify the Commonwealth's intention in providing this assistance.

108. A National Principle guides the LGGCs in distributing the Local Roads grants to LGBs. It tells the LGGCs to distribute their grants on the basis of relative road needs (including length, type and use of roads) and the need to preserve assets. The LGGCs use different approaches to implementing this Principle. Some use an asset preservation model, others use simpler methods based on population and road length.

109. The National Principle has been an appropriate means of guiding the LGGCs on how to distribute Local Roads funds among LGBs. Subject to some minor rewording to improve its clarity, we think it should be retained as a guide to the distribution of the Local Roads grants pool.

CONCLUSIONS

110. Overall, we think the intentions of the Commonwealth in providing financial assistance for local government are being achieved. All LGBs are receiving some assistance and greater amounts are being delivered to relatively more disadvantaged councils.

20 The exceptions were LGBs in South Australia. They perceived their State's share of the existing Local Roads grants was unfair. They favoured combining the Local Roads grants with the General Purpose grants if the combined pool were to be distributed among the States on a population basis.

111. We have concluded that the Financial Capacity and Certainty of Funding purposes are being effectively achieved. The Minimum Grant National Principle, which is associated with the Financial Capacity purpose, is well understood and is being applied correctly by all the LGGCs.

112. The Equitable Level of Services purpose is broadly being achieved, although there are technical aspects of LGGCs' implementation of this purpose that could be improved. While the general intention of the Horizontal Equalisation National Principle is being implemented, we do not think the language of this Principle reflects the circumstances which apply and it should be amended so that it relates to the assessment of relative need based on equalisation principles.

113. The National Report should provide commentary on the extent to which LGGCs are modifying their equalisation assessments to deliver greater stability in annual grants. It should report on:

- the methods LGGCs use to constrain grant changes;
- how much these methods are constraining the equalisation outcomes;
and
- whether there should be any limit on the extent to which these arrangements can be used.

114. The Effort Neutrality Principle is appropriate and understood by LGGCs. The Other Grant Support Principle is also appropriate but it is not applied consistently by all LGGCs. Some minor clarification of it would make the concept easier to understand and assist LGGCs to implement it more consistently.

115. The Efficiency and Effectiveness purpose is not being achieved. We think the purpose should be removed because it is conceptually inconsistent with arrangements which provide for the distribution of untied grants.

116. The Aboriginal Peoples and Torres Strait Islanders purpose is also not being effectively achieved. Again, we think the purpose should be removed because it is conceptually inconsistent with arrangements which provide for the distribution of untied grants. The Principle, however, should be strengthened to make explicit that the needs of all Indigenous people (whether living in discrete communities or mainstream communities) must be reflected in the assessments of the LGGCs. A set of performance measures assessing LGBs' performance in providing services to Indigenous people should be developed and reported on in the National Report. The National Report should also report on whether the LGGCs' assessments are recognising the needs of Indigenous people.

117. The Transparency and Accountability goal is being achieved to a limited extent but further improvements can be made. LGGCs should provide more information in their annual reports and the National Report should provide commentary on the approaches used by LGGCs to enhance the transparency and accountability of their processes.

118. We have interpreted the Consistency of Methods goal as being about consistency with the National Principles and, therefore, the intentions of the Act. We think the language of the Act should be changed to make this intention clear. This goal is being achieved to a limited extent but further improvements can be made. While the approaches of LGGCs are consistent with some of the National Principles, more could be done to make assessment methods consistent with the Horizontal Equalisation, Other Grant Support and Aboriginal Peoples and Torres Strait Islanders Principles.

119. A separate Local Roads pool should continue and the Act should include a Local Roads purpose to clarify the aims of the Commonwealth in providing the assistance.

CHAPTER 4

FUTURE DIRECTIONS

Overview

1. In Chapter 3, we concluded that the current arrangements are generally delivering outcomes consistent with the Commonwealth's intentions. However, improvements can be made to make the arrangements clearer and more transparent and to promote greater consistency of LGGCs' methods with the National Principles.

2. We think that the current arrangements would be improved by:

- (i) creating a separate pool of financial assistance for each of the Commonwealth's objectives, with appropriate National Principles to guide LGGCs in allocating each pool to LGBs; and
- (ii) requiring a more consistent implementation of the National Principles by LGGCs to ensure the Commonwealth's intentions are effectively achieved.

3. Requiring a more consistent implementation of the National Principles will result in changes in the grants received by LGBs. We think transitional arrangements should be considered to enable:

- (i) LGGCs to modify their assessment methods, where necessary; and
- (ii) LGBs to adjust to the changes in their grants.

The Modified Arrangements

4. We have concluded that the Commonwealth's intentions are to provide:

- (i) a share of its financial assistance grants to all LGBs;
- (ii) funding to contribute to the costs faced by LGBs in maintaining their local roads; and

- (iii) relatively greater financial assistance to those LGBs, which, because of the greater costs they face in providing services or because of their more limited ability to raise revenue, are relatively more disadvantaged than other LGBs.

5. These are reasonable and appropriate intentions and there is a wide measure of support among LGBs for them. The implementation of the intentions, however, would be helped if they were more clearly reflected in the funding arrangements, including the purposes and principles.

6. In this chapter, we therefore propose arrangements that we think will:

- (i) provide a clearer statement of what the Commonwealth intends the financial assistance process to achieve;
- (ii) simplify the relationship between the key elements of the process — the purposes, principles and pools; and
- (iii) provide a clearer link between these purposes and the instruments that are being used to achieve them.

7. The arrangements we are proposing do not require a change in the amount of assistance provided under the Act, nor any State's share of that assistance.

8. Given that the Commonwealth assistance is directed to three broad objectives, we recommend the creation of three pools, with each pool reflecting one of the Commonwealth's objectives. We propose that there be:

- a Per Capita pool;
- a Local Roads pool; and
- a Relative Need pool.

9. In the next three sections we discuss how the intrastate distribution of these pools would be done, and what National Principles might be required to guide the LGGCs and help to achieve the Commonwealth's purposes.

DISTRIBUTING THE PER CAPITA POOL

10. In the previous chapter we concluded that the purpose of improving the financial capacity of LGBs was an appropriate one and that a minimum per capita grant component should be retained.

11. At present, the per capita component (the minimum grant) is funded from the same pool as the component of grants intended to improve equity (the equalisation component). Attempting to achieve these two competing objectives by distributing the one pool is conceptually confusing and, in practice, gives rise to some difficulties and uncertainty¹.

12. The Commonwealth could more clearly achieve its purpose of providing every LGB with a share of financial assistance grants by replacing the present minimum grant arrangement with an equivalent per capita grant to every LGB. This would make clear the Commonwealth's role in supporting the provision of municipal services to every citizen to at least the same per capita level. It would also avoid the uncertainty arising from the present situation where two objectives are funded from one pool.

13. We think that the most transparent way of implementing this approach would be to divide the present General Purpose pool into a per capita grant pool and an equity (or relative need) pool. This change would not, of itself, change LGB allocations². The proposed Per Capita grant pool would be funded with what would have been 30 per cent of the State's General Purpose pool. It would be distributed among all LGBs on a population basis. The existing Minimum Grant Principle would have to be replaced by a new National Principle that would require LGGCs to 'distribute these grants on a per capita basis'.

14. These proposals would make the existing Financial Capacity purpose unnecessary and it could be deleted from the Act.

15. Our recommendations are:

- (i) a separate grant pool be established and a purpose written into the Act to state that the new pool is intended to provide every LGB with the same amount of assistance per capita;
- (ii) the Per Capita pool be funded with what would have been 30 per cent of the State's General Purpose pool; and
- (iii) a 'Per Capita' National Principle be prepared to instruct the LGGCs to distribute this pool on the basis of population.

16. The proposed purpose could be 'to provide an equal per capita amount of assistance to each local governing body to improve its capacity to provide services'.

1 In particular, the process becomes iterative and the dividing line between minimum grant LGBs and other LGBs is not clear. This is because the LGGCs make their assessments based on the whole General Purpose pool being available. They then determine the minimum grant LGBs and the funds needed to finance them. This reduces the amount of assistance left to meet the assessed needs of the other LGBs. This reduction can result in some borderline LGBs now being deemed to be minimum grant LGBs and the process repeats. LGGCs do not know in advance how many iterations they will need to have before they can finalise which LGBs are minimum grant LGBs, which are not and the grants going to each.

2 This issue is discussed in Chapter 7 of the working papers associated with this report.

17. The proposed Per Capita National Principle could be as follows.

Grants to local governing bodies under Section ? of the Act shall be allocated to each local governing body on the basis of its population. This principle applies only to the Per Capita component of financial assistance grants.

DISTRIBUTING THE LOCAL ROADS POOL

18. The Commonwealth's purpose in providing Local Roads funding through a separate pool has been to make a contribution to the costs faced by LGBs in maintaining their local roads. The interstate distribution of this pool differs from that of the General Purpose pool. There was almost universal support among the participants for retaining a separate Local Roads pool.

19. We have retained a separate Local Roads pool in our proposed modified arrangements. We do not propose any substantive changes to the existing approach, except for the introduction of a roads funding purpose which is missing from the current Act. The Local Roads pool would be distributed among LGBs on the basis of relative road needs, which would relate to the cost of maintaining an existing road network.

20. The principal influences on an LGB's cost of providing road services include:

- (i) the age of its roads;
- (ii) the type and length of its roads;
- (iii) the number and type of vehicles that use its roads; and
- (iv) the climate and terrain.

21. We considered the question of whether the assessment of relative road needs should include needs faced by LGBs in augmenting their existing road networks. LGGCs and LGBs said that augmentation needs should not be assessed because:

- doing so could require LGGCs to measure unmet road needs, which could be very large compared with the limited Local Roads assistance that was available; and
- the task of developing an assessment method would be complex and the necessary data are not readily available.

22. For these reasons, we accept that assessing road needs should not be extended to encompass augmentation of an existing road network.

23. We do not think it is necessary for the Act to define relative road needs or to mandate a method of calculating them. LGGCs already have expertise in assessing relative road needs — they measure them in their existing road assessment(s). The Act should provide LGGCs with the flexibility to develop a roads assessment method that reflects the influences on the cost of maintaining local roads in their State. Flexibility is required because the influences that affect costs in one State are not necessarily relevant in another, or if they are, the size of their effect can be different.

24. The Western Australian, South Australian and Tasmania LGGCs, with the agreement of their LGBs, use part of the Local Roads grants for special road needs such as maintaining bridges or roads to Indigenous communities. We think this practice is consistent with the Local Roads National Principle.

25. Our recommendations are:

- (i) to continue to identify a separate pool that would provide every LGB with a share of Local Roads funding;
- (ii) to create a new local roads purpose to clarify why the Commonwealth is providing the assistance; and
- (iii) to retain the existing National Principle (with minor simplifying amendments) to instruct the LGGCs to distribute this pool on the basis of relative road needs.

26. A proposed purpose could be ‘to improve the capacity of all local governing bodies with responsibility for local roads to maintain those roads’ and the proposed amended National Principle could be:

Grants to local governing bodies under Section ? of the Act shall be allocated on the basis of the relative road needs of each local governing body for roads expenditure. Local governing bodies would be assessed to have greater relative need if they faced higher costs of providing road services. This principle applies only to the Local Roads component of financial assistance grants.

DISTRIBUTING THE RELATIVE NEED POOL

27. The establishment of this pool would be funded from what is left of the present General Purpose pool after the proposed Per Capita grant pool is established – that is, 70 per cent of the present General Purpose pool. Not every LGB would receive grants from the Relative Need pool, because its purpose would be to provide additional assistance to disadvantaged LGBs.

28. The Commonwealth could continue to achieve its purpose of providing relatively greater financial assistance to those LGBs which are relatively more disadvantaged by ensuring that this pool is distributed on the basis of relative need. As discussed in Chapter 3, we recommend the use of a concept of relative need in place of horizontal equalisation.

29. The concept of relative need which we propose is relative need based on equalisation principles. This concept would make it clear that the equity purpose of the Act is to provide assistance to only those LGBs which, for reasons beyond their control, do not have the financial capacity to provide the average level of services.

30. The constraints which prevent an LGB from providing the average level of services are that it faces higher costs of service provision and/or a limited ability to raise revenue. The relative need approach requires LGGCs to determine which LGBs:

- (i) incur higher per capita expenditures in providing services; and
- (ii) have lower per capita capacity to raise revenue.

31. There are a number of essential requirements in any relative need (or equalisation) process. The most important are a comprehensive assessment of needs and an effort neutral approach. A comprehensive assessment of needs means an assessment of:

- (i) each area of expenditure and revenue;
- (ii) each of the influences that affect the cost of providing services or the capacity to raise revenue of LGBs; and
- (iii) both relative advantage and relative disadvantage for each service and revenue source.

32. The Commonwealth's financial assistance grants are not designed to provide sufficient assistance to meet all of the assessed needs of the disadvantaged LGBs. In these circumstances LGGCs have to decide how to distribute the limited assistance available from the Relative Need pool among the disadvantaged LGBs in their State. Possible approaches include distributing the pool so that they:

- (i) meet some of the disadvantage of every disadvantaged LGB. For example, LGGCs could allocate the funds to meet the same proportion of needs — this is the approach used by the LGGCs of Victoria, Western Australia, Tasmania and the Northern Territory;
- (ii) reduce the level of disadvantage of the most disadvantaged LGBs³; or

3 The assistance is first used to remove the relative disparity between the most disadvantaged and the second most disadvantaged LGBs. The per capita shortfall of the most disadvantaged LGB is reduced to the level of the second most disadvantaged LGB. The assistance is then used to remove the relative disparities between these two LGBs and the third most disadvantaged LGB. The per capita shortfalls of these two LGBs are reduced to the level of the third most disadvantaged LGB. This process continues until the assistance is exhausted.

- (iii) provide a safety net which would meet all the needs of very disadvantaged LGBs and meet some of the needs of the remaining disadvantaged LGBs using one of the other two methods — this is the approach favoured by the New South Wales, Queensland and the South Australian LGGCs⁴.

33. We do not think there are any overriding conceptual or methodological issues arising from these alternative approaches. It is a matter of judgement as to whether one delivers outcomes more in line with the underlying equity intention and there are practical issues for LGGCs to consider⁵.

34. We think that how the limited assistance is to be distributed should be left to the judgement of individual LGGCs because:

- the diversity of LGBs' circumstances suggests that it would not be sensible to mandate a single approach for every LGGC; and
- it requires LGGCs to balance the equity objective against the practicalities associated with having insufficient assistance to meet all of the assessed needs.

35. ***Other National Principles.*** If the concept of relative need based on equalisation principles is adopted, the Horizontal Equalisation National Principle would be replaced. The new principle should instruct LGGCs to distribute the Relative Need pool on the basis of relative need based on equalisation principles.

36. The current National Principles relating to Aboriginal Peoples and Torres Strait Islanders, Effort Neutrality and Other Grant Support would be retained (with minor amendments to make their meaning clearer) because they are consistent with, and complement, relative need based on equalisation principles.

- The Other Grant Support Principle is consistent with the requirement that an assessment should be made of all revenues. It explicitly tells LGGCs to make an assessment of grants received by LGBs.
- The Effort Neutrality Principle is an integral part of equalisation. It says that an individual LGB's decisions about what to provide or how to provide it should not affect its grant.

4 New South Wales LGGC does not factor back the assessments of Silverton, Tibooburra or Lord Howe Island. The Queensland LGGC does not factor back the assessments of its Deed of Grant in Trust councils. The South Australian LGGC does not factor back the assessments of the five discrete Indigenous communities or the Outback Areas Community Development Trust.

5 The three approaches are considered further in the working papers associated with this report.

- The Aboriginal Peoples and Torres Strait Islanders Principle is consistent with the requirement to measure the effect of each influence on the cost of providing services. It explicitly tells LGGCs those influences are to include the effects of the higher demand for and the higher costs of providing services to Indigenous people, and/or the reduced capacity to raise revenue from them.

37. Our recommendations are to:

- (i) establish a Relative Need pool and clearly state that its purpose is to provide assistance to disadvantaged LGBs;
- (ii) introduce a Relative Need Principle that would instruct LGGCs to distribute this pool using assessments of relative need based on equalisation principles; and
- (iii) retain the Aboriginal Peoples and Torres Strait Islanders, Effort Neutrality and Other Grant Support Principles.

38. A proposed purpose for the Relative Need pool could be ‘to provide additional assistance to needier local governing bodies to improve their capacity to provide services’.

39. The proposed National Principles could be:

Relative Need. Grants to local governing bodies under Section ? of the Act shall be allocated using assessments of relative need based on equalisation principles. Relative needs of local governing bodies will be measured through a comprehensive assessment of the expenditure they would incur in providing a standard level of services and the revenues they could access from a standard effort. Local governing bodies will be assessed to have greater relative need if, for reasons beyond their control, they face higher than average costs of providing services or a reduced capacity to raise revenue. This principle applies only to the Relative Need component of financial assistance grants.

Aboriginal Peoples and Torres Strait Islanders. The assessment of a local governing body’s relative need based on equalisation principles is to include recognition of the needs of all Indigenous people within its boundaries. In this respect, local governing bodies will be assessed to have greater relative need if, for reasons beyond their control, they face a higher than average demand for services, higher than average costs of providing services or a reduced capacity to raise revenue. This principle applies only to the Relative Need component of financial assistance grants.

Effort Neutrality. An effort or policy neutral approach will be used in assessing the full range of the expenditure local governing bodies would incur in providing a standard level of services and the revenues they could access from a standard effort. An individual local governing body's policies or choices in relation to the services it provides or the revenues it accesses should not influence the level of grant it receives. This principle applies only to the Relative Need component of financial assistance grants.

Other Grant Support. The assessment of a local governing body's relative need based on equalisation principles is to include a recognition of any grants, including the Per Capita and Local Roads grants provided by this Act, received by local governing bodies and used to finance expenditure for which a relative needs assessment is made. This principle applies only to the Relative Need component of financial assistance grants.

CONSISTENCY AND FLEXIBILITY

40. The National Principles are intended to provide guidance to LGGCs on how Commonwealth financial assistance is to be distributed.

41. We acknowledge that LGGCs must have the flexibility to use their judgement about how to design assessment methods that best address the circumstances that affect LGBs in their State. But, that judgement should be exercised in a manner consistent with the intentions of the Commonwealth as expressed through the National Principles.

42. At present, some LGGCs' practices are inconsistent with the National Principles and this may be, in part, due to a lack of clarity in the Principles. It would be highly desirable if the new Act made the meaning of each Principle clearer.

43. Some of the practices of LGGCs that are inconsistent with the National Principles are also inconsistent with equalisation principles. These include a failure to:

- make assessments for every area of expenditure and revenue;
- take proper account of the grants LGBs receive from the Commonwealth and State; and
- assess advantage as well as disadvantage.

44. Our conclusions are.
- (i) that LGGCs' methods and approaches must be consistent with the National Principles; and
 - (ii) providing they are consistent with the National Principles, LGGCs should have the flexibility to develop assessment methods that reflect the circumstances of the LGBs in their State.

TRANSPARENCY AND ACCOUNTABILITY

45. Best practice funding models are concerned not only with the fairness of the outcomes they produce but with the transparency and accountability of the process.

46. In the previous chapter we said that improvements could be made in terms of transparency and accountability. We think the National Report has an important role to play in:

- (i) focussing attention on how well LGGCs are explaining their processes;
- (ii) commenting on the degree to which information provided in LGGCs' annual reports enables an LGB, if it wished:
 - to verify its grant allocation;
 - to understand why its grant has changed from its previous level;
 - to understand why its grant differs from that of a neighbouring or similar LGB in the State; and
 - to understand the key drivers of its grant allocation.

TRANSITIONAL ARRANGEMENTS

47. If our recommendations are accepted, LGGCs will need to change some of their practices to make them consistent with the National Principles. Changing LGGCs' practices will, in turn, have implications for grant allocations to LGBs.

48. We recommend a transitional period of five years to give:
- LGGCs time to adjust their methods; and
 - LGBs time to adjust to the changes in their grant allocations.

49. The transitional period is intended to facilitate these changes by spreading their effect over a number of years, it is not intended that it would defer their introduction. It would be appropriate for the National Report to monitor and report on the effectiveness of the transitional arrangements.

50. We think there should be a review of these transitional arrangements after five years.

CONCLUSIONS

51. We have concluded that the current arrangements are generally delivering outcomes consistent with the Commonwealth's intentions. We think improvements can be made to make the arrangements clearer and more transparent and to promote greater consistency of LGGCs' methods with the National Principles.

52. We have recommended three pools, one for each of the Commonwealth's funding objectives, which we have called:

- the Per Capita pool — distributed on a population basis;
- the Local Roads pool — distributed according to relative road needs; and
- the Relative Need pool — distributed according to relative need based on equalisation principles.

53. The Act should continue to specify goals relating to:

- (i) increasing the transparency and accountability of the States in respect of the allocation of these funds; and
- (ii) improving the consistency in the methods by which the States allocate the Relative Need and the Local Roads pools.

54. The Act should continue to provide for:

- (i) the formulation of National Principles to guide States' allocation of the funds to LGBs;
- (ii) an annual report to the Parliament about the operation of the Act, including commentary on the States' allocation of the funds to LGBs.

55. We think that the National Report needs to play a much stronger monitoring role. Areas that it should monitor and report on include:

- the extent to which LGGCs' assessment methods and approaches are consistent with the National Principles;
- the extent to which LGGCs are modifying their equalisation assessments to deliver greater stability in annual grants;
- the extent to which LGGCs' assessment methods recognise the needs of Indigenous people;
- the performance of LGBs in providing services to Indigenous people (performance measures should be developed for this purpose);
- the extent to which LGGCs' processes explain how individual grants have been calculated and provide sufficient information to enable LGBs to calculate them if they wish; and
- the effectiveness of the proposed transitional arrangements.

56. Acceptance of our recommendations would lead to changes in some of the assessment practices of LGGCs and these changes will in turn change the grant allocations of LGBs. We think that a five year transitional period should be allowed to give:

- LGGCs time to change their assessment methods; and
- LGBs time to adjust to the change in their grant.

CHAPTER 5

OTHER ISSUES

1. The issues addressed in this chapter are:
 - (i) eligibility;
 - (ii) changes in local government finance;
 - (iii) changes in functions or responsibility of LGBs;
 - (iv) the escalation process;
 - (v) the timing of grant allocation announcements and determining grant pool adjustments; and
 - (vi) ministerial responsibility.

ELIGIBILITY

2. The terms of reference ask us to examine and report on the eligibility for assistance under the Act of bodies declared by the Minister to be LGBs. This section addresses that issue.

3. Only LGBs are eligible for financial assistance grants under the Act. In Section 4, the Act defines a 'local governing body' to be:

- (i) a local governing body established by or under a law of a State, other than a body whose sole or principal function is to provide a particular service, such as the supply of electricity or water; or
- (ii) a body declared by the Minister, on the advice of the relevant State Minister, by notice published in the Gazette, to be a local governing body for the purposes of the Act.

4. In June 2000, there were 690 LGBs 'established by or under a law of a State'. There were a further 40 declared LGBs.

5. The declared bodies are:
- two community councils in New South Wales;
 - the Docklands Authority in Victoria;
 - five Indigenous councils and a trust for providing services in the unincorporated areas in South Australia; and
 - 29 Indigenous community councils and two trusts for providing road services in the unincorporated areas in the Northern Territory.

6. Other than the Docklands Authority, these bodies provide local government-type services in remote, sparsely populated and unincorporated areas. We think the arrangement for declaring bodies that provide local government-type services in these areas to be eligible for funding is working well and should continue.

7. Some participants in the review suggested extending eligibility to other bodies. Since the Act provides financial assistance for local government purposes and related purposes, we have inferred that the Commonwealth regards it as more important that local government services rather than particular types of bodies are funded. We think it is appropriate that the Act provides the Minister with the capacity to declare bodies that are providing local government-type services, but are not LGBs under State legislation, to be eligible to receive financial assistance grants. The current eligibility provisions provide for this and we do not think they need to be changed.

8. At present, the Commonwealth Minister can declare an LGB only at the request of a State Minister. We think either Minister should be able to initiate a proposal for a declaration but both Ministers should have to agree to that declaration.

9. The current Act is not clear on whether an existing declaration can be revoked. We see no reason why the Commonwealth and State Ministers should not be able to agree to revoke an existing declaration.

CHANGES IN LOCAL GOVERNMENT FINANCE OVER TIME

10. The Commonwealth has been providing untied financial assistance to local government since 1974–75. Until the Territories achieved self-government, these grants did not cover the ACT or the Northern Territory. Grants for LGBs in the Northern Territory began in 1979–80 and a grant to the ACT for municipal purposes began in 1988–89. Local Roads grants were added to the financial assistance grants in 1991–92¹.

¹ The Commonwealth previously paid these as tied grants to the States under the *Australian Land Transport Development Act 1988*.

11. The amount of financial assistance has grown from \$126 million in 1974–75² to over \$1.3 billion in 2000–01. The Commonwealth has always paid these grants through the States rather than directly to LGBs.

12. The terms of reference ask us to examine and report on:

- the impact of the Act on the raising of revenue by local governing bodies and on the assistance provided by the States to local governing bodies; and
- the implications of any changes in the functions or responsibilities of local governing bodies.

13. To understand whether Commonwealth assistance has had any impact on local government revenue raising and expenditure patterns, or on State assistance, we undertook an analysis of local government revenue and expenditure data for the period 1961–62 to 1997–98³. The data relate to mainstream councils and, in 1997–98, Community Government councils in the Northern Territory.

Local Government Revenue

14. During the review, a number of participants, particularly LGBs, said that:

- local government is increasingly being ‘drawn into’ new areas of service provision, often without access to additional funding;
- local government’s revenue raising abilities have been restricted by policies imposed by other spheres of government, such as rate pegging and rate capping in New South Wales, the 20 per cent mandated rate cut in Victoria in 1995–96 and State Agreement Acts⁴ in Western Australia;
- Commonwealth and State assistance has not been sufficient to enable local government to finance its expanding services; and
- local government has responded in many ways, including increasing rates and user charges, contracting work out, generating greater efficiencies, cutting back on non-essential services and spending less on roads, and increasing borrowings.

2 \$69 million of this was paid to the States as tied grants for local roads.

3 The analysis is based on unpublished Government Finance Statistics data compiled by the ABS. In such a long time series there may have been changes to ABS classifications and coding. However, we are not aware of any such changes and have made no adjustments. Data for 1998–99 are not included because they are prepared on an accrual basis and are not comparable with data for earlier years. The data have been converted to constant prices using an ABS Gross Domestic Product price deflator.

4 The Acts override an LBG’s scope to raise revenue from land in its jurisdiction.

15. The terms of reference do not tell us how to assess the impact of the Act on local government revenue raising and the provision of State assistance. The impact can be assessed in different ways. We have examined the impact from three perspectives:

- whether own source revenue and State assistance have grown in absolute terms over time;
- if so, whether they have grown faster or slower than the inflation rate; and
- whether the relative importance of each form of own source revenue and of State assistance has changed over time.

16. Since the introduction of the Act in 1974–75, local government revenue from all sources has grown on average by 10.1 per cent per annum. The fastest growing revenue source was user charges (13.1 per cent per annum). Other local government revenue (11.0 per cent), Commonwealth assistance (10.8 per cent) and municipal rates (9.4 per cent) grew at about the average rate. The slowest growing revenue source was State assistance (6.6 per cent).

17. Over the same period inflation averaged 6.3 per cent per annum. All revenue sources, therefore, grew faster than the inflation rate. This means that each of the forms of local government revenue has increased in real terms since the introduction of the Act.

Table 5-1 LOCAL GOVERNMENT REVENUE SOURCES

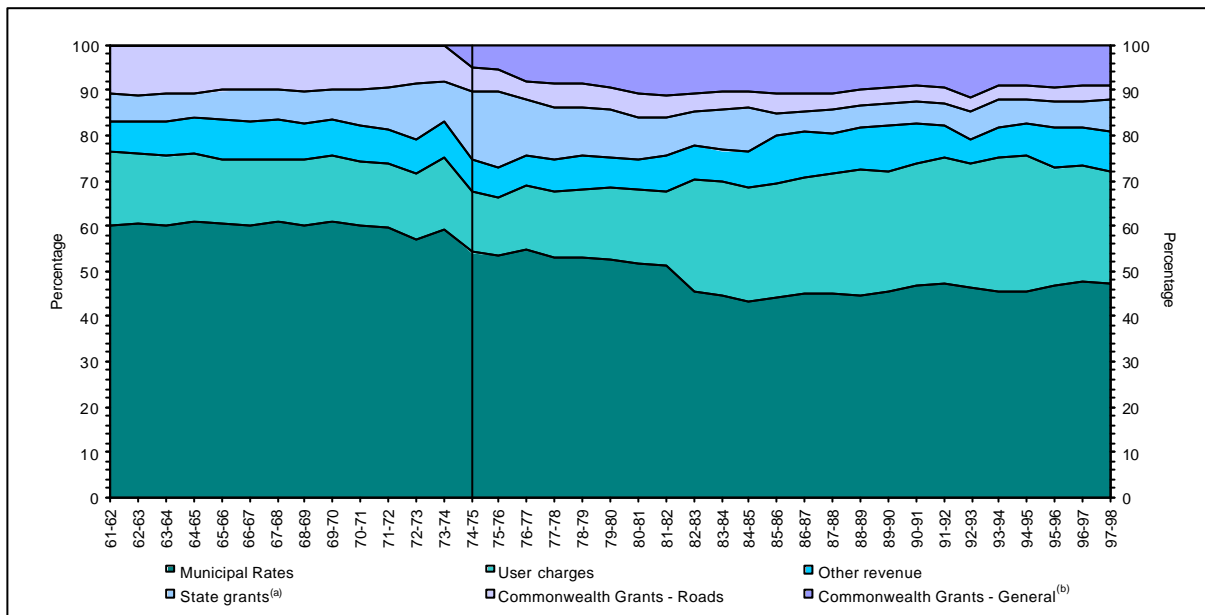
Year	Own-source Revenue			Transfers		Total Revenue
	Municipal Rates	User Charges	Other Revenue	Commonwealth	State	
	\$m	\$m	\$m	\$m	\$m	\$m
(a) Revenue in current prices						
1974–75	705	174	95	137	193	1 304
1997–98	5 620	2 947	1 052	1 443	848	11 911
Average annual rate of growth, 1974–75 to 1997–98 (%)	9.4	13.1	11.0	10.8	6.6	10.1
(b) Revenue in constant 1997–98 prices						
1974–75	2 842	703	381	550	779	5 256
1997–98	5 620	2 947	1 052	1 443	848	11 911
Average annual rate of growth, 1974–75 to 1997–98 (%)	3.0	6.4	4.5	4.3	0.4	3.6

Source: ABS Government Finance Statistics data.

18. Figure 5-1 shows the contribution — in percentage terms — of the different sources of revenue available to local government at the national level.

19. **Own-source revenue.** Figure 5-1 shows that local government’s own relative revenue raising effort (municipal rates plus user charges and other revenue) was relatively steady over the period, despite a dip in 1974–75 and 1975–76⁵. Although the importance of municipal rates has declined, they remain local government’s primary revenue source. For a number of reasons, including a greater range of services, user charges have become an increasingly important source of revenue. The growth in user charges does not appear to be related to the introduction of untied financial assistance.

Figure 5-1 LOCAL GOVERNMENT REVENUE SOURCES, 1961–62 TO 1997–98



(a) State Grants include all Commonwealth payments through the States to local government except for the local government financial assistance grants and Local Roads grants.

(b) Commonwealth Grants - General include local government financial assistance grants and specific purpose payments paid directly to local government.

Source: Unpublished ABS Government Finance Statistics data.

20. We have concluded that the introduction of the Commonwealth’s financial assistance grants has had little impact on local government revenue raising efforts at the national level⁶.

21. The outcome at the State level is less clear. The working papers associated with this report provide a series of charts showing local government revenue by source for each State⁷. These show that since the introduction of the untied financial assistance in

5 The introduction of untied financial assistance in 1974–75 caused each of the other sources of revenue to decline as a share of total local government revenue.

6 We think that the approach we have used is appropriate given the terms of reference, but there are other ways we could have examined this issue. For instance, we could have assessed whether the growth of local government own-source revenue had increased in line with that of the States and the Commonwealth; or, we could have checked whether local government own-source revenue had increased in real terms. These measures are discussed in the working papers associated with this report.

7 Greater care has to be taken in drawing conclusions from State level data. Data quality — the classification of similar transactions over time for example — is likely to be poorer, particularly for smaller States.

1974–75, own-source revenue has increased as a proportion of total revenue in New South Wales (77 to 84 per cent), Queensland (60 to 83 per cent), Western Australia (68 to 79 per cent) and South Australia (77 to 84 per cent). In Victoria and Tasmania, it has remained about the same proportion of total revenue (76 per cent for each). Own-source revenue appears to have declined as a proportion of total revenue in the Northern Territory (53 to 46 per cent).

22. **State assistance.** Since the introduction of untied financial assistance grants, transfers from the Commonwealth and States to local government have varied between 25 per cent of local government revenue in 1974–75 and about 18 per cent in the 1990s. The share of revenue coming from Commonwealth grants has varied between 16 per cent in the early 1980s and 12 per cent in the late 1990s.

23. Although it has increased in real terms, State assistance to local government has declined in relative importance since 1974–75. State assistance was about 15 per cent of local government revenue in 1974–75 but declined to 7 per cent in 1997–98. Table 5-1 shows that, over this period, State assistance increased at a slower rate than total local government revenue (6.6 per cent per annum compared to 10.1 per cent, respectively).

24. The analyses in the working papers show a broadly similar outcome for State assistance in all States except the Northern Territory. Since 1974–75, State assistance as a proportion of total revenue has fallen in the largest States: New South Wales (14 to 5 per cent), Victoria (14 to 10 per cent), Queensland (26 to 7 per cent), Western Australia (17 to 10 per cent), South Australia (10 to 5 per cent) and Tasmania (7 to 4 per cent).

CHANGES IN LOCAL GOVERNMENT FUNCTIONS AND RESPONSIBILITIES OVER TIME

25. Many of the LGBs we consulted said that local government's functions and responsibilities have increased. These changes were said to have resulted from:

- (i) *devolution* — where another sphere of government gives local government responsibility for new functions⁸;
- (ii) *'raising the bar'* — where another sphere of government, through legislative or other changes, increases the complexity of or standard at which a local government service must be provided, and hence increases its cost;
- (iii) *cost shifting* — where there were two types of behaviour. The first is where local government agrees to provide a service on behalf of another sphere of government but funding is subsequently reduced or stopped, and local government is unable to withdraw because of

8 Functions can be taken away, but this has not been the trend.

community demand for the service. The second is where, for whatever reason, another sphere of government ceases to provide a service and local government steps in⁹;

- (iv) *increased community expectations* — where the community demands improvements in existing local government services; and
- (v) *policy choice* — where individual LGBs choose to expand their service provision.

26. LGBs' representatives claimed that changes in the responsibilities of local government have been occurring at an increasing rate. They were concerned that these increasing responsibilities, devolved by the State and (to a lesser extent) the Commonwealth, were not being matched by an increase in funding or in appropriate access to additional revenue. Local government has responded by placing more reliance on user charges (a trend evident in our revenue analysis), reducing expenditure in discretionary areas (particularly roads) and by increased borrowings. Where local government is able to introduce a user charge, there are often substantial differences in the capacity of individual LGBs to raise revenue from this source.

27. Our analysis of local government expenditure over the period 1961–62 to 1997–98 provides support for many of these claims. Again, more details can be found in the working papers associated with this report.

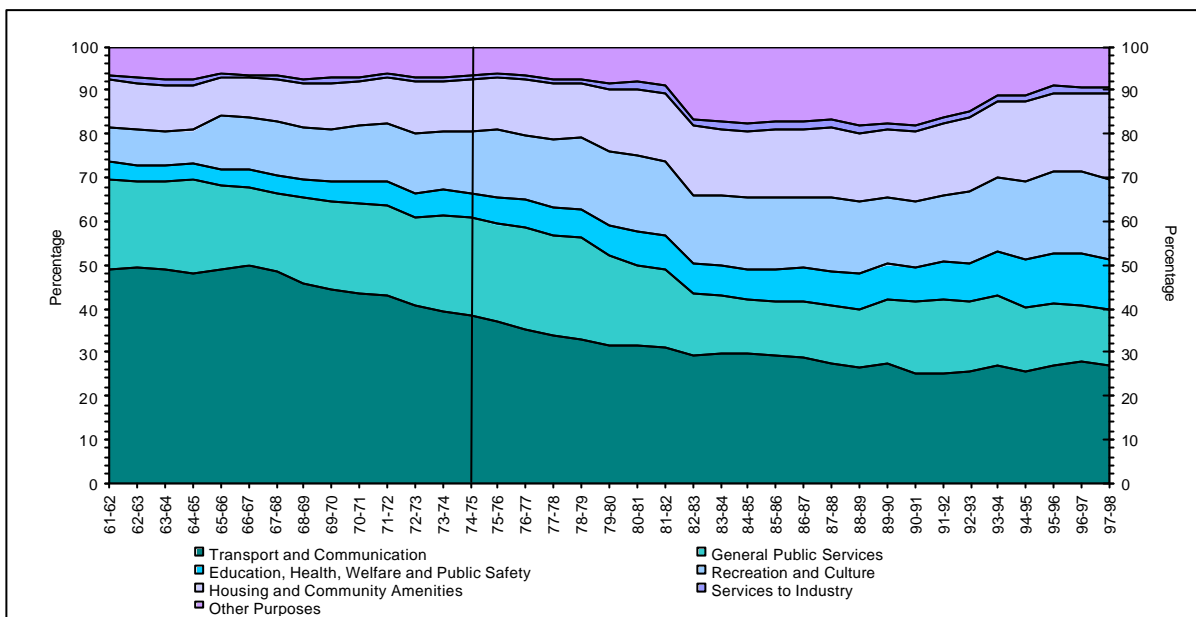
28. Figure 5-2 shows the changes in the composition of local government expenditure over the period of our analysis. There have been substantial changes. Some of the bigger ones have been:

- (i) a move away from property-based services to human services;
- (ii) a decline in the relative importance of road expenditure¹⁰ (although it remains the largest function, its level of importance has declined from about half of total expenditure in the 1960s to a little more than a quarter in the 1990s);
- (iii) an increase in the relative importance of Recreation and Culture, and Housing and Community Amenities (these are now large areas of local government expenditure, each approaching 20 per cent of total); and
- (iv) an expansion of Education, Health, Welfare and Public Safety services (this has increased from 4 per cent of total expenditure in 1961–62 to about 12 per cent in 1997–98).

9 This is not limited to public services. In some areas, local government is also stepping in to provide private services such as banking facilities.

10 LGBs appear to have deferred road expenditure rather than reduce human services.

Figure 5-2 COMPOSITION OF LOCAL GOVERNMENT EXPENDITURE, 1961–62 TO 1997–98



Source: Unpublished ABS Government Finance Statistics data.

29. This analysis shows that, at the national level:

- the composition of services provided by local government has changed markedly over the last 30 to 35 years; and
- local government is increasingly providing human services (social welfare type services) at the expense of its traditional property-based services (particularly roads).

30. The analyses in the working papers suggest there are broadly similar findings for each State.

Implications

31. The terms of reference ask us to examine the implications of any changes in the functions or responsibilities of LGBs.

32. Compared with the situation before 1974–75, we have seen that:

- following the initial impact of the injection of Commonwealth funds, local government has maintained the share of revenue it derives from its own-sources;
- the share of local government revenue coming from the Commonwealth has increased;

- the share of revenue coming from State grants has declined; and
- local government responsibilities have broadened.

33. Local government organisations argued that, to meet the new responsibilities, they need increased revenue from the Commonwealth in the form of financial assistance grants. They said that, unless this is achieved, there will be a continuing deterioration in local government services, particularly in infrastructure and the local road network¹¹.

34. The financial pressures being faced by LGBs are not due to a single influence. It is therefore unlikely that a single response would be reasonable or appropriate.

35. Where the source of the financial pressure is a result of the discretionary actions of the LGB itself (because LGBs have chosen to respond to particular needs of their residents), it would be appropriate for LGBs to meet these pressures from their own revenue sources.

36. Where the source of the financial pressure is the result of changing policies or actions of other spheres of government (the State or the Commonwealth), it would be appropriate for that sphere to acknowledge the effect of its actions on local government. Where these actions impose extra functions on local government greater financial assistance could be appropriate. Financial assistance could also be appropriate where these actions reduce the revenue capacity of local government (for example rate pegging, fee capping or the granting of rate concessions/exemptions to industry).

37. The diversity of LGBs further complicates this issue. While a change in the policy of another sphere of government may affect all LGBs, the different circumstances of each LGB can mean that the same change leads to very different financial pressures. For example, not every LGB has the same capacity to raise user charges. Giving LGBs an increased power to levy user charges does not mean they all have the same increase in capacity to provide additional services.

38. Devolving functions to LGBs which are already highly dependent on grants can impose particular difficulties. If these LGBs have low revenue capacities they will not have the financial capacity to finance the new function. This situation may not be alleviated even if a new revenue source was also devolved to local government. Their low revenue capacity means that these LGBs might not raise sufficient revenue from the new source to enable them to provide the function. In the extreme, devolving functions can place at risk the financial viability of some LGBs.

11 Recognising the need to improve local road condition, the Commonwealth recently announced the provision of \$1.2 billion over four years in tied grants for local government over four years under the *Roads to Recovery* Program.

THE ESCALATION PROCESS

39. The Act describes a process for determining the annual increase in assistance provided by the Act. Currently, the same process is applied to both the General Purpose and the Local Roads pools at the national level.¹² The process ensures that each pool is maintained in real per capita terms.¹³

40. We have considered what sort of escalation process might apply to the three pool framework we have proposed. Most participants were satisfied with the existing process which increases each pool at the same rate.

41. We asked the participants for their views on:

- (i) whether the existing arrangement of applying the same rate of increase to each pool should be retained; or
- (ii) whether a new arrangement should be considered, under which it would be possible to apply a different rate of increase to each pool (in a way that would not change the interstate distribution of assistance).

42. The second option would be relevant if the Commonwealth and State Ministers wished to have the flexibility of being able to apply a different escalation process to each pool — thereby changing the weight given to each of the Commonwealth's purposes.

43. Most participants strongly supported the first option. They thought the second option would increase the complexity and the volatility of the allocation process. If the second option was adopted, they indicated that it:

- should require the agreement of both the Commonwealth and State Minister; and
- once agreed, the issue should not be reconsidered again for three to five years.

44. We have not proposed any change in the existing arrangements.

12 Sections 9 and 10 describe the escalation process to apply to the General Purpose pool. Sections 12 and 13 describe the process to apply to the Local Roads pool.

13 The escalation process is based upon Budget estimates of national population growth and the growth of the CPI.

ANNOUNCING GRANT ALLOCATIONS AND DETERMINING GRANT POOL ADJUSTMENTS

45. Local government planning and budgeting requirements mean LGBs begin to prepare their budgets for the coming financial year as early as February. However, they do not receive notification of their grant allocation until August. Many LGBs said that this creates considerable difficulties, particularly if their grant is less than they expected and they have to adjust allocations within an already approved budget.

46. In addition, the current arrangements are confusing for LGBs. The national grants pool is initially estimated based on expected increases in CPI and population. Grants are then allocated to LGBs based on the estimated size of the pool. In the following financial year, adjustments are made to the grants paid to LGBs in the previous year because actual increases in CPI and population in the previous year differ from the estimated changes.

47. Final grant allocations to each LGB cannot be announced before the Commonwealth brings down its Budget in May, but it should be possible to announce them very shortly after that time. To do so would require:

- (i) LGGCs to have their grant recommendations completed before May (based on the previous year's national pool);
- (ii) a quicker approval process — the process by which the Commonwealth approves the LGGCs' recommendations; and
- (iii) final grant allocations to be determined using the level of funding announced in the Commonwealth budget.

48. Under this process, the final grant distribution to the States would be based on the estimates of CPI and population available at the time of the Commonwealth budget. This would allow the level of funding for each State to be announced in that budget. We propose that there be no adjustment in the following year for changes in these estimates. This would greatly simplify the process.

49. Some participants were concerned that this arrangement could result in a decline in total grants in real terms if the CPI and population growth were underestimated and no adjustments were made to the grants pool in the following year. Some LGGCs suggested another solution, that is to add (subtract) any under (over) payment to (from) the next year's grants pool. We have looked at the estimates for the period 1995–96 to 2000–01. In some years there are underestimates and in other years overestimates. Overall, the difference was very small and for that reason we think there should be no adjustment in the following year.

50. It is possible for LGGCs to complete their grant recommendations before May. Some of them already do so. Once the level of funding for the State is known, they could then finalise each LGB's grant allocation very quickly.

51. The process of approving distribution methods could begin prior to May. The new grant allocations do not need to be known to complete this process. The impact of the new recommendations could be assessed by applying them to the previous year's level of funding. Provided the information is in a form that allows the Commonwealth Minister to ensure the new assessments will distribute all the funds, the approval process could be completed prior to May. If approved, the new recommendations would then be applied to the current year's level of funding.

52. These changes may involve some compromises (for example, some LGGCs may have to use older data) but there would be substantial benefits to LGBs' budgetary processes. It will be important for LGGCs to consider whether the benefits outweigh the costs of this proposal.¹⁴ We think the benefits are large and the Commonwealth, in consultation with the States and local government, should develop improved arrangements along these lines.

MINISTERIAL RESPONSIBILITY

53. Constitutionally, local government is the responsibility of the States. States provide the legislative framework within which LGBs operate, and oversee their operations. Prior to 1974, the States were the main source of additional financial assistance for local government. With the introduction of Commonwealth financial assistance grants for local government in the mid-1970s, the respective roles of the Commonwealth and the States in relation to local government funding have become blurred. In line with their constitutional position, we think the States continue to have the major responsibility for ensuring the financial viability of local government, with the Commonwealth being a provider of 'supplementary' funding by way of financial assistance grants.

54. The provision of this supplementary funding by the Commonwealth to local government raises broader issues of accountability and the relationships between the Commonwealth Minister, State Ministers and the LGGCs (bodies which are established under State legislation).

55. The Act cannot work effectively without co-operation and agreement between all parties, particularly the Commonwealth and State Ministers.

56. The particular issue of governance that we have considered is the Commonwealth Minister's responsibility for approving the recommendations of the LGGCs. The current Act does not allow the Minister to change the recommendations if he/she does not approve them. The only option available to the Minister is to withdraw the assistance. For most LGBs, the Commonwealth financial assistance is an essential element of their revenues. Withdrawal of the assistance pending some resolution between the Ministers would make it extremely difficult for them to manage their budgets.

14 The Victorian LGGC said that when they discussed the option of using older data with some LGBs, they argued comprehensively against it.

57. The Department of Territories and Regional Services (DoTRS) said that where there was a dispute about grant allocations it would be appropriate for the Commonwealth to have the final say because these are Commonwealth funds designed to achieve Commonwealth policy priorities for local government. It suggested that a range of options could be open to the Commonwealth, including:

- certifying the LGGCs' methods before notice of grant outcomes;
- calling in an independent third party arbitrator to resolve dispute;
- allocating grants based on previous year's distribution until the dispute is resolved; or
- altering an LGGC's recommendations following the failure to reach agreement with the State Minister after a designated period.

58. The States, LGGCs and LGBs consider that the independence of the LGGCs could be undermined if the Commonwealth Minister had a unilateral power to change the LGGCs' recommendations. They believe that any disagreement on grant allocations should be dealt with through negotiations between the Commonwealth and the State Ministers. Some suggested providing the Commonwealth Minister with a capacity to refer recommendations back to LGGCs for reconsideration. If, however, the LGGC returned the same recommendations, the dispute would remain.

59. There is currently no proposed dispute resolution process that has the support of the main parties in the allocation process. We think it would be unhelpful to attempt to mandate a dispute resolution process in the absence of a clear consensus, particularly given the constitutional status of local government. We think the circumstances in which disputes might arise, and the way these might be resolved do not lend themselves to legislation. It is clear that resolution of any disagreement on grant allocations would require bilateral negotiations between the Commonwealth and relevant State Minister.

ATTACHMENT A

THE EXISTING NATIONAL PRINCIPLES

1. The National Principles relating to the allocation of General Purpose grants payable under Section 9 of the *Local Government (Financial Assistance) Act 1995* (the Act) among local governing bodies are as follows:

- (i) ***Horizontal Equalisation.*** General purpose grants will be allocated to local governing bodies, as far as practicable, on a full horizontal equalisation basis as defined by the Act. This is a basis that ensures that each local governing body in the State/Territory is able to function, by reasonable effort, at a standard not lower than the average standard of other local governing bodies in the State/Territory. It takes account of differences in the expenditure required by those local governing bodies in the performance of their functions and in the capacity of those local governing bodies to raise revenue.
- (ii) ***Effort Neutrality.*** An effort or policy neutral approach will be used in assessing expenditure requirements and revenue raising capacity of each governing body. This means as far as practicable, policies of individual local governing bodies in terms of expenditure and revenue effort will not affect grant determination.
- (iii) ***Minimum Grant.*** The minimum general purpose grant allocation for a local governing body in a year will be not less than the amount to which the local governing body would be entitled if 30 per cent of the total amount of general purpose grants to which the State/Territory is entitled under Section 9 of the Act in respect of the year were allocated among local governing bodies in the State/Territory on a per capita basis.
- (iv) ***Other Grant Support.*** Other relevant grant support provided to local governing bodies to meet any of the expenditure needs assessed should be taken into account using an inclusion approach.
- (v) ***Aboriginal Peoples and Torres Strait Islanders.*** Financial assistance shall be allocated to councils in a way which recognises the needs of Aboriginal peoples and Torres Strait Islanders within their boundaries.

2. The National Principle relating to the allocation of the amounts payable under Section 12 of the Act (the identified road component of the financial assistance grants) among local governing bodies is as follows:

- (i) The grants should be allocated to local governing bodies as far as practicable on the basis of the relative needs of each local governing body for roads expenditure and to preserve its road assets. In assessing road needs, relevant considerations include length, type and usage of roads in each local governing area.

ATTACHMENT B

THE PROPOSED PURPOSES AND NATIONAL PRINCIPLES

Purpose and Principle relating to the Per Capita Pool

Per Capita Purpose. The purpose of these funds is to provide an equal per capita amount of assistance to each local governing body to improve its capacity to provide services.

Per Capita National Principle. Grants to local governing bodies under Section ? of the Act shall be allocated to each local governing body on the basis of its population. This principle applies only to the Per Capita component of financial assistance grants.

Purpose and Principle relating to the Local Roads Pool

Local Roads Purpose. The purpose of these funds is to improve the capacity of all local governing bodies with responsibility for local roads to maintain those roads.

Local Roads National Principle. Grants to local governing bodies under Section ? of the Act shall be allocated on the basis of the relative road needs of each local governing body for roads expenditure. Local governing bodies would be assessed to have greater relative need if they faced higher costs of providing road services. This principle applies only to the Local Roads component of financial assistance grants.

Purpose and Principles relating to the Relative Need Pool

Relative Need Purpose. The purpose of these funds is to provide additional assistance to needier local governing bodies to improve their capacity to provide services.

Relative Need National Principle. Grants to local governing bodies under Section 7 of the Act shall be allocated using assessments of relative need based on equalisation principles. Relative needs of local governing bodies will be measured through a comprehensive assessment of the expenditure they would incur in providing a standard level of services and the revenues they could access from a standard effort. Local governing bodies will be assessed to have greater relative need if, for reasons beyond their control, they face higher than average costs of providing services or a reduced capacity to raise revenue. This principle applies only to the Relative Need component of financial assistance grants.

Aboriginal Peoples and Torres Strait Islanders National Principle. The assessment of a local governing body's relative need based on equalisation principles is to include recognition of the needs of all Indigenous people within its boundaries. In this respect, local governing bodies will be assessed to have greater relative need if, for reasons beyond their control, they face a higher than average demand for services, higher than average costs of providing services or a reduced capacity to raise revenue. This principle applies only to the Relative Need component of financial assistance grants.

Effort Neutrality National Principle. An effort or policy neutral approach will be used in assessing the full range of the expenditure local governing bodies would incur in providing a standard level of services and the revenues they could access from a standard effort. An individual local governing body's policies or choices in relation to the services it provides or the revenues it accesses should not influence the level of grant it receives. This principle applies only to the Relative Need component of financial assistance grants.

Other Grant Support National Principle. The assessment of a local governing body's relative need based on equalisation principles is to include a recognition of any grants, including the Per Capita and Local Roads grants provided by this Act, received by local governing bodies and used to finance expenditure for which a relative needs assessment is made. This principle applies only to the Relative Need component of financial assistance grants.

ATTACHMENT C

ACQUITTAL AGAINST THE TERMS OF REFERENCE

1. This acquittal provides a consolidation of the Commission's response to the terms of reference. References are provided to the section in the report where the Commission has addressed specific matters raised by the terms of reference.

The effectiveness of the current arrangements under the Act to achieve the purposes of the Act and the goals in providing the grants (referred to in Section 3 of the Act).

- The current arrangements have broadly achieved the Commonwealth's purposes and goals.
- Some of the existing purposes and goals are not clear. Their language needs to be improved so they are better understood and more effectively achieved.
- The Financial Capacity and Certainty of Funding purposes have been achieved (Chapter 3, paragraphs 12 to 17 and paragraphs 60 to 69).
- The underlying intention of the Equitable Level of Services purpose is broadly being achieved (Chapter 3, paragraphs 18 to 49).
- The Efficiency and Effectiveness purpose is not being achieved. This is not a relevant purpose for an Act that provides for the distribution of untied assistance (Chapter 3, paragraphs 70 to 76).
- The Aboriginal Peoples and Torres Strait Islanders purpose is not being achieved. This is not a relevant purpose for an Act that provides for the distribution of untied assistance (Chapter 3, paragraphs 77 to 87).
- Transparency of and accountability in the grant distribution process can and should be improved (Chapter 3, paragraphs 88 to 92).
- The methods of Local Government Grants Commissions (LGGCs) are not consistent with the intentions underlying the purposes and Principles in all respects, and changes are required (Chapter 3, paragraphs 93 to 100).

The appropriateness of the current National Principles and, in particular, the retention or variations of the minimum grant for the general purpose component in Section 6 of the Act.

- The underlying intention of the Horizontal Equalisation Principle is being implemented but horizontal equalisation is not being achieved. The language of the Horizontal Equalisation National Principle should be revised. The term horizontal equalisation should be replaced with relative need based on equalisation principles (Chapter 3, paragraphs 18 to 39).
- The provision of a minimum level of financial assistance to all local governing bodies (LGBs) should be retained. The Minimum Grant Principle should be replaced by a Per Capita Principle which would provide a universal grant to all LGBs. The universal grants would be funded by what is now 30 per cent of the General Purpose pool (Chapter 3, paragraphs 50 to 59).
- The Effort Neutrality, Other Grant Support and Identified Road Component are appropriate Principles and should be retained but their language should be improved to make them easier for LGGCs and LGBs to understand (Chapter 3, paragraphs 40 to 49).
- The Aboriginal Peoples and Torres Strait Islanders Principle has not been consistently addressed by LGGCs. The Principle should be retained and strengthened to make explicit that the needs of Indigenous people must be recognised in equalisation assessments (Chapter 3, paragraphs 77 to 87).

The consistency with the National Principles of the methods and policies used by each of the State Grants Commissions in distributing funds to councils.

- While the underlying intention of the Horizontal Equalisation Principle is being implemented some changes are needed in LGGCs' methods to promote more effective implementation of equalisation (Chapter 3, paragraphs 18 to 49).
- LGGCs' methods are consistent with the Minimum Grant, Effort Neutrality and Identified Road Component Principles (Chapter 3, paragraphs 40 to 59).
- LGGCs are not consistently implementing the Other Grant Support Principle (Chapter 3, paragraphs 44 to 49).
- The Aboriginal Peoples and Torres Strait Islanders Principle has not been consistently addressed by LGGCs (Chapter 3, paragraphs 77 to 87).

The effectiveness of the arrangements under this Act in relation to ensuring that the allocation of funds for local government purposes is made on a full horizontal equalisation basis as mentioned in paragraph 6(2)(a).

- While horizontal equalisation cannot be achieved, the current arrangements have, in broad terms, ensured that funds have been distributed in way that is consistent with the Commonwealth's intentions (Chapter 3, paragraphs 18 to 49).

The impact of the Act on the raising of revenue by local governing bodies and on the assistance provided by the States to local governing bodies.

- The Act appears to have had little impact on overall local government revenue raising effort (Chapter 5, paragraphs 14 to 21).
- State assistance, while continuing to increase in real terms, has declined in importance since the introduction of Commonwealth assistance (Chapter 5, paragraphs 22 to 24).

The implications of any changes in the functions or responsibilities of local governing bodies.

- The types of services being provided by local government have changed markedly (Chapter 5, paragraphs 25 to 38).
- Local government is increasingly providing human services (social welfare type services) at the expense of its traditional property-based services (particularly roads) (Chapter 5, paragraphs 25 to 38).
- Some changes are the result of the changing priorities of local government, others are imposed on them by other spheres of government. The general broadening of local government functions has implications for local government finances (Chapter 5, paragraphs 25 to 38).

The eligibility for assistance under this Act of bodies declared by the Minister under Section 4 to be local governing bodies.

- The existing criteria are sufficiently flexible to allow any organisation that provides local government type services to be declared (Chapter 5, paragraphs 2 to 9).
- The existing arrangements should be altered to allow either the Commonwealth or State Minister to initiate a request for declaration, but both should have to agree to the declaration (Chapter 5, paragraphs 2 to 9).
- The Commonwealth and State Ministers should have the power to revoke an existing declaration provided both agree (Chapter 5, paragraphs 2 to 9).