VICTORIA GRANTS COMMISSION

General Purpose Grants - Review of Standardised Revenue Assessment:

Implementation of Recommendations

What are general purpose grants?

General purpose grants are the largest component of the untied general revenue assistance provided by the Australian Government to local government. The Victoria Grants Commission is responsible for recommending the allocation of these funds to Victorian councils. About $265 million has been made available for distribution to Victorian councils as general purpose grants in 2004/05.

Are there guidelines for how the Commission allocates grants?

All State Grants Commissions are required to allocate general purpose grants in accordance with a set of nationally agreed principles. These require that the funds be allocated, as far as practicable, on the basis of full horizontal equalisation; that is, on the basis of the relative needs of councils.

The national principles also require the Commissions to allocate general purpose grants on an effort or policy neutral basis, ignoring as far as possible the policies of individual councils in terms of expenditure and revenue effort. In addition, the Commissions are required to take account of the grant support provided to councils by other levels of government and to provide a minimum grant to each council even if the needs based assessment indicates that the council should receive less than that amount. In 2004/05, the minimum grant is equivalent to $16.20 per capita, and seven Victorian councils have received this amount.

How are general purpose grants currently allocated?

The Victoria Grants Commission assesses the relative needs of all Victorian councils by calculating each council's standardised expenditure (or relative expenditure needs) and their standardised revenue (or relative revenue raising capacity).

This process produces a raw grant for each council, which is the difference between its standardised expenditure and its standardised revenue. The available general purpose grants pool is then allocated in proportion to each council's raw grant, taking account of the minimum grant requirement.

To provide some stability in grant outcomes, the Commission has, in recent years, capped both increases and decreases in general purpose grant movements. In 2004/05, grant decreases have been limited to 6% (compared with 2003/04) and increases have been restricted to 15%, except where this is overridden by the minimum grant requirement.

How has standardised revenue been calculated in the past?

A council's standardised revenue is intended to reflect its relative capacity to raise revenue from its community. In the past, standardised revenue has been calculated for each council by multiplying its valuation base (on a net annual value basis) by the average rate in the dollar across all Victorian councils. The payments in lieu of rates received by some councils for major facilities such as power stations and airports are added to their standardised revenue to ensure that all councils are treated on an equitable basis.

Until 2003/04, rate revenue raising capacity was based on a three-year average of each council's valuation base to smooth annual fluctuations. However, the 2001 Review of General Purpose Grant Methodology recommended that the Commission adopt a two-year average of valuations as data quality improved with the introduction of consistent two-yearly valuations. With data now available from the second biennial revaluation conducted in 2002, the Commission decided to implement this recommendation for the 2004/05 allocations.

Given the rapid escalation in valuations over recent years, the Commission acknowledges that a council's actual capacity to increase rate revenue may not match the increase in standardised revenue based on valuations. This is achieved by constraining increases in each council's assessed revenue capacity. In 2004/05, the maximum increase for each council was set at the statewide average increase in standardised revenue (12%) plus the council's own rate of population growth to reflect growth in the property base.

Why has the Commission reviewed the way standardised revenue is assessed?

In 2003 the Victoria Grants Commission initiated a review of the way in which standardised revenue is assessed. This arose from a number of concerns the Commission identified about the current method of calculating standardised revenue, which were reinforced through consultation with councils. These concerns included the impact of rapidly increasing valuations on the calculation of standardised revenue and recognition that councils have differing levels of access to other sources of revenue such as user fees and charges that are not currently taken into account in the allocation model.

The Commission engaged a consultant to assist it with the review and a Discussion Paper was released in September 2003. Regional seminars were conducted in October 2003 to discuss the relevant issues more fully with councils, and councils were then provided with an opportunity to make written submissions. This feedback informed the Final Report, which was circulated to all councils in March 2004.

What recommendations did the Final Report make?

The Final Report made a series of recommendations in relation to the assessment of revenue capacity:

1. That the Commission continue the current system of using standardised rate revenues, and not introduce either valuation discounting or a differential property class approach.
2. That the Commission continue to use annual caps on increases in standardised rate revenues, to soften the impacts of changes on individual councils, but modify the caps by distinguishing between valuation changes and increases in the property base.
3. That the CIV valuation base be adopted for standardised rate revenue calculations.
4. That no specific adjustment for socio-economic status be included in the revenue assessment (in relation to the assessment of standardised rate revenue) at this time.
5. That the current method of assessing other grants under the inclusion approach in standardised expenditure be continued.
6. That a revenue component be introduced for user fees and charges, by including in each expenditure function the median other revenues for that function, weighted by appropriate adjustors.

How did the Commission respond to the recommendations?

In releasing the Final Report in March 2004, the Commission indicated to councils that it had decided to adopt its recommendations on an in-principle basis, but would not implement the recommendations until 2005/06. The decision to delay implementation was intended to provide the opportunity for detailed modelling to more fully inform councils of the likely impact on grant outcomes and allow appropriate consideration to be given to issues yet to be resolved, including the adjustors to be applied in assessing standardised user fees and charges (Recommendation 6).

While the 2004/05 general purpose grants have been allocated under the existing methodology, the Commission undertook to remodel these grants to incorporate the Final Report recommendations, and make this information available to councils. This data will allow councils to compare their general purpose grant outcome for 2004/05 under the existing methodology to a projected grant for 2005/06 incorporating the recommended changes to the methodology. It will also allow councils sufficient opportunity to budget for possible changes to their general purpose grant from 2005/06.

How will the allocation methodology change?

A number of the review recommendations will not result in a change to the way the Commission assesses councils' standardised revenue. However, there are two major changes that will be made and these are reflected in the modelling that accompanies this information sheet:

- standardised rate revenue capacity will, in future, be based on capital improved valuations, rather than net annual values as has been the case up to and including 2004/05; and
- an assessment of each council's relative capacity to generate revenue from user fees and charges will be included in the standardised revenue calculation. The differing capacity of councils to generate revenue from this source will be reflected through a series of "revenue adjustors".

Why will standardised rate revenue capacity be based on capital improved valuations?

From 2005/06, the Commission will base its calculation of standardised rate revenue on the capital improved valuation (CIV) base of each council. This recognises that most councils now rate on the basis of CIV and will improve the transparency and simplicity of the grants allocation system.

A two-year moving average of CIV data for each council will be used in calculating standardised rate revenue capacity. The valuation base of each council, calculated in this manner, will be multiplied by the average rate in the dollar across all Victorian councils. Actual payments received in lieu of rates will continue to be added to this result and the Commission will continue to constrain increases in standardised rate revenue for individual councils in line with the statewide average increase in standardised rate revenue adjusted by the council's own rate of population growth to reflect growth in the property base.

How will the move to capital improved valuations affect grant outcomes?

The use of capital improved valuations will tend to favour those councils with a ratio of net annual values to capital improved values that is higher than the state average. These tend to be those councils with a significant commercial and/or industrial property base relative to those that have predominantly residential or farming property bases.

Why will revenue from user fees and charges be included in the assessment of revenue capacity?

User fees and charges comprise about 19% of councils' aggregate revenue base. The Commission's assessment of councils' expenditure needs encompasses virtually all recurrent expenditure; however, to date, revenue from user fees and charges has not been included in the assessment of councils' revenue capacity. Councils have differing levels of access to user fees and charges and, on equity grounds, there is a strong case for their inclusion in the allocation model.

How will revenue from user fees and charges be included?

Actual revenues from fees and charges vary widely across councils. Average (or mean) revenues can be distorted by very large revenues collected by one or two councils. Therefore, the Commission intends to use the median (or middle) revenue figure for most categories of activity, as shown in the table below. However, for two functions where the median revenue exceeds the mean, the mean figure will be used.

How will the differing capacity of councils to generate user fees and charges be taken into account?

In at least some of the functional areas, some councils clearly have a greater capacity to generate user fees and charges than others councils due to their particular characteristics. The Commission intends to apply a set of revenue adjustors to the standard fees and charges for those activities to take account of this. These will be similar in application to the cost adjustors used in the calculation of standardised expenditure.

The revenue adjustors the Commission intends to use are:

- Household Income – recognises the impact that average household incomes have on the level of fees and charges that a council can raise
- Socio-Economic – recognises that residents of areas of relative socio-economic disadvantage will have a relatively lower capacity to pay fees and charges
- Tourism – recognises the impact that relatively high levels of tourism have on the level of fees and charges that a council can raise
- Value of Development – recognises that municipalities that have a relatively high value of development (as measured by building approvals) have a greater capacity to raise fees and charges, particularly in terms of planning and building services
- Valuations (Commercial/Industrial) – recognises that municipalities that have a high proportion of commercial and industrial properties (as a proportion of their overall valuation base) have a greater capacity to raise more revenue, particularly in respect of parking fees and fines

The proposed application of these revenue adjustors is shown in the following table:

Function	Standard Fees & Charges	Revenue Adjustors
Governance	$5.67 per person *	Nil
Family & Children	$8.56 per person	Socio-Economic
Aged & Disabled	$73.39 per person (over 60) *	Household Income
Recreation & Culture	$9.87 per person	Valuations (Commercial/Ind.)
Waste Management	$19.31 per dwelling	Nil
Local Roads & Bridges	$0.48 per person	Nil
Traffic & Street Management	$3.28 per person	Valuations (Commercial/Ind.)
Other Infrastructure Services	$2.29 per person	Nil
Business & Economic Services	$20.79 per person	Tourism (50%) Value of Development (50%)

Standard fees and charges are median actual revenues for all councils for 2002/03, except where these are higher than the mean fees and charges revenue for that function. In those two cases, the mean is used as the standard (denoted by *).

How will the inclusion of standardised fees and charges affect grant outcomes?

In the calculation of general purpose grants, the difference between a council's expenditure needs (standardised expenditure) and revenue capacity (standardised revenue) - the raw grant - is critical in determining the grant received. Councils for which the ratio of standardised expenditure to standardised revenue is comparatively low will have a relatively small raw grant and will therefore receive a relatively low grant (on a per capita basis). Most metropolitan councils are in this situation, whereas rural and regional councils tend to have a comparatively high ratio of standardised expenditure to standardised revenue, due to higher per capita expenditure needs and lower per capita rate revenue raising capacity. These councils therefore generally receive grants that, on a per capita basis, are above the State average.

The inclusion of standardised fees and charges will add to the standardised revenue base of all councils and will therefore reduce the raw grant for all councils. However, on a proportional basis, raw grants will decrease more for metropolitan councils than for rural and regional councils as shown in the Commission's modelling. As a result, the inclusion of standardised fees and charges will have a positive impact for most rural and regional councils relative to most metropolitan councils.

What transition arrangements will be used to introduce the changes?

In recent years, the Commission has capped the decrease in each individual council's general purpose grant at 6%, compared with the grant for the previous year. While relatively straightforward, this has not differentiated between councils in terms of the relative impact that such a decrease has on their revenue base.

In moving to grant outcomes fully based on the revised methodology, the Commission plans to tie the maximum decrease in each council's grant to a proportion of its "untied revenue". Untied revenue will be defined as the individual council's rate revenue base for the previous year, plus their financial assistance grants (general purpose plus local roads grants) for the previous year. This mechanism has been suggested by the National Office of Local Government as a way of phasing in significant changes to grants on an equitable basis over a period of time.

In the first year, it is proposed that any grant decrease should be limited to 0.50% of untied revenue.

For example, for a council with rate revenue of $50 million and total financial assistance grants of $10 million, total untied revenue is $60 million. Any grant decrease in the initial year would therefore be limited to $300,000.

The maximum reduction for the second year would be 0.75% of untied revenue, increasing to 1.00% in the third year and 1.25% in the fourth year.

This transition process is expected to move all councils to their actual grant levels within a four year period.

What will be the impact of these changes on my council's grant outcome?

The Commission has prepared a spreadsheet (Table 1) to enable all councils to compare their actual general purpose grant outcome for 2004/05 to what their grant would have been had the methodology changes been incorporated in the allocations.

The first block of data (green headings) shows the calculation of each council's actual grant for 2004/05. This shows grants on both an uncapped basis and a capped basis, highlighting the impact on all councils' grant outcomes of the application of a 6% limit on grant decreases and a 15% ceiling on grant increases.

The second block of data (blue headings) shows a projected grant for 2005/06, incorporating the changes to the standardised revenue calculation, but with all other parameters unchanged. Again, these are shown on an uncapped basis and then on a capped basis, assuming that a limit of 0.50% of each individual council's untied revenue is applied to any decrease in that council's general purpose grant outcome.

The third block of data (orange headings) provides a comparison between the actual and recalculated grant outcomes.

A separate spreadsheet (Table 2) shows the detailed calculation of standardised revenue used in Table 1 for both the 2004/05 actual grants and the 2005/06 projected grants. This also highlights the impact of the constraint on growth in standardised rate revenue for individual councils applied by the Commission.

What will my council's actual grant be for 2005/06?

It is important to note that, while the projections for 2005/06 incorporate the changes to the method of calculating standardised revenue, all other parameters are the same as were used in allocating the actual 2004/05 grants. No changes have been assumed in relation to the overall size of the grant pool, property valuations, council expenditure and revenue data or demographic information. The projection can be used as a guide to the impact of the methodology changes on future grant outcomes, but cannot be used as a forecast of actual grant outcomes for 2005/06.

The Commission is unable to provide a forecast of actual outcomes for 2005/06 or future years at this stage.

What happens now?

The Commission will conduct a series of regional meetings with all councils in early September to provide further information on the modelling and the impact of implementing the package of changes. Councils will then have an opportunity to make written submissions to assist the Commission in finalising the changes to the methodology, including the application of revenue adjustors and the proposed transition arrangements. Written submissions should be sent to the Commission by Friday 29 October 2004.

Further information

Further information about the Commission's current allocation methodology and the Review of Standardised Revenue Assessment can be found in the following publications:

- *Victoria Grants Commission Annual Report 2002/03*, Victoria Grants Commission, October 2003
- *Allocation of General Purpose Grants: Review of Standardised Revenue Assessment – Discussion Paper,* Victoria Grants Commission, October 2003
- *Allocation of General Purpose Grants: Review of Standardised Revenue Assessment – Report on Consultation and Final Recommendations,* Victoria Grants Commission, March 2004

These publications are available on the Victoria Grants Commission's web-site www.doi.vic.gov.au/vgc or may be obtained by contacting the Commission on tel: (03) 9208 3609.

August 2004