

**Submission by the Australian Local Government  
Association to the  
Commonwealth Grants Commission Review of the  
Financial Assistance Grants**

**1 March 2013**

## **Executive Summary**

This submission responds to the Terms of Reference given to the Commonwealth Grants Commission (CGC) by the Treasurer to undertake this review and the issues paper released by the CGC in November 2012.

The Australian Local Government Association (ALGA) has long called for a significant review into local government funding and welcomed the announcement of this review. However, the finalised terms of reference are very restrictive and do not address many of the most pressing issues facing local governments and how they balance their economic sustainability with providing services to communities.

Until those broader matters are encompassed in a comprehensive review the key issue of improving the financial sustainability of local government will not be addressed.

### **The history of local government funding**

Local government has a history going back more than 170 years in Australia, which is longer than the existence of any state government. How to best ensure that councils are able to provide local services and infrastructure is a key question which federal governments have sought to address through funding local government.

The modern era of federal funding for local government began with the Whitlam Government in the 1970s recognising that rapid changes in responsibilities faced by councils required direct support from the Commonwealth. This led to creation of personal income transfers (PITs) under the Fraser Government at a rate of 2% of personal income tax revenue. This was subsequently reduced by the Hawke Government to 1% of total Commonwealth tax revenue.

The current arrangement, comprising a general purpose payment (GPP) and an identified local road grant (ILRG) making up the FAGs was established in 1991. While the current indexation process was put in place in 1994 and some changes were brought about under the *Local Government (Financial Assistance) Act 1995* (the Act), the system for local government Commonwealth funding has remained relatively unchanged for around twenty years.

Up until 2000, both states and local government each received a Financial Assistance Grant were indexed on the same basis, but the introduction of the GST in that year saw the states receiving a GST grant, linked to the GST tax revenue. Local government's arrangements remained unchanged. While GST revenue continues to increase at a 25% higher rate than FAGs, FAGs as a proportion of Commonwealth tax revenue have been declining to its lowest rates.

### **Reviews of local government funding**

There have been several reviews of federal funding for local government in recent times and the Commonwealth has looked into this matter no less than 6 times in just over 25 years, including reviews undertaken by the CGC, the Productivity Commission and a special review commissioned by the House of Representatives (the Hawker Review). Each review has had its own particular remit and

restrictions. Despite this, there has been a strong level of consistency about the issues and recommendations that have arisen. These include:

- the quantum of funding is insufficient ;
- the indexation methodology is not reflective of local government cost pressures; and
- National Principles need to be applied in a more uniform nature.

### **General Purpose funding**

As noted earlier, FAGs are made of two components, a GPG and the ILRG. The GPG operates in much the same way as the GST. Both are general purpose payments and derived from Commonwealth tax revenues. They are not, however, treated equally. The GST is not tied in any way to any particular outcome or policy directive. The FAGs must consider the National Principles, outlined in the Act when being distributed.

The second way in which the two revenue streams are not treated equally is the difference in their rates of increase. Since 2001, FAGs have increased by 47.5%, while GST grants have increased by 75.6%. Over the same period Commonwealth tax revenue, the funding source of FAGs, has increased by 62%.

### **The National Principles**

The National Principles are outlined in Section 9 of the FAGs legislation and they must be considered by state grants commissions when determining how FAGs are distributed within each jurisdiction. They were established to ensure a greater degree of consistency in how the FAGs are distributed.

Jurisdictions are able to apply the Principles differently, as long as they are consistent with the Act. Different issues are considered by jurisdictions in making allocations between councils. ALGA believes the state grants commissions should maintain their role, but acknowledges the efforts made by the Commonwealth to focus on the consistency of the application of the Principles.

### **The quantum of funding**

The total amount of the FAGs pool is no longer adequate to meet the needs of councils and their communities and has been declining in relative terms, especially when considered in the context of changes in local government' role.

The role of local government across Australia has been changing over recent decades with a move away from property-based services to human services. This is evidenced by the decline in the relative importance of road expenditure in the functional mix of local government services.

There are also differences between jurisdictions in the relative importance of particular functions. Such differences are an integral elements when considering the role of State Local Government Grants Commissions in developing appropriate methodology for intrastate distribution of FAGS versus a centralised approach to equalisation.

Local Government's primary revenue source is its taxation (rate) revenue. Rate revenue on a per capita basis has increased faster than the CPI. The need to more fully exploit the rate base is partly a

consequence of grants and subsidies from other spheres of government declining relative to the real cost of maintaining current service levels. For example, current grants and subsidies increased by only 51% against a total revenue increase of 87% over the period from 2001/02 to 2010/11.

Between 2001/02 and 2010/11, GST revenue increased by 75.6% whereas FAGS increased by only 47.5%. This time-span includes the period since the GFC where GST growth slowed significantly. FAGS has declined from 0.78% of total Commonwealth taxation revenue in 2001/02 to 0.71% in 2010/11.

### **Indexation of FAGs**

The current indexation arrangements for FAGs are not adequate to maintain the grants' 'purchasing power' for councils. This is because the indexation does not reflect the actual cost increases councils face in delivering services and infrastructure.

In determining the growth in the funding pool for the coming year, the Commonwealth Government estimates the consumer price index (CPI) and the anticipated population growth for the coming year. The overall growth in the funding pool is determined by these two factors.

Local Government has argued that the CPI component of FAGS indexation does not adequately reflect the costs associated with maintaining the same level of local government service. The range of local government services is driven by factors other than those measured by the CPI.

Most State local government associations have developed a Local Government Cost Index to assist councils in determining a level of rate increase necessary to maintain service levels and these cost indices show that the cost of providing local government services have increased at a faster rate than the CPI.

Use of an appropriate Local Government Cost Index rather than CPI would more effectively help councils to meet the costs of providing services and infrastructure.

ALGA supports the development of a national approach to a Local Government Cost Index. The ABS may be an appropriate body to develop such an index.

The risk to councils from the current indexation process was highlighted by the outcome of the 2011 ABS intercensal error, which saw the ABS revise down population estimates. These revised estimates were treated in the same manner as if population growth had fallen and FAGs were reduced immediately. This led to a 2.5% reduction in FAGs across the country. This poses a threat to already financially strained councils and a reflection of a weakness in the current indexation methodology.

### **Keeping FAGs untied**

As a general purpose grant, ALGA strongly believes that FAGs remain should remain untied. Local councils need to maintain control over their own spending priorities. Councils know their communities and their needs best.

In recent years there has been a move to tie more Commonwealth grants to particular outcomes or policy directives. ALGA believes that this would weaken local government's financial independence,

create the risk of greater political direction from national government and reduce the ability of councils to meet local community needs.

There are also practical concerns. There would be increased costs of administration at the federal level and at the council level as councils were forced to meet more complicated application or accountability requirements.

## Overview

The Australian Local Government Association (ALGA) is the national voice of more than 560 local government authorities. It is a federation of state and territory local government associations and includes the ACT Government (reflecting the combination of state and municipal functions). The President of ALGA is a member of the Council of Australian Governments (COAG) as well as many other Ministerial Councils. As a federated body, ALGA has consulted with its membership, the state and territory local government associations, in developing this submission. However, those associations will be providing their own submissions, reflecting the situation in each jurisdiction.

ALGA has long argued for a review of the Financial Assistance Grants (FAGs) provided by the Commonwealth Government to local government. This has reflected ALGA's view that since 1996 the amount of the grants has not kept pace with the needs of councils and the expectations of their communities and that a review is necessary to highlight this inadequacy and provide the basis for reform of FAGs.

ALGA's view is that the key reforms necessary for the FAGs are an increase in the FAGs pool so that it can more effectively address the issue of improving the financial capacity of local government bodies, and a change to the methodology for the indexation of the grants so that indexation more accurately reflects the actual increases in costs faced by local governments.

The FAGs for local government remained in existence after the FAGs for state governments were superseded by the introduction of the GST revenue distribution in 2000. While the GST revenue has been a growth tax, tied to the growth in the broad economy, the local government FAGs have been treated as a Specific Purpose Payment (SPP) from the Commonwealth to the states and their growth has been limited to an annual increase based on the increase in the Consumer Price Index and population growth.

When the funding for other Commonwealth SPPs was reformed with the implementation of the 2008 Intergovernmental Agreement on Federal Financial Relations, which saw substantial increases in the base level of the payments and changes to indexation methodologies, local government FAGs were specifically excluded.

The result of these two developments is that the inadequacy of funding for local government FAGs remains to be addressed.

The current review of FAGs was foreshadowed in the 2011-12 Federal Budget, although the terms of reference were not released until August 2012. The terms of reference indicate a review in two stages with the Commonwealth Grants Commission playing the lead role in the first stage. The terms of reference for the CGC review specifically exclude issues relating to the amount of funding provided under the grants and the indexation methodology.

ALGA strongly believes that the terms of reference for the review are unacceptably narrow and will not in any way address the financial sustainability challenges faced by councils. ALGA does not believe it is possible to usefully review the FAGs without broader consideration of the history of the

grants, the trends in FAGs funding, the changing nature of local government revenue and expenditure, and the weaknesses in the current indexation methodology. ALGA understands the advice of the CGC that issues outside the narrow remit of the Commission's terms of reference will not be considered but ALGA believes a broader more comprehensive review of federal funding of local government is necessary.

ALGA is strongly concerned by the possibility, implicit in the terms of reference, that the Commonwealth Government may consider tying the FAGs to Commonwealth-determined outputs and thus remove the current freedom councils have to spend the FAGs addressing priorities determined by local communities. ALGA does not believe that such a move would contribute in any way to an objective of enhancing the effectiveness of local governments.

### History of Commonwealth general support funding to local government

The modern period of local government general Commonwealth funding began in 1974, with the introduction of general revenue assistance (GRA). GRA recognised the additional pressures that were being placed on local government authorities through an increased role in health and welfare service provision.

Under the *Grants Commission Act 1973* regional bodies were created to represent and act on behalf of local government. The purpose of the bodies under the GRA arrangements was to have them apply for assistance on behalf of councils, with those grants directed at ensuring local councils were not at a financial disadvantage in comparison to other related representative bodies. However, it quickly became clear that this process was not meeting the needs of local government as it was an application-based process, which meant some councils were favoured and others unable to gain funding.

The Fraser Government in 1976 introduced the *Local Government (Personal Income Tax Sharing) Act 1976*. This was the first step towards creating the funding mechanism we know today.

This Act put in place a process by which local government as a whole would be entitled to a fixed portion of Commonwealth income tax revenue. This would commence as 1.52%, then be increased to 1.75% and finally to 2% in 1980/81. These were known as PITs (personal income transfers) and would fluctuate in line with Commonwealth tax receipts, increasing in good times but also declining when times were tougher. This process laid the framework that would become the standard for local government tax sharing.

This would change again under the Hawke Government during the 1980s. The Government changed the funding mechanism from 2% of personal income tax revenue, which was becoming an increasingly large amount, to 1% of general taxation revenue.<sup>1</sup> The Government made a decision to investigate the benefits of tax sharing arrangements with the states, territories and local government in 1985/86. Through that process the increase in general revenue funding for local government was capped at a maximum real rate of 2% per year. It should be noted that since the

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<sup>1</sup> Based on FY 2010-11, 2% of personal income tax revenue would equal \$4.1 billion – roughly double the amount local government receives through FAGs.

conclusion of a direct tax sharing arrangement, the portion of general revenue directed towards local government has had a downward trajectory, dropping below 1% over the past decade.

In 1986, the *National Inquiry into Local Government Finance* (the Self Inquiry) made recommendations to ensure that both a general purpose payment (GPP) system for local government should be maintained, and that funding should be linked to any increases provided for the state GPPs.

The next major development on this issue was in 1991 when the Commonwealth untied the previously tied local road grants and linked them with the GPP. This created a separate identified local road grant (ILRGs) that would be paid to councils. From that point on, FAGs would constitute two separate payments, the GPP and the ILRGs. Although both components were untied in the hands of councils, they continued to be identified separately because the basis on which they were allocated between the states and territories was different.

In 1994, the states agreed to the introduction of an 'escalation factor' to their FAGs and this was also therefore applied to the local government payments. This escalation factor was designed to take population growth and inflation into account when determining the FAGs payments each year. This is a determination made by the Commonwealth Treasurer.

By the mid 1990s, therefore, the mechanism for the current FAGs process was established. However, developments at the end of the decade would see increased inequality between state and local government payments, with sharp increases for state funding and very small proportional increases for local government.

With the implementation of the Goods and Services Tax (GST) in 2000, the relationship between the Commonwealth, the states and local government changed completely. With the states now receiving an allocation from GST revenues, it was left to the Commonwealth to continue to fund local government FAGs from general tax revenue.

During this time, the legislative instrument that supports the FAGs process, the *Local Government (Financial Assistance) Act 1995*, was amended to include how the escalation factor agreed five years earlier would operate since it could no longer be linked to the escalation of state government FAGs.

Despite the changes in 2000/01, the actual make up and mechanism behind FAGs has not changed since 1995. The changes that have occurred since then have been minor and administrative in nature. The approach adopted to addressing shortcomings in the current system seems directed by two goals; the first being the need to avoid creating 'losers' in the system and the second, the desire to avoid making the legislative changes needed to fix holes and streamline processes.

### **Recent reviews of local government funding and revenue**

Since the introduction of the GST in 2000, and the establishment of the present system of grant funding for the states and local government, there have been four reviews commissioned by the Government and one by ALGA, and they are;



- Commonwealth Grants Commission 2001( interstate distribution of FAGS);
- *Rates and Taxes: A Fair Share for Responsible Local Government (The Hawker Review) 2003;*
- *Local Roads Inquiry (Commonwealth Grants Commission) 2006*
- *National Financial Sustainability of Local Government (PricewaterhouseCoopers) 2006;* and
- *Local Government Revenue-Raising Capacity (Productivity Commission) 2008.*

While each of these reviews has had a different remit, it is no surprise that each has highlighted the same key concerns about the sustainability of local government funding and these are the key issues that ALGA will highlight in this submission.

The other similarity among these reviews is that apart from the creation of the South Australian supplementary roads grant, which emerged out of the Hawker Review, no significant recommendation to increase efficiency and promote a strong local government sector has been acted on.

It would be impossible to give a clear picture of the financial situation of local government, especially given the very restrictive terms of reference for this review process, unless a thorough examination of those often highlighted needs is considered in this submission.

### General Purpose funding

The FAGs are made up of two separate components, general purpose funding and identified funding for local roads.

Local government strongly believes that general purpose component serves the function of a tax sharing grant, similar to the function served by the GST grants to the states. The GST is generated from Commonwealth taxation revenue (although it is the GST revenue, not general tax revenue) and then distributed to the states, which use the grants to form part of their operating budgets for the coming year. They are not provided to deliver a specific outcome, nor is future funding tied to any indicator. Similarly, Fags are funded out of general tax revenue and are distributed through the states councils which use them as part of their operating budgets.

Despite having a similar structure and purpose, there has been a marked difference in the treatment of FAGs when compared with the GST. Increases to the FAGs have been at a much slower rate than the GST and importantly, increases to the FAGs are slower than those in general taxation revenue, which is the baseline source of FAGs funding.

### General Purpose Funding increases

Local government continues to have to undertake an increasing set of responsibilities with a funding arrangement that is inadequate and contrasts significantly with the GST. The most stark demonstration of this inequity is the difference in the rate of increase between FAGs and the GST since 2000. Between 2001/02 and 2010/11 while GST revenue increased by 75.6%, FAGs have increased by only 47.5%.

The contrast is even more apparent when growth in GST revenue prior to the Global Financial Crisis is examined. By 2007/08, GST revenue had increased by 62% and other Commonwealth taxation revenue by 60.4%, whereas FAGs had increased by only 27.9%.

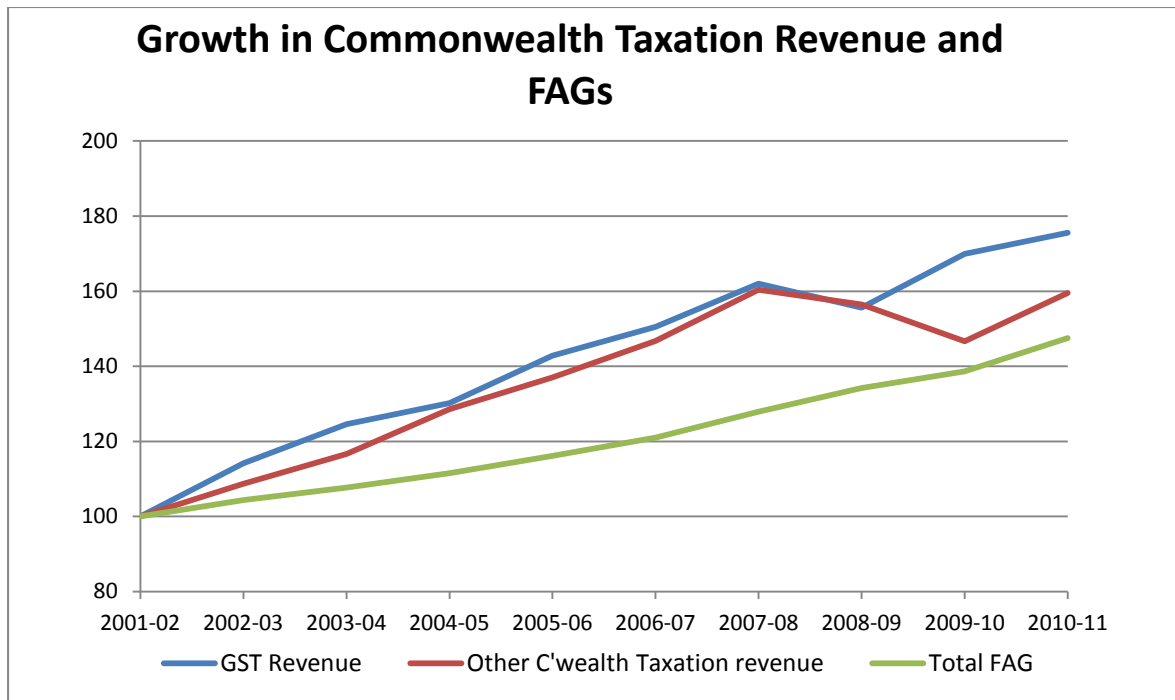
This trend relative to the revenue base of the Commonwealth has been evident over the past twenty years, with local government arguing that FAGS should be tied as a percentage of Commonwealth taxation revenue. The amount of FAGs has declined from more than 1% of total Commonwealth taxation revenue in 1995/96 to 0.78% in 2001/02 and 0.71% in 2010/11.

#### Commonwealth Taxation Revenue and FAGS, 2001/02 to 2010/11

	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11
GST Revenue \$m	27,389	31,257	34,121	35,655	39,118	41,208	44,381	42,626	46,553	48,093
Other C'wealth Taxation revenue \$m	150,449	163,570	175,439	193,476	206,104	220,780	241,291	235,376	220,618	239,982
Total FAGS \$m	1394	1455	1501	1555	1619	1687	1783	1872	1933	2057
FAGS as % total Taxation Revenue including GST	0.78%	0.75%	0.72%	0.68%	0.66%	0.64%	0.62%	0.67%	0.72%	0.71%

#### Index of change 2001/02 to 2010/11

	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11
GST Revenue	100.0	114.1	124.6	130.2	142.8	150.5	162.0	155.6	170.0	175.6
Other C'wealth Taxation revenue	100.0	108.7	116.6	128.6	137.0	146.7	160.4	156.4	146.6	159.5
Total FAGS	100.0	104.4	107.6	111.5	116.1	121.0	127.9	134.2	138.6	147.5



### The National Principles

According to Subsection 3(2) of the *Local Government (Financial Assistance) Act 1995*, the Federal Parliament provides financial assistance grants to the states and self-governing territories for the purpose of improving:

- *the financial capacity of local governing bodies;*
- *the capacity of local governing bodies to provide their residents with an equitable level of services;*
- *the certainty of funding for local governing bodies;*
- *the efficiency and effectiveness of local governing bodies; and*
- *the provision by local governing bodies of services to Aboriginal and Torres Strait Islander communities.*

The current National Principles were adopted following the Australian Urban and Regional Development Review in 1993. They have effectively remained the same since that time apart from the adoption of an amalgamation principle in 2006 following the Hawker review.

The main objective of having National Principles was to establish a consistent basis across Australia for distributing financial assistance grants to local government under the Act. The formulated National Principles are a disallowable instrument. As such, any amendments, including establishment of new principles, must be tabled in both Houses of Federal Parliament before they can come into effect.

The National Principles relating to allocation of **general purpose grants** (GPG), payable under Section 9 of the Act among local governing bodies, are as follows:

### **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 each local governing body in the state or 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 or 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.

### **Effort neutrality**

An effort or policy neutral approach will be used in assessing the expenditure requirements and revenue-raising capacity of each local 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.

### **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 or territory is entitled under section 9 of the Act in respect of the year were allocated among local governing bodies in the state or territory on a per capita basis.

### **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.

### **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.

### **Council amalgamation**

Where two or more local governing bodies are amalgamated into a single body, the general purpose grant 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.

The National Principle for the allocation of the **Identified Road Grant** (IRG) among local governing bodies under Section 12 of the Act is as follows:

### **Identified road component**

The identified road component of the financial assistance 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.

### Applying the National Principles

Each of the state and territory grants commissions has a clear methodology as to how they interpret and apply these principles when determining the distribution of FAGs each year. This creates issues of consistency since each state grants commission adopts a different approach with the result that similar councils in different jurisdictions are treated differently. State grants commissions, while referencing the principles as a base-line, can apply additional standards, such as climate needs, worker mobility, tourism and natural disaster risk. As long as the national principles are applied and demonstrated, there is no need to maintain consistency across jurisdictions.

This submission will focus on two of the National Principles, support for Indigenous and Torres Strait Islands and the impact of 'Other grant support'. At times, these principles are counter-intuitive to a general purpose grant and place councils of similar size, shape and location at a potential disadvantage, when compared to councils in a different state.

ALGA fully supports the position that the needs of Indigenous Australians must be a focus of government funding priorities. It is appropriate that there be a national principle highlighting this issue although the Commission has in the past questioned the need for the matter to be specifically referred to in the objectives of the legislation governing the FAGs. This goes to the heart of how far a general purpose funding program should be directed to achieving specific narrow policy objectives. This is also true for rural and remote community funding. While the needs of both these groups (and many other needs) can be taken into account in determining distributions, the special needs of Indigenous communities and rural and regional communities are best addressed through separate and targeted programs, not through the general purpose funding of FAGs.

The second issue of concern to ALGA is the application of the 'other grants' principle. The principle specifically suggests that additional grants for council activities (including SPPs) can, depending on the grants commission, be counted toward council revenue, when determining the equalisation needs of a council. This means that the impact of the provision of additional funds to address particular problems identified by the state or Commonwealth governments can be significant diminished or eliminated. This clearly undermines the nature of a general purpose grant system.

An example is how a major SPP, such as Roads to Recovery is treated by grants commissions across the country, and how the presence of this grant funding can affect a council's allocation of FAGs funding. In 2012, Queensland undertook a review of its FAGs methodology and changed the degree to which Roads to Recovery would be considered inclusive to the Grants Commission's determinations, from 50% to 0%.<sup>2</sup> In South Australia Roads to Recovery is part of a suite of transport

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<sup>2</sup> <http://www.qlggc.qld.gov.au/docs/methodology-review-2011-09.pdf>

grants which are taken into account by the Commission.<sup>3</sup> There is a different calculation in Tasmania, Victoria and the Northern Territory.

The review of FAGs undertaken by the CGC in 2001 and the Hawker Review in 2003, both highlighted elements of the administrative requirement of the FAGs system, including the role of local government grants commissions (LGCCs).

ALGA fully supports maintaining the current role of state LGCCs in making recommendations for FAGs distribution within their own jurisdictions. ALGA believes that local knowledge and a local focus is necessary to ensure the best distribution for FAGs. It would be naive to expect that a centralised and national grants commission would be able to develop and apply the required knowledge and experience to the intricacies of state distributions. It is important that the National Principles are applied effectively and ALGA supports efforts to ensure consistency in this area. The Commonwealth Government has placed great emphasis in the past decade on trying to improve the consistency of methodologies between local government grants commissions.

### The quantum of FAGs

The demands on local government revenue have been an issue of concern to ALGA for many years. In recent decades, councils have moved away from funding traditional council activities such as transport infrastructure and waste disposal, in order to address human services provision. In fact, the proportion of spending on social/human services, including childcare, home care, and other services now exceeds traditional council activities. This has been apparent since the early 1970s, and as previously noted, this provided the genesis of Commonwealth grants to local government which that evolved subsequently to become the FAGs.

It is clear that the size of the FAGs funding pool is too small for the tasks now faced by local government when it comes to the provision of high quality services for their communities. The clearest demonstration of this dilemma is the funding gap identified by ALGA research that shows a \$1.2 billion infrastructure spending gap for local roads. A primary reason for this gap is the insufficient FAGs pool which has led to councils deferring funding for roads in favour of human service provision which requires more immediate action.

Councils have also moved to a more diversified set of funding sources to address the need for additional resources although the demands on council revenues have continue to expand.

### Revenue

In 2008, the Productivity Commission released *Assessing Local Government Revenue Raising Capacity*. This report was undertaken with the full engagement and support of local government. Among its findings was that almost 91% of local government's revenue in 2006/07 was from its own sources. Over the last decade, local government has consistently raised more than 80 per cent of its total revenue from own sources. Local government is also utilising almost 90 per cent of its total

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<sup>3</sup> [http://www.localgovt.sa.gov.au/\\_\\_data/assets/pdf\\_file/0006/178053/Information\\_Paper\\_-\\_Final\\_Proof.pdf](http://www.localgovt.sa.gov.au/__data/assets/pdf_file/0006/178053/Information_Paper_-_Final_Proof.pdf)

hypothetical maximum own-source revenue capacity, which indicates there is limited scope for local government to introduce new or additional revenue imposts.

However, it is also noted in the latest Local Government National Report that averages can mask the true situation of specific local councils and important differential impacts on different groups. The Productivity Commission (PC) has confirmed that a significant number of local councils, particularly in rural and remote areas, will remain dependent on grants from other spheres of government to meet current expenditure. The PC further concludes that some councils will always remain highly dependent on FAGSs, notwithstanding they might have fully utilised their own-source revenue raising capacity.

Local council revenues have faced pressures in recent years. While revenue from rates has been grown steady, revenues from over the counter services have grown more slowly as has revenue from grants and subsidies. The need to more fully exploit revenue designated as 'other' revenue sources is evident. The data on what is included in the 'other' category is not uniform across councils, but capital grants, developer charges and natural disaster relief usually fall under this category.

When the increases in revenue sources across a number of years are examined, some basic trends emerge.

#### Local Government Australia, Revenue by Source

GFS Revenue \$m	2001 -02	2002 -03	2003 -04	2004 -05	2005 -06	2006 -07	2007 -08	2008 -09	2009 -10	2010 -11	increase 01/02 to 10/11
Taxation revenue	6,757	7,224	7,671	8,183	8,726	9,405	10,139	10,896	11,607	12,408	84%
Current grants and subsidies	2,237	2,098	2,204	2,075	2,054	2,158	2,306	3,370	2,895	3,376	51%
Sales of goods and services	5,662	6,003	6,322	6,754	6,672	7,533	8,092	8,634	9,245	8,466 <sup>4</sup>	50%
Interest income	370	422	510	588	632	766	819	760	669	1,192	222%
Other	2,893	2,967	3,118	3,616	5,705	6,277	6,438	7,047	7,602	8,060	179%
Total	17,920	18,714	19,825	21,216	23,789	26,139	27,794	30,706	32,019	33,503	87%

While rates revenue continues to increase, albeit below the rate of increase for the period as a whole, the growth in revenue from the 'other' category is clear an increase of nearly 180%. The continued ability for local government to demonstrate conservative financial management, despite increasing pressures, is shown through the 222% increase in interest income. However, these strong increases are in contrast to the slow rate of growth in revenue from grants and subsidies. The lower

<sup>4</sup> The drop in this year is due SEQ Water and Sewerage no longer being under local government management.

proportion of grant revenue does not reflect a lack of need. Rather it highlights the fact that the growth in FAGs has not kept pace with the needs of local governments which have been forced to seek additional revenue from other sources.

## Expenditure

Many councils are now expected to provide a greater range of services to their communities than at any other time in the more than 170 year long history of local government in Australia. In part this reflects the impact of cost shifting. That is, the shifting of financial responsibility for a service from one level of government to another. Over the years, local government has been increasingly affected by decisions of Commonwealth and state governments to remove funding or change the eligibility criteria of a service. Councils are often placed in a position of having to fully fund a service that they had been providing, in partnership or on behalf of other levels of government, to ensure that their communities who need these services can continue to access them.

### Local Government Australia, Expenditure by Function \$m

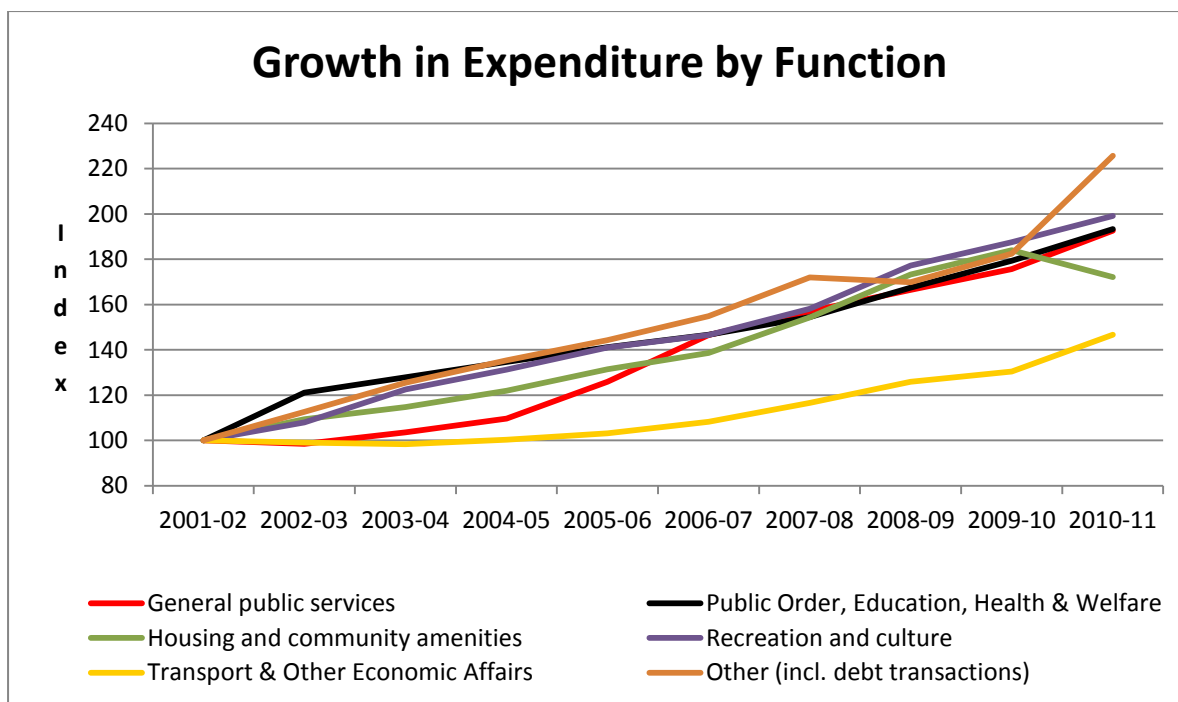
Outlays by Function \$m	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11
General public services	2,913	2,868	3,018	3,196	3,667	4,267	4,573	4,849	5,118	5,611
Public order and safety	303	421	454	479	501	521	535	592	662	769
Education, Health & Welfare	1,212	1,413	1,483	1,562	1,637	1,702	1,806	1,946	2,054	2,160
Housing and community amenities	3,747	4,098	4,300	4,568	4,926	5,196	5,780	6,493	6,892	6,451 <sup>5</sup>
Recreation and culture	2,190	2,364	2,682	2,874	3,088	3,208	3,462	3,880	4,107	4,359
Transport & Other Economic Affairs	5,217	5,168	5,132	5,236	5,385	5,650	6,083	6,572	6,803	7,656
Public debt transactions	356	364	360	360	372	391	428	375	453	578
Other	671	793	929	1,030	1,110	1,200	1,338	1,370	1,420	1,739
Total	16,609	17,489	18,358	19,305	20,686	22,135	24,005	26,077	27,509	29,323

Source: ABS 5512.0.

<sup>5</sup> The decline in expenditure in housing and community amenities between 2009/10 and 2010/11 is a result of South East Queensland (SEQ) water and sewerage functions being transferred out of the general local government sector.







The changing role of local government and the shift away from property-based services towards human services has been observed by many inquiries and reviews over a lengthy period. For example, in the 2001 review of the *Local Government (Financial Assistance) Act 1995*, the Commonwealth Grants Commission (CGC) found that the composition of local government expenditure had changed including:

- a move away from property-based services to human services;
- a decline in relative priority of road expenditure;
- an increase in the relative importance of Recreation and Culture, and Housing and Community Amenities;
- an expansion of Education, Health, Welfare and Public Safety services.

The Northern Territory has the highest expenditure when measured on a per capita basis at \$1,932, some 46% above the national average. This is a reflection of its relatively small and low density population.

At the other end of the scale, South Australia and Victoria have the lowest expenditure on a per capita basis, reflecting the density of settlement in the incorporated areas of each of these States.

#### Local Government Expenditure by State/Territory, 2010/11

	NSW	Vic	Qld	SA	WA	Tas	NT	Total
Total Expenditure \$m	\$9,088	\$6,544	\$7,997	\$1,753	\$2,890	\$603	\$449	\$29,323

Population 000's	7248	5575	4513	1645	2387	512	232	22112
<b>Expenditure per capita</b>	<b>\$1,254</b>	<b>\$1,174</b>	<b>\$1,772</b>	<b>\$1,066</b>	<b>\$1,211</b>	<b>\$1,178</b>	<b>\$1,932</b>	<b>\$1,326</b>

Source: ABS 5512.0

There are also differences in expenditure by function between local governments in each state/territory.

The high proportion of outlays in Victoria on education, health & welfare (18%) contrasts with the same function in Queensland which represents only 2% of total outlays. In the Northern Territory, roads represent only 10% of total outlays whereas in Queensland this represents 30% of local government outlays.

#### Share of Outlays by function and State/Territory, 2010/11

\$m	NSW	Vic	Qld	SA	WA	Tas	NT	Total
General public services	18%	13%	27%	14%	13%	17%	37%	19%
Public order and safety	3%	2%	2%	2%	4%	1%	4%	3%
Education, Health & Welfare	5%	18%	2%	8%	7%	6%	7%	7%
Housing and community amenities	26%	22%	20%	22%	18%	21%	19%	22%
Recreation and culture	13%	18%	11%	19%	23%	17%	11%	15%
Transport and communications	19%	18%	30%	19%	26%	30%	10%	23%
Other economic affairs	3%	5%	2%	4%	3%	5%	8%	3%
Public debt transactions	2%	1%	3%	2%	1%	1%	0%	2%
Other	9%	3%	3%	10%	7%	3%	4%	6%
<b>Total</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>

These differences are important, but despite the varied demands on local government expenditure across the various jurisdictions there are a number of common elements. The FAGs pool is too small, councils are at their upper limit of self-funding capacity and the expenditure demands on councils continue to expand and vary. This is not a scenario where horizontal fiscal equalisation can be achieved.

## Indexation of FAGs

In determining the growth in the funding pool for the coming year, the Commonwealth Government estimates the consumer price index (CPI) and the anticipated population growth for the coming year. The overall growth in the funding pool is determined by these two factors.

At the completion of the financial year, final consumer price index and population figures are available, and the Commonwealth makes a cash adjustment to each state's funding pool.

ALGA has expressed a number of concerns about the inadequate nature of this indexation methodology. Over the last decade in particular, the inadequate escalation methodology has contributed to a growing gap in the funds required by local government to meet increased demand for local community infrastructure and services. In contrast, the general purpose funding provided from the Commonwealth to the states and territories through the GST more transparently reflects growth in the real economy and trends in costs.

## **Local Government Costs versus CPI**

Local Government has argued that the CPI component of FAGs indexation does not adequately reflect the costs associated with maintaining the same level of local government service. The cost base of the range of local government services is driven by factors other than those measured by the CPI.

Most state local government associations have developed a Local Government Cost Index to assist councils in determining a level of rate increase necessary to maintain service levels. Many of these indices are based on methodologies which weight the contribution to the index of key cost drivers. These cost drivers include CPI, employee costs and construction costs.

For example, the Municipal Association of Victoria uses a cost index based on 80% of wage price movements and 20% on construction cost increases.

The Local Government Association of Queensland (LGAQ) uses a 50% weighting of CPI and 50% weighting of the Road and Bridge Construction Index. With recent volatility in the road and bridge construction index, the LGAQ has moved to using five year averages to moderate impacts relating to current economic conditions.

The Western Australian Local Government Association (WALGA) uses a number of indices although CPI, wage prices and construction costs are key drivers.

The Local Government Association of South Australia had the Australian Bureau of Statistics (ABS) construct a basket of local government cost components for their cost index. The cost components included in the model are:-

**Operating:-**

Salaries & Wages	Motor Vehicle Expenses
Superannuation	Printing, publishing & recorded media
Contractual Services (Excluding Waste )	Other Operating Expenses
Waste Management	Insurance
Electricity	Property Expenses
Gas	Consultancy Expenses, and
Water & Sewerage	Telecommunications Expenses
Fuel	

**Capital:-**

- Construction of Buildings
- Construction of Infrastructure
- Purchase of Plant & Equipment

In NSW, the Independent Pricing and Regulatory Tribunal (IPART) has also calculated a Local Government Cost Index using the following weightings:

**Current**

- Employee benefits and on-costs 41.2%
- Plant and equipment leasing (excluding waste management) 0.4%
- Operating contracts (excluding waste management) 1.4%
- Legal and accounting services 1.1%
- Office and building cleaning services 0.2%
- Other business services 6.1%
- Insurance 1.7%
- Telecommunications, telephone and internet services 0.6%
- Printing, publishing and advertising 0.6%
- Motor vehicle parts 0.5%
- Motor vehicle repairs and servicing 0.7%
- Automotive fuel 1.2%

Electricity 2.4%

Gas 0.1%

Water and sewerage 0.5%

Road, footpath, kerbing, bridge and drain building materials 3.0%

Other building and construction materials 0.9%

Office supplies 0.4%

Emergency services levies 1.4%

Other expenses 8.8%

**Total Current 73.1%**

### **Capital**

Buildings – non-dwelling 6.9%

Construction works – roads, drains, footpaths, kerbing, bridges 13.7%

Construction works – other 1.4%

Plant and equipment – machinery 4.2%

Plant and equipment – furniture etc. 0.3%

Information technology and software 0.5%

**Total Capital 26.9%**

As can be seen from the above, employee costs are the major driver followed by road construction costs, none of which are in any way part of the FAGs indexation determination.

### **Comparison of Local Government Cost Index and CPI**

	2003	2004	2005	2006	2007	2008	2009	2010	Increase 2003 to 2010
NSW IPART	4.4%	4.1%	4.3%	4.2%	3.5%	4.0%	3.4%	3.0%	35.4%
LGASA	4.1%	4.1%	3.4%	3.6%	3.9%	3.9%	4.4%	2.8%	34.5%
CPI	2.8%	2.7%	2.5%	2.5%	4.0%	2.1%	4.5%	1.5%	24.8%

Source: IPART, LGA SA and ABS 6401.0

The key issue is that the CPI does not effectively measure the increasing cost of providing a similar basket of local government services on an annual basis. The value of FAGs is clearly eroded by the current indexation approach.

The table below provides an analysis of FAGs outcomes if a form of local government cost index was used to replace CPI. Population increase is also included in these calculations as it is in the current FAGS methodology. The alternative cost indices use different weightings of the wage price index (WPI), ABS Road & Bridge Index and CPI.

The analysis shows that, using some form of Local Government Cost Index would have seen a FAGs increase of between 83% and 85% between 1999/00 and 2011/12. This compares with the actual increase of only 70%. In 2011/12, total FAGS would have been between \$2.37 billion and \$2.39 billion, more than \$210 million extra (around 10%) in FAGs funding to local government.

**Table 5.2: FAGS increase using alternative cost indices**

	<b>Actual FAGS</b>	<b>WPI</b>	<b>50% CPI&amp; 50% road index</b>	<b>80% WPI&amp; 20% road index</b>	<b>50% WPI, 30% road, 20% CPI</b>
1999-00	\$1,271.3	\$1,285.68	\$1,297.70	\$1,290.05	\$1,292.7
2000-01	\$1,328.0	\$1,348.56	\$1,371.49	\$1,350.71	\$1,358.9
2001-02	\$1,394.4	\$1,409.26	\$1,433.02	\$1,412.52	\$1,420.5
2002-03	\$1,455.1	\$1,477.04	\$1,511.04	\$1,486.46	\$1,495.4
2003-04	\$1,501.0	\$1,547.03	\$1,572.85	\$1,556.18	\$1,562.0
2004-05	\$1,555.1	\$1,626.77	\$1,649.65	\$1,638.66	\$1,641.9
2005-06	\$1,619.3	\$1,718.77	\$1,765.04	\$1,740.31	\$1,747.8
2006-07	\$1,686.7	\$1,816.01	\$1,842.75	\$1,836.85	\$1,836.7
2007-08	\$1,783.0	\$1,925.93	\$1,986.87	\$1,959.49	\$1,966.2
2008-09	\$1,871.6	\$2,038.93	\$2,071.32	\$2,071.33	\$2,066.8
2009-10	\$1,933.3	\$2,129.79	\$2,157.81	\$2,161.63	\$2,155.7
2010-11	\$2,057.2	\$2,236.26	\$2,282.17	\$2,276.58	\$2,273.0
2011-12	\$2,158.8	\$2,346.43	\$2,370.67	\$2,389.66	\$2,375.0
	69.8%	82.5%	82.7%	85.2%	83.7%

Having FAGs tied to a share of Commonwealth taxation revenue (1%) is ALGA's preferred approach. However it is also important that an appropriate indexation methodology be used through a Local Government Cost Index which would help to maintain the value of FAGs for councils.

ALGA strongly supports the development of a national approach to a Local Government Cost Index. ABS currently publishes the Producer Price Index which covers a range of industries and services and ALGA supports the development of a Local Government Cost Index by the Bureau.

### The ABS intercensal error

As noted earlier, part of the cash adjustment to each States' FAGs is related to updated population estimates provided by ABS. The results of the 2011 Census led to some significant adjustments in population Australia-wide and within each State. ABS has acknowledged that the intercensal error for the 2006-2011 period is the highest on record.

Where adjustments are significant and involve a reduction in anticipated grants, this can have an impact on council budgets as funding certainty is reduced.

This table shows the differences in population by State at the time of the 2011/12 budget compared with the estimates contained in the final budget outcome documents on which adjustments are based. The Australian population at December 2011 was 341,434 less than was forecast at the time of the 2011/12 budget. The largest decrease in population estimate was in Queensland where the final estimate is 2.8% less than the budget estimate.

#### December 2011 Population estimates

State/Territory	Budget 11/12	Final 11/12 Budget Outcome	Change	% change
NSW	7,360,346	7,247,669	-112,677	-1.5%
VIC	5,674,844	5,574,455	-100,389	-1.8%
QLD	4,640,631	4,513,009	-127,622	-2.8%
WA	2,365,603	2,387,232	21,629	0.9%
SA	1,667,161	1,645,040	-22,121	-1.3%
TAS	513,875	511,718	-2,157	-0.4%
ACT	365,984	370,729	4,745	1.3%
NT	235,207	232,365	-2,842	-1.2%
	22,823,651	22,482,217	-341,434	-1.5%

This led to a nationwide reduction in FAGs of 2.5%. The Commonwealth immediately reduced payments, even after the Budget announcements. While local government supports the need to ensure public funds are spent with the utmost care and probity, the impact of reducing already strapped councils grant by 2.5% is substantial and may well be the difference between a service being provided or not. In its submission to the ABS on this issue, ALGA highlighted the position of vulnerable councils and called for greater consultation with local government, as well as investigating a way to apply any future adjustments in a more phased manner.

This intercensal adjustment also highlighted an ongoing risk to local government funding for the future. As long as the indexation of FAGs is so tightly linked to population, and population is only thoroughly examined every five years through the census, it exposes local government to uncertainty about unexpected funding reductions. This is at a time when local government expenditure continues to rise, regardless of population growth, as it is impacted by a wider range of factors.

The intercensal adjustment, as well as the indices developed by various state and territory local government associations highlight that the elements which make up the FAGs indexation are completely inappropriate as an indicator of true cost pressures faced by councils.



## Ensuring FAGs remain untied

ALGA's position on whether FAGs funding is to remain untied is clear. ALGA would strongly object to any suggestion that FAGs should be tied. The National Principles already place conditions and standards on how councils receive their funding. However, local government would consider a decision to tie FAGs funding to specific outcomes determined by the Commonwealth to be entirely inconsistent with the purpose of the grants.

Tying the grants creates issues related to the equitable treatment of local and state government funding. As noted earlier, FAGs are general purpose funding in nature, rather than a targeted program. They are designed to ensure that councils can undertake their vital work and provide primary services to communities according to those communities needs and based on councils' knowledge. The States are not expected to meet Commonwealth policy needs when using their general purpose funding. To treat local government differently would be inequitable.

In recent years and certainly since the introduction of the GST in 2000, there have been a number of times where the Commonwealth and the states have worked together through the Council of Australian Governments (COAG) process to bring about a national outcome. Key examples of this include reforms to education, as well as healthcare. In each of these scenarios, funding in the form of the Specific Purpose Payment or SPPs has been made available to the states. These payments do not interfere with the amount of GST funding. Most importantly of all, those SPPs are not drawn from the GST pool. Local government should be treated in the same way. If the Commonwealth has specific outcomes in mind, it should provide additional funding tied to that outcome, rather than seek to tie general purpose funding.

The second issue is protecting the independence and financial sustainability of local government. Local government is not a branch or an arm of the Commonwealth. It is a level of government in its own right. Local councils know their communities needs and concerns. Each community is different, and any attempt to tie local government FAGs funding to particular outcomes would raise many questions:

- Who determines the outcomes?
- Who determines the time frames for delivery?
- Will FAGs funding be vulnerable to changes in Commonwealth political needs?
- Who will analyse the outcomes?

These questions highlight the final issue of concern for local government in ensuring FAGs remain untied: who will manage and pay for the additional administration of such a large program? Currently the administrative costs of the FAGs program are kept to a minimum and are generally borne by the states through the costs of their local government grants commissions. These commissions usually have very small secretariats and a number of part time commissioners. The costs for councils reflect the effort required to provide the information local government grants

commissions need to make determinations related to grant allocations. Once received by councils, the FAGs form part of the general revenue of councils and require no special accounting treatment.

If, however, the FAGs was to be reshaped into a targeted program with specified Commonwealth outcomes then outcome measures would be developed and reported against and program evaluation data would need to be collected and assessed. Significant additional resources would be required within the Commonwealth to administer and evaluate the program. Significant resources might be required in councils if the program moved to an applications-based approach or to an approach requiring separate and detailed acquittal.

An example of a comparable administered program is Caring for Our Country. This is a funding program with a value of less than one-third of FAGs and it's annual expenditure on administration is nearly \$2.5 million per year<sup>6</sup>. Tied funding programs, while politically attractive, are very expensive to administer.

Local government is committed to ensuring that FAGs, as a general purpose payment, like the GST remain untied.

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<sup>6</sup> Department of Agriculture, Forestry and Fisheries, *Portfolio Budget Statement*, May 2012, p. 18