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

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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.

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 that cover vast geographic areas, like Australia, Canada and the USA. 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 USA, 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'.

A similar embryonic debate is beginning to take shape in Australia (Galligan 1995). However, almost all the extant discussion has focused entirely on federal–state relationships to the virtual exclusion of local government (Sharman 1998). 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 sections. 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.

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.

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

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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 percent), followed by intergovernmental grants (17.4 percent) and sale of goods and services (22.9 percent). 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.

Nevertheless, there is considerable variation in the composition of local government revenue across the states and over time (AURDR 1994a).

Table 1: Taxation by Level of Government

Level	1990/91	1991/92	1992/93	1993/94	1994/95	1995/96
Commonwealth	93,413	87,530	88,830	93,328	105,092	115,486
	(78.5)	(76.1)	(75.4)	(74.5)	(75.9)	(76.3)
State/Territory	21,121	22,572	24,093	26,787	28,144	30,360
	(17.7)	(19.8)	(20.4)	(21.4)	(20.3)	(20.1)
Local	4,480	4,703	4,968	5,145	5,265	5,428
	(3.8)	(4.1)	(4.2)	(4.1)	(3.8)	(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.

Table 2: Local Government Revenue Sources, 1995/96

Revenue Source	NSW	Vic	Qld	SA	WA	Tas	NT	Total
Taxes, fees and fines	1,979	1,287	1,109	461	512	142	31	5,522
	(49.2)	(48.9)	(37.6)	(58.3)	(46.0)	(46.3)	(43.1)	(46.5)
Public trading	80	0	417	1	0	26	0	532
	(2.0)	(0.0)	(14.1)	(0.1)	(0.0)	(8.5)	(0.0)	(4.4)
Interest received	175	74	51	43	43	12	1	399
	(4.3)	(2.8)	(1.7)	(5.4)	(3.9)	(3.9)	(1.4)	(3.4)
Grants received	642	589	388	126	238	67	24	2,074
	(15.6)	(22.4)	(13.2)	(15.9)	(21.4)	(21.8)	(33.3)	(17.4)
Sales of goods	807	680	788	125	257	47	16	2720
and services	(20.0)	(25.8)	(26.7)	(15.8)	(23.1)	(15.3)	(22.2)	(22.9)
Other revenue	343	2	194	34	62	13	0	649
	(8.5)	(0.1)	(6.6)	(4.3)	(5.6)	(4.2)	(0.0)	(5.5)
Total	4,026	2,633	2,947	791	1,112	307	72	11,888
	(100.0)	(100.0)	(100.0)	(100.0)	(100.0)	(100.0)	(100.0)	(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.

For example, the proportion of revenue derived from grants ranges from 33 percent in the Northern Territory to just over 13 percent in Queensland, while taxes, fees and fines make up 58 percent of local government revenue in South Australia and just 38 percent in Queensland. The AURDR (1994a: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 USA, 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. 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 USA, 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 USA 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 USA lies in 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).

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).

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 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 only responsible for a relatively narrow range

Table 3: National Grant Allocation, 1991–92 to 1997–98

	General purpose	Local Roads	Total
1991–92	714.969	303.174	1018.14
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.

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	48.10	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.

Table 5: Specific Purpose Payments to Local Government, 1996–97

Title	NSW	Vic	Qld	SA	WA	Tas	NT	Total
Current payments								
Home & community care	979	1093	92	148	406	113	-	2832
Aged/disabled homes & hostels	6415	12236	2339	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
Capital payments								
Aged/disabled homes & 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.

of property-related functions. 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. 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. First, 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 will be developed at length in the next section.

Second, 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 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.

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). The magnitude and composition of these payments directly reflects the modifications in Commonwealth/local relations.

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. 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.

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. The inter-state distribution 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 population; and (iv) provision for informal local government bodies, such as Aboriginal communities in remote areas, to receive grants. 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' (NOLG 1997:59). 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 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. 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. 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 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, while 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 made generate '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). 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).

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, while 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 assessed annual value. Substantial differentials exist in the ability of local governments to generate revenue derive from these differences (MCS 1996:15).

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 is whether limits are set on the proportion of total general rates to be raised from a flat charge per property. Second, across the states discounts for rate remissions also vary. Third, in all states and territories there is considerable discretion in the use of differential rates for residential, commercial, industrial property, etc. Finally, rate capping or pegging may impact upon the revenue capacity of local governments across states.

How much revenue assistance is given to local governments will also depend on the methodology employed by the relevant LGGC. First, 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. Second, 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 three 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, it has been 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 (NOLG

1997:101). However, the NOLG (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 and Wollongong areas, with the remainder of the state receiving the balance. 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. 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. On the other hand, South Australia distinguishes between metropolitan and non-metropolitan roads for the local roads component. The general purpose component is distributed in an identical manner, except that roads are divided into six categories. 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.

Differences in the allocation of road grants across states arise for four main reasons (NOLG 1997). First, some states distribute some part of their grants solely on the basis of road length and population, like South Australia and NSW.

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 young people and aged	No	No	No	No	No	No	No
Climatic influences	No	No	No	No	No	No	No

Source: NOLG (1997), 1996–97 Report on the Operation of the Local Government (Financial Assistance) Act 1995.

Other states, such as Western Australia, have constructed sophisticated asset preservation models that take into account maintenance and eventual replacement. Second, most other states factor additional disability factors into assessing expenditure needs. These needs may relate to climate, topography, traffic volume, and so on. Third, a number of states, including Tasmania and NSW, make allowances for the type of road in the allocation. Finally, several states use different methods to allocate the local roads component in the general purpose component, although others do not.

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 various state LGGCs in the use of these factors.

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.

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. 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). 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.

However, it has been argued that LGGC methodologies have influenced the efficiency of local councils, irrespective of their lack of legislative mandate (AURDR 1994a). Both 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, sparcity, location and cost disabilities, [the grants system] may not be conducive to an efficient allocation if resources' (AURDR 1994a:55). 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

Table 7: 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: AURDR (1994) National Survey of Councils

are cost effective' (AURDR 1994a:14).

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 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.

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 7, 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.

Concluding Remarks

In common with all federal systems of government, the Australian fiscal federalism is characterised by fiscal imbalance. First, 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 second, 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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