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Local Government Financial Interrelationships with State
and Commonwealth Governments**

by

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Abstract

After a somewhat lengthy hiatus, the appropriate nature of a federal system of governance is once again on the public agenda in a number of countries, including Australia. However, the nascent debate on Australian federalism has hitherto focused almost entirely on Commonwealth-state interrelationships to the virtual exclusion of local government. Since Australian local government employs around 156,000 people and spends in excess of \$10 billion this neglect is unfortunate. In an effort to at least partly remedy this oversight, the present paper seeks to assess various unsettled questions in local government financial relationships with both Commonwealth and state governments, especially the issue of financial assistance grants and their efficiency consequences.

Key Words: Federalism, local government, financial assistance grants

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The Debate on Australian Federalism: Local Government Financial Interrelationships with State and Commonwealth Governments

It is now widely accepted that good governance of an advanced modern economy will typically involve some combination of local and central government decision-making, especially in countries which cover vast geographic areas, like Australia, Canada and the United States. Nevertheless, considerable current interest has once again been directed at precisely how various public responsibilities should be allocated between the different tiers of government in a federation. In the United States, federalism is firmly back on the public agenda (Donahue 1997). For instance, Inman and Rubinfeld (1997) have recently proposed three alternative models to inform this debate, namely 'economic federalism', 'cooperative federalism', and 'democratic federalism'. In advocating the investigation of these three principles, Inman and Rubinfeld (1997: 44-45) argue as follows:

In considering the implications of these principles, it is helpful to bear in mind that those who value a federal system typically do so for some mix of three reasons: it encourages and efficient allocation of national resources; it fosters political participation and a sense of the democratic community; and it helps to protect basic liberties and freedoms. The means for implementing these three objectives involve decisions about the institutions of federalism: the number of lower-tier governments, their representation in the central government, and the assignment of policy responsibilities between the vertical tiers of government.

Although still in its infancy, a similar embryonic debate is beginning to take shape in Australia (Galligan 1995). However, almost all the extant discussion has focussed entirely on federal/state relationships to the virtual exclusion of local government (Sharman 1998). Given the nature of the Australian Constitution, whilst the neglect of local government in the debate is perhaps understandable, it is nonetheless true that numerous significant issues in the interrelationships between federal, state and local government remain unsettled. The present paper seeks to at least partly remedy this neglect in Inman and Rubinfeld's (1997) 'economic federalism' sphere by reviewing local government financial relationships in Australia and exploring various unresolved questions in this area.

The paper itself is divided into four main parts. The first section examines the sources and composition of Australian local government finance. The second section investigates the

nature of financial assistance grants. The controversial question of the efficiency consequences of grant distribution is addressed in the third section. The paper ends with some brief concluding remarks in the final section.

Sources and composition

Local governments in Australia finance their activities from a variety of sources. The main sources are: (i) taxes on property (or municipal rates), (ii) fees and fines (referring to user charges imposed for services rendered and fines associated with regulatory functions), (iii) net operating surplus of public trading enterprises (normally utilities), (iv) grants from the Commonwealth or respective state government, and (v) interest received from council investments.

Table 1 *Taxation by level of government*

Level	1990/91	1991/92	1992/93	1993/94	1994/95	1995/96
Commonwealth	93413 (78.5)	87530 (76.1)	88830 (75.4)	93328 (74.5)	105092 (75.9)	115486 (76.3)
State/Territory	21121 (17.7)	22572 (19.8)	24093 (20.4)	26787 (21.4)	28144 (20.3)	30360 (20.1)
Local	4480 (3.8)	4703 (4.1)	4968 (4.2)	5145 (4.1)	5265 (3.8)	5428 (3.6)

Source: ABS 5506.0 *Taxation Revenue, Australia*.

Notes: Totals exclude direct taxes paid by State and Territory government public trading enterprises to the Commonwealth government; taxes are in \$ millions, figures in brackets are the corresponding percentage of total taxation.

Taxation by level of government in Australia is outlined in Table 1. In terms of overall public sector revenue-raising capacity in Australia, the Commonwealth raises approximately 75 percent, the states around 21 percent, and local government about 4 percent. Accordingly, in the Australian federal system, own-source revenues as a percentage of own-purpose outlays (an indicator of vertical fiscal imbalance) are 142 percent for the Commonwealth, 50 percent for the states, and 80 percent for local government.

As itemised in Table 2, the main sources of revenue for Australian local governments are taxes, fees and fines (46.5%), followed by intergovernmental grants (17.4%) and sale of goods and services (22.9%). A more accurate and comprehensive breakdown of revenue by specific source is unfortunately not available. However, estimates indicate that municipal rates comprise some 90 percent of taxes, fees and charges, with the remainder being mainly garbage fees. Of the grants received, approximately 70 percent are financial assistance grants and specific purpose payments made by the Commonwealth, of which the larger portion are

general purpose grants (some 57 percent) and identified local roads grants a further 25 percent.

Table 2 *Local government revenue sources, 1995/96*

Revenue source	NSW	Vic.	Qld.	SA	WA	Tas.	NT	Total
Taxes, fees and fines	1979 (49.2)	1287 (48.9)	1109 (37.6)	461 (58.3)	512 (46.0)	142 (46.3)	31 (43.1)	5522 (46.5)
Public trading operating surplus	80 (2.0)	0 (0.0)	417 (14.1)	1 (0.1)	0 (0.0)	26 (8.5)	0 (0.0)	523 (4.4)
Interest received	175 (4.3)	74 (2.8)	51 (1.7)	43 (5.4)	43 (3.9)	12 (3.9)	1 (1.4)	399 (3.4)
Grants received	642 (15.6)	589 (22.4)	388 (13.2)	126 (15.9)	238 (21.4)	67 (21.8)	24 (33.3)	2074 (17.4)
Sales of goods and services	807 (20.0)	680 (25.8)	788 (26.7)	125 (15.8)	257 (23.1)	47 (15.3)	16 (22.2)	2720 (22.9)
Other revenue	343 (8.5)	2 (0.1)	194 (6.6)	34 (4.3)	62 (5.6)	13 (4.2)	0 (0.0)	649 (5.5)
Total	4026 (100.0)	2633 (100.0)	2947 (100.0)	791 (100.0)	1112 (100.0)	307 (100.0)	72 (100.0)	11888 (100.0)

Source: ABS 5512.0 *Government Finance Statistics, Australia*.

Notes: Revenues are in \$ millions, figures in brackets are the corresponding percentage of total revenues.

Nevertheless, there is considerable variation in the composition of local government revenue across the states and over time (AURDR 1994a). For example, the proportion of revenue derived from grants ranges from 33 percent in the Northern Territory to just over 13 percent in Queensland, whilst taxes, fees and fines make up 58 percent of local government revenue in South Australia and just 38 percent in Queensland. The AURDR (1997a: 77) concluded that “if the data on rating support can be seen as a guide to the degree of fiscal imbalance, then it would appear that Queensland and Western Australia have the greatest disparity within their respective states, and Victoria and South Australia the least”.

In terms of international comparisons, several points can be raised. In the case of the United States, the degree of vertical fiscal imbalance is reasonably similar to that in Australia, with local government raising about 70 to 80 percent of its own requirements. However, the source of the imbalance is quite different, with the larger portion of funding assistance being made by state rather than federal government. By contrast, in Australia the balance is provided almost exclusively by the federal government. As indicated in Table 3, the Commonwealth grant for 1997/98 is estimated to be some \$1.2 billion; \$0.372 billion for the purposes of local roads, and \$0.840 billion in financial assistance grants. In the U.S., only about 17 percent of grants to local government are ‘block’ or general purpose grants, with the remainder being ‘categorical’ or specific purpose grants. In addition, extensive use is made in the U.S. of federal ‘mandates’ which dictate the actions of local governments but provide no finance

(AURDR 1994a: 17). However, the main difference between Australia and the United States lies in is the broader range of revenue-raising instruments available to local government in the latter country. These include personal income taxes (providing approximately 5 percent of own-source revenue), corporate income taxes (1 percent), property taxes (74 percent) and taxes on consumption (20 percent).

Table 3 *National grant allocation, 1991/92 to 1997/98*

	General purpose	Local Roads	Total
1991/92	714.969	303.174	1018.143
1992/93	730.122	318.971	1049.093
1993/94	737.203	322.065	1059.268
1994/95	756.446	330.471	1086.917
1995/96	806.748	357.977	1164.725
1996/97	833.693	369.034	1202.727
1997/98	840.112	372.782	1212.894

Source: National Office of Local Government (1997) *1996/97 Report on the Operation of the Local Government (Financial Assistance) Act 1995*.
Notes: Grants to the Australian Capital Territory under the Act commenced in 1995/96; the 1997/98 grant allocation is the estimated entitlement; figures are in \$ millions.

A similar situation holds in other federal OECD countries. For example, in Austria local government raises 34.7 percent of own-source revenue through personal income taxes, 5.5 percent from corporate income taxes, 11.0 percent from payroll taxation, 5.4 percent from property taxes, and 34.5 percent from consumption and other taxes. In Germany and Switzerland, personal income taxes are the primary own-source revenue, providing 66.5 and 76.5 percent of own-source revenues respectively. However, in Canada local governments are equally dependent upon property taxes (80 percent), despite having recourse to residual, mainly business, taxes (18 percent).

Table 4 *Financial assistance grants as a percentage of rate revenue by ACLG category*

	NSW	Vic.	Qld.	SA	WA	Tas.
UCC	0.31	1.72	11.59	3.55	4.17	6.23
UDV/UDL	11.16	12.35	17.95	16.77	11.32	22.41
UDM	6.99	10.34		15.57	11.17	21.31
UDS		1.92		11.88	10.11	
URV/URL	18.6	15.09	14.36	23.37	14.10	
URM	19.16	21.53		19.01	21.58	33.81
URS	24.48	22.84	15.93			17.22
UFL	33.32	28.86	24.17	32.47	37.64	17.61
UFM/UFS	57.35	37.79	36.83	35.77	75.12	51.93
RAV/RAL	64.68	37.22	39.03	26.99	60.37	40.33
RAM	90.94	48.43	77.68	45.48	82.39	64.41
RAS	91.45	50.79	143.79	58.10	82.90	106.76
RTL					41.80	
RTM/RTS/RTX			215.78	17.82	134.65	
Overall	23.26	18.32	25.57	21.65	29.79	28.11

Source: Australian Urban and Regional Development Review (1994a) *Financing Local Government: A Review of the Local Government (Financial Assistance) Act*.

Codes: (first two letters) UD – urban developed; UF – urban fringe; UR – urban regional; RA – rural agricultural; RT – rural remote; (third letter) C – capital city; V – very large; L – large; M – medium; S – small; X – extra small.

In terms of Australian local government own-source revenue, several salient features can be identified. First, when combined together the sources of revenue which can be assessed by local councils (including the use of loan funds) represent at least 80 percent of ordinary services revenues for most Australian local governments. Nevertheless, rates on property remain the dominant own-source revenue component of local government in Australia, providing as they do some 40 to 50 percent of total ordinary services revenue (MCS 1996: 4). Second, despite having recourse to only a relatively small number of revenue sources, local government in Australia is likewise only responsible for a relatively narrow range of property-related functions. This would suggest that reliance on property taxes is not as problematic, at least on a theoretical level, as it might at first appear. However, recent legislative reforms indicate that the emphasis in Australian local government is increasingly being shifted towards ‘service-related’ functions and this is likely to see an increase in the use of ‘user-pay’ charges (MCS 1996; McNeill 1997). Finally, quite apart from theoretical issues surrounding the use of property rates as a means of finance, the rate-based revenue-raising capacity of Australia local governments is subject to considerable distortion. Many of these issues involve artificial restrictions on revenue raising, such as rate capping and the overall

rating methodology set down in the various states.¹ However, controversy also surrounds the manner in which the various granting bodies distribute funds in light of revenue-raising capacity, and this issue will be developed further below.

Several interesting points also arise concerning the composition of intergovernmental grants in local government finance. Firstly, as detailed in Table 4, the contribution of grants to total revenue sources varies not only across states (as detailed in Table 2), but also across local government classifications within states. The contribution of (Commonwealth provided) financial assistance grants to, say, large urban fringe areas, varies from under 18 percent of own-source rate revenue in Tasmania to more than 37 percent in Western Australia. Similarly, grants as a proportion of rate revenue within states vary significantly. For example, in NSW grants to Sydney (as the capital city) sum to less than 1 percent of rate revenue, but increase to more than 90 percent for small rural urban areas. This reflects not only the structural composition, rate revenue-capacity, and rating effort of the councils, but also the diverse methodologies employed by the various state governments to allocate financial assistance. These issues will be developed at length in the next section.

Table 5 *Specific purpose payments to local government, 1996/97*

Title	NSW	Vic.	Qld.	SA	WA	Tas.	NT	Total
<i>Current payments</i>								
Home and community care	979	1093	92	148	406	113	–	2832
Aged/disabled homes and hostels	6415	12236	3239	2382	4367	437	45	29121
Disability services	851	495	434	–	–	–	17	1796
Children's services	58660	75436	15206	1288	12394	7899	1894	172777
Indigenous employment strategies	38	98	822	79	–	–	19	1057
LGDP	892	274	141	283	200	116	524	2440
Other current	–	–	–	–	20	–	–	–
Total current	67836	89632	19934	4101	17467	8565	2499	210033
<i>Capital payments</i>								
Aged/disabled homes and hostels	565	3908	188	37	225	168	–	5090
Disability services	12	11	–	–	–	–	–	23
Children's services	328	216	69	5	63	332	156	1169
Total capital	905	4135	256	43	288	500	156	6282
Total payments	98740	93767	20191	4143	17755	9064	2654	216315

Source: Commonwealth of Australia (1997) *Final Budget Outcome, 1996/97*.

Secondly, despite the common description of Australian local government as a state responsibility, the vast majority of grants derive from the Commonwealth. In 1996/97 the

¹ Evidence presented to the IPART (1998) inquiry into local government service provision suggested that a number of factors can influence local government performance. These include: rate pegging, economies of scale and scope, and competitive tendering. Some council submissions commented that rate pegging impacted negatively on efficiency levels and blurred accountability between state and local government. Moreover, it was argued that rate pegging did not recognise that communities may be willing to pay higher rates for higher service quality, and thereby impacted upon the qualitative dimension of local government performance.

Commonwealth provided general purpose and local roads grant allocations of \$833.7 and \$369.9 millions respectively. Moreover, since Commonwealth funding for local government commenced in 1974/75, the Commonwealth has provided over 80 percent of total local government grant income through the provision of financial assistance grants. In 1995/96 the Commonwealth provided over 97.4 percent of government assistance to local government in Australia. Furthermore, the contribution of state governments to sub-jurisdictional local governments has steadily declined over time.² For example, in New South Wales in 1996/97 federal grants were approximately \$284m for the purposes of equalisation (an increase of 3.9 percent from 1995/96) and \$108m for roads (an increase of 4 percent). Direct funding from the NSW State Government on the other hand is mainly channelled as grants for roads or pensioner rate rebates. Local councils manage a specified portion of the road network with a block grant from the Roads and Traffic Authority. In 1994/95 \$277m was provided under this system.

Finally, in addition to financial assistance grants, the Commonwealth has also been a significant provider of funding for other services such as childcare, aged, employment and other community welfare programs. Details are provided in Table 5 for fiscal year 1996/97. These specific purpose payments or SPPs totalled \$216.3 million in 1996/97 or more than 20 percent of total Commonwealth grants to local government (excluding the roads component).³ The magnitude and composition of these payments directly reflects the modifications in Commonwealth/local relations.

² One major contribution made by the states to local government is in the form of road finance. For example, councils in NSW maintain a network of 160,000 kilometres of regional and local roads, and 9,000 kilometres on behalf of the state Roads and Transport Authority (RTA). Funding for this purpose amounted to \$287 million in 1996/97.

³ Specific purpose payments or SPPs are made under Section 96 of the Constitution, whereby Parliament may grant financial assistance to any state on such terms and conditions as it sees fit. There are three types of SPPs: (i) payments 'to' state governments – these are made direct to state governments for funding expenditures by the states; (ii) payments 'through' state governments – payments to state governments to be passed on to other bodies or individuals. The main payments in this category relate to higher education, non-government schools and local government general purpose assistance; and (iii) SPPs made direct to local government.

Most SPPs paid 'to' the states (about 60 percent of the total) are on the condition that policy objectives set by the Commonwealth, or national policy objectives agreed between the Commonwealth and the states, are met. It is because of the conditions attached to SPPs that they are sometimes called 'tied grants'. The Commonwealth can attach conditions to these SPPs to reflect policy objectives in programme areas, and often include requirements for certain levels of spending by the states. SPPs that are paid 'through' the states account for around 39 per cent of total SPPs. These SPPs have a minimal impact on state budgets as they are essentially Commonwealth own-purpose outlays, with the states acting as the Commonwealth's agent. The small number of SPPs paid directly to local government (rather than 'through' the states) currently account for slightly more than 1 percent of the total.

Financial assistance grants

Under the *Commonwealth of Australia Constitution Act 1900* (§81), the Commonwealth is given powers to grant financial assistance to any state for any purpose on such terms and conditions as Parliament thinks fit. Nevertheless, Commonwealth assistance to local government did not effectively commence until 1974/75 when untied grants were distributed on the basis of recommendations made by the Commonwealth Grants Commission (CGC), operating under the *Grants Commission Act (1973)*. This was the first instance when the CGC was required to review local government finances. Before this, its main role (and that pursued since) had been the allocation *between states* of Commonwealth general purpose grants.⁴ However, despite the allocation of local government assistance being subsequently taken up by separate state Grants Commissions, the basic principles and procedures of fund distribution were established at this time. These included the allocation of funds on a 'horizontal equalisation' basis and the assessment of councils' ability to raise revenue solely on the basis of rateable property values.⁵

In 1976 the *Local Government (Personal Income Tax Sharing) Act* was passed. This provided for payments to the states of a specified percentage of Commonwealth personal income tax revenue to be distributed in turn to local government. Initially, local government's overall share was 1.52 percent, which represented a significant increase on amounts paid in previous years, and was subsequently increased to 2 percent from 1977. The inter-state distribution

⁴ The primary role of the CGC (1993: 6) is to recommend adjustments to the equal per capita distribution of Commonwealth general revenue grant assistance to the states, usually on the basis of fiscal equalisation:

Each state should be given the capacity to provide the same standard of state-type public services as the other states, if it makes the same effort to raise revenues from its own sources and conducts its affairs at an average level for operational efficiency.

To make these assessments, the CGC identifies 19 revenue and 41 expenditure categories for each state. For each revenue category the tax base available to the state is calculated, along with an average tax rate. Similarly, for each expenditure category, levels are calculated for disability factors outside the control of the state government which affect the provisions of public services. state grant relativities are then adjusted for expenditure and revenue disabilities based on the calculation of a national state average.

The implementation of the principle of fiscal equalisation thereby involves a per capita comparison of summated "standardised expenditure" (or weighted averages of all the categories of recurrent services provided by subnational governments) less any specific purpose payments (SPPs) which may have been paid with aggregated "standardised revenues" (or the revenue raising capacities of the subnational governments). The outcome of this process, referred to as the standardised budget deficit, provides an assessment of the relative needs of different states for Commonwealth financial assistance.

⁵ As subsequently defined under the *Local Government (Financial Assistance) Act (1995: §6)* the principle of horizontal equalisation is a basis of distributing funds:

[T]hat ensures that each local governing body in the state is able to function, by reasonable effort, at a standard not lower than the standard of other local governing bodies in the state, and that takes account of differences in the expenditure required by those local governing bodies in the performance of their function and in the capacity of those local governing bodies to raise revenue.

principles were to allocate 30 percent to councils on a per capita basis, with the remainder made on a horizontal equalisation basis. Subsequently, these and other principles were enshrined in the *Local Government (Financial Assistance) Act 1986* following recommendations made by the 1985 *National Inquiry into Local Government Finance*. The main features of this Act were: (i) distribution of grants among states (including the Northern Territory) on a per capita basis; (ii) distribution within states (referred to as Financial Assistance Grants or FAGs) to be determined by State Local Government Grants Commissions (LGGCs) on the basis of horizontal equalisation; (iii) a minimum grants entitlement for each councils based on population⁶; and (iv) provision for informal local government bodies, such as Aboriginal communities in remote areas, to receive grants.⁷ The main effects of this Act were effectively to sever the link between Commonwealth personal income tax revenues and total payments to local government, and to establish the 30 percent per capita grant allocation as a ‘safety net’ for council revenues.

Additional reports into local government finance and the methodologies used by the state LGGCs to distribute FAGs followed in 1994; namely, *Financing Local Government: A Review of the Local Government (Financial Assistance) Act 1986* and *Local Government Funding Methodologies*. The main finding of these reports was “that the seven different models operating were of little relevance in ensuring equity in grant distribution or allowing for the monitoring of outcomes” (OLG 19976: 59). Accordingly, the revised *Local Government (Financial Assistance) Act 1995* made a number of changes. These included: (i) recognition of the importance of improving efficiency and effectiveness in councils; (ii) recognition of the importance of improving local government services to Aboriginal and Torres Strait Islander communities; (iii) provision of a report to Parliament on the operation of the Act and performance of councils; (iv) provision of National Principles to provide additional criteria for the allocation of funds among councils; (v) inclusion of grants to the Australian Capital Territory for local government purposes.

Closely associated with the framing of the new Act, followed an agreement by Commonwealth, State/Territory ministers and the Australian Local Government Association to a set of principles for allocating general purpose and local road grants. In part, these

⁶ The Local Government (Financial Assistance) Act (1995: §6) defines the minimum grant such that:

No local governing body in a state will be allocated an amount ... that is less than the amount that would be allocated to the body if 30 per cent of the amount to which the state is entitled ... were allocated among local governing bodies in the state on a *per capita basis* [emphasis added].

National Principles were intended to reflect existing and well-established distribution practices that were employed not only by most state and territory LGGCs, but also those of the CGC. Of the five principles embodied in Part A of the National Principles (general purpose grants), the first three (horizontal equalisation, effort neutrality and minimum grants) reiterated principles that existed in the current legislation.⁸ Additional principles related to the recognition of additional revenue used to meet expenditure needs being included in assessment calculations, and the needs of Aboriginal and Torres Strait Islanders.⁹ Part B of the National Principles (roads component) stipulated that the identified roads component of FAGs should be made as far as practicable on the basis of the relative needs of each council. Relevant consideration for the purpose of this principle included the length, type and usage of roads in each local governing area.

Methods used by Local Government Grants Commissions

Despite the fact that the Commonwealth government provides the funding, the actual allocation and distribution of monies to local governments is made through state-based Local Government Grants Commissions (LGGCs). The principles applied by these LGGCs to grant allocation are largely based upon a common legislative core: (i) allocation of funds on a full horizontal equalisation basis; (ii) the functioning of each local government at a standard not lower than the average standard of other local governing bodies in the state; (iii) the assessment of revenue and expenditure needs and disabilities; and (iv) effort neutrality. The most important consideration here is that the allocation of grants is based on the LGGCs *objective* assessment of local government needs and disabilities: both expenditure – the differential costs, relative to standard, that a council needs to provide a standard level of services – and revenue – the differential revenues a council would raise if the standardised revenue effort was applied to its revenue base. In the case of expenditure disabilities, factors usually taken into account include socioeconomic, demographic and geographic attributes, whilst revenue disabilities are largely proxied by variance in rateable property value. It is important to note that the horizontal equalisation principles under which these assessments are

⁷ Under the Local Government Act (§4); a body declared by the Minister, on the advice of the relevant state Minister, by notice published in the Gazette, to be a local governing body for the purposes of this Act.

⁸ Effort (or policy) neutrality means that as far as practicable, that policies of individual local governing bodies in terms of revenue and expenditure effort will not affect grant determination. The assessment of a financial assistance grant is therefore effort neutral when it neither rewards nor penalises a council where expenditure or revenue raising patterns vary from the state average because of policy differences, differences in efficiency, or levels of self-help.

made generates “...equalisation of the capacity to provide services, but not the equalisation of outcomes” (AURDR, 1994a: 25). Furthermore, despite the fact that the various LGGCs derive their existence from a common Act and the state governments have agreed to a set of shared national principles, considerable differences in the state methodologies for funding assistance remain.

Revenue capacity

For most states, differences in the expenditure needs of councils and differences in revenue capacity for revenues other than rates affect grants much less than differences in rate revenue capacity (NOLG 1997: 98). This supports the case that decisions made by the various LGGCs about the horizontal equalisation of rates revenue will exercise a dominant influence on the redistribution of funds resulting from differential general purpose grants. However, considerable debate has arisen on the efficacy of the use of rateable property values alone as a means of assessing local government revenue raising capacity (as against some other multiple indicator) (NOLG 1997). Put simply, the debate has been concerned with the differential between a council’s theoretical revenue capacity and its actual ability to raise revenue by rates and other means. However, the debate has also been more practically concerned with the impact of different rating systems across the states, and different approaches employed by the various LGGCs, for the stated objective of horizontal equalisation.¹⁰

Several different rating bases are employed in the states. Local governments in NSW, Queensland and the Northern Territory exclusively employ ‘unimproved’ property values, either ‘land’ or ‘site’ based [where land values are based on natural states, whilst site values are for cleared areas exclusive of buildings and other improvements]. In Victoria and South Australia, the basis of assessment is the improved (or capital) value of the property, whereas in Western Australia unimproved values are used for rural properties, and improved values are used for urban properties. In Tasmania, the basis of assessment is gross rental value or

⁹ Previously, special purpose payments (or SPPs) though recognised by the various grants commissions, were excluded from calculations for the purposes of grants, though this was clearly inconsistent with the underlying principle of fiscal equalisation.

¹⁰ Morton Consulting Services (1996: i) opens the arguments as follows:

The argument about what is revenue capacity tends to centre on whether assessments of capacity should be based on the actual tax base used – property valuation, or whether it is more relevant to assess the capacity of the community to pay – the cash flow of residents. The use of property values includes a notion of underlying wealth of a community whereas the use of indicators such as personal income relates revenue capacity to the current resources available to pay for basic living necessities. Expenditures from local government rates and charges not only provide benefits consumed by residents on an annual basis, but they also act to increase the value of property and hence the wealth of residents of an areas.

assessed annual value (AAV). Substantial differentials exist in the ability of local governments to generate revenue derive from these differences. For example, in a study comparing Tasmanian AAV in relation to capital (improved) and land (unimproved) value, it was found that AAV as a percentage of capital value ranged from 4.5 percent to 11.8 percent, whilst AAV as a percentage of land value ranged from a low of 7.8 percent to a high of 88.7 percent (MCS 1996: 15). The report (MCS 1996: 15) concluded that “the diversity of situations in many other states would further magnify the extremes between the different valuation systems and the relativities between councils in the assumed rate base”.

The assessment of revenue capacity in each state, and consistency across state borders, will also depend on any additional provisions relating to revenue raising practice. The four main considerations are: (i) the use of minimum rates; (ii) pensioner remissions; (iii) differential rates; and (iv) rate capping (NOLG 1997: 100). First, the main difference between states in minimum rate provisions are whether limits are set on the proportion of total general rates to be raised from a flat charge per property. In Victoria and Tasmania, this limit is set at 20 percent, which serves to minimise the distortion between relative property values and the actual rates raised, implying that assessing revenue disability in these states on the basis of property is more appropriate than the remaining states. Second, across the states discounts for rate remissions also vary. In NSW the discount is set by legislation to a minimum pensioner rebate of 50 percent, whereas in other states these concessions are subject to the discretion of local government. Typically, LGGCs do not adjust revenue assessments for pensioner remissions. Third, in all states and territories there is considerable discretion in the use of differential rates for residential, commercial, industrial property, etc. The differential rating system is seen as one way in which the imposed tax base system can be more closely aligned with capacity to pay. Finally, rate capping or pegging may impact upon the revenue capacity of local governments across states. For example, in NSW councils have been restricted in the use of rating capacity since 1977.

How much revenue assistance is given to local governments will also depend on the methodology employed by the relevant LGGC. Firstly, NSW, Victoria, South Australia and Tasmania all rely almost exclusively on the valuation tax base to calculate revenue capacity. How closely these methods approximate the underlying revenue raising capacity will generally depend on the property valuation technique employed. For example, it is assumed that incomes in the community are most closely approximated by rental value (as in Tasmania), followed by improved capital values (as in South Australia), followed by

unimproved values. In Queensland a combination of indicators of revenue capacity are used. These include (ranked in order of magnitude): rateable property, gross value of rural production, personal income, an indicator of retail sales, and unimproved capital value. In Western Australia, the LGGC distinguishes between urban properties, agricultural properties, pastoral properties, and three classes of mining properties. In the Northern Territory the basis of assessment is personal income. Secondly, even though all LGGCs take account of SPPs (in line with the National Principles concerning other revenue sources) there is some variation in the way in which these SPPs are recognised. For instance, in Tasmania grants are averaged over 3 years, with only 80 percent being taken into account, while in NSW, Victoria and Western Australia, various discounting methods are applied.

In general, the debate on assessing the revenue raising capacity in local government, and more importantly, the methods by which grants are allocated to attain horizontal equalisation on the revenue side, remains unresolved. On one hand, the Morton Report (1996) concluded that, other than the efficacy of different rating systems in proxying the true revenue raising capacity of local government, “LGGCs should use a combination of indicators in their assessment methodology” (MCS 1996: 45). Furthermore “revenue calculation should not be seen as a calculation of the capacity to raise rates, but as a broader calculation of capacity to raise revenue by whatever means a councils chooses” (MCS 1996: 39). This was supported by an earlier CGC report entitled *Report on the Interstate Distribution of General Purpose Grants for Local Government* (1991), which advocated the assessment of revenue raising capacity on the basis of land value for commercial and industrial land, household income for residential land, and farm income for rural land. On the other hand, Emery (1997) has argued that LGGCs using aggregate property values will maintain consistency with state practices and the fact that property rates are the dominant source of local government revenue. Both sides of the debate recognise the data issues involved in making consistent comparisons between local government areas on any basis other than property values (OLG 1997: 101). However, the Office of Local Government (1997: 101) has recently concluded that:

[A]nyone comparing the different methods of assessing rating capacity used by Commissions would find it difficult to escape the conclusion that they are too various for all to be consistent with equalisation.

Roads grants

The Commonwealth contributes to the funding of road construction and maintenance through both the local roads and the general purpose components of grants. However, neither part of

the grant is tied, and councils generally spend significantly more on roads than the local roads component of the grant received (NOLG 1997).

In NSW some 25 percent of the local roads component is distributed to councils in the Sydney, Newcastle, Wollongong areas, with the remainder of the state receiving the balance. Of the former, 57 percent is distributed in proportion to road length, 38 percent in accordance with population, and 5 percent to bridge length. For the latter, 74 percent is distributed in proportion to road length, 19 percent to population, and 7 percent to bridges. For the general purpose component, the NSW LGGC distinguishes between urban local, sealed rural, and unsealed rural local roads. Disability factors for topography, climate, soils, materials, drainage, traffic density and travel are taken into account. Additional expenditure needs are factored in for culverts and bridges.

In Victoria the local roads and general purpose component are distributed according to a 'Mulholland asset preservation model'. This method distinguishes between road surfaces, and combines ratings for soil, traffic, climate, drainage, materials and terrain to assess relevant needs. Tasmania also allocates 66.5 percent of the local roads component on this basis. For the remainder, 28.5 percent is distributed in proportion to bridge deck areas (excluding culverts), and 5 percent allocated to councils with an above average ratio of unsealed roads to sealed roads.

In Queensland, 63 percent of the local roads component is distributed on the basis of road length, 37 percent on the basis of population, and grants are limited to a maximum annual reduction of 5 percent for any single council. For the general purpose component, roads are distinguished by surface type (sealed, gravelled, formed and unformed) and relative disabilities calculated in reference to traffic volume, topography and road type. For Western Australia, 93 percent of the local roads component and all of the general purpose component are distributed on the basis of an 'asset preservation model'. This model takes into account annual and recurrent maintenance costs and the costs of end-of-life reconstruction. Allowances are also made for the expenditure needs of heavy traffic, extra curbing and intersections, bridges, and road surface. On the other hand, South Australia distinguishes between metropolitan and non-metropolitan roads for the local roads component. The metropolitan component is distributed in equally-weighted proportions to road length and population, whereas the non-metropolitan includes additional factors relating to area and other road needs. The general purpose component is distributed in an identical manner, except that roads are divided into six categories (metropolitan sealed and unsealed; provincial town

sealed and unsealed; and rural sealed and unsealed). Finally, in the Northern Territory local roads are maintained through a roads trust. Funds are distributed on 'needs' criteria from this trust on the basis of road lengths weighted by type (that is, sealed, kerbed and guttered; sealed; gravel; cycle path; formed; and flat-bladed track).

Differences in the allocation of road grants across states arise for four main reasons (NOLG 1997). Firstly, some states distribute some part of their grants solely on the basis of road length and population, like South Australia and NSW. Other states, such as Western Australia, have constructed sophisticated asset preservation models that take into account maintenance and eventual replacement. Secondly, most other states factor additional disability factors into assessing expenditure needs. These needs may relate to climate, topography, traffic volume, and so on. Thirdly, a number of states, including Tasmania and NSW, make allowances for the type of road in the allocation. Additional allowances are usually made for urban and rural sealed roads over, say, urban and rural unsealed roads. Finally, several states use different methods to allocate the local roads component in the general purpose component, although others do not. Examples in the first instance include Queensland and NSW, and in the second, Western Australia and Tasmania.

General purpose grants

Although roads are the biggest category of expenditure for many councils, the LGGC in each state assesses between five and thirty classes of expenditure. For each class of expenditure, the LGGCs estimate how much each council, in the circumstances in which it is placed, would have to spend to provide services of average standard. Estimates are guided by the objective assessment of expenditure 'disabilities' (or disability factors) in each class of expenditure, corresponding to postulated systemic influences on expenditure which are beyond a council's control. Consistent with the notion of effort neutrality, the LGGCs do not compensate for cost differences which arise due to policy decisions of the council, management performance, or accounting differences. For example, in Table 6 the disability factors for general administration expenditures in each state are detailed. Factors usually taken account of in assessing disabilities include the proportion of the population from low socioeconomic backgrounds, population growth and decline, and scale allowances. However, there is not a great deal of consistency across the LGGCs in the use of these factors, with some states, such as NSW and Tasmania, taking account of considerably more factors than others, like Victoria.

The different disabilities are added to estimate the overall cost disability in percentage terms. This multiplied by state average expenditure per capita provides a measure of ‘standardised expenditure’: that is, how much each council would have to spend to provide the average level of service. The disabilities thus obtained may either be positive (a cost disadvantage) implying a greater than average per capita cost of service provision, or negative (a cost advantage) implying a lesser than average per capita cost of service provisions. Typically, negative disabilities are not calculated, so that the minimum weighting for the disability is zero. Grants are then applied in proportion to assessed disability factors and standard per capita grants for each category of expenditure.

Across the various states, a great deal of variation exists in the functions (or areas of expenditure) assessed, the types of disability factors taken into account, and the weighting applied to each factor in overall disability calculation. For example, 21 local government functions are assessed in NSW, 20 in Victoria, 18 in South Australia, 11 in Tasmania and only 9 in Western Australia. In the interests of brevity, we will examine only the New South Wales LGGC’s (NSWLGGC) methodology in more detail. Selected details on other state methodologies may be found in NOLG (1997).

Table 6 *General administration disability factors, 1997*

Themes	NSW	Vic.	Qld.	SA	WA	Tas.	NT
Scale allowance	Yes	No	Yes	No	Yes	Yes	Yes
Population growth or decline	Yes	No	Yes	Yes	Yes	Yes	Yes
Persons of non-English speaking background	Yes	No	No	Yes	No	No	No
Duplication of facilities, scatter of settlement	Yes	No	Yes	Yes	No	Yes	Yes
Isolation	Yes	No	Yes	No	Yes	Yes	Yes
Proportion of non-residents	No	No	No	Yes	Yes	Yes	No
Proportion of Aboriginals	Yes	No	No	Yes	No	No	Yes
Proportion of young people, aged	No	No	No	No	No	No	No
Climatic influences	No	No	No	No	No	No	No

Source: National Office of Local Government, *1996-97 Report on the Operation of the Local Government (Financial Assistance) Act 1995*.

In NSW expenditure allowances are calculated for 21 functions or areas of expenditure (NSWLGGC 1994). These functions include general administration services, airports, services for the aged and disabled, cultural amenities, control of animals, general health services, library services, recreational services, stormwater damage and flood mitigation, street light, and street and gutter cleaning. An additional allowance is calculated for those councils operating outside the Sydney statistical divisions to reflect isolation.

Table 7 *Sundry NSW disability factors*

	Aged/ disabled	Building control	Children services	General admin.	General services	Library	Town planning	Recreation	Garbage
Climatic influences								Yes	
Development activity							Yes		
Designated developments							Yes		
Disposal cots									Yes
Scatter of settlement	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Heritage/environment							Yes		
Population growth/decline				Yes			Yes		
Proportion of Aboriginals				Yes	Yes				
Proportion of NESB		Yes		Yes	Yes	Yes	Yes		
Proportion of non-residents		Yes				Yes	Yes	Yes	
Proportion of aged	Yes					Yes			
Proportion of pensioners	Yes				Yes				
Proportion of single parents			Yes						
Proportion of young			Yes		Yes	Yes		Yes	
Regional centre, CBD							Yes		
Scale allowance				Yes					
Urban/rural density								Yes	Yes

Source: New South Wales Local Government Grants Commission (1994) *Annual Report 1993/94*.

The disability factor assessed for any particular function depends primarily on the disability (or disabilities) being assessed. For example, as shown in Table 7, aged and disabled services, building control, and children's services are assessed on the basis of three disabilities, whereas town planning has eight assessable disability factors. The individual disability (or council measure) is then divided by the state standard (usually the average) and weighted by some factor which reflects the significance of the measure in terms of the expected additional cost.

For example, the disability factor applied to per capita grants for town planning expenditure is a function of eight individual disabilities. These are: (i) population growth, which recognises the additional cost of forward planning in high growth areas; (ii) development activity, a regression-based measure of building approvals; (iii) non-residential properties, indicating the greater complexity of processing development applications; (iv) heritage/environment, additional costs due to greater complexity in plan preparation and control; (v) regional centre CBDs, additional costs coming from non-residential use; (vi) non-English speaking background persons, reflecting additional costs of providing information; (vii) population distribution, recognising the costs of staff travel and service duplication; and (viii) designated developments, additional costs implied by complexities involved with the Environmental Planning and Assessment Act. However, these individual disabilities are not fully weighted in the final disability factor. The heaviest weightings in the case of town planning are for

population growth and development activity, with lower weightings for the proportion of NESB persons and non-residential properties. In addition, while some of the individual disabilities are continuous variables, others are discrete. For example, the NSW LGGC divides councils into five categories on the basis of heritage considerations and environmentally sensitive areas (extreme, very high, high, above average, and average) whereas population growth is taken as the average annual population growth rate over the previous five years. Still others, such as the measure of development activity, are per capita estimates based on a regression model: ie. per capita planning expenditure is regressed against new dwellings per capita and the total value of non-residential building approvals per capita.

The potential impact of disability factors on grant relativities can be further elaborated upon by examining the range for the individual disabilities. For example, referring to town planning again, population growth rates in NSW during 1993 ranged from -0.033 to 4.6 percent, the regression-based estimate of development from 3.95 to 395.86, the percentage of non-residential properties from 0 to 30.57 percent, the population distribution index from 0 to 50.47, and the percentage of households from a non-English speaking background from 0.04 to 43.78 percent. The final disability factor (bearing in mind the fact that equal weightings for individual disabilities do not apply) ranged from 0 to 384 with an average of 30.95. This implies that overall cost disadvantages (negative cost differentials are not calculated) in town planning ranged up to 10 times the state average on a per capita basis (the state standard cost in 1993 was \$7.37 net of income) (NSWLGGC 1994).

Grant allowances for the majority of functions are ultimately calculated by multiplying the number of units to be serviced by the standard expenditure per unit for that function and the disability factor for the function in percentage terms. Generally, the number of units serviced is measured by the number of properties most relevant to the function, i.e. non-urban properties for noxious weed control, urban properties for street lighting. However, the LGGCs calculation of equalisation grants is made without reference to the funds made available by the Commonwealth. The actual equalisation grant made to a council will therefore depend on a number of additional factors that vary from year to year. The first is the re-scaling of the notional grant to the funds made available by the Commonwealth, and the second is the bringing up of councils below the per capita minimum entitlement to that level (i.e. if 30 percent of the funds available were distributed on a per capita basis). Once this is done, each council receives approximately 60 percent of the amount assessed as need. Therefore the distribution of grants within any state on a full horizontal equalisation basis is unlikely to be

achieved (AURDR 1994a: 19). Problems certainly exist because of conceptual difficulties, data limitations and the subjective nature of examination. However, the primary barrier to full horizontal equalisation, independent of the overall fund allocation by the Commonwealth, is the statutory requirement of a per capita minimum grant (NOLG 1997: 25).

Efficiency and grant distribution

To date, the Commonwealth has not required the LGGCs to pay explicit attention in grant allocation to the efficiency with which local councils operate.¹¹ The reasons for this are threefold. First, under the *Local Government (Financial Assistance) Act* horizontal equalisation has been the major policy goal. Second, the phrase ‘by reasonable effort’ in the legislation has largely been interpreted to refer solely to the rating effort of councils, and does not take into account any matters concerning reasonable efforts to ensure economic efficiency. Finally, the assumption of ‘effort neutrality’ which relates to policy decisions by councils, has been interpreted to mean that councils should not be able to act in a manner which affects their grant (AURDR 1994a: 13).¹² Accordingly, grants to councils only reflect factors beyond their control, and therefore the LGGC grants process neither rewards nor penalises councils with differing levels of efficiency.¹³

However, it has been argued that LGGC methodologies have influenced the efficiency of local councils, irrespective of their lack of legislative mandate (AURDR 1994a).¹⁴ Both

¹¹ There is currently no restriction on the Commonwealth actually pursuing efficiency as an objective in the local government grants process. The AURDR (1994a: 15) identifies several reasons why the Commonwealth may wish to intervene in grant outcomes in the future: “each council is a productive unit and thus a contributor to the effective operation of the local, regional and national economies ... it is in the interest of all that councils make a sensible evaluation of potential new capital expenditure ... [and] improvement in council operations over time requires innovation and experimentation ... it may be appropriate for the Commonwealth to finance pilot projects.

¹² The AURDR (1994a: 21) argued that “the need for central government concern over local government efficiency depends on the significance of grants as a source of local authority revenue”. The approach used to address these concerns in the U.S. (where grants are relatively low) is a combination of grant-matching, specific purpose payments, and low levels of financial assistance. By contrast in the U.K. (where own-source income is relatively low) these concerns have been addressed structurally (i.e. through compulsory tendering and privatisation) rather than through grant mechanisms. The AURDR (1994a: 21) reasoned that “Australia sits in the middle” of these two approaches.

¹³ The main issue addressed by the Commonwealth in this regard relates to complexity in the grants process. At present, “complexity in LGGC methodology is of little concern to the Commonwealth ... however, if at odds with the intent of the current Act, council actions do influence their grants or the Commonwealth wishes to increase it emphasis on council productive efficiency or the Commonwealth takes the view that more than money is necessary to improve the ‘political’ efficiency of councils, then complex LGGC methodology maybe counter to the Commonwealth’s interest” (AURDR 1994a: 13).

¹⁴ The AURDR (1994a: 108) reported four options available to promote efficiency through the grants system. First, the *process approach* would advise councils of comparative costs, and warn inefficient councils of the need to improve efficiency, and reward efficient councils with efficiency ‘dividends’. The *element approach* would introduce efficiency directly in the grants mechanism with an efficiency bonus. The *managerial approach* would audit councils on the achievement of a predetermined efficiency measure, and pay an efficiency dividend on achievement. Finally, the

positive and negative factors have been identified. On one hand, it has been argued that “by providing the highest per capita support to those councils with revenue raising difficulties and expenditure needs in regard to size, sparsity, location and cost disabilities, [the grants system] may not be conducive to an efficient allocation of resources” (AURDR 1994a: 55). IPART (1998: 39) likewise supported this contention:

The Federal Assistance Grants Act 1995 provides a direct grant for local government against formulae determined by each state through the Grants Commission to equalise the effect of remoteness and size. This formula actually creates and encourages inefficiency by retaining small institutions...[It has been proposed] that the grant formula should not fully and automatically compensate councils to the full extent of higher overhead costs associated with remoteness and size as it reduces the incentive to form larger organisations or to become more efficient.”

Alternatively, it has been observed that “councils which are cost effective may be rewarded through unit cost adjustments up to the standard if their operations are cost effective” (AURDR 1994a: 14). For example, the NSW Local Government Grants Commission (NSWLGGC 1994: 16) has argued that the grants process indirectly rewards efficient councils:

Because if the effort neutral approach a council’s grant is assessed independent of policy decisions by councils, a council that provides a cost effective service still receives grant funding which it can allocate to its priorities. For example, two councils which were identical in every respect except efficiency would receive identical grants. The efficient council can use its grant funds to provide even better facilities for the rate payers. The inefficient council of the two would need to apply the grant funds to prop up an inefficient operation.

However, the Grants Commission’s (1994: 16) argument that “the use of council’s expenditure in the calculations [expenditure disabilities] is limited to determining a state standard cost for each selected function” ignores the impact of several inefficient or efficient councils on grant outcomes. For example, suppose that councils’ expenditure in a particular function is broadly efficient. In the case of industry wide efficiency this would infer a lower standard cost for that function, irrespective of factors beyond managerial control, thereby putting strong pressure on councils to improve efficiency to the state standard. Alternatively, if the industry standard is broadly inefficient, thereby implying a higher standard expenditure cost, the incentive for councils to improve their inefficiency is removed. At the very least, these factors may serve to institutionalise a given level of efficiency in a given function over

benchmark approach would set targets for performance, and reward councils with an allocation of funds proportional to the council’s achievement.

time. Moreover, the fact that councils can internally subsidise inefficient functions, combined with the impact of the minimum per capita grant, suggests that any purported financial penalties may be limited.

Table 8 *Extent to which councils have been encouraged to be more efficient due to LGGC method and formulae*

	NSW	Vic.	Qld.	SA	WA	Tas.	Total
Large	8.8	25.8	13.5	12.7	26.8	20.0	17.3
Small	51.5	28.8	28.8	52.7	42.9	40.0	41.3
Not at all	33.8	43.9	50.0	32.7	30.4	40.0	37.8
Unsure	5.9	1.5	7.7	1.8	0.0	0.0	3.5

Source: Australian Urban and Regional Development Review (1994) *National Survey of Councils*.

On balance, evidence from the 1993 National Survey of Councils suggests that the grants process used in Australia does influence efficiency, in spite of being overtly effort neutral (AURDR 1994a). As shown in Table 8, 17.3 percent of all surveyed councils indicated that LGGC methodologies had encouraged them to be more efficient to a large extent, 41.3 percent to a small extent, and 37.8 percent not at all. Just 12 percent thought that efficiency was not a criteria used by the LGGC in determining grants.

From local governments’ viewpoint, this same survey indicated that the grants process is seen to reward inefficiency and penalise efficient councils. The AURDR (1994a: 60) undertook a number of statistical tests to evaluate the hypothesis “that a council with a lower than standard unit expenditure would, after the application of a disability factor, invariably always be given a significantly higher standardised unit expenditure (and consequently a higher grant) and *vice versa*”. The results indicated that a strong relationship did exist between actual unit expenditure and standardised expenditure per capita. The AURDR (1994a: 61) concluded that:

[T]he application of disability factors are serving to improve the grant outcome for councils with low unity expenditures on administration and worsen the grant outcome for councils with high unit expenditures ... there seems to be some support for the proposition that in the way the Commission apply their judgements on disability factors in order to determine standardised expenditures, that LGGCs are implicitly rewarding [efficient] councils and penalising [inefficient] councils.

However, the study has a number of limitations. First, and foremost, the AURDR (1994a: 63) itself admits that the use of expenditure per capita as a proxy for technical efficiency “has been shown to be inadequate measure”. A subsequent analysis found that the chosen measure of efficiency, namely administration expense per capita, was totally unrelated to an alternative

measure of efficiency, administration expense as a percentage of total expenditure. Second, the study was based solely on the Victorian Grants Commission, and whilst the AURDR (1994a: 60) argued that the results “are illustrative of the likely outcomes in other states”, this is unlikely to be the case given the variation in methodologies across borders. Furthermore, and as indicated earlier in Table 5, the Victorian Grants Commission takes account of very few disability factors in its allocations. For example, whereas in most states an increasing share of funds has been directed to councils with the highest index of socio-economic disadvantage, the reverse appears to hold in Victoria (AURDR 1994b: xii). This suggests that the postulated association between efficiency (as measured by per capita administration costs) and grants may not be valid because efficient councils are implicitly being given more income by the grants process. Rather, it may be the case that when the grants methodology fails to correctly account for all disability factors (i.e. those that usually apply to high administration cost councils) all low administration per capita councils, whether efficient or not, are given larger grants than should be the case under horizontal equalisation.

Concluding remarks

In common with all federal systems of government, the Australian fiscal federalism is characterised by fiscal imbalance. Firstly, vertical fiscal imbalances arise because different levels of government have differing capacities to raise revenues to finance expenditure. As we have seen, the power of Australian local government to raise revenue is extremely attenuated. And secondly, horizontal fiscal imbalances occur since different levels of government, including local government, experience divergent costs in the provision of public goods and do not have equivalent revenue-raising capacities. Whilst most federal countries have pursued formal or informal tax-sharing arrangements between different levels of government, Australia has established a policy of horizontal fiscal equalisation and effort (or policy) neutrality, with the Commonwealth distributing grants to both local and state government. Indeed, it has been cogently argued that "Australia has developed the most comprehensive, effective and equitable system of fiscal equalisation in the world" (Matthews 1994: 16).

However, despite the fact that the Commonwealth government provides the funding, the actual allocation and distribution of monies to local governments is made through state-based LGGCs. The principles applied by these LGGCs to grant allocation are largely based upon a common legislative core: (i) allocation of funds on a full horizontal equalisation basis; (ii) the functioning of each local government at a standard not lower than the average standard of

other local governing bodies in the state; (iii) the assessment of revenue and expenditure needs and disabilities; and (iv) effort neutrality. The most important consideration here is that the allocation of grants is based on the LGGCs *objective* assessment of local government needs and disabilities and is technically independent of policy-related council decisions, including those relating to efficiency and effectiveness. However, there is some anecdotal evidence to suggest that LGGC methodologies do influence council efficiency, and thereby compromise the primacy of the horizontal equalisation objective.

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