



Research Paper
No. 19 2000-01

Commonwealth General Purpose Financial Assistance to Local Government

ISSN 1328-7478

© Copyright Commonwealth of Australia 2001

Except to the extent of the uses permitted under the *Copyright Act 1968*, no part of this publication may be reproduced or transmitted in any form or by any means including information storage and retrieval systems, without the prior written consent of the Department of the Parliamentary Library, other than by Senators and Members of the Australian Parliament in the course of their official duties.

This paper has been prepared for general distribution to Senators and Members of the Australian Parliament. While great care is taken to ensure that the paper is accurate and balanced, the paper is written using information publicly available at the time of production. The views expressed are those of the author and should not be attributed to the Information and Research Services (IRS). Advice on legislation or legal policy issues contained in this paper is provided for use in parliamentary debate and for related parliamentary purposes. This paper is not professional legal opinion. Readers are reminded that the paper is not an official parliamentary or Australian government document. IRS staff are available to discuss the paper's contents with Senators and Members and their staff but not with members of the public.

Published by the Department of the Parliamentary Library, 2001

I N F O R M A T I O N A N D R E S E A R C H S E R V I C E S

Research Paper
No. 19 2000-01

Commonwealth General Purpose Financial Assistance to
Local Government

Richard Webb
Economics, Commerce and Industrial Relations Group
6 February 2001

Acknowledgments

This is to acknowledge the help given by colleagues in the Parliamentary Library in producing this paper and by external readers who provided comments.

Inquiries

Information and Research Services publications are available on the ParlInfo database.
On the Internet the Department of the Parliamentary Library can be found at: <http://www.aph.gov.au/library/>

IRS Publications Office
Telephone: (02) 6277 2778

Contents

Glossary	
Major Issues	i
Introduction.	1
History of General Purpose Assistance	2
Tax Sharing Arrangements	2
Hawke Government.	3
Self Report and the 1986 Act.	3
Commonwealth Grants Commission Report on the Interstate Distribution of Grants	4
Untying of Local Road Funds and Identified Roads Grants	5
Review of the 1986 Act	5
Local Government (Financial Assistance) Act 1995	6
A New Tax System	7
Issues in Commonwealth Assistance	8
Level of Assistance	8
Interstate Distribution of Grants.	9
Financial Assistance Grants.	9
Identified Road Grants	10
Minimum Grant	11
Intrastate Fiscal Equalisation and Grants Commission Methodologies	12
Burden Shifting.	13
Conclusions.	14
Endnotes.	14
Appendix 1	19
Appendix 2	21

Glossary

Financial assistance grants: payments that local government can use for any purpose. Financial assistance grants are distributed among the States on an equal per capita basis.

Fiscal equalisation: with respect to the States, (full horizontal) fiscal equalisation is the provision of financial assistance which, as assessed by the Commonwealth Grants Commission, is designed to provide a State with the capacity to provide services at a standard comparable with those of the other States but without requiring that State to impose a greater burden of taxation. As applied to local government, fiscal equalisation seeks to ensure that each local government in a State can function, by reasonable effort, at a standard not lower than the average standard of other local governments in the State. Fiscal equalisation takes account of differences in local governments' expenditure requirements and capacity to raise revenue.

General purpose assistance: the term used to describe jointly financial assistance grants and identified road grants.

Grants: non-repayable, non-interest bearing assistance.

Identified road grants: untied grants to local government. Identified road grants were previously paid as specific purpose payments under the *Australian Land Transport Development Act 1988* and distributed among the States on the basis of criteria established under this Act. The payments were untied with effect from 1 July 1991. Identified road grants are distributed among the States in the same proportions that existed when the grants were untied in 1991–92. (See also specific purpose payments and untied grants).

Local government: a body established under State legislation, which delegates various functions to that body. Local government thus forms part of and is an extension of the State government sector. Also includes a body declared to be a local governing body under the *Local Government (Financial Assistance) Act 1995*.

Specific purpose payments: payments for policy purposes related to particular functional activities, for example, health and education. Specific purpose payments are made under section 96 of the Constitution, which states that the Parliament may grant financial assistance to any State on such terms and conditions as may be specified. (See also untied grants).

Untied grants: payments to which no conditions on use are attached. (See also specific purpose payments).

Major Issues

Local government is a small but important part of the public sector, being responsible for providing a wide range of services. The ability of local government to provide services depends partly on Commonwealth general purpose financial assistance, which takes the forms of financial assistance grants and grants for local roads known as identified road grants. In 1997–98, such assistance accounted for around 12 per cent of local government revenue.

How the Commonwealth determines the level of assistance and how it is distributed among local governments are, however, not widely understood. This paper seeks to help Parliamentarians improve their understanding of how current arrangements have evolved and of their limitations. The paper also provides background to the review by the Commonwealth Grants Commission of the *Local Government (Financial Assistance) Act 1995*, which governs the provision of general purpose assistance.¹ The paper's main focus is, however, on two issues that the review's terms of reference specifically exclude, namely, the interstate distribution of grants and level of the grants. The paper also discusses specific purpose payments made under the *Roads to Recovery Act 2000* because they are also spent on local roads. The paper does not discuss other specific purpose payments made directly to local government for purposes such as child care programs that local governments administer on behalf of the Commonwealth and funding for aged and disabled persons' homes and hostels.

The Commonwealth has been providing general purpose assistance to local government since it first provided assistance in 1974–75. Local governments can use financial assistance grants for any purpose. While, in theory, local governments can spend identified road grants for any purpose, in practice, the grants are spent on roads. The Commonwealth pays financial assistance and identified road grants 'through' the States; that is, on condition that the States pass the funds to local government. Grants made under the roads to recovery program are specific purpose payments. State Grants Commissions determine the allocation of funds among local governments within their respective States.

General purpose assistance has been declining as a proportion of gross domestic product (GDP) since at least 1991–92. In the absence of action to change the situation, this trend will continue. The *Local Government (Financial Assistance) Act 1995* provides for the level of financial assistance grants and identified road grants to be increased annually in accordance with rates of population growth in each jurisdiction and changes in the consumer price index. This formula maintains the per capita value of assistance in real

terms and places a 'floor' under the level of assistance. But the formula does not provide growth in the real level of assistance. Since GDP has grown faster, the level of general purpose assistance has fallen as a proportion of GDP. The Australian Local Government Association—the body that represents local government at the national level—argues that the level of general purpose assistance should be increased and set at one per cent of total Commonwealth taxation receipts. In 1999–2000, application of this proposal would have resulted in assistance of \$1.525 billion compared with actual assistance of \$1.265 billion. Under this proposal, the level of grants would, however, fluctuate with economic activity and discretionary changes to taxation levels, and hence increase uncertainty as to the level of funding to local government.

The injection of roads to recovery funds will, however, increase substantially spending on local roads. In 2000–01, the Commonwealth began to provide grants under the *Roads to Recovery Act 2000* for the construction, upgrading and maintenance of roads. The Commonwealth pays roads to recovery grants directly to local governments. The payment of \$1.2 billion over five years under the roads to recovery program will boost spending on local roads substantially. In annual average terms, the program is equivalent to additional local government road spending of \$240 million, or 59 per cent of the \$406.9 million allocated to identified road grants in the 2000–01 Budget. Roads to recovery grants are paid directly to local governments.

It could be argued that the funds allocated to roads to recovery could be better used to increase financial assistance grants on the grounds that local governments are best placed to determine their priorities and can spend financial assistance grants in accordance with those priorities. But the Australian Local Government Association favours the continued separation of identified road grants from financial assistance grants on the grounds that combining the two would see large changes in the distribution of the funding among the States, and lead to volatility in the grants provided to local governments. Moreover, local governments spend more on local roads (in excess of \$2.5 billion annually) than is funded by identified road grants (estimated at \$407 million in 2000–01) so that much of any additional funds in the form of financial assistance grants would be likely to be spent on roads.

The interstate distribution of general purpose grants to local government differs from that which would exist if the basis of distribution were fiscal equalisation. In this respect, Commonwealth assistance to local government differs from assistance to the States where the Commonwealth Grants Commission, in allocating revenue from the goods and services tax among the States, aims to achieve fiscal equalisation. The interstate distribution of financial assistance grants, which is on an equal per capita basis, is inconsistent with fiscal equalisation, and the Commonwealth Grants Commission concluded in a 1991 report that it would not be appropriate to continue indefinitely this method of distribution because it departs from fiscal equalisation. But the Commonwealth Grants Commission also observed that distributing financial assistance grants on a fiscal equalisation basis would be disruptive since this would entail redistributions of funds

among the States and local governments. The interstate distribution of identified road grants is also unlikely to be consistent with fiscal equalisation. Identified road grants are distributed on the shares that existed when the grants were untied in 1991–92 and is thus increasingly anachronistic.

The Government decided against using these shares for the roads to recovery program. The interstate distribution of roads to recovery grants, which takes account of road length, population and other factors, is also unlikely to be consistent with fiscal equalisation. While the resulting interstate distribution is similar to the distribution of identified road grants, Victoria, Queensland and South Australia benefit relative to the allocation of identified road grants.

Political considerations seem to militate against changing the distribution of general purpose assistance among the States. A major change in the basis of distribution, such as a move to fiscal equalisation, would entail disruption, with some States—and hence some local governments—losing funds and others gaining.

The *Local Government (Financial Assistance) Act 1995* requires the State Grants Commissions to allocate financial assistance grants and identified road grants among local governments on the basis of agreed national principles. The objective of the principles is to ensure that the Commissions distribute grants on a nationally consistent basis. The main principle is fiscal equalisation, which seeks to improve the equity of grant outcomes. But it is questionable to what extent equalisation is being achieved. The State Grants Commissions do not use consistent methodologies to determine the intrastate allocation of grants. Moreover, it is questionable whether some of the methodologies meet the objective of fiscal equalisation. Further, the national principles seem to be internally inconsistent. In particular, the principle allowing local governments to receive minimum grants seems to be contrary to fiscal equalisation.

Introduction

The Commonwealth has been providing general purpose assistance to local government since it first provided assistance in 1974–75. Under existing arrangements, general purpose assistance takes the forms of financial assistance grants and untied road funding known as 'identified road grants'. Legislative authority for financial assistance grants and identified road grants² is contained in the *Local Government (Financial Assistance) Act 1995*. Local governments can use financial assistance grants for any purpose. In theory, local governments can also spend identified road grants for any purpose but, in practice, the grants are spent on roads.

Financial assistance grants are distributed among the States on an equal per capita basis. Identified road funds are, in effect, distributed on the basis of criteria established under the *Australian Land Transport Development Act 1988* (see discussion below under untying of local road funds and identified road grants). The *Local Government (Financial Assistance) Act 1995* requires the State Grants Commissions to allocate financial assistance grants and identified road grants among local governments on the basis of 'national principles'. The main purpose of these principles is to ensure that the Commissions distribute grants on a nationally consistent basis.

This paper traces the evolution of Commonwealth general purpose assistance to local government and discusses related issues including:

- the level of assistance
- the interstate allocation of assistance
- the treatment of identified road grants
- the application of the national principles
- State Grant Commission methodologies, and
- the extent to which actual grant allocations are consistent with fiscal equalisation.

Beginning in 2000–01, the Commonwealth began to make specific purpose payments under the *Roads to Recovery Act 2000* for the construction, upgrading and maintenance of roads. The paper also discusses these grants because they are also spent on local roads. The

paper does not discuss other specific purpose payments made directly to local government for 'policy' purposes (see Box 1).

Box 1: Specific Purpose Payments Made Directly to Local Government Authorities

The Commonwealth pays current and capital specific purpose payments directly to local governments for purposes such as health and education. Examples of current payments are funds for the provision of residential and community-care services for the frail aged and services for people with disabilities. Examples of capital payments are funds for constructing community child care centres. The 2000–01 Budget allocated \$1323.9 million towards general purpose assistance compared with specific purpose payments made directly to local governments of \$125.5 million.³

History of General Purpose Assistance⁴

As noted, the Commonwealth first provided general purpose assistance to local government in 1974–75 in line with the Labor Party's policy of providing assistance to local government to promote equality among regions, and to ensure adequate services and the development of resources at local and regional levels. The *Grants Commission Act 1973* authorised the Commonwealth Minister to approve the establishment of regional organisations to represent local governments located in the region, and laid down procedures for the organisations to apply for financial assistance. The Act further provided for the Commonwealth Grants Commission to inquire into and report on applications. In the event, the Government distributed the grants among local governments in each State in accordance with the Commission's recommendations. In the following two years, the Commission assessed the applications and the Government again accepted the Commission's recommendations.

Tax Sharing Arrangements

In 1975, the Liberal – National Country Party coalition adopted the provision of assistance to local government as part of its federalism policy. The arrangements the Whitlam Government had put in place changed with the election of the Fraser Government and its 'new Federalism' policy of sharing personal income tax revenue among the Commonwealth, State and local governments. Under the provisions of the *Local Government (Personal Income Tax Sharing) Act 1976*, local government received in 1976–77 the equivalent of 1.52 per cent of net personal income tax collections in the previous year. In November 1977, the Prime Minister, the Hon. Malcolm Fraser MP, announced the Government's intention to increase this proportion to two per cent over the following three years. In the event, the proportion was increased to 1.75 per cent in 1979–

80 and to two per cent in 1980–81. The method of allocation of grants among the States was changed from the full equalisation to a method based partly on per capita grants (the so-called minimum grant) and partly on equalisation.⁵ Responsibility for determining the intrastate distribution of grants of the part-equalisation component was passed to the newly-created local government Grants Commissions established by the States. The sharing of personal income tax receipts continued through to 1984–85.

Hawke Government

The Hawke Government dropped these arrangements, arguing that the economy could not afford tax sharing with the States and local government. Instead, the Government increased local government assistance in 1985–86 by the change in the consumer price index and an additional two per cent growth factor over the 1984–85 level. The distribution among the States remained the same as that specified in the *Local Government (Personal Income Tax Sharing) Act 1976*.

Self Report and the 1986 Act

On 10 May 1984, the Government announced the establishment of a Committee of Inquiry into Local Government chaired by Professor Peter Self. The Committee's terms of reference were wide-ranging including the level and form of Commonwealth funding. The Committee presented its report on 29 October 1985.⁶ In April 1986, the Government announced that it had accepted the thrust of the report and that arrangements for the provision of assistance would change from 1986–87 onwards. The new arrangements closely followed the Inquiry's recommendations.⁷ Key features of the new arrangements, contained in the *Local Government (Financial Assistance) Act 1986*, were:

- financial assistance grants replaced personal income tax sharing
- in 1986–87, grants were to be increased by the greater of either the 1985–86 level of assistance adjusted for inflation (that is, a 'real terms' guarantee) or the percentage change in general purpose payments to the States
- for 1987–88, the level of assistance was to be determined by the same means as for 1986–87 but using 1986–87 payments as the base
- in following years, the level of assistance to local government would be linked to the level of assistance to the States, whereby the annual level of local government assistance would be determined by increasing the amount paid in the previous year by the percentage change in general purpose payments to the States⁸

- the distribution of assistance among the States was to be phased from existing arrangements—which were still partly based on the recommendations of the Commonwealth Grants Commission made in 1977—to an equal per capita basis by 1989–90
- the State Grants Commissions were to determine the intrastate distribution of grants according to principles, formulated by each State, that took fiscal equalisation into account
- all local governments would be entitled to a minimum grant based on population,⁹ and
- provision was made for informal local government bodies, such as Aboriginal communities in remote areas, to receive grants.

Local government benefited from the 'real terms' guarantee in 1986–87 and 1987–88 because grants to the States fell in real terms in those years, but suffered cuts in real terms in 1988–89, 1989–90 and 1990–91 when real State general purpose funding fell.

The interstate distribution of local government assistance in 1988–89 reflected the transition to equal per capita grants. In 1989–90, grants were distributed on an equal per capita basis.

Commonwealth Grants Commission Report on the Interstate Distribution of Grants

Despite the decision to allocate grants on an equal per capita basis, the 1989 Premiers' Conference agreed that the Commonwealth Grants Commission should report on the interstate distribution of general purpose grants to local government. The Commission's two main tasks were to comment on the desirability of adopting full fiscal equalisation (as distinct from the part-equalisation under the Fraser Government noted above) and to calculate what the distribution of grants would be if full fiscal equalisation were adopted. The Commission's report was released in March 1991.¹⁰ The Commission supported, in principle, the adoption of fiscal equalisation:

In principle, we believe it would not be appropriate to continue indefinitely an interstate distribution of general purpose assistance for local government on a basis (equal per capita) which departs so markedly from fiscal equalisation.¹¹

But the Commission recommended against using the per capita relativities that it had assessed for allocating assistance for local government among the States in 1991–92 because of data and methodology deficiencies.¹²

The Premiers' Conference of 31 May 1991 considered the Commission's report. Given the Commission's concerns, the Commonwealth announced in May 1992 that grants would continue to be distributed on an equal per capita basis. Hence grants have continued to be distributed on this basis since 1989–90.

Untying of Local Road Funds and Identified Roads Grants

Until 1990–91, the Commonwealth provided specific purpose grants to local government for local roads under the *Australian Land Transport Development Act 1988*. The grants were distributed on the basis of criteria in this Act. The October 1990 Special Premiers' Conference agreed that road funds would be untied with effect from 1 July 1991; that is, the conditions applying to road grants would be abolished and local government could spend the funds for any purpose. The untied grants are called identified road grants.¹³

In June 1991, the *Local Government (Financial Assistance) Act 1986* was amended to allow road funding to be added to financial assistance grants from 1995–96 and hence distributed on a per capita basis. But this would have been to the detriment of Western Australia, Tasmania, the ACT, the Northern Territory and Queensland.¹⁴ The 1995 Premiers' Conference therefore decided that local road funds would continue to be distributed on the basis of the criteria in the *Australian Land Transport Development Act 1988*.¹⁵ The effect of this decision has been to freeze the interstate distribution of identified road grants at the historical shares that applied in 1991–92 when grants were untied.

Review of the 1986 Act

In June 1993, local government Ministers agreed to a review of funding arrangements to ensure an efficient and effective use of resources under the *Local Government (Financial Assistance) Act 1986* given the level of funding and distribution of funds among the States. The Australian Urban and Regional Development Review undertook the study.¹⁶ The review's findings included:

- there had been a shift in the share of funding to rural councils in all States and the Northern Territory except Victoria
- State Grants Commissions were following two models of fiscal equalisation: in one, an increasing share of funds was allocated to local governments with increasing populations whereas in the other model, the reverse was true
- in most States, an increasing share of assistance went to local governments with the greatest socio-economic disadvantage
- the need for a uniform national reporting framework was urgent
- absorbing local road funding into financial assistance grants and hence distributing road funding on an equal per capita basis would be disruptive and was not recommended, and
- additional measures to encourage efficiency in local government should be implemented.

Local Government (Financial Assistance) Act 1995

Following consideration of the review and consultations with State and local governments, the Commonwealth undertook further reforms, which were contained in the *Local Government (Financial Assistance) Act 1995*. This Act retained most of the features of the 1986 Act. The main change was the requirement that national principles replace the arrangements whereby each State formulated principles. The main objective of the national principles (see Box 2) was to establish a more nationally consistent and transparent basis for the way State Grants Commissions determine the intrastate allocation of funds.

Box 2: National Principles Relating to the Allocation of Grants

1. The national principles relating to the allocation of general purpose grants are:

(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 the expenditure requirements and revenue-raising capacity of each governing body. This means as far as practicable, that 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 identified road component of the general purpose grants is:

Identified road component. 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.

Other changes to the 1986 Act included:

- recognition of the need for local government to be efficient and effective
- recognition of the need to improve the provision of services to Aboriginal and Torres Strait Islander communities
- the requirement that the Commonwealth Minister with portfolio responsibility for administering Commonwealth financial assistance to local government, report annually to Parliament on the operation of the 1995 Act, and

- the requirement that a review of the 1995 Act be carried out by 30 June 2001.

With respect to the review, on 1 June 2000, the Minister for Finance and Administration the Hon. John Fahey MP directed the Commonwealth Grants Commission to review the operation of the 1995 Act. The terms of reference are set out in Appendix 1.

The 25 March 1994 Premiers' Conference decided that financial assistance grants paid to the States would be maintained in real per capita terms over the next three years. This decision affected local government grants because the 1995 Act provided for local government general purpose assistance to be increased annually by an escalation factor that reflected the underlying movement in general revenue assistance paid to the States. The escalation factor for State grants reflected indexation for population growth and the consumer price index. The consequence of the Conference decision was to maintain the level of grants in real per capita terms and place a 'floor' under the value of assistance.

A New Tax System

As part of *A New Tax System* (ANTS), the Howard Government proposed that the States assume responsibility for providing financial assistance grants to local government from 1 July 2000.¹⁷ Payments were to be made under the terms of the *Intergovernmental Agreement on the Reform of Commonwealth-State Financial Relations*, which heads of government signed at the 1999 Premiers' Conference. But under the agreement between the Government and the Australian Democrats to modify the goods and services tax (GST) and implement a package of other proposals, the Government agreed to retain responsibility for assisting local government.¹⁸

The Howard Government's decision to replace financial assistance grants—and revenue replacement payments—¹⁹to the States with revenue from the GST from 1 July 2000 severed the link between grants to the States and grants to local government established in the 1986 Act. The Government therefore introduced the *Local Government (Financial Assistance) Amendment Act 2000*. The main purpose of this Act was to maintain the level of assistance to local government in real per capita terms.²⁰ Thus in 2000–01, the increase in general purpose assistance will be based on an escalation factor based on population growth and the increase in the consumer price index but excluding the estimated effect of the tax reform measures in *The New Tax System*.²¹

Local governments can claim input tax credits for the GST. It seems likely that local government will, overall, obtain savings from the implementation of the GST.²²

Issues in Commonwealth Assistance

The Commonwealth Grants Commission's discussion paper, prepared for the review of the *Local Government (Financial Assistance) Act 1995*, lists 15 issues on which it has specifically sought views (see Appendix 2). The following examines some of these and other issues in Commonwealth assistance to local government.

Level of Assistance

In 1997-98, Commonwealth general purpose assistance accounted for around 12 per cent of local government revenue.²³ The terms of reference for the review state that it will not address the quantum of funds available under the Act. Nonetheless, local governments see the level of assistance as a major issue. The amounts of assistance since 1991-92 when road grants were untied are shown in Table 1.

Table 1: Commonwealth assistance to local government since 1991-92 (\$m)

Year	Financial assistance grants	Identified roads grants	Total grants	Gross domestic product	Total grants as share of GDP (%)
1991-92	715.0	303.2	1 018.1	405 795	0.251
1992-93	730.1	319.0	1 049.1	426 708	0.246
1993-94	737.2	322.1	1 059.3	449 416	0.236
1994-95	756.5	330.5	1 087.0	473 180	0.230
1995-96	806.8	358.0	1 164.7	507 096	0.230
1996-97	833.7	369.9	1 203.6	532 401	0.226
1997-98	832.9	369.6	1 202.4	564 580	0.213
1998-99	854.2	379.0	1 233.2	595 716	0.207
1999-00	880.6	390.7	1 271.3	632 391	0.201
Est2000-01	914.8	405.9	1 320.8	na	na

Est: estimate

Sources: National Office of Local Government²⁴ Submission to the Commonwealth Grants Commission Inquiry into the *Local Government (Financial Assistance) Act 1995*, p. 45. Reserve Bank statistical series table G10.

Table 1 also shows that assistance has fallen as a proportion of GDP since 1991-92. The main reason is that the indexation arrangements have not provided growth in the real level assistance even though the economy is growing. As noted, indexing assistance for population growth and the consumer price index has maintained assistance in real per capita terms and in effect placed a 'floor' under the value of assistance. But the indexed value of assistance has not risen as fast as real GDP.

The Australian Local Government Association argues that assistance should be increased and fixed at one per cent of total Commonwealth taxation receipts.²⁵ In 1999–2000, application of this proposal would have resulted in assistance of \$1.525 billion compared with actual assistance of \$1.265 billion.²⁶ However, under this proposal, the level of grants would depend on the level of economic activity and discretionary changes to taxation rates.

The payment of \$1.2 billion over five years under the roads to recovery program (discussed below under roads to recovery) will boost spending on local roads substantially. In annual average terms, the program is equivalent to additional road spending of \$240 million, or 59 per cent of the \$406.9 million allocated to identified road grants in the 2000–01 Budget. In contrast, the level of financial assistance grants will continue to fall relative to GDP in the absence of measures to boost funding. Further, it could be argued that the funds allocated to roads to recovery could be better used to increase financial assistance grants on the grounds that local governments are best placed to determine their priorities and can spend financial assistance grants as they wish.²⁷

Interstate Distribution of Grants

The terms of reference for the review also state that the review will not address the interstate distribution of grants. However, the bases on which grants are distributed raise a number of issues, particularly their consistency with fiscal equalisation.

Financial Assistance Grants

As noted, financial assistance grants have been distributed among the States on an equal per capita basis since 1989–90, and the Commonwealth Grants Commission concluded that it would not be appropriate to continue indefinitely this method of distribution as it departs from fiscal equalisation. This raises the question of whether the basis of distribution should be changed to one that results in fiscal equalisation.

A number of factors would have to be taken into account when considering moving from an equal per capita basis. The Commonwealth Grants Commission noted that these considerations included:

- (i) The per capita basis of distribution is simple and predictable. An equalisation basis would be much more complex and would deliver less predictable outcomes, particularly in the early years.
- (ii) A change to an equalisation system would entail extra administrative costs for both the Commonwealth and the States. These costs have to be considered in relation to the relatively small size of the pool.

(iii) A move to an equalisation basis would be very disruptive to local authorities in New South Wales and Victoria.²⁸

Identified Road Grants

As noted, the interstate distribution of identified road grants is still based on the shares that prevailed when the grants were untied in 1991–92 and is thus increasingly anachronistic. Moreover, this distribution is likely to be inconsistent with the fiscal equalisation principle since the distribution was based on the criteria in the *Australian Land Transport Development Act 1988*. The national principle requiring local government Grants Commissions to take account of road needs and asset preservation further moves the distribution of identified road grants away from a distribution based on fiscal equalisation.

Another issue is whether identified road grants should continue to be identified separately or combined with financial assistance grants. As noted, the proposal that identified road grants be absorbed into financial assistance grants with effect from 1995–96, and distributed among the States on an equal per capita basis, was rejected. No timetable has subsequently been proposed to absorb identified road grants into financial assistance grants.

Views on the desirability of combining the two grants differ. On the one hand, the National Office of Local Government, for example, believes that:

... local road infrastructure warrants separate identification because of the importance placed on it by local communities particularly in regional and rural Australia as well as the States and the Northern Territory and the Commonwealth Government.²⁹

The Australian Local Government Association also does not favour combining the two pools:

... combination of the two pools would see large changes in the distribution of the funding between the States. This would lead to volatility in the grants provided to local governing bodies. Separation of the funds is symbolic and continues to demonstrate a Commonwealth commitment towards road funding.³⁰

Moreover, local governments spend more on local roads (in excess of \$2.5 billion annually) than is funded by identified road grants (estimated at \$407 million in 2000–01) so that much of any additional funds in the form of financial assistance grants would be likely to be spent on roads.

On the other hand, the South Australian Government favours combining the funds and allocating them on a per capita basis on the grounds that South Australia is disadvantaged under existing arrangements.³¹

Roads to Recovery Grants

The Commonwealth began providing grants under the *Roads to Recovery Act 2000* for the construction, upgrading and maintenance of roads in 2000–01. Roads to recovery grants are paid directly to local governments. As noted, the program will boost spending on local roads substantially. Roads to recovery grants are paid directly to local governments.

The Government decided against using the shares used to distribute identified road grants for the roads to recovery program. But the distribution of roads to recovery grants is similar, in the case of the most populous jurisdictions, to the distribution of identified road grants because both are based on similar methodologies. The distribution of roads to recovery grants—which is based on 50 per cent road length and 50 per cent population 'adjusted to achieve some equity and fairness'³²—is also unlikely to be consistent with fiscal equalisation.

The differences between the proposed roads to recovery distribution and the distribution of identified road grants are shown in Table 2.

Table 2: Distribution of roads to recovery and identified roads grants

State	Roads to Recovery (%)	Identified road grants (%)
NSW	28.3	29.0
VIC	20.8	20.6
QLD	20.8	18.7
WA	15.0	15.2
SA	8.3	5.5
TAS	3.3	5.3
NT	1.6	2.3
ACT	1.6	3.2

Sources: The Prime Minister Hon John Howard MP and the Hon John Anderson MP, Deputy Prime Minister and Minister for Transport and Regional Services, joint press release, 27 November 2000. Budget paper No. 3, 2000-01.

Table 2 shows that Victoria, Queensland and South Australia gain under the roads to recovery program compared with the distribution of identified road grants.

Minimum Grant

Section 6(2) of the *Local Government (Financial Assistance) Act 1995* provides that each local government is entitled to receive a minimum grant. This section provides that the Minister, in formulating national principles, must ensure that the allocation of funds is made, as far as practicable, on a fiscal equalisation basis. But the Minister also must ensure that a local government in a State must not receive less than the amount that the local

government would receive if 30% of the amount to which the State is entitled were allocated among local governments in the State on a per capita basis.

The purpose of the minimum grant is to compensate local government for the narrowness of the tax base, namely, municipal rates. The minimum grant also provides a measure of funding certainty. The number of local governments receiving the minimum grant rose from 35 in 1995–96 to 67 in 1999–2000, while the proportion receiving the grant rose from 19 per cent in 1997–98 to 30 per cent in 1999–2000.³³

Views differ on the desirability of retaining the minimum grant. The Australian Local Government Association argues that the grant should be retained because it recognises the existence of vertical fiscal imbalance between the taxing and spending powers of the Commonwealth and local government and because it provides funding stability.³⁴ On the other hand, the National Office of Local Government believes that the grant requirement is no longer appropriate on the grounds that it improves the financial capacity of relatively wealthy local governments to the detriment of poorer local governments. The National Office of Local Government therefore recommends that the minimum grant provision be removed.³⁵

Intrastate Fiscal Equalisation and Grants Commission Methodologies

The principle of fiscal equalisation underlies the intrastate distribution of grants, and is contained in the *Local Government (Financial Assistance) Act 1995* and the national principles. Section 3 of the *Local Government (Financial Assistance) Act 1995* defines fiscal equalisation as that allocation of funds that:

- (a) 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
- (b) 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.

But it is questionable to what extent equalisation is being achieved. The State Grants Commissions do not use consistent methodologies to determine the intrastate allocation of grants. Moreover, it is questionable whether some of the methodologies meet the objective of fiscal equalisation:

The Act does not appear to be meeting its goal in promoting consistency in the grant distribution methodologies employed by the State and Territory Grants Commissions.³⁶

It would be unreasonable not to expect grant outcomes to reflect the unique situation of each State and Territories' Local Government structure. However, it appears that the

differences in grant outcomes are not solely explained by these State and Territory differences and reflect aspects of State and Territory Grants Commissions methodologies which according to the Local Government National Report are difficult to defend and not consistent with the objective of horizontal equalisation.³⁷

The National Office of Local Government therefore advocates that:

The Commonwealth Grants Commission assess the feasibility of developing, in consultation with State and Territory Local Grants Commissions, a standard framework that could be adopted by all State and Territory Grants Commissions to guide them in their application of the National Principles and their general purpose and local road grants methodologies. This standard framework would seek to promote, as far as is practical, greater consistency in methodologies between State and Territory Grants Commissions and greater consistency in the application of the National Principles.³⁸

Burden Shifting

Since the provision of Commonwealth assistance is not linked to specific performance requirements, local governments have an incentive to seek higher levels of funding from the Commonwealth. On the other hand, the fall in Commonwealth assistance relative to GDP may have encouraged local governments to rely more on own-source revenue and raise efficiency. As the National Office of Local Government observed:

The provision of financial support may have a negative impact on the financial capacity of Local Government over the longer term. In the absence of financial assistance grants Local Government may have been more inclined to investigate other revenue sources and pursue efficiency gains through resource sharing, amalgamations and improved financial and work practices. The 1994 Review found that where there was a significant reduction in financial assistance grants, councils typically focussed on rate substitution in the first few years and later focussed on greater efficiencies and rationalisation of services in order to keep annual rate increases in line with community expectations. This negative impact is likely to be small.³⁹

The provision of Commonwealth assistance also provides State governments with an incentive to limit their grants to local government. The 1985 review of the *Local Government (Personal Income Tax Sharing) Act 1976* found that some reduction in State assistance was associated with Commonwealth assistance but that it was difficult to attribute the reduction to increased Commonwealth assistance.⁴⁰ Whether or to what extent 'burden shifting' from the States to the Commonwealth now occurs is unclear.

Conclusions

Successive Commonwealth governments have been content to maintain the level of assistance to local government in real per capita terms and so allow assistance to fall relative to GDP. Reversal of this fall would require a change to the method of determining the level of assistance.

It seems unlikely that the interstate distribution of general purpose assistance will be changed soon. The distribution was debated in 1999 during the negotiations between the States and the Commonwealth over the ANTS package but nothing was resolved.⁴¹ Moreover, political considerations seem to militate against changing the methods of distribution as the Federal Minister for Regional Services, Territories and Local Government, Senator the Hon. Ian Macdonald, pointed out to a meeting of the Local Government Association of Queensland:

... the political reality is this: that there is no purpose in the Federal Government re-examining interstate distribution until the States and the Territories can agree on a common approach or until the peak body of Local Government in Australia – the Australian Local Government Association, to which you all belong, can put forward a whole of Local Government submission to the Federal Government. And until you can get the States to agree, until you can get Local Government to agree, the political reality is that there is no purpose in the Federal Government re-examining that issue.⁴²

A major change to the basis of distribution, such as a move to fiscal equalisation, would entail disruption, with some States—and hence some local governments—losing funds and others gaining.

Scope exists for improvement in areas such as greater consistency in the methodologies the State Grants Commissions use. The review of the 1995 Act now being conducted by the Commonwealth Grants Commission will contain recommendations for such improvements. The final report is to be presented to the Minister for Finance and Administration late in June 2001.

Endnotes

-
1. The Commonwealth Grants Commission has released a draft report, which is available at http://www.cgc.gov.au/Local%20Gov%20Pages/draft_report.htm
 2. There is some confusion in the use of terminology. The terminology in this paper is that used in Commonwealth Budget Paper No. 3 where 'general purpose' assistance encompasses financial assistance grants and identified road grants. However, the term general purpose grants is often applied to financial assistance grants. The Commonwealth Grants Commission uses financial assistance grants to encompass general purpose and identified road grants.

3. Commonwealth of Australia, *Budget Paper No. 3, 2000–01*, pp. 25 and 115.
4. For a more comprehensive history, see Department of Transport and Regional Services, National Office of Local Government, 'Submission to the Commonwealth Grants Commission Inquiry into the *Local Government (Financial Assistance) Act 1995*', at: http://www.cgc.gov.au/Local%20Gov%20Pages/national_office_of_local_government.htm Appendix 2, 28 July 2000.
5. Each State was required to allocate a minimum of 30 per cent of grants among local government on a basis which took account of each local authority's population, with the proviso that the States may also take account of size and population density, as well as any other matter agreed between the Commonwealth and the State concerned. The balance of assistance was to be allocated having regard to each authority's financial needs as assessed by the State Grants Commissions. Following representations by Tasmania, the issue of the percentage distribution among the States was referred to the Commonwealth Grants Commission. In its *Special Report on Financial Assistance for Local Government*, the Commission recommended that the distribution be changed slightly. The Premiers accepted this recommendation at the Premiers' Conference held on 1 July 1977.
6. National Inquiry into Local Government Finance, *Report*, AGPS, 1985.
7. P. Self, 'The Federal Government's Role in Local Government Finance', in G. Brennan, ed., *Local Government Finance*, Centre for Research on Federal Financial Relations, Australian National University, *Occasional Paper No. 41*, p. 9, Canberra, 1987.
8. Defined as the sum of financial assistance grants, identified health grants and general purpose capital assistance.
9. The Act provided that no local authority would receive an amount less than the amount it would receive if 30 per cent of the State's grant were allocated on an equal per capita basis.
10. Commonwealth Grants Commission, 'Report on the Interstate Distribution of General Purpose Grants for Local Government 1991', AGPS, 1991.
11. *ibid.* p. xxv.
12. *ibid.* p. xxii.
13. The term 'identified' is used because they are separately identified from financial assistance grants, which are allocated among the States on a different basis from road grants.
14. *Budget Paper No. 3, 1995–96*, p. 33.
15. In essence, these criteria were designed to reflect relative road needs.
16. Australian Urban and Regional Development Review, 'Financing Local Government. A Review of the Local Government (Financial Assistance) Act 1986', *Discussion Paper #1*, February 1994, and *Local Government Funding Methodologies*, November 1994.
17. As noted, constitutional responsibility for establishing local government lies with the States. Indeed, the Constitution does not mention local government even though local government existed long before Federation. All State and Territory jurisdictions have passed legislation establishing local governments except the Australian Capital Territory (ACT), which has both

- State-like and local government functions. The ACT has received assistance for local government functions since 1988–89.
18. Prime Minister, 'Changes to the goods and services tax', Media Release, 31 May 1999.
 19. In 1997, the Commonwealth imposed surcharges on the excise on tobacco, alcohol and petroleum after the High Court cast doubt on the constitutional validity of all State franchise fees. The Commonwealth returned the surcharge revenue to the States as revenue replacement payments. These payments ceased on 30 June 2000 with the introduction of the GST.
 20. For the Bills Digest, see <http://www.aph.gov.au/library/pubs/bd/1999-2000/2000BD166.htm>
 21. This is consistent with the decision that the consumer price index estimate, excluding the effect of tax reform, be used for indexation purposes for most Commonwealth expenses including specific purpose payments. Automatic escalation of grants is not guaranteed since the 1995 Act provides the Commonwealth with discretion to adjust the escalation factor to suit its budgetary or other circumstances.
 22. Arthur Andersen, 'Impact of GST on Local Government', Report prepared for the Victorian Department of Infrastructure and Department of Treasury and Finance, August 1999.
 23. Department of Transport and Regional Services, 'Submission to the Commonwealth Grants Commission Inquiry into the *Local Government (Financial Assistance) Act 1995*', p. 15.
 24. The National Office of Local Government is the unit in the Department of Transport and Regional Services responsible for, among other things, providing the Minister for Regional Services, Territories and Local Government with advice on matters relating to local government.
 25. Australian Local Government Association, 'Initial Submission to the Commonwealth Grants Commission's Discussion Paper CG 2000/1', p. 8. Available at: http://www.cgc.gov.au/australian_local_government_association.htm
 26. Based on total taxation revenue of \$152.457 billion. See Commonwealth Treasury, 'Final Budget Outcome 1999–2000', pp. 22 and 53.
 27. This argument is an example of the 'choice' model, which holds that local government better reflects community wishes than centralised government. The Government's decision on roads to recovery is an example of the 'agency' model, in which local government is seen as the vehicle for implementing central government decisions.
 28. Commonwealth Grants Commission, *op. cit.*, p. xxv.
 29. Department of Transport and Regional Services, *op. cit.*, p. 35.
 30. Australian Local Government Association, *op. cit.*, p.21.
 31. South Australian Government submission to the Commonwealth Grants Commission Review of the Commonwealth *Local Government (Financial Assistance) Act 1995*, p. 16.
 32. Senator the Hon. Ian Macdonald, Minister for Regional Services, Territories and Local Government, *Senate additional estimates hearings*, 1 December 2000, at RRA&T 153.
 33. Department of Transport and Regional Services, *op. cit.*, p. 32.

34. Australian Local Government Association, op. cit., p.17.
35. Department of Transport and Regional Services, op. cit., p. 7.
36. *ibid.* p. 26.
37. *ibid.* p. 34.
38. *ibid.* p. 6.
39. *ibid.* p. 16.
40. *ibid.* p. 29.
41. Senator Hon I. Macdonald, Minister for Regional Services, Territories and Local Government, 'Address to the Local Government Association of Queensland Annual Conference', 27 July 2000, http://www.dotrs.gov.au/media/macdon/speeches/ms13_2000.htm
42. *ibid.*

Appendix 1

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 government bodies; and
 - (iv) the eligibility for assistance under this Act of bodies declared by the Minister under Section 4 to be local government 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.

Appendix 2

Issues Raised in the Commonwealth Grants Commission Discussion Paper on the Review of the *Local Government (Financial Assistance) Act 1995*

- (i) Are the objectives of the Commonwealth in providing assistance to local government fulfilled through the operations of the Local Government Grants Commission in your State? Are there other objectives that should be considered?
- (ii) Are the National Principles (the guidelines for the distribution of Commonwealth financial assistance to local government) fulfilled through the operations of the Local Government Grants Commission in your State? Are there other principles that should be considered?
- (iii) Is equalisation still a relevant objective of the Commonwealth in relation to financial assistance for local government, and why?
- (iv) What is the purpose of the minimum grant? Is the concept of a minimum grant still relevant to the distribution of funds, and why? What would happen if it were changed?
- (v) Are the current arrangements surrounding the allocation of Commonwealth assistance sufficiently transparent? Are the National Principles sufficiently understood?
- (vi) Do you understand how grants are calculated by your State Grants Commission? What do you consider are the shortcomings/strengths of your State Grants Commission's allocation method? What additional information should your State Grants Commission provide?
- (vii) How important is stability in the size of grant funding for councils as an attribute of the grant distribution system?
- (viii) To what extent do the methods of your State's Local Government Grants Commission take account of the special circumstances of indigenous communities?
- (ix) Should consideration be given to combining the general purpose and roads funding pools?
- (x) What has been the impact of the Commonwealth assistance on the level of State assistance to local government?
- (xi) What has been the impact of the Commonwealth assistance on the efforts made by local government to raise revenue from its own sources?
- (xii) What Commonwealth and State assistance for specific purposes is provided for local governments? Is the assistance based on an assessment of individual submissions or a broad assessment of the needs of local governments in a field?
- (xiii) What limitations are imposed on local government revenue bases, eg rate-capping and other (limiting) State legislation?
- (xiv) What major changes have there been since the Act was passed in 1995 in the distribution of service provision responsibilities or revenue capacities between the Commonwealth, State and local spheres of government? Are any other changes under active consideration?
- (xv) To what extent do the administrative arrangements imposed by the Act need re-examination or amendment?