



## Commonwealth general purpose financial assistance to local government (revised September 2007)

Richard Webb  
Economics Section

### Executive summary

Commonwealth financial assistance grants to local government take the forms of general purpose grants, and grants for roads known as identified local road grants. The Commonwealth pays the grants to the states on condition that the states pass the funds to local government

- State Grants Commissions in each state determine the *intrastate* allocation of funds among local governments within their respective jurisdictions.

The level of assistance has been declining as a proportion of gross domestic product because the formula used to calculate assistance does not provide growth in the real level of per capita assistance

- but payments under the roads to recovery program (see below) have offset the decline to some extent.

The *interstate* distribution of assistance differs from what would be the case if the basis were fiscal equalisation

- the interstate distribution of general purpose grants is on an equal per capita basis, and identified road grants are distributed on the basis of the shares that existed when the grants were untied in 1991–92

The Government has not adopted proposals to change financial assistance arrangements. For example, it did not adopt

- the recommendation of the Commonwealth Grants Commission that three assistance pools be established—the per capita grant pool, the relative need pool, and the local roads pool
- nor a House of Representatives committee proposal that a new methodology for the distribution of financial assistance grants be designed.

Change to the methods for distributing financial assistance among the states is unlikely because that would entail some states—and hence some local governments—losing funds and others gaining.

The roads to recovery program is the Government's preferred method for increasing assistance to local government

- the interstate distribution of roads to recovery payments is similar to the distribution of identified road grants
  - but Victoria, Queensland and South Australia benefit relative to the allocation of identified road grants.

## Contents

Executive summary . . . . .	1
Introduction . . . . .	2
History of Financial Assistance . . . . .	3
Whitlam Government . . . . .	3
Tax Sharing Arrangements . . . . .	3
Hawke Government . . . . .	4
Self Report and the 1986 Act . . . . .	4
Commonwealth Grants Commission 1991 Report on the Interstate Distribution of Grants . . . . .	5
Untying of Local Road Funds and Identified Roads Grants . . . . .	6
Review of the 1986 Act . . . . .	7
Local Government (Financial Assistance) Act 1995 . . . . .	7
A New Tax System . . . . .	9
Commonwealth Grants Commission 2001 Review of the 1995 Act . . . . .	10
House of Representatives Committee on Local Government and Cost Shifting . . . . .	12
Issues in Commonwealth Assistance . . . . .	13
Level of Assistance . . . . .	13
Interstate Distribution of Grants . . . . .	15
General Purpose Grants . . . . .	15
Identified Local Road Grants . . . . .	16
Interstate Distribution . . . . .	16
Commonwealth Grants Commission report . . . . .	17
Combining Identified Road Grants and General Purpose Grants . . . . .	18
Roads to Recovery Payments . . . . .	19
Minimum Grant . . . . .	21
Intrastate Fiscal Equalisation and Grants Commission Methodologies . . . . .	22
Burden Shifting . . . . .	23
Conclusions . . . . .	25
Appendix 1 . . . . .	27
Appendix 2 . . . . .	28
Appendix 3 . . . . .	29

## Glossary

**Financial assistance grants:** the term used to describe jointly general purpose grants and identified local road grants.

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

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

**Identified local road grants:** untied grants to local government. Identified local 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 local 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).

## Introduction

The Commonwealth has provided financial assistance to local government since 1974–75. Financial assistance grants take two forms: general purpose grants and untied local road funding known as 'identified local road grants'. The legislative authority for general purpose grants and identified local road grants<sup>1</sup> is the *Local Government (Financial Assistance) Act 1995*. Local governments can use general purpose grants for any purpose. In principle, local governments can also spend identified road grants for any purpose but, in practice, spend the grants on roads.

General purpose 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 general purpose 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 financial 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.

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 local roads. The roads to recovery program has since been continued under the *AusLink (National Land Transport) Act 2005*. The paper discusses roads to recovery payments because local governments spend the payments on roads. The paper does not discuss other specific purpose payments made directly to local government for 'policy' purposes (see Box 1).

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1. Budget Paper No. 3 uses the term where 'general purpose assistance' when referring to general purpose grants and 'untied local road funding' when referring to identified local road grants.

### **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 2006–07 Budget allocates \$1677 million towards financial assistance grants compared with specific purpose payments made directly to local governments of \$497 million (including \$405 million for roads to recovery).<sup>2</sup>

## History of Financial Assistance<sup>3</sup>

### Whitlam Government

The Commonwealth first provided financial 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

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2. Australian Government, *Budget Paper No. 3, 2006–07*, pp. 26 and 84 at <http://www.budget.gov.au/2006-07/bp3/html/index.htm>. Accessed 14 November 2006.

3. 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*', Appendix 2, 28 July 2000.

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 full equalisation to a method based partly on per capita grants (the so-called minimum grant) and partly on equalisation.<sup>4</sup> 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.<sup>5</sup> 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.<sup>6</sup> Key features of the new arrangements, contained in the *Local Government (Financial Assistance) Act 1986*, were:

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4. 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.
  5. National Inquiry into Local Government Finance, *Report*, AGPS, 1985.
  6. 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.

- 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 States<sup>7</sup>
- 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,<sup>8</sup> 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 1991 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

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7. Defined as the sum of financial assistance grants, identified health grants and general purpose capital assistance.
  8. 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.

the distribution of grants would be if full fiscal equalisation were adopted. The Commission's report was released in March 1991.<sup>9</sup> 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.<sup>10</sup>

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.<sup>11</sup>

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 general purpose 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 governments could spend the funds for any purpose. The untied grants are called identified local road grants.<sup>12</sup>

In June 1991, the *Local Government (Financial Assistance) Act 1986* was amended to allow road funding to be added to general purpose 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.<sup>13</sup> 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*.<sup>14</sup> The effect of this decision has been

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9. Commonwealth Grants Commission, *Report on the Interstate Distribution of General Purpose Grants for Local Government 1991*, AGPS, 1991.

10. *ibid.* p. xxv.

11. *ibid.* p. xxii.

12. The term 'identified' is used because they are separately identified from general purpose grants, which are allocated among the States on a different basis from road grants.

13. Australian Government, *Budget Paper No. 3, 1995–96*, p. 33.

14. In essence, these criteria were designed to reflect relative road needs.



to freeze the interstate distribution of identified local 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.<sup>15</sup> The review's findings included:

- there had been a shift in the share of funding to rural councils in all States (except Victoria) and the Northern Territory
- 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 general purpose 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.

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15. 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.

### 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.

(vi) **Council amalgamation.** Where two or more local governing bodies are amalgamated into a single body, the general purpose grants provided to the new body for each of the four years following amalgamation should be the total of the amounts that would have been provided to the former bodies in each of those years if they had remained separate entities.

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.

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 financial 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 thereby 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 to local government from 1 July 2000.<sup>16</sup> 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.<sup>17</sup>

The result of this was to remove local government from direct tax sharing, and to enshrine specific purpose payments—the untied financial assistance grants and other specific purpose payments—as the mechanism for inter-governmental financial transfers from the Commonwealth government to local government. The Australian Local Government Association's position with regard to these arrangements is that, while local government has no difficulty with the continuing use of specific purpose payments by the Commonwealth government to achieve specific policy objectives, local government does not accept as appropriate that the specific purpose payments mechanism should be used to provide untied inter-governmental transfers from the Commonwealth government to local government.<sup>18</sup>

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16. 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.

17. Hon. John Howard (Prime Minister), *Changes to the goods and services tax*, media release, 31 May 1999 at [http://www.pm.gov.au/news/media\\_releases/1999/changes3105.htm](http://www.pm.gov.au/news/media_releases/1999/changes3105.htm). Accessed 14 November 2006.

18. Personal communication with the Australian Local Government Association, 25 July 2007.

The Howard Government's decision to replace financial assistance grants—and revenue replacement payments—<sup>19</sup> to 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.<sup>20</sup> Thus since 2000–01, the increase in financial assistance has been 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*.<sup>21</sup>

Local governments can claim input tax credits for the GST. It seems likely that local government, overall, obtained savings from the implementation of the GST.<sup>22</sup>

### Commonwealth Grants Commission 2001 Review of the 1995 Act

As noted, one of the changes to the 1986 Act was the requirement that a review of the 1995 Act be carried out by 30 June 2001. On 1 June 2000, the then Minister for Finance and Administration, the Hon. John Fahey, directed the Commonwealth Grants Commission to review the operation of the 1995 Act. The terms of reference are set out in Appendix 1. Broadly, they asked the Commission to examine:

- whether the Act's goals are being achieved
- the appropriateness of the national principles
- how local government functions have changed, and
- whether the State Grants Commissions' methodologies are consistent with the national principles.

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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. Richard Webb, 'Local Government (Financial Assistance) Amendment Bill 2000', *Bills Digest*, no. 166, Parliamentary Library, Canberra, 1999–2000, at <http://www.aph.gov.au/library/pubs/bd/1999–2000/2000BD166.htm>. Accessed 16 November 2006.

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.

The Commission [reported](#) on 18 June 2001.<sup>23</sup> Its main findings and recommendations were:

- the types of services that local governments provide have broadened and shifted towards human services. Changing priorities and the imposition of additional functions by the other tiers of government ('cost shifting') account for the changes
- current arrangements have broadly achieved the Act's goals although some are being achieved and others not
- the underlying intent of the horizontal equalisation principle is being implemented but horizontal equalisation is not and cannot be achieved
- State Grants Commissions' methodologies are not consistent with the intentions underlying the national principles in all respects, so changes are required to achieve more effective implementation of equalisation
- a concept of 'relative need based on equalisation principles' should replace the term horizontal equalisation in the Act
- three pools should be established: the per capita grant pool, the relative need pool, and the local roads pool
  - the per capita pool would provide each local government with the same amount per capita; this pool would replace the minimum grant principle
  - the purpose of the relative need pool would be to assist disadvantaged local governments; distribution among local governments would be based on assessments of relative need in turn based on equalisation principles
  - the per capita and relative need pools would be funded from the general purpose grants, with 30 per cent of each State's general purpose grants allocated to the per capita pool and 70 per cent to the relative need pool, and
  - the local roads pool would be distributed among local governments on the basis of relative road needs, that would relate to the cost of maintaining an existing road network.

These changes would not, of themselves, result in a change in the grants paid to local governments but would improve the transparency of current arrangements.

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23. Commonwealth Grants Commission, *Review of the Local Government (Financial Assistance) Act 1995*, June 2001, at [http://www.cgc.gov.au/Local\\_Gov\\_Downloads/LocalGov2001/Final\\_Report/Final\\_Report.pdf](http://www.cgc.gov.au/Local_Gov_Downloads/LocalGov2001/Final_Report/Final_Report.pdf). Accessed 15 November 2006.

The terms of reference specifically precluded the Commission from examining the level of assistance and its interstate distribution. This limited the value of the review because they are two major issues (see the discussion below under 'issues in Commonwealth assistance'). That said, the Commission's report is an extremely valuable contribution to achieving a more rational allocation of Commonwealth assistance to local government.

## House of Representatives Committee on Local Government and Cost Shifting

The Government did not formally respond to the Commission's report but drew on it. The Howard Government's election commitments on local government included an undertaking to inquire into the incidence of cost shifting onto local government by the States. On 30 May 2002, the then Minister for Regional Services, Territories and Local Government, the Hon. Wilson Tuckey, [announced](#) that the House of Representatives Economics, Finance and Public Administration Committee would inquire into cost shifting and the financial position of local government.<sup>24</sup> This Inquiry was specifically tasked with examining the recommendations of the Commonwealth Grants Commission's review of the operations of the *Local Government (Financial Assistance) Act 1995*. The inquiry's terms of reference are set out in the Appendix 2.

The Committee produced its report—[Rates and Taxes: A Fair Share for Responsible Local Government](#)—in October 2003.<sup>25</sup> The Committee made 18 recommendations which are set out in Appendix 3. With respect to Commonwealth funding of local government, recommendation 16 stated:

The Committee recommends that a new methodology for the distribution of FAGs to local government be designed which incorporates the following elements:

- a national model which is consistent across each LGB;
- distribution of funds on equalisation principles ie on the basis of need;
- funds to be paid direct to local government;
- funds to remain untied and be allocated from one pool;

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24. The Hon. Wilson Tuckey, (Minister for Regional Services and Local Government), *Local Government Inquiry to Look at Cost Shifting*, media release WT29/2002, Parliament House, Canberra, 30 May 2002, at [http://www.ministers.dotars.gov.au/wt/releases/2002/may/wt29\\_2002.htm](http://www.ministers.dotars.gov.au/wt/releases/2002/may/wt29_2002.htm). Accessed 15 November 2006.

25. Australian Government, *Government Response to the Report of the House of Representatives Standing Committee on Economics, Finance and Public Administration: Rates and taxes. A Fair Share for Responsible Local Government*, Canberra, June 2005, at [http://www.dotars.gov.au/local/publications/pdf/local\\_10436\\_DOT\\_Document.pdf](http://www.dotars.gov.au/local/publications/pdf/local_10436_DOT_Document.pdf). Accessed 14 November 2006.

- data on local conditions/factors to be provided by Local Government Grant Commissions;
- a weighted factor be applied to indigenous community councils to ensure their level of disadvantage is taken into account;
- appropriate acquittal arrangements; and
- a new model, as presented by Professor Farish, to be designed by a Federal and Local Government Finance Advisory Group of experts and phased in over three years, with the process to be facilitated by the Commonwealth Grants Commission. (para 6.164).

In its [response](#) in June 2005, the Government rejected this recommendation. Consequently, the methodology for the calculation of financial assistance remains unchanged.

However, the Government agreed to an additional National Principle, which deals with amalgamations:

The Government does, however, agree that the financial assistance grants should not be seen to financially penalise councils which amalgamate. The Minister for Local Government, Territories and Roads will propose a new National Principle under the *Local Government (Financial Assistance) Act 1995* specifying that financial assistance grants for amalgamated councils be maintained for four years after an amalgamation so that the grants do not act as a disincentive to voluntary amalgamation. It is intended that funding for the amalgamated council for the four years would be determined as if the councils had not amalgamated.

A new National Principle to effect this decision was introduced in February 2007.

## Issues in Commonwealth Assistance

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

### Level of Assistance

Local governments see the level of Commonwealth financial assistance grants as a major issue (such assistance accounts for around seven per cent of local government revenue).<sup>26</sup>

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26. Department of Transport and Regional Services, 'Submission to the Commonwealth Grants Commission Inquiry into the *Local Government (Financial Assistance) Act 1995*', Canberra, July 2002, p. 15, at [http://www.cgc.gov.au/Local\\_Gov\\_Downloads/National\\_Office\\_of\\_Local\\_Government/NOLG\\_with\\_Appendix\\_3.pdf](http://www.cgc.gov.au/Local_Gov_Downloads/National_Office_of_Local_Government/NOLG_with_Appendix_3.pdf). Accessed 16 November 2006.

The amounts of financial assistance grants since 1991–92 when road grants were untied, and payments under the roads to recovery program, are shown in Table 1.

Table 1: Financial assistance grants and roads to recovery payments since 1991–92 (\$ million)

Year	General purpose	Local roads	Total grants	GDP	Total grants/GDP (%)	Roads to recovery	Total grants plus roads to recovery	Grants & roads to recovery/GDP (%)
1991-92	715.0	303.2	1018.1	416 934	0.244			
1992-93	730.1	319.0	1049.1	438 000	0.240			
1993-94	737.2	322.1	1059.3	459 963	0.230			
1994-95	756.4	330.5	1086.9	486 577	0.223			
1995-96	806.7	358.0	1164.7	518 158	0.225			
1996-97	833.7	369.9	1203.6	545 735	0.221			
1997-98	832.9	369.6	1202.4	577 422	0.208			
1998-99	854.2	379.0	1233.2	607 862	0.203			
1999-00	880.6	390.7	1271.3	645 153	0.197			
2000-01	919.8	408.2	1328.0	689 340	0.193	33.7	1361.7	0.198
2001-02	965.8	428.6	1394.4	735 783	0.190	418.5	1812.9	0.246
2002-03	1007.9	447.2	1455.1	782 798	0.186	200.0	1655.1	0.211
2003-04	1039.7	461.3	1501.1	838 252	0.179	302.2	1803.2	0.215
2004-05	1077.1	478.0	1555.1	894 665	0.174	253.1	1808.2	0.202
2005-06	1119.9	496.9	1616.8	961 919	0.168	307.5	1924.3	0.200

Sources: Department of Transport and Regional Services, *Local Government National Report 2004–05* p. 45; Australian Bureau of Statistics, *National Income, Expenditure and Product*, catalogue 5206.0; and Department of Transport and Regional Services annual reports, various years.

Note: Data for 2005-06 estimated

Table 1 shows that financial assistance grants have fallen as a proportion of GDP since 1991–92. As noted, indexing assistance for population growth and the consumer price index maintains assistance in real per capita terms. While indexation has the effect of placing a 'floor' under the real value of assistance, it does not provide any increase in the real level of assistance even though real GDP is increasing.

Table 1 also shows that payments under the roads to recovery program have offset, to some extent, the decline in financial assistance grants as a proportion of GDP. Since its inception, payments under the roads to recovery program have averaged 0.212 per cent of GDP. Consequently, in 2004–05, the total of financial assistance grants and roads to recovery payments was about the same proportion of GDP as grants were late in the 1990s.



The Australian Local Government Association argues that financial assistance grants should be set at one per cent of total Commonwealth taxation receipts.<sup>27</sup> In 2005–06, application of this proposal would have resulted in financial assistance grants of \$2.457 billion compared with actual assistance of \$1.617 billion.<sup>28</sup> However, under this proposal, the level of grants would depend on the level of economic activity and discretionary changes to taxation rates.

## Interstate Distribution of Grants

### General Purpose Grants

As noted, general purpose grants have been distributed among the States on an equal per capita basis since 1989–90, and the Commonwealth Grants Commission in 1991 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.<sup>29</sup>

The disruption attendant on a move towards equalisation—there would be winners and losers—and uncertainties about outcomes militate against any attempt to adopt equalisation.

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27. Australian Local Government Association, 'Initial Submission to the Commonwealth Grants Commission's Discussion Paper CG 2000/1', p. 8, at [http://www.cgc.gov.au/Local\\_Gov\\_Downloads/Aust\\_Localgov\\_Assoc\\_Sub/Australian\\_Local\\_Government\\_Association.pdf](http://www.cgc.gov.au/Local_Gov_Downloads/Aust_Localgov_Assoc_Sub/Australian_Local_Government_Association.pdf). Accessed 16 November 2006.
  28. Australian Government, *Final Budget Outcome 2005–2006*, pp. 21 and 62, at <http://www.budget.gov.au/2005-06/fbo/html/index.htm>. Accessed 15 November 2006.
  29. Commonwealth Grants Commission, *Report on the Interstate Distribution of General Purpose Grants for Local Government 1991*, op. cit., p. xxv.

## Identified Local Road Grants

### Interstate Distribution

Because the interstate distribution of identified local road grants is based on the shares that prevailed when the grants were untied in 1991–92, the distribution is increasingly anachronistic. This distribution is effectively based on the criteria in the *Australian Land Transport Development Act 1988*.

In its response to the House of Representatives Economics, Finance and Public Administration Committee inquiry, the Government undertook to:

... ask the Commonwealth Grants Commission to review the current interstate distribution of the identified roads component of the financial assistance grants and to report back to Government by 30 June 2006.<sup>30</sup>

In October 2005, the Government sent to the Commonwealth Grants Commission [terms of reference](#) asking the Commission to:

... review of the interstate distribution of the local road grants paid as local government financial assistance grants (FAGs). The terms of reference provide guidance to the Commission to recommend a new methodology for the distribution of identified local roads grants to local government. The methodology should ensure that the distribution of this funding is based on the relative needs of local government in States and Territories for local roads rather than the current historical share.<sup>31</sup>

A feature of the terms of reference is the emphasis on relative needs, suggesting that the Government is seeking a more rational distribution of grants.

On 18 May 2006, the Commission issued a [draft report](#).<sup>32</sup> The report examined several models but did not recommend a model pending further investigation and comments from

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30. Australian Government, *Government Response to the Report of the House of Representatives Standing Committee on Economics, Finance and Public Administration. Rates and Taxes: A Fair Share for Responsible Local Government*, June 2005, at [http://www.dotars.gov.au/local/publications/pdf/local\\_10436\\_DOT\\_Document.pdf](http://www.dotars.gov.au/local/publications/pdf/local_10436_DOT_Document.pdf). Accessed 14 November 2006.

31. Terms of reference for the Commonwealth Grants Commission review of the interstate distribution of local road grants are at [http://www.cgc.gov.au/LR2006/LR2006\\_downloads/TOR/LR2006\\_tor.pdf](http://www.cgc.gov.au/LR2006/LR2006_downloads/TOR/LR2006_tor.pdf). Accessed 14 November 2006.

32. Commonwealth Grants Commission, *Draft report for the review of the interstate distribution of local road grants*, 18 May 2006, at [http://www.cgc.gov.au/LR2006/LR2006\\_downloads/Report/ROADS%20DRAFT%20REPORT.pdf](http://www.cgc.gov.au/LR2006/LR2006_downloads/Report/ROADS%20DRAFT%20REPORT.pdf). Accessed 14 November 2006.

interested parties. The Commission noted that the inadequacy of data raised concerns about its ability to fulfil satisfactorily the terms of the reference.

#### Commonwealth Grants Commission report

In conjunction with the 2007–08 Budget, the Government released a report by the Commonwealth Grants Commission (CGC), which dealt with the distribution among the states of identified road grants. The recommendations of the report titled *Report on the Review of the Interstate Distribution of Local Road Grants* would, if adopted, change the amount each of the states receive.<sup>33</sup> The following examines the Report and some of its implications.

In 2005, the Government asked the CGC to recommend a new methodology. The CGC recommended that:

... as an interim measure, until reliable and comparable data on road characteristics are available for all States, the local roads grants be distributed among the States on the basis of average expenditure per person in urban, rural and remote areas and the population of each State resident in those areas.<sup>34</sup>

The assessed state shares of local road maintenance expenditure, based on the CGC's approach using data for 2002–03 to 2004–05 are shown in Table 2.

Table 2: Assessed state shares of local government road maintenance expenditure based on data for 2002–03 to 2004–05 and recommended distribution for 2006–07 (per cent)

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT	Aust
Current shares (including supplementary funds for South Australia)	28.3	20.1	18.3	14.9	7.8	5.2	3.1	2.3	100.0
Recommended shares from CGC report (based on data 2002–03 to 2004–05)	31.3	22.0	20.2	11.3	8.9	3.3	1.2	1.8	100.0
Adjusted shares from CGC report for 2006–07 <sup>#</sup>	31.1	22.0	20.5	11.3	8.8	3.3	1.2	1.8	100.0

Source: CGC, *Report on the review of the interstate distribution of local road grants*, p. ix.

#: the CGC shares have been adjusted for movements in population shares to December 2005.

33. Commonwealth Grants Commission, *Report on the Review of the Interstate Distribution of Local Road Grants*, Canberra, 2006 at [http://www.cgc.gov.au/LR2006/LR2006\\_downloads/Report/ROADS%20FINAL%20REPORT%2030%20June.pdf](http://www.cgc.gov.au/LR2006/LR2006_downloads/Report/ROADS%20FINAL%20REPORT%2030%20June.pdf). Accessed 24 July 2007.

34. *ibid.*, p. ix.

For 2006–07, the estimated identified local road grant amount was \$518 million.<sup>35</sup> Applying the current shares and the CGC’s recommended shares for 2006–07 to this amount results in the following distribution among the states.

Table 3: Estimated state amounts of untied local road funding for 2006–07: current shares and CGC recommended shares (\$ million)

	NSW	Vic	Qld	WA	SA	Tas	ACT	NT	Aust
Current shares	150	107	97	79	28	27	17	12	518
CGC recommended shares for 2006–07	161	114	106	59	46	17	7	9	518
Gain(+)/loss(-)	11	7	9	-20	18	-10	-10	-3	0

Source: CGC, *Report on the review of the interstate distribution of local road grants*, p. ix.; Budget Paper No. 3 2007–08, p. 23.

Table 3 shows that if the CGC’s recommendations for 2006–07 had been adopted, NSW, Victoria, Queensland and South Australia would have gained while Western Australia, Tasmania, the ACT and the Northern Territory would have lost.

#### Combining Identified Road Grants and General Purpose Grants

Another issue is whether identified road grants should continue to be identified separately or combined with general purpose grants. As noted, the proposal that identified road grants be absorbed into general purpose 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 general purpose grants.

Views on the desirability of combining the two grants differ. On the one hand, the former National Office of Local Government<sup>36</sup> believed 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.<sup>37</sup>

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

35. Budget Paper No. 3, 2007–08, p. 23.

36. The National Office of Local Government is no longer a recognised Australian Government agency. The Australian Government’s relationship with local government is administered through the Department of Transport and Regional Services.

37. Department of Transport and Regional Services, *op. cit.*, p. 35.

bodies. Separation of the funds is symbolic and continues to demonstrate a Commonwealth commitment towards road funding.<sup>38</sup>

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.<sup>39</sup>

#### Roads to Recovery Payments

In November 2000, the Government [announced](#) spending of \$1.2 billion over four years under the roads to recovery program.<sup>40</sup> Payments under this program are allocated to local governments that receive financial assistance grants, and are additional to financial assistance grants. Roads to recovery payments are made directly to local governments. The first payments were made in March 2001.

In January 2004, the Government [announced](#) that a further \$1.23 billion would be provided over the four years from July 2005 to June 2009 under AusLink—the Government's land transport plan.<sup>41</sup> Of this, \$300 million is to be distributed annually over four years to local governments, and \$30 million will be spent on roads in unincorporated areas (locations where there are local roads but no local governments to administer them). Funding for local roads in the Indian Ocean Territories is also to come from this source. Payments are made under the *AusLink (National Land Transport) Act 2005*.

On 9 May 2006, the Australian Government [announced](#) that a further \$307.5 million (including \$7.5 million for roads in unincorporated areas) would be provided in 2005–06 as a supplement to the program.<sup>42</sup>

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38. Australian Local Government Association, op. cit., p. 21.

39. South Australian Government submission to the Commonwealth Grants Commission Review of the Commonwealth *Local Government (Financial Assistance) Act 1995*, p. 16.

40. Hon. John Howard (Prime Minister) and Hon. John Anderson (Deputy Prime Minister and Minister for Transport and Regional Services), *\$1.6 billion investment in roads*, media release A186/2000, 27 November 2000, at <http://www.ministers.dotars.gov.au/ja/releases/2000/november/a271100.htm>. Accessed 16 November 2006.

41. Hon. John Anderson (Deputy Prime Minister and Minister for Transport and Regional Services) and Hon. Ian Campbell (Minister for Local Government, Territories and Roads), *Major downpayment on Australia's transport future*, media statement APM4/2004, 22 January 2004, at [http://www.ministers.dotars.gov.au/ja/releases/2004/January/APM\\_4\\_2004.htm](http://www.ministers.dotars.gov.au/ja/releases/2004/January/APM_4_2004.htm). Accessed 16 November 2006.

42. Hon. Warren Truss (Minister for Transport and Regional Services) and Hon. Jim Lloyd (Minister for Local Government and Roads), *\$307.5 million funding boost for Australia's local roads*, media release 010aTRS/BUDGET Joint, 9 May 2006, at

The Government decided against using the shares used to distribute identified road grants for the roads to recovery program. The distribution of roads to recovery payments—which is based on 50 per cent road length and 50 per cent population 'adjusted to achieve some equity and fairness'<sup>43</sup>—is unlikely to be consistent with fiscal equalisation. But the distribution of roads to recovery payments 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 differences between the roads to recovery distribution and the distribution of identified road grants are shown in Table 4.

Table 4: 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: Hon. John Howard (Prime Minister) and the Hon. John Anderson, (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. South Australia also benefited from \$26.3 million, set aside in the 2004–05 Budget, for local roads in that State. This amount is to be spent over three years, and is additional to that provided as untied local road grants and under the roads to recovery program.<sup>44</sup> In the 2007–08 Budget, the Government announced that it would continue supplementary funding for South Australia of \$57 million over four years.<sup>45</sup>

It could be argued that the funds allocated to roads to recovery could be better used to increase general purpose grants on the grounds that local governments are best placed to

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[http://www.ministers.dotars.gov.au/wtr/releases/2006/May/010atrs\\_budget\\_wtr.htm](http://www.ministers.dotars.gov.au/wtr/releases/2006/May/010atrs_budget_wtr.htm). Accessed 16 November 2006.

43. Senator the Hon. Ian Macdonald, (Minister for Regional Services, Territories and Local Government), *Senate additional estimates hearings*, 1 December 2000, at RRA&T 153.

44. Australian Government, *Budget Paper No. 2, 2004–05*, p. 254, at <http://www.budget.gov.au/2004-05/bp2/download/expense.pdf>. Accessed 14 November 2006.

45. Budget Paper No. 2 2007–08, p. 300.

determine their priorities and because they can spend general purpose grants as they wish.<sup>46</sup> On the other hand, local governments spend more on local roads (in excess of two billion dollars annually) than is funded by identified road grants and roads to recovery payments, so that much of any additional funds in the form of general purpose grants would be likely to be spent on roads.

## 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 per cent 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 grant also provides a measure of funding certainty. The number of local governments receiving the grant and the proportion of the population covered by minimum-grant local governments is trending upwards: in 1996–97, 45 local governments received the grant compared with 87 in 2004–05, while the proportion of the population covered rose from 15 per cent to 34 per cent over the same period.<sup>47</sup>

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.<sup>48</sup> On the other hand, it could be argued 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. As noted, the Commonwealth Grants Commission recommended that an equivalent per capita grant to every local government replace the minimum grant:

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46. 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.

47. Department of Transport and Regional Services, National Office of Local Government, *Local Government National 2004-05 Report on the Operation of the Local Government (Financial Assistance) Act 1995*, p. 57, at [http://www.dotars.gov.au/local/publications/reports/2004\\_2005/pdf/Local\\_report.pdf](http://www.dotars.gov.au/local/publications/reports/2004_2005/pdf/Local_report.pdf). Accessed 15 November 2006.

48. Australian Local Government Association, op. cit., p. 17.

The Commonwealth could more clearly achieve its purpose of providing every local government body with a share of financial assistance by replacing the present minimum grant arrangements with an equivalent per capita grant to every local government body. This would make clear the Commonwealth's role in supporting the provision of municipal services to every citizen to at least the same level per capita. It would avoid the uncertainty arising from the present situation where the two objectives [improving financial capacity and equity] are funded from one pool.

We think that the most transparent way of implementing this approach would be to divided the present General Purpose pool into a per capita grant pool and an equity (or relative need) pool.<sup>49</sup>

### **Intrastate Fiscal Equalisation and Grants Commission Methodologies**

The principle of fiscal equalisation underlies the intrastate distribution of grants, and is contained in the 1995 Act and the national principles. Section 3 of the Act 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.<sup>50</sup>

Further:

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

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49. Commonwealth Grants Commission, *Review of the Local Government (Financial Assistance) Act 1995*, op. cit., p. 37.

50. Department of Transport and Regional Services, 'Submission to the Commonwealth Grants Commission Inquiry into the *Local Government (Financial Assistance) Act 1995*', op. cit., p. 26.



to the Local Government National Report are difficult to defend and not consistent with the objective of horizontal equalisation.<sup>51</sup>

The former National Office of Local Government advocated 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.<sup>52</sup>

With respect to the Commonwealth Grants Commission's proposal for a relative needs pool, it concluded that decisions about how assistance should be distributed among needy local governments should be left to the judgement of the individual State Grants Commissions because of the diversity of local government needs and because the State Grants Commissions will have to balance the equity objective against the practicalities associated with having insufficient assistance to meet all of the assessed needs.<sup>53</sup>

## **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 former 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.<sup>54</sup>

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51. *ibid.* p. 34.

52. *ibid.* p. 6.

53. Commonwealth Grants Commission, *Review of the Local Government (Financial Assistance) Act 1995*, *op. cit.*, p. 37.

54. Department of Transport and Regional Services, 'Submission to the Commonwealth Grants Commission Inquiry into the *Local Government (Financial Assistance) Act 1995*', *op. cit.*, p. 16.

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.<sup>55</sup> The Commonwealth Grants Commission, in its review of the 1995 Act, found that the Act seems to have had little effect on overall local government revenue raising effort.<sup>56</sup> What is clear is that the relative contribution of State government assistance to local government revenue has fallen: the Commonwealth Grants Commission found that although it has increased in real terms, State government assistance was about 15 per cent of local government revenue in 1974–75 but had fallen to seven per cent in 1997–98.<sup>57</sup>

Local governments contend that the States and (to a lesser extent) the Commonwealth have placed increasing responsibilities on them. The Commonwealth Grants Commission's analysis of local government expenditure over the period 1961–62 to 1997–98 supported many of these claims. The Commission also found that local governments have 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.<sup>58</sup>

The House of Representatives Committee recommended (recommendation 6) that an inter-governmental agreement be adopted which:

- recognises cost-shifting as a problem which has occurred over a number of years;
- allocates revenue to local government from the relevant level of government if responsibilities are devolved ...

In April 2006, these principles were broadly incorporated into [\*The Inter-Governmental Agreement Establishing Principles Guiding Inter-Governmental Relations on Local Government Matters\*](#) (the *Agreement*). Paragraph 3 of Part 1 of the *Agreement* states:

The Parties agree in principle that where local government is asked or required by the Commonwealth Government or a State or Territory Government to provide a service or function to the people of Australia, any consequential financial impact is to be considered within the context of the capacity of local government.

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55. *ibid.* p. 29.

56. Commonwealth Grants Commission, *Review of the Local Government (Financial Assistance) Act 1995*, *op. cit.*, p. 51.

57. *ibid.* p. 50.

58. *ibid.* p. 53.

While drawing on this principle, paragraph 10 of Part III of the *Agreement* stops short of requiring the other levels of government to allocate revenue when they want local government to undertake a function. Rather, the other levels of government must take account of the financial and other consequences:

Where the Commonwealth or a State or Territory intends to impose a legislative or regulatory requirement specifically on local government for the provision of a service or function, subject to exceptional circumstances, it shall consult with the relevant peak local government representative body and ensure the financial implications and other impacts for local government are taken into account.

Moreover, the other levels of government cannot simply lumber local government with additional responsibilities. Paragraph 8 of Part III states:

Where the Commonwealth or a State or a Territory seeks through non-regulatory means, the provision by local government of a service or function they shall:

- (i) respect the right of local governing bodies to decide whether they will accept the responsibility for the delivery of a service or function on behalf of another sphere of government ...

## Conclusions

The contrast between Commonwealth financial assistance arrangements for the States and local government is striking. The States have access to a source of general purpose assistance, namely, the goods and services tax (GST). Revenue from the GST is likely to increase in line with growth in the economy. In contrast, local government does not have access to such a 'growth tax'. This has led, among other things, to calls for local government to be allocated a proportion of GST revenue. An argument underlying these calls is that because local government is the creation of the States, the States should be responsible for ensuring that local government has adequate funding but have failed to do so. Any move to apportion some GST revenue to local government is unlikely to succeed. The States would be likely to resist any such move, and the Howard Government's policy is not to change the GST agreement between the Commonwealth and the States and Territories.

Successive Commonwealth governments have maintained the level of financial assistance grants to local government in real per capita terms and so allowed the level of grants to fall relative to GDP. There is no indication that the Commonwealth is likely to change the mechanism that would increase the level of financial assistance grants over and above what is now provided. Rather, the roads to recovery program is the Government's preferred method for increasing assistance. As noted, the roads to recovery program has increased assistance substantially.

History suggests that political considerations militate against changing the distribution of financial assistance grants among the States. A major change in the basis of distribution would entail disruption with some States—and hence some local governments—losing funds

and others gaining: it is a zero-sum game. The distribution was debated in 1999 during the negotiations between the States and the Commonwealth over the ANTS package but nothing was resolved.<sup>59</sup> As the former 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.<sup>60</sup>

Local governments seem to be increasingly caught in a 'cost squeeze'. As the House of Representative inquiry showed, State governments in particular are shifting responsibilities onto local governments without providing additional commensurate revenue. While Commonwealth financial assistance grants as a proportion of local government revenue have risen, State government assistance has fallen. The Commonwealth Grants Commission has observed:

Where the source of the financial pressure is a 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.<sup>61</sup>

It could be argued that so far, neither the State nor Commonwealth governments have met this test.

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59. 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, at [http://web.archive.org/web/20010110031900/www.dotrs.gov.au/media/macdon/speeches/ms13\\_2000.htm](http://web.archive.org/web/20010110031900/www.dotrs.gov.au/media/macdon/speeches/ms13_2000.htm). Accessed 16 November 2006.

60. *ibid.*

61. Commonwealth Grants Commission, *Review of the Local Government (Financial Assistance) Act 1995*, *op. cit.*, p. 55.

## 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

### **Standing Committee on Economic, Finance and Public Administration. Inquiry into Local Government and Cost Shifting, terms of reference.**

The Minister for Regional Services, Territories and Local Government has asked the Committee to inquire into: cost shifting onto local government by state governments and the financial position of local government. This will include an examination of:

1. Local government's current roles and responsibilities.
2. Current funding arrangements for local government, including allocation of funding from other levels of government and utilisation of alternative funding sources by local government.
3. The capacity of local government to meet existing obligations and to take on an enhanced role in developing opportunities at a regional level including opportunities for councils to work with other councils and pool funding to achieve regional outcomes.
4. Local government expenditure and the impact on local government's financial capacity as a result of changes in the powers, functions and responsibilities between state and local governments.
5. The scope for achieving a rationalisation of roles and responsibilities between the levels of government, better use of resources and better quality services to local communities.
6. The findings of the Commonwealth Grants Commission Review of the Local Government (Financial Assistance) Act 1995 of June 2001, taking into account the views of interested parties as sought by the Committee. The inquiry is to be conducted on the basis that the outcomes will be budget neutral for the Commonwealth.

## Appendix 3

Recommendations of the House of Representatives Standing Committee on Economics, Finance and Public Administration report, *Rates and Taxes: A Fair Share for Responsible Local Government*.

### Roles and responsibilities

#### Recommendation 1

The Committee recommends that the Prime Minister and the Treasurer meet with State and Territory Premiers/Chief Ministers and Treasurers and local government to develop a Federal-State inter-governmental agreement which identifies:

- the roles and responsibilities of local government in delivering Federal and State programs;
- policy priorities and strategies at the local level;
- the allocation of funds and resources from the Federal and the State governments to local government in order to fulfil its responsibilities; and
- the expected performance and funding responsibilities on the part of all levels of government. (para 2.75)

#### Recommendation 2

The Committee recommends that local government nominate one representative from each State and the Northern Territory to represent local government at Federal-State inter-governmental agreement negotiations. (para 2.80)

#### Recommendation 3

The Committee recommends that the Minister representing the Minister for Local Government, Territories and Roads propose, as a precursor to the Summit on inter-governmental relations, a resolution that the House of Representatives recognises local government as an integral level of governance of Australia. (para 2.89)

### 3 Cost shifting

#### Recommendation 4

The Committee recommends that, when developing Federal-State intergovernmental agreements, the Federal government consider:

- including representation from local government during negotiations; and
- requiring a commitment from State governments to identify and provide a share of payments to local government when it is seen as having a significant role in delivery of programs under the agreement. (para 3.95)

### **Recommendation 5**

The Committee recommends that, in line with the Tasmanian Partnership Agreement, Federal and State governments pay rates to local government. (para 3.111)

### **Recommendation 6**

The Committee recommends that the Prime Minister and the Treasurer meet with State and Territory Premiers and Treasurers and local government representatives to develop a Federal-State inter-governmental agreement which:

- recognises cost shifting as a problem which has occurred over a number of years;
- allocates revenue to local government from the relevant level of government if responsibilities are devolved;
- addresses State restrictions on local government revenue raising such as rate capping, levies and charges and non-rateable land; and
- develops local government impact statements to identify the financial impact on local government of legislation by State and Commonwealth governments. (para 3.123)

### **Recommendation 7**

The Committee recommends that the Federal government consider extending ANAO's powers to examine the expenditure of Federal Specific Purpose Payments to and through the States to local government. (para 3.128)

### **Recommendation 8**

The Committee recommends that the Minister for Finance issue a direction to all Federal agencies to ensure that all renegotiated and future Federal-State SPP agreements:

- describe clear Federal government objectives and measurable outcomes;
- specify performance indicators that are directly linked to the objectives to ensure financial accountability;
- define the roles and responsibilities of each party to the agreement;



- require State governments to report on the volume of funds to be distributed to local government to perform functions; and
- disclose the funding adjustments to be applied to State governments in the case of cost shifting to local government. (para 3.135)

## **4 Infrastructure**

### **Recommendation 9**

The Committee recommends that local government bodies be required to audit the state of their infrastructure (using a nationally accepted methodology) and provide status reports to the Commonwealth Grants Commission as one of the inputs into the needs based formula for Federal FAGs to local government.

- The infrastructure data collected should be used to adjust FAGs where councils are found to be negligent in managing infrastructure. (para 4.29)

### **Recommendation 10**

The Committee recommends that SPPs directed to local government, such as roads, should be conditional on States not reducing their effort. (para 4.51)

## **5 Capacity building in our regions**

### **Recommendation 11**

The Committee recommends that the Local Government and Planning Ministers' Council establish a body along the lines of the UK IDeA to address capacity building. This body should also oversee the Federal and State governments' best practice awards. (para 5.19)

### **Recommendation 12**

The Committee recommends that the Federal government establish a Local Government Liaison Unit to:

- liaise with State departments of Local Government and local government peak bodies to strengthen Federal/State/local relations;
- provide the contact point and conduit for local government at the Federal level and provide information on new Federal initiatives, policies and programs;
- receive feedback on the performance of Federal programs and any cost shifting occurrences; and

- coordinate periodic strategic meetings and policy briefings for a Federal and local government officers' forum and other interested parties as required. (para 5.26)

### **Recommendation 13**

The Committee recommends that the Commonwealth Grants Commission, in consultation with the LGGCs in each State, assess the efficiencies of amalgamations or regional cooperation of local government, and use available mechanisms to adjust FAGs grants for the benefit of the sector at large.

- To facilitate amalgamations, where appropriate, councils should not be financially penalised through a net loss of FAGs payments for four years. (para 5.67)

### **Recommendation 14**

The Committee recommends that the Federal government:

- continue to develop partnership arrangements with local government on the delivery of Federal programs and service delivery; and
- as appropriate, engage established regional organisations of councils, or similar regional bodies, which have demonstrated capacity, in regional planning and service delivery. (para 5.89)

## **6 Commonwealth funding of local government**

### **Recommendation 15**

The Committee recommends that the Commonwealth, States and local governments consider what tax design improvements would be necessary to eliminate tax on tax effects arising out of the GST. (para 6.65)

### **Recommendation 16**

The Committee recommends that a new methodology for the distribution of FAGs to local government be designed which incorporates the following elements:

- a national model which is consistent across each LGB;
- distribution of funds on equalisation principles i.e. on the basis of need;
- funds to be paid direct to local government;
- funds to remain untied and be allocated from one pool;

- data on local conditions/factors to be provided by LGGCs;
- a weighted factor be applied to indigenous community councils to ensure their level of disadvantage is taken into account;
- appropriate acquittal arrangements; and
- a new model, as presented by Professor Farish, to be designed by a Federal and Local Government Finance Advisory Group of experts and phased in over three years, with the process to be facilitated by the Commonwealth Grants Commission. (para 6.164)

## 7 The way forward

### Recommendation 17

The Committee recommends that COAG host a Summit in 2005 on Intergovernmental Relations:

- to report on the implementation of the Committee's recommendations;

to review:

- SPPs paid to States and Territories with a view to isolating funds for direct payment to local government;
- the relevant anomalies of ANTS;
- the revenue raising capacity of councils with consideration of financial penalties for States and Territories which fail to adequately support or deliberately suppress that capacity; and
- successful State/local government partnerships and the opportunities for Federal government participation in those partnerships;
- to determine processes to develop:
  - methods to resolve duplication and overlap of service provision;
  - a fully responsible financial role for local government free from policies that arbitrarily limit revenue raising capacity from their normal sources;
  - a direct financial relationship between the Commonwealth and local government;
  - a national methodology for local government bodies to evaluate their infrastructure needs and requirements; and

- a set of principles to reduce cost shifting and unfunded mandates and to ensure that Commonwealth and State and Territory responsibilities administered by local government are adequately funded. (para 7.19)

## **Recommendation 18**

The Committee recommends that the Federal Treasurer assume responsibility for the financial relationship with local government. (para 7.20)

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