VICTORIA GRANTS COMMISSION

Allocation of General Purpose Grants:

Review of Standardised Revenue Assessment

Report on Consultation and Final Recommendations

PREPARED FOR THE VGC BY

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Executive Summary

Process

This Report outlines a number of proposals for changing the way the Victoria Grants Commission (VGC) assesses Standardised Revenue in calculating General Purpose Grants.

The Report follows:

- A Discussion Paper, released in early October 2003
- A series of regional seminars held:
  - In Ararat, Monday 27 October 2003
  - In Shepparton, Tuesday 28 October 2003
  - In Melbourne, Wednesday 29 October 2003
- An opportunity for councils to make written submissions to the VGC by 28 November.

The VGC received 42 submissions on the review. The key recommendations from each are summarised in Appendix 1, and illustrative comments are included in the discussion in sections 5-7.

The original timetable envisaged a Final Report by the end of 2003, with the VGC assessing the recommendations and including any changes in the grants for 2004/05. However, many submissions argued for a longer process. Councils urged the VGC to release the results of the consultation process and any revisions to the recommendations, and also give councils information on the likely impact of the changes.

To provide a useful resource for councils, this Report is a stand-alone document. It incorporates most of the material in the Discussion Paper, reports on reactions arising from the consultation, and provides further analysis and final recommendations.

Background

The Victoria Grants Commission allocates some $280 million of Commonwealth funds as General Purpose Grants to Victorian councils each year.

These funds form part of Federal tax sharing arrangements, and are governed by several National Principles. In allocating the funds, the VGC is required to take account of differences both:

- In the *expenditure* required by councils in the performance of their functions; and
- In their capacity to raise *revenue*.

From March 2000 to May 2001, the VGC conducted a thorough review of the methodology for General Purpose Grants (referred to in this Discussion Paper as the 2000/01 Review). That Review considered both the expenditure and revenue aspects of the methodology, and recommended a number of changes to each. Following consultation with councils, the VGC adopted a revised methodology from 2002/03.

Following the 2000/01 Review, a number of issues emerged on the revenue aspects of the methodology:

- A review by the Commonwealth Grants Commission of all states' grant methodologies suggested some changes – notably the inclusion of revenues that are not currently taken account of;
- In response to the recent property price boom, the VGC instituted controls on annual increases in standardised rate revenues. However, there is concern that this measure is not sustainable in the long term;
- The VGC was also concerned that communities' capacity to pay could be incorporated better;
- Councils have raised some issues – especially the continued use of Net Annual Value as the valuation base for the VGC calculations.

The current process investigated these issues, and the Discussion Paper made a number of recommendations to improve the current methodology. As noted below, this Report revised those recommendations in the light of the consultation with, and issues raised by, councils.

Most submissions saw equity (or fairness) as the central principle for grant distribution, and this issue is consequently discussed in some detail in this report.

Recommendations

This Report gives final recommendations to the VGC for improvements to the methodology for assessing revenue in General Purpose Grants calculations. The final recommendations are:

1. That the VGC continues the current system of using standardised rate revenues, and does not introduce either valuation discounting or a differential property class approach.

   [Confirmed from recommendation in Discussion Paper]

2. That the VGC 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.

   [Changed from recommendation in Discussion Paper, which recommended ceasing these caps]

3. That the VGC move to the CIV valuation base for standardised rate revenue calculations.

   [Confirmed from recommendation in Discussion Paper]

4. That no specific adjustment for socio-economic status be included in the revenue assessment at this time.

   [Confirmed from recommendation in Discussion Paper]

5. That the VGC continue with its current method of assessing other grants under the inclusion approach in Standardised Expenditure.

   [Confirmed from recommendation in Discussion Paper]

6. That the VGC include a revenue component for user fees and charges, by including in each expenditure function the median other revenues for that function, weighted by appropriate adjustors.

   [Modified from recommendation in Discussion Paper, which suggested a scaled $55 per head on standardised revenue]

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1. Introduction

In August 2003, the Victoria Grants Commission (VGC) appointed Milbur Consulting Pty Ltd to conduct a review of Standardised Revenue Calculations in the calculation of General Purpose Grants. The brief for the project specified two key outputs:

- A Discussion Paper, to be prepared by the end of September, for detailed consultation with councils; and
- A Final Report, to be completed by the end of December, to enable the VGC to incorporate the findings in the allocation of grants for the 2004/05 financial year.

The VGC received a total of 42 submissions – one from the MAV, 17 from metropolitan councils (1 of these being a joint submission from a group of councils), and 24 from rural and regional councils (1 of these from a group of smaller councils). Key recommendations from each are noted in Appendix 1, and illustrative comments included in each section below.

Many submissions argued for a longer process than originally envisaged. Councils urged the VGC to release the results of the consultation process and any revisions to the recommendations, and also give councils information on the likely impact of the changes. In these views, the VGC should not implement any changes prior to giving councils the opportunity to review this information.

To provide a useful resource for councils, this Report is a stand-alone document. It incorporates most of the material in the Discussion Paper, reports on reactions arising from the consultation, and provides further analysis and final recommendations.

1.1 Scope of Project

The consultancy brief for this project set out the scope:

> The project involves a review of the methodology used by the Victoria Grants Commission to calculate standardised revenue in the general purpose grants model.
>
> The Commission has a number of concerns about the current method of calculating standardised revenue, which have been reinforced through consultation with councils:
>
> - Rapidly increasing valuations across many parts of Victoria are having a significant impact on the calculation of standardised revenue and the general purpose grants outcomes for many councils. The Commission has mitigated this impact in both 2002/03 and 2003/04 by applying a cap to increases in standardised revenue; however, such a mechanism is unlikely to be sustainable in the long-term;
> - The current method of calculating standardised revenue focuses only on relative valuations and does not take account of factors such as the relative socio-economic status or income of ratepayers, which impact on each council's relative capacity to raise revenue from their its; and
> - Councils have differing levels of access to other sources of revenue such as user charges which are not currently taken into account in the allocation model.

The Victoria Grants Commission wishes to address these and other relevant issues to ensure that the methodology it uses to allocate general purpose grants continues to be relevant to the needs of councils.

From this Brief, the Review took the following steps:

- A Discussion Paper, released in early October 2003
- A series of regional seminars held:
  - In Ararat, Monday 27 October 2003
  - In Shepparton, Tuesday 28 October 2003
  - In Melbourne, Wednesday 29 October 2003
- An opportunity for councils to make written submissions to the VGC by 28 November.
- This Report on Consultation and Final Recommendations.

1.2 The 2000/01 Review

This project draws on the Review of General Purpose Grants, which the VGC conducted between March 2000 and May 2001 (referred to as the 2000/01 Review). The process of this earlier review was:

April – May 2000	Initial seminars and council questionnaire
October	Publication of Issues and Options paper
November	Consultation with Councils on Issues and Options
May 2001	Publication of Final Report, including results of consultation process
2002/03	New methodology used for Grants

The 2000/01 Review considered both revenue and expenditure aspects of the General Purpose Grant methodology. While it recommended one major change on the revenue side (the process for assessing other grant revenues – see section 6 below), the Final Report concentrated on changes to the expenditure methodology.

Both the Issues and Options Paper and the Final Report discussed key issues on the revenue side, including the use of valuations, the valuation base, and the treatment of other revenues. The ground covered in these earlier discussions is referred to in the relevant sections in this Report.

1.3 Subsequent Issues Raised by Councils

The VGC has an extensive consultation program with councils. There are four main aspects:

- Meetings with individual councils – the VGC is now two years into a three year program which will involve meeting one-on-one with every council in Victoria;
- An opportunity each year in February for councils to make formal submissions to the VGC for consideration in the allocation of grants for the following year;
- Regional seminars, held in May each year following the announcement of the grants for the new financial year; and
- Opportunities for council input to major reviews of the grants methodology, both through regional seminars and submissions.

Since the VGC adopted the new methodology for General Purpose Grants from 2002/03, councils have raised a number of issues in submissions, and in meetings with the VGC. On the revenue assessment side, the three key queries have been:

- Why is the VGC continuing to use NAV as the valuation base, when nearly all councils now use CIV?
- Many communities raise rates issues centring on capacity to pay: either from asset rich/income poor pensioners, or from socio-economic status. Why does the VGC not deal with such capacity to pay issues?
- Why is no account taken of other revenues such as car parking?

These questions were investigated in the Discussion Paper, and are discussed in the relevant sections below.

1.4 Council Comments on Process

Councils were generally complimentary on the process followed by the VGC. Melbourne commented

> *"The Commission is to be commended on the extent of consideration and consultation that has been undertaken in this Review and the consultation that is undertaken on a regular basis."*

Mildura

> *"we would like to commend the Commission for the way it has managed the consultation process. Our officers found the regional information session in Ararat informative, and the discussion paper 'user-friendly'."*

One process issue arose during the consultation – the extent to which the discussion should stay at an 'in-principle' level or should include modelling of the results for each council. As Surf Coast noted

> *"At the Melbourne seminar, it was suggested that the VGC advise councils about the outcomes before a decision is taken. The VGC rejected this hip pocket method. However it is difficult to understand how this will work and how it will impact on council grants. It is perhaps unfair to ask councils to comment on such a complex package without more information about how it will work."*

Greater Geelong agreed

> *"While we can appreciate the intention to gain 'agreement in principle', the practicality is that Council needs to know how these changes will affect its ability to fund and deliver programs. . . The proposed changes can only be seriously evaluated with the consequences known up front. It is suggested that remodelling of the 2003/04 grants would be a useful basis to see the effects of the proposed changes."*

And East Gippsland also referred to the modelling issue:

> *"any concerns are brought about by the unknown outcomes in relation to recommendation 5.4 [ie the move to CIV]."*

Kingston took an opposing view:

> *"Kingston is pleased that the discussion paper did not include any modelling of the likely effect of the recommended changes on individual council grants. Too often equity or otherwise is argued from the 'hip pocket' perspective, rather than as a discussion of the principles being proposed."*

Some submissions raised general process issues:

> *"Bayside's effective position, in the absence of more constructive proposals, is the maintenance of the current process and for all local councils to commence a concentrated and coordinated process to lobby the Federal Government for a greater share of taxation revenue in the form of grants."*

While Monash

> *"Is very concerned at the frequency of which major reviews of the VGC grant methodology continue to occur. The reviews have resulted in significant variations to councils' grant outcomes, and caused uncertainty in the preparation of long term financial plans"*

Subsequent to the release of the Discussion Paper, in late November, a Federal Parliamentary committee discussed the more general issues in its report *Rates and Taxes: A Fair Share for Local Government*[1]. The Commonwealth Government has announced that it will be responding to this report in early 2004, following discussions with State Ministers for Local Government and Planning.

The *Rates and Taxes* report proposed fundamental changes in the administration of General Purpose Grants for local government – most importantly, that

- Grants should be allocated on a needs basis across Australia (instead of the current per capita allocation to each State, with subsequent needs-based allocation within each State); and
- Grants should be administered by the Commonwealth Grants Commission.

Apart from changes that may come from that Federal report, this Final Report concludes a series of reviews that the VGC has recently undertaken into both Roads and General Purpose Grants. While the VGC proposes to continue its annual process of consulting with councils and 'fine tuning' the methodology in response to comments and suggestions received, no further general reviews are envisaged the near future.

[1] Federal House of Representatives Standing Committee on Economics, Finance, and Public Administration *Rates and Taxes: A Fair Share for Local Government* released on 24 November 2003

2. Principles and Practice

2.1 Principles

2.1.1 National Act and Principles

Commonwealth funding for local government commenced in the early 1970s. The funding is now distributed under the Local Government (Financial Assistance) Act 1995, which sets out the key objectives:

> *"to provide financial assistance to the States and Territories to improve:*
>
> - *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"* (NOLG, 1999, p73)

In 1995, Ministers of Local Government from the Commonwealth and States agreed on a set of five key National Principles for the allocation of General Purpose Grants in Australia:

> The Commonwealth Local Government (Financial Assistance) Act 1995 requires that the distribution of general purpose grants be consistent with the relevant nationally-agreed principles:
>
> a) Horizontal Equalisation:
>
> General purpose grants are to be allocated to councils, as far as practicable, on a full horizontal equalisation basis. This aims to ensure that each council is able to function, by reasonable effort, at a standard not lower than the average standard of other councils in the State/Territory. It takes account of differences in the expenditure required by councils in the performance of their functions and in their capacity to raise revenue.
>
> b) Effort Neutrality:
>
> In allocating general purpose grants, an effort or policy neutral approach is to be used in assessing the expenditure requirements and revenue raising capacity of each council. This means, as far as practicable, the policies of individual councils in terms of expenditure and revenue effort will not affect the grant determination.
>
> c) Minimum Grants:
>
> The minimum general purpose grant for a council is to be not less than the amount to which it would be entitled if 30 per cent of the total amount of general purpose grants were allocated on a per capita basis (in Victoria in 2003/04 this equals $15.90 per head of population).

d) Other Grant Support:

In allocating general purpose grants, other relevant grant support provided to councils to meet any of the expenditure needs assessed is to be taken into account.

e) Aboriginal Peoples and Torres Strait Islanders:

Financial assistance is to be allocated to councils in a way which recognises the needs of Aboriginal peoples and Torres Strait Islanders within their boundaries.

2.1.2 Key Goals

The 2000/01 Review discussed in detail the principles underlying grant allocation. Drawing on a local government grants review underway in the UK at the same time, the Review surveyed Victorian councils on desirable features of a grants process. These discussions suggested five key requirements of the system:

- Fairness
- Predictability
- Responsiveness
- Transparency (including clarity)
- Stability

These goals can come into conflict – for example, the simplest system would be a standard per head allocation to all councils, but that would take no account of differences in council needs or revenue capacity, and so would fail on the fairness requirement.

Councils generally held that the fairness goal is the most important, with the other goals receiving similar, lower, importance. In the words of a typical response to the Issues and Options Paper:

> *"We clearly recognise that the Grants Commission operates within a national framework underpinned by Commonwealth legislation and by National Principles. We support the continued application of the Principles and accept that the goal of fairness in grant distribution is fundamental to both a national approach and to the achievement of broad support for the funding models. We support the key requirements of fairness, predictability, responsiveness, transparency and stability and argue that these are critical to the grants calculation processes."*

From such widespread support, the 2000/01 Review Final Report restated the findings of the Issues and Options Paper:

1. *The ideal grants system would be one that:*
    - *Meets the National Principles set out in the Commonwealth Act and the Commonwealth / State agreement*
    - *Achieves the most important goal of fairness; and*
    - *Also achieves the other goals which are seen as important by councils: predictability, responsiveness, transparency and stability.*

2. *In the interests of achieving the goal of fairness, and meeting the National Principle of Horizontal Equalisation, the grants allocation process needs to consider both the needs faced by councils, and their capacity to raise revenue.*

From these findings, the key questions for the current discussion are:

- Does the current revenue assessment process face any problems: with the National Principles; with the key goal of fairness; and/or with the other goals of predictability, responsiveness, transparency and stability?
- If problems do exist, can they be remedied?
- Whether or not problems exist, can improvements be suggested to the current process?

Because of the central importance of fairness, section 3 discusses this principle. Prior to doing so, however, it is useful to outline the VGC's current methodology for General Purpose Grants.

2.2 Current VGC Process

In keeping with the requirement of allocating General Purpose Grants to councils on the basis of horizontal equalisation, the VGC seeks to equalise the capacity of each council in Victoria to provide an average range of services at a standard level.

A council's standardised expenditure normally exceeds its standardised revenue. The difference between the two is termed the 'raw grant', which represents the funding required by each council to achieve full equalisation. As the available Commonwealth funds are generally less than the sum of the calculated raw grants, the funds are distributed in proportion to each council's raw grant.

2.2.1 Standardised Expenditure

Standardised expenditure is calculated for each council on the basis of nine specified functions. For each function[2], the standardised expenditure is the product of:

- The council's relevant unit of need (such as population, number of households serviced);
- The standard cost per unit of need (the average Victorian cost of providing that function);
- A cost adjustor (which scales standardised expenditure for factors beyond each council's control, such as its socio-economic profile, scale, or isolation).
- The total for the function is then reduced by standardised grant revenues for that function, to take account of grants received from State and Commonwealth Governments.

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[2] The procedure differs for one of the nine functions, that of local roads and bridges. Here the VGC uses each council's share of the total local roads pool, incorporating cost modifiers used in calculating the local roads grants.

Example: The standardised expenditure for the function of Family and Community services for a specific council is calculated as follows:

- the council has 84,846 people (its units of need)
- the standard unit cost (for all councils) for this function is $81.35
- the council has a composite cost adjustor of 0.990 for this function[3], reflecting factors such as the relative socio-economic status of its population and the proportion of children under five years of age.

For this council, these three elements comprise Gross Standardised Expenditure

= 84,846 x $81.35 x 0.990 = $6,833,200

A deduction is then made for standardised grant revenue, which is calculated:

- the standard revenue per unit (for all councils) for this function is $26.70
- this is multiplied by the units of need, 84,846 people for this council

The Net Standardised Expenditure (for Family and Community Services)

= $6,833,200 - $2,265,388 [= 84,846 x $26.70] = $4,567,812

This process is repeated for each of the nine specified expenditure functions. The standardised expenditures for all functions are then added together to produce total Net Standardised Expenditure (NSE). In the above council's case, the total NSE is $51.9 million.

2.2.2 Standardised Revenue and Grants

The standardised revenue for each council is obtained by multiplying its total net annual value (averaged over the past three years) by the average (or implied) rate across all Victorian councils. For the 2003-04 grants, the implied rate was 7.0 cents in the dollar.

Example: This council has a Net Annual Value (NAV) of $265.9 million

Standardised revenue = $265.9 million x 7.0 cents = $18.6 million

Each council's 'raw grant' can then be calculated by subtracting the standardised revenue from the NSE:

Raw Grant = Net Standardised Expenditure *less* Standardised Revenue

For this council:

Raw Grant = $51.9 million - $18.6 million = $33.3 million

However, the total of raw grants across Victoria is greater than the amount of money the VGC has available. Consequently, all grants are scaled back, and the VGC also makes some other adjustments to give all councils at least a minimum grant, and to ensure that movements between years are not too severe. In total, these adjustments mean the raw grant was multiplied by 0.1816 to produce the final grant for 2003-04:

For this council:

Final grant = $33.3 million x 0.1816 = $6.047 million

[3] The composite cost adjustor combines specific cost adjustors for each relevant variable (socio economic status, scale etc). Specific cost adjustors are generally calculated on scales from 0.75 - 1.50.

2.3 Other Approaches for Revenues

The Commonwealth Government provides an annual total of just over $1 billion in General Purpose Grants to local government across Australia. Local Government Grants Commissions (LGGCs) allocate the funds in each State. While each LGGC is bound by the National Principles, the methodologies differ between the States, and have also developed over time.

It is therefore of value to this review to survey briefly the differing approaches taken.

2.3.1 Prior to 2000

At the start of Federal funding for local government in 1973, the Commonwealth Grants Commission (CGC) used valuation bases as the sole measure of revenue capacity in its allocation process (Morton, 1996, p6). When LGGCs became responsible for grants allocation within each State in the late 1970s, they all continued assessing revenue capacity by using the valuation base and this has been the approach since.

The CGC revisited the revenue capacity issue in 1991, and argued then that revenue capacities from three classes of ratepayers should be assessed separately:

- For commercial and industrial ratepayers, property values were judged the best measure;
- For most residential property, household income was a better measure; and
- For farming properties, average farm income over a period was more appropriate.

This issue was further considered in a 1996 comprehensive review of the revenue raising capacity of local government (Morton, 1996). This looked at the way that each LGGC considered revenues, and was especially critical of those States which use unimproved (site) value as their valuation base, arguing they:

> *"Are unlikely to provide any reasonable estimate of revenue raising capacity between councils because they are not a reasonable indicator of cash flow, or of wealth, or of permanent income"* (Morton, p ii)

Morton therefore preferred Victoria's use of Net Annual Value.

Morton had some sympathy with the CGC's idea of separate approaches for each category of ratepayer. However, he noted some serious problems. First, it is always a vexed issue on how to combine widely differing measures. Second, there are data problems with each of the alternative assessments:

> *"The ABS personal income figures are self-assessed and are available in income ranges without an aggregate figure. Assumptions are needed to estimate the gross income. The figures are also only updated at five year intervals . . . Retail turnover does not include all establishments of a commercial and industrial nature, and therefore does not fully cover the sectors that are to be represented by this data. This data is also only updated at five year intervals[4]. Agricultural production statistics which are generally available are of a gross nature, and do not net out the costs of production which vary substantially from sector to sector"* (Morton, p 45).

[4] In fact, data problems have led to the discontinuance of this series by the ABS

Faced with such problems, it is not surprising that Morton supported the decision of LGGCs to continue with the use of a simple valuation base, concluding:

> *"the simple fact is that it is not possible to accurately assess the relative revenue capacity of local governments"* (Morton, p iii).

In other words, Morton preferred a simple valuation based system as he felt that more complex approaches would reduce transparency without demonstrably improving equity outcomes.

2.3.2 2001 Commonwealth Review

In June 2001, the CGC reported to the Commonwealth Government on its review of the operation of the Local Government (Financial Assistance) Act 1995 (CGC, 2001).

The CGC had been asked to examine and report on how well Local Government Grants Commissions' (LGGCs') policies and methods concurred with the National Principles – in particular that of full horizontal equalisation.

The CGC found that generally the current arrangements had led to a distribution of funds in line with the National Principles, but made a number of recommendations for LGGCs to consider. It also specifically addressed revenue raising capacity, identifying a range of issues.

The CGC review contained three main suggestions for this Paper:

- LGGCs should be more explicit in assumptions about the influence of policy and non-policy influences in assessing revenue capacity;
- While the valuations approach is a reasonable way of assessing rate revenues, an approach distinguishing between property classes may have advantages;
- LGGCs should include the full range of non-rate revenue in their calculations.

As outlined in Appendix 3, most LGGCs are considering improvements to their revenue methodologies, with:

- Rates on differing property groups assessed separately;
- Measures of socio-economic status being included;
- Other revenues also being included.

The following sections discuss the possibility of such changes being made in Victoria.

3. Equity and the Eye of the Beholder

3.1 Comments on Fairness

A central issue for this Review, as for any grants process, is that of fairness. As one pithy comment put it:

> *"The problem with the Grants Commission is that you want to vote with your hip pocket, but you can't always do so."*

This issue was discussed in some detail in the general review of General Purpose grants in 2000/01. The *Issues and Options Paper* for that review noted:

> *"Internationally, the fundamental goal of grants to local government is fairness. Where councils have higher levels of need, or lower levels of capacity to fund those needs, then they should receive higher grants. The priority given to fairness by Victorian councils' mirrors that found in the recent UK survey. However, that survey noted some problems in clearly defining 'fairness':*
>
> *"Respondents were roughly equally divided between those who gave definitions that focused on the amount of resources available to their own authority, and those who took a broader view in defining fairness . . .*
>
> *"Comments such as 'I think it's a system which reflects the actual needs of the people I serve and it enables us as a council to provide the level of services for the people we represent', typified the comments of those who focused on their own locality. The broader approach is illustrated by the following definition given by a chief executive: 'It's got to be about a reflection of genuine needs which relate to socio-economic needs of the population, and resources needs, where there are low resource levels.' "* (2000 *Issues and Options Paper*, p10).

In the current project, many submissions agreed on the emphasis on fairness – but disputed whether it was being pursued either in the Discussion Paper or by competing proposals.

The Metro Group submission noted that

> *"The [Discussion] paper makes several references to the need for fairness in the Commission's outcomes. As has been explained, the submission councils do not believe that the present method is fair."*

Corangamite

> *"it is important that any recommendations that are pursued are seen as fair and equitable. It is also important that if changes are put in place that they are not too complex to understand."*

Frankston opposed the proposed move to CIV, partly on the equity grounds that "such a change would dramatically impact on rural communities in Victoria which are in greatest need."

Another council argued

> *"We are aware there is a strong push from some councils to adopt CIV as the basis for assessing revenue capacity. Their possible motive in seeking this change is not for a fairer system, but to obtain a larger share of the grant pool."*

3.2 Assessing Equity

In the face of such strongly-held views, how do we decide what is fair? In asking this question, it should be stressed that fairness is not the only criterion used in calculating grants. While it is seen (both by councils and in the National Principles) as the most important goal, other goals are also to be included.

In the grants context, the practical application of 'fairness' is: should any growth in funds go towards councils of type x, or councils of type y? Or indeed, to take the point further, should there be a redistribution of current allocations away from councils of type x towards councils of type y (or vice versa)?

The key starting point is the first National Principle, of Horizontal Fiscal Equalisation. In allocating grants funds, the VGC is required to take account of differences both:

- In the *expenditure* required by councils in the performance of their functions; and
- In their capacity to raise *revenue*.

The balance between these two is the Raw Grant for each council. As noted in section 2.2.2, the total grants funds available to the VGC are substantially less than the total of Raw Grants across Victoria. How councils respond to this situation gives a guide for assessing the 'fairness' of outcomes.

The central test used in the following discussion is:

- If a council's revenues – collected at standard effort – are significantly less than its expenditure requirements, there is an equity case to increase grants for that council;
- Conversely, if a second council's revenues – again collected at standard effort – more than meet its expenditure requirements, there are fewer equity grounds for increasing grants than for the first council.

To do this, this section looks at the standardised expenditure and revenue patterns for councils, using the following six categories: metro central (excluding the City of Melbourne, which is a special case, especially on the revenue side), metro developed, metro fringe, regional centres, regional urban, and rural agricultural.

The first step is to look at standardised expenditure. The following table shows the standardised expenditure per head for

- "Base Net Standardised Expenditure (NSE)", excluding roads and prior to the application of cost adjustors. It is notable that there is not a wide range around the state average of $515 per head for NSE: metro fringe is somewhat lower (primarily because of the lower proportion of older people in the metro fringe communities); and rural agricultural a little higher (primarily because the VGC applies some minimum levels in some expenditure categories);
- The net effect of the cost adjustors, which is to reduce standardised expenditure per head in most metro councils and increase the figure in regional and rural councils;
- Net Standardised Expenditure for local roads – which is much higher in regional and, above all, rural councils; and
- The total NSE per head, which sums the previous three columns.

Table 1: Components of Net Standardised Expenditure ($ Per Head)

	Base Net Standardised Expenditure	Impact of Cost Adjustors	Net S'dised Expenditure Local Roads	Total Net Standardised Expenditure
Metro Central	520	-16	16	520
Metro Developed	510	-37	18	491
Metro Fringe	497	-13	47	531
Regional Urban	522	79	217	818
Regional Centres	517	38	62	617
Rural Agricultural	579	83	445	1,107
State	515	0	75	590

These components are illustrated for metro developed and regional urban councils:

Chart 1:

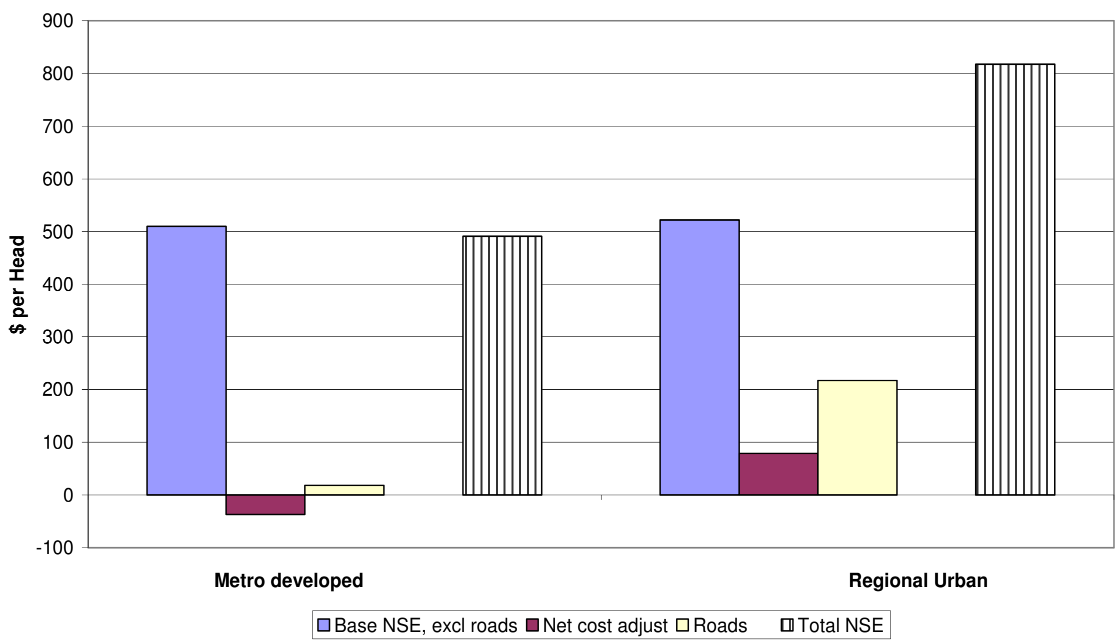

Chart 1 illustrates the similar Base NSE per head figure for the two groups, the net impact of the cost adjustors (negative for metro developed, positive for regional urban), the roads component (significantly higher for regional urban). Together these elements produce NSE per head figures of $491 for metro developed and $818 for regional urban.

The total of Net Standardised Expenditure gives the expenditure needs of each council to provide a similar standard of services – and therefore also represents the revenue each council requires. Table 2 shows the revenue components, per head of population, for each VGC category:

- NSE, which represents revenue required;
- Standardised rates, as calculated by the VGC – showing the rates per head collected at the average rate across Victoria of 7 cents in the $ NAV;
- VGC grants (both General Purpose and Local Roads);

- Other roads funds (primarily VicRoads reimbursement for works undertaken by councils on State roads, and Roads to Recovery grants);
- Total other revenues; and
- A rate adjustment figure. This indicates whether the councils rate above or below the standardised rate. It essentially indicates whether the other revenue components (including standardised rates) are sufficient to meet required revenue, or whether the council has to rate at a higher level.

Table 2: Key Revenue Components ($ Per Head)

	Net St'dised Expend.	St'dised Rates	VGC Grants	Local Road Grants	Other Revenues	Rate Adjustment
Metro Central	520	494	32	10	92	-108
Metro Developed	491	340	36	11	180	-76
Metro Fringe	530	257	63	20	145	45
Regional Urban	818	264	158	55	220	121
Regional Centres	617	220	87	24	166	120
Rural Agricultural	1,107	278	267	159	276	127

Again, the components are illustrated for metro developed and regional urban councils.

Chart 2:

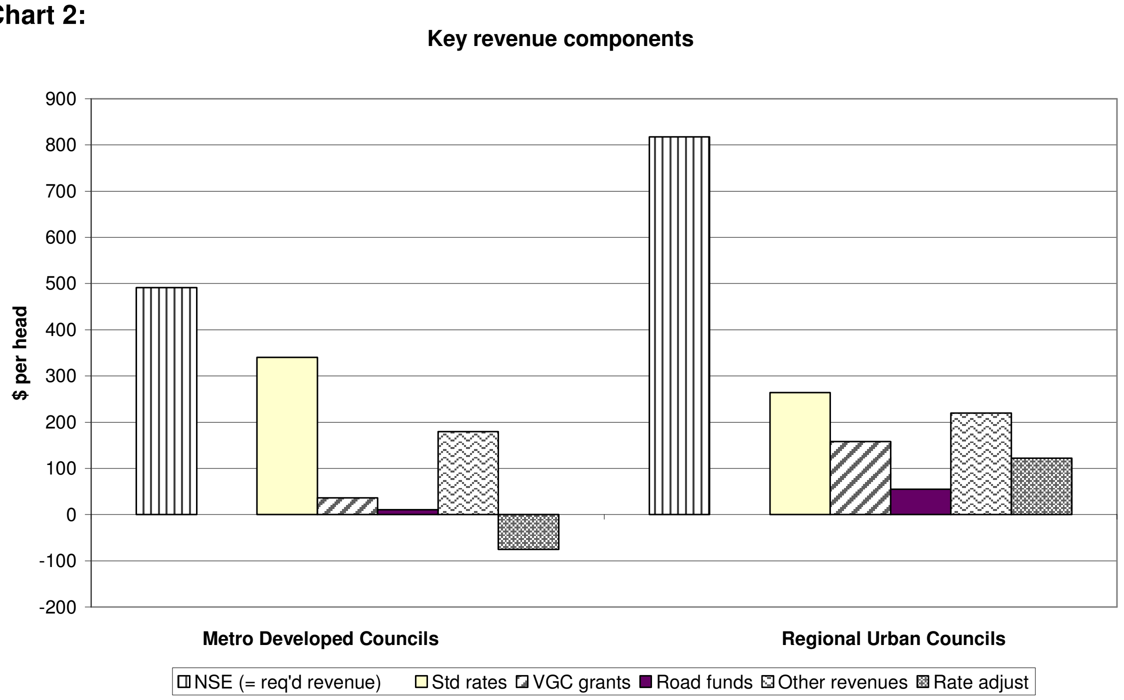

Chart 2 shows metro developed councils have higher standardised rates (because of higher property valuations) than regional urban councils. Despite the fact that the metro developed councils receive considerably less in VGC grants, and in other roads funds, and receive slightly less in other revenues, the total of these components for metro developed councils is greater than the revenue required to fund NSE. Consequently, the metro developed councils, on average, can strike rates at $76 per head below the standardised rate level.

In contrast, the regional urban councils, despite receiving more in VGC grants, other road funds, and slightly more in other revenues, are not able to fund all of the required NSE. Consequently, they strike actual rates averaging some $121 per head higher than the standardised rate.

As well as providing a picture of expenditure and revenues across Victoria, this discussion raises some important issues for VGC funding:

- Councils in regional Victoria, and above all the rural agricultural councils, have the highest expenditure needs as assessed by Net Standardised Expenditure;
- The current pattern of VGC grants recognises this, and provides higher grant levels to these councils;
- However, there is still a significant funding gap for regional and rural councils compared with NSE requirements – one which the VGC grants pattern modifies but does not eradicate.

The introduction to this section suggested the central test of fairness in grants should be the following:

- If a council's revenues – collected at standard effort – are significantly less than its expenditure requirements, there is an equity case to increase grants for that council;
- Conversely, if a second council's revenues – again collected at standard effort – more than meet its expenditure requirements, there are fewer equity grounds for increasing grants than for the first council.

On this test, the regional urban and especially rural agricultural councils have the strongest equity claims for increases in grants.

3.3 Responses to the Discussion Paper

The analysis in the previous section largely mirrors that in the Discussion Paper for this review. The general argument was broadly supported by many, especially non-metropolitan, submissions. However, it was hotly disputed by others. Fairness formed a central part of the arguments of the Metropolitan Councils' group submission, especially in criticising the use of valuations.

The submission presented a detailed comparison of the uncapped standardised revenue for each council with the actual rates collected, showing that many metropolitan councils raise significantly less in rates than the standardised rates methodology calculates. The same point is apparent from the VGC's Annual Report[5], which gives the implied rate for each council. The metropolitan councils with the largest gaps between actual rates revenue and the standardised rates are those with implicit rates well below the State-wide rate of 7 cents in the $ NAV. The submission argues that on

> *"the VGC calculations Metro capacity is calculated much higher [than actual rates] and rural capacity much lower. How valid are these [VGC] results when we recognise that the real situation is what councils have shown that they can raise from rates."*

The submission suggests that the VGC should have regard to actual rate raising [which would be contrary to the National Principle of Effort Neutrality], and consequently adjust the standardised rates methodology, possibly by discounting valuations.

[5] VGC's Annual Report 2002-03, Appendix 4, pp77-79

It is agreed that these councils are charging less than the average rate across the State. The key question is what to make of this information. Does this reflect some underlying "capacity to rate (and pay)" – or, as argued in the previous section, are these more favoured councils, striking lower rates than the average because they are able to, given the strength of their other revenues in relation to expenditure needs?

3.4 Additional Data

The evidence in the discussion in section 3.2 supports the latter interpretation. This is further supported by Table 3, which compares average residential rates per assessment with median weekly household income, taken from the 2001 Census (detailed data for each council is given in Appendix 4).

Table 3: Comparison of Median Income and Average Residential Rates

	Median Income ($ per week)	Average Residential Rates ($)	Rates as % Weekly Income
Inner Melbourne	902	697	77%
Developed Metro	909	595	65%
Fringe metro	877	667	76%
Regional Centres	653	601	92%
Regional Urban	671	626	93%
Rural Agricultural	599	486	81%

These figures show that the average residential rate per assessment in 2001 was a smaller proportion of median weekly household income in metropolitan areas than in regional Victoria.

This supports the above analysis that the metropolitan councils are charging less in rates simply because they can. Their total income sources are such that they can strike a rate less than the average, both in terms of rate in the $, and in terms of rates as a percentage of household income. Conversely, the higher than average rates struck by rural councils are because they have to fund their expenditure somehow – and this is not an indication of the greater rating capacity of their communities.

This section started by noting that fairness is not the only criterion for assessing grants, and other considerations have to be made. Nonetheless, fairness is the most important of the goals of the grants process. The analysis presented here indicates that, on equity grounds, the strongest case for increases in funds is that of councils in regional Victoria and especially rural agricultural areas.

This finding is applied in a number of the discussions below.

4. Council Revenues

The first National Principle for General Purpose Grants specifies that:

> *"Grants will be allocated on a basis that takes account of differences in the expenditure requirements facing councils and <u>in the capacity of those councils to raise revenue</u>"* (emphasis added).

With changes to the methodology since the 2000/01 Review, the VGC calculations of net standardised expenditure now take account of almost all recurrent expenditure by Victorian councils. However, the revenue side of the equation is not as comprehensive. Revenues are assessed in two ways:

- Standardised Revenue is calculated on the basis of each council's property valuations, based on NAV, multiplied by a State-wide average rate in the $;
- Specific purpose grants from State and Commonwealth Governments are calculated on a standardised basis, and deducted from standardised expenditure in the relevant expenditure categories (this is termed the "inclusion" method, and is consistent with the fourth National Principle)

Between them, these two categories cover some 61% of council revenues. The other 39% comes from VGC grants (11%) and council own-source revenues, predominantly fees, fines and charges (28%).

This section commences the discussion by summarising the picture of council revenues across Victoria. Following sections build on this information by discussing possible ways the revenues can be included in the assessment process.

4.1 Revenue Components

Each October, all councils in Victoria provide details of their expenditure and revenue to the VGC. Utilising some averaging in the VGC methodology, for both rates revenues and expenditure, the broad picture of key revenue items in 2000/01 was as follows:

Table 4: Local Government Revenue & Expenditure 2000/01

Revenue		
Standardised Rate Revenue	$1.563 b	51.3%
Specific Purpose Payments	$0.292 b	9.6%
Local Roads Grants	$0.106 b	3.5%
General Purpose Grants	$0.227 b	7.5%
User Charges, etc	$0.732 b	24.0%
Other Recurrent Revenue	$0.126 b	4.1%
Total	$3.046 b	
Expenditure		
Gross Standardised Expenditure	$3.059 b	

Total Gross Standardised Expenditure, as calculated by the VGC, is thus close to total revenues.

However, the VGC allocation process currently only considers two types of revenue:

- Rates (in standardised revenue) and
- Specific Purpose Payments (in Grant revenues deducted from Standardised Expenditure – including in this case the VGC local roads grants).

As a result, the VGC's general purpose grant distribution process for 2002/03 showed a gap between Gross Standardised Expenditure and assessed revenues:

Table 5: VGC Grant Allocation 2002/03

Expenditure		
	Gross Standardised Expenditure	$3.059 b
Revenue		
	Standardised Rate Revenue	$1.563 b
	Specific Purpose Payments	$0.292 b
	Local Roads Grants	$0.106 b
Total revenues considered in allocation process		$1.961 b
	Raw Grant Gap	$1.098 b

The Commission allocated general purpose grants of $248.5 million, meeting 22.6% of the aggregate raw grant gap (for many councils the proportion of the gap funded was less than this, due to the impact of minimum grants and grant capping). The balance of the raw grant gap remains unfilled, and there is an implicit assumption that all councils have an equal capacity to fill the gap.

In its 2001 review, the Commonwealth Grants Commission argued that the exclusion of non-rate revenue sources has the potential to distort the allocation of grants. There are two potential sources of distortion:

- Councils have different access (as is indicated in section 7) to other revenues. By excluding such revenues, the current system favours councils with good access to fees and charges, and effectively penalises those with less access.
- Councils also differ in the size of their raw grant, and the inclusion of other revenues can have widely differing impacts.

These factors are also considered in the discussion below.

5. Rate Revenue Capacity

The above discussion has indicated that rates form some 50% of total council revenues in Victoria. In view of this importance, rating capacity has long been the central part of standardised revenue assessment.

Section 2.2.2 outlined how the VGC currently calculates standardised revenue – by applying a standardised average rate (7 cents in the $ for the 2003/04 allocations) to each council's NAV valuation base. This section considers a number of possible alterations to this methodology.

5.1 Use of Valuations

5.1.1 2000/01 Review

The September 2000 Issues and Options Paper discussed the use of valuations for assessing revenue capacity. Its findings were:

4. It is clear that revenue capacity does differ between councils, and some effective way of measuring this is needed. While arguments from critics make good points, the most effective (albeit not perfect) way of capturing such differences is to use a standardised valuation approach.

6. The move to more frequent revaluations could allow valuations to be averaged over two years rather than the current three.

7. The most appropriate way to adjust Council rate bases for any payments in lieu of rates appears to be a simple addition to the standardised revenue.

The Issues and Options Paper noted the views of several critics of the use of standardised valuations. These points were also raised in the consultation process for the 2000/01 Review. One key point was that the standardised rates calculated by the VGC are in some cases much higher than the actual rates charged by some Councils. One submission argued

> *"There is some merit in the Commission looking at the (constrained) actual rate level rather than a hypothetical standardised rate level, although it is conceded that this conflicts with the principle of effort neutrality, and may be capable of manipulation by Councils who may keep rates low in order to gain an increased grant"*

Similar views were strongly put by others:

> *"the present method unfairly overstates the ability of many councils to raise revenue and penalises efficiencies."*

Another submission urged further analysis of the 1991 recommendations of the Commonwealth Grants Commission. As noted in section 2.3.1, that CGC report had suggested

> *"that revenue capacities from three classes of ratepayers should be assessed separately:*
>
> - *Commercial and industrial ratepayers to be assessed with use of property values;*
> - *Residential property to be assessed on the basis of household income; and*
> - *Farming properties on average farm income over a period."*

While this submission noted the data issues raised in the Issues and Options Paper on this matter, it felt "the goal of fairness should be placed ahead of logistical issues related to data collection, which can potentially be rectified."

However, most councils in 2000 supported the continued use of valuations as the measure of revenue capacity. One council

> *"supports the retention of a standardised valuation approach. The use of other methodologies such as actual rates levied conflicts with the National Principle of Effort Neutrality".*

And another argued

> *"With the changes to the Valuation of Land Act requiring a move towards more frequent valuations and a common valuation date, this method will become more responsive and more consistent across Councils in future. Actual rates raised should not be used to determine capacity to raise rates, as clearly this contravenes effort neutrality principles."*

There was thus considerable agreement with the VGC's approach of standardising rate revenues, and this was supported in the Review's Final Report. As one submission had argued, the other two possibilities were:

- Discounting of rate revenues, following the New South Wales model (where valuations are discounted to 30%); or
- A differential rating system, separating rates on the three property classes: residential (which could be assessed on household income), commercial and industrial (using property values), and rural (average farm income over a period).

5.1.2 Discussion Paper

The Discussion Paper looked at these two possibilities in turn.

(a) Discounting of rate revenues

Appendix 3 discusses the New South Wales model, and its use of discounted rate revenues. Over the years, a number of submissions to the VGC have urged this approach be adopted. In response, the VGC has argued:

- The NSW Commission model requires assessed revenue capacity to approximately equal assessed expenditure needs. Because the NSW Commission does not assess all local government expenditure needs, the revenue side of the equation needs to be artificially reduced – and hence discounting is applied.
- Discounting of valuations in NSW is not a direct response to increasing valuations – it is a requirement of that Commission's allocation model.
- The CGC 2001 review voiced some concerns about the approach used by the NSW Commission in discounting valuations – it views the discount as being arbitrary.
- Even with the discount, 21 of Sydney's 41 councils (51%) currently receive a minimum grant. This compares to seven of Melbourne's 31 councils (23%).

The Discussion Paper felt that these arguments regarding discounting remain compelling – especially as the VGC has over the past two years incorporated virtually all recurrent expenditure onto the expenditure side of its model.

(b) Differential revenue assessments

The discussion in section 2.3.1 above noted Morton's 1996 criticisms of the differential rating proposal:

- It is always a vexed issue on how to combine widely differing measures, with little to choose in principle between different techniques for combination. The choice therefore becomes somewhat arbitrary, with each technique producing winners and losers; and
- Morton identified significant data problems with each of the proposed alternative assessment bases: household income for residential properties and farm income for rural properties[6].

These points were reinforced in consultation during the 2000/01 Review, with comments such as:

> *"The land valuation systems provide the best long term indicator of capacity to pay of ratepayers and thus the capacity of councils to derive revenue. The use of household incomes to establish revenue capacity has significant flaws.*
>
> *"Under the Best Value valuation methods, valuations will be obtained every two years in future, whereas household income collection is only conducted every five years. The rural sector has the potential for enormous variations in income from year to year and the use of a single year to derive household incomes may work against councils which are predominantly rural based".*

The Final Report considered this issue further, arguing:

> *"It is certainly possible to calculate implicit rates for each property class separately, and this can be done either by using differential rates on valuations, or by using other variables, such as suggested in the 1991 Commonwealth Grants Commission report. The key challenge is how then to combine the three different figures.*
>
> *"This process would be fairly straightforward if there is a stable and common relationship across Councils between the three property classes. Thus, if all (or even most) councils gave a 20% discount on the residential rate to rural properties, and struck a commercial rate 20% higher than the residential rate, some basic rules of thumb could be applied."*
>
> *"To test whether a stable or common relationship exists, information was collected for each Council from that Council's October 2000 data return.*

This data in fact showed a wide variation in the relationships between property classes, and the Report concluded

> *"There is thus no common relationship across Councils in their rating treatment of residential, commercial, and rural properties. To establish State-wide implicit differential rates, or to combine other indicators of capacity to pay, it would be necessary for the VGC to apply a common relationship. As such a common relationship does not exist in reality, the VGC would have to make an ultimately arbitrary choice – one that would benefit some Councils and impact adversely on others. Not only would the*

[6] Household income is only available from the Census every five years, and farm income is both similarly episodic, and volatile. For example, using farm income figures from the generally good 2001 year would produce very different results from the drought-affected 2003. Patterns across Victoria differed as well, with differing experiences for example in wool, wheat, dairying, grapes and timber.

initial choice be arbitrary, but it would also be extremely difficult to handle changes over time. This is not a desirable outcome."

To test this potential approach further, analysis for this Review looked at council rates and valuations data for 2001/02[7]. This showed:

Table 6: Council Rates and Valuations 2001/02

Property class	Total rates, $ million	CIV valuations, $ million	State-wide Rate in $
Residential	1,273	329,496	0.0039
Commercial	351	74,352	0.0047
Rural	129	30,389	0.0042
Total (incl. other)	1,762	436,160	0.0040

There are two strong results in these figures:

- Despite the fact that most councils strike different rates for the three property classes, there is not in fact a wide differential between the state-wide implicit rates for those classes;
- Surprisingly, the implicit rate for rural property is slightly above that for residential property, despite the fact that most rural properties receive substantial discounts on the general rate (averaging some 30%, although there is considerable variation around this figure). The reason for this is that the non-metro councils with farms typically strike higher overall rates than do metropolitan councils (as analysed in section 3.4).

In sum, calculating standardised rate revenues for each property class and then combining them on the basis of the above relationships faces a number of major hurdles:

- As noted by Morton, the underlying data proposed for measuring the different classes is problematic;
- As noted by the 2000/01 Review Final Report, there is considerable variation in the relationships between the classes, which would require the VGC to make ultimately arbitrary judgements to combine them;
- The use of simple averages (which are similar between the classes), would not show much change on the current system, despite the increased complexity. As a general principle, it is undesirable to reduce transparency without a strong equity benefit; and
- To the extent that the change would make a difference, the compositional effects would mean a surprising increase in average rates in the $ (and standardised rate revenues) for rural councils.

The Discussion Paper recommended that the VGC continue the current system of using standardised rate revenues, and should not introduce either valuation discounting or a differential property class approach.

[7] This data was solely for 2001/02, and so did not include the averaging over three years applied in the VGC standardised rate revenues methodology.

5.1.3 Responses

Opinions split on regional lines. The recommendation regarding the use of valuations was opposed 7:5 by metropolitan councils, but emphatically supported 21:2 by regional submissions.

Submissions from	Supporting recommendation	Opposing recommendation	No comment
Metropolitan councils	5	7	5
Regional and rural councils	21	2	1
All submissions (incl MAV)	26	10	6

As noted above, the Metropolitan Councils group submission criticised the use of valuations, and suggested that the VGC should have regard to actual rate raising, and consequently adjust the standardised rates methodology, possibly by discounting valuations. This was supported by several metropolitan councils, such as Darebin:

> *"while the discussion paper is wide reaching and thorough, it is our view that it does not propose any real solutions to the difficulties currently faced by the Commission in dealing with the issue of revenue raising capacity."*

Knox

> *"The discussion paper has failed to address the sector's significant concerns about the continued use of raw valuation data. . . The boom of property values in recent times has created unrealistic forecasts of revenue raising capacity and this in turn impacts on the fairness of grants distributed."*

Manningham

> *"is disappointed with regard to this recommendation. The continuation of the status quo will not address what has been acknowledged as a fundamental problem, which is distorting the quantum of grants for many councils. . . Whilst Council favours the notion of discounting, it would nevertheless welcome any measure or combination of measures which would address the current weakness in the methodology.*

And the MAV

> *"would like to see further work done by the VGC on approaches that do not rely on valuations. Two such approaches could compare net standardised expenditure for each function with cost adjustors, against actual revenue for the same function, or against standardised revenue for each function."*

Other councils preferred the Discussion Paper analysis. A group of smaller councils argued

> *"The present methodology is not overstating the capacity of most smaller population Shires to raise revenue."*

Central Goldfields

> *"The use of valuations is the more consistent and responsive method to assess rate revenue capacity and should be retained."*

Glenelg pointed out

> *"Special Rate Agreements are considered in this formula already, which can have negative impacts on grant allocations. It is only fair to consider the full impact of property price increases as well. This puts all councils back on a level playing field."*

Ballarat

> *"Property valuations are a broad indicator of wealth. But they are not an indicator of a ratepayer's income, other assets or expenditure needs. . . It is acknowledged that the measurement of revenue raising capacity of councils is extremely difficult and despite numerous reviews there is no obvious method that Grants Commissions can universally apply."*

Mansfield

> *"Council notes the difficulties in using property valuations for assessing rating capacity. Local government has generally been unable to come up with universally accepted alternatives to this dilemma, and it is unrealistic to expect that the Grants Commission will solve this same problem. . . The alternatives in the Discussion paper do not appear to offer fair and transparent solutions and Council therefore supports the preferred option of continuing to use property valuations to assess rate revenue capacity."*

Swan Hill

> *"To move away from a universal system of application of the rating valuations would require the Grants Commission to make subjective assessments to the extent to which property classes have the ability to pay rates. . . Council therefore believes to move away from unadjusted property valuations for the purpose of determining rate raising capacity would introduce unnecessary subjectivity and complexity, therefore potentially conflicting with national principles."*

Mildura, while feeling "the discussion paper does not go far enough to satisfy us that it has explored the alternatives in detail," stated

> *"We acknowledge the great difficulties faced by the VGC with this matter, and recognise that there appears no simple alternative."*

This is reminiscent of Winston Churchill's 1947 musing

> *"No one pretends that democracy is perfect or all wise. Indeed, it has been said that democracy is the worst form of government, except for all the others that have been tried from time to time."*

5.1.4 Comment and Recommendation

The critics of the use of valuations in calculating standardised revenue make some strong points. To some extent, increased attention to other revenues, as recommended below, will reduce the influence that rate revenues have on grants. However, as many submissions commented, the critics did not propose an attractive alternative. The three key alternatives raised in submissions were:

- *Utilising actual rates raised.* This proposal is in conflict with the National Principle of Effort Neutrality – that policy decisions by councils should not affect grant outcomes. It also raises equity issues, as discussed in section 3, as it would allow councils to benefit from improved grants if they are in the lucky situation where they are able to strike rates less than the average;
- *Discounting valuations*. As detailed in section 5.1.2, this suggestion is based on the NSW model which bears little relationship to the Victorian model. It also raises the

equity issue of assisting councils in stronger financial positions (see discussion in section 3);

- *Assessing revenues from different property classes.* The above discussion argued that this would increase complexity without necessarily improving equity outcomes – and it could indeed increase the possibility of arbitrary results in grants.

Additional comment is worthwhile on the two options outlined in the detailed MAV submission, of comparing net standardised expenditure for each function (with cost adjustors), against either:

- Actual revenue for the same function, or
- Standardised revenue for each function."

These ideas are discussed further in section 7, in relation to other revenues (and that section proposes modifications to incorporate the suggestion). With respect to standardised rate revenues, the MAV suggestions face two problems:

- The use of actual rates raised runs into the Effort Neutrality issue noted above; while
- It is difficult to see how overall rate revenues could be usefully (and transparently) allocated against the nine expenditure functions. Any split up would involve arbitrary elements – and would considerably increase the complexity of the grants process.

This Final Report therefore confirms the recommendation from the Discussion Paper:

1. That the VGC continues the current system of using standardised rate revenues, and does not introduce either valuation discounting or a differential property class approach.

5.2 Capping of Revenue Increases

5.2.1 2000/01 Review

From 2002/03, the VGC has placed caps on annual increases in standardised rate revenues. This subject was not included in the 2000/01 Review, but was foreshadowed in a submission to that Review, which argued strongly:

> *"We see a gathering storm for Metro Councils . . . This is because of the continuing escalation of property values in Melbourne disproportionately to the rest of the State . . grants will continue to be reduced based solely on rising property values, which do not reflect revenue raising capacity."*

The argument here is that councils set their rates in the $ by setting a rate revenue target, and then dividing that into the property valuation base. If property values increase, councils tend to raise the same rate revenue – and the rate in the $ falls. However, the VGC approach to revenue capacity assumes that an increase in property values will give councils an increased capacity to raise revenue.

5.2.2 Discussion Paper

The Discussion Paper noted that other councils have subsequently taken up this refrain in annual submissions to the VGC. In response to this concern, as noted above, the VGC has capped annual increases in revenues. This has been done by assessing the State-wide average increase in property values from one year to the next[8], and capping the movement for all councils at this level. In consequence, standardised revenues could not move more than 6% for the 2002/03 grant calculations, or more than 7% for the 2003/04 grant calculations.

However, in adopting this measure, the VGC has expressed some concern. The Brief for this project noted:

> *"rapidly increasing valuations across many parts of Victoria are having a significant impact on the calculation of standardised revenue and the general purpose grants outcomes for many councils. The Commission has mitigated this impact in both 2002/03 and 2003/04 by applying a cap to increases in standardised revenue; however, such a mechanism is unlikely to be sustainable in the long-term."*

There are four key reasons why "such a mechanism is unlikely to be sustainable in the long-term":

- It creates a potential breach with the National Principles. The first Principle, that of Horizontal Fiscal Equalisation, requires the VGC to take account of differences in councils' capacity to raise revenue. As noted above, there can be concerns about how well particular measures reflect this capacity to raise revenues. However, once a measure is adopted, a constraint such as the 6-7% cap could over time move councils increasingly away from the underlying measure.
- It does not differentiate between two sources of increase in total valuations – property price rises, and growth in the property stock. While the former does not necessarily lead to an increase in rate revenues (as argued above), the latter certainly does.
- It raises equity issues. While most councils in Melbourne, and across much of Victoria, have shared in the property boom of the last few years, some communities and councils have not. This, in general, has reflected less robust economic growth in those communities. A cap on revenue increases assists those councils that are doing relatively well, and works against those which are not.
- It complicates the assessment process, working against the transparency principle.

The Discussion Paper noted three broad options:

- Maintain the current capping regime. For the reasons noted above, this was not favoured.
- Loosen the regime, so wider caps (perhaps 10% per annum) are used. This would smooth the strongest effects of property price increases. However, the VGC already has a regime which modifies the impacts of any changes in grants (the –6% floor on the movement in annual grant for any council). There does not appear to be a strong argument for separate controls within the formula.
- Remove the controls, and return to using the standardised rate revenues based on three year average valuations.

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[8] As the VGC averages valuations over three years, the movement is actually from one three year average to the following three year average.

The Discussion Paper preferred the third of these options, and recommended that the VGC cease using annual caps on increases in standardised rate revenues, but continue to rely on the overall –6% control on Grant changes to soften the impacts of changes on individual councils.

5.2.3 Responses

Once again, opinions split heavily on regional lines. The recommendation was opposed 10:3 by metropolitan councils, but supported 18:4 by regional submissions.

Submissions from	Supporting recommendation	Opposing recommendation	No comment
Metropolitan councils	3	10	4
Regional and rural councils	18	4	2
All submissions (incl MAV)	21	14	7

The Metropolitan Councils group submission opposed the proposal, presenting detail which it claimed

> *"demonstrated that the General Purpose grants of many metro councils have been significantly reduced by the massive increase in NAV caused by the property boom."*
>
> *"The Discussion paper has not analysed this position, or acknowledged these facts . . . [but] recommends that the VGC remove the caps applied to revenue increases. We find the arguments inadequate, the analysis deficient and the conclusions opinion based."*

Ballarat (and many other councils) endorsed comments in the VGC's 2002 Annual Report which recognised a problem with rapidly increasing valuations:

> *"We would urge the Commission to take long term action to overcome the problem of excessive growth in valuations . . Revenue capping has been successful. It should only be replaced if another measure can be found which does the job better."*

Mildura

> *"We urge the VGC to continue to use capping until a more robust alternative can be found."*

Moonee Valley

> *"The VGC must find a way to restrict the excessive growth in valuations. Revenue capping has been successful. It should only be replaced if another measure can be found which addressed the matter more equitably."*

Greater Shepparton disagreed

> *"In response to the rapidly increasing valuations across many parts of Victoria, intervention by the Commission to mitigate the impacts has been justified. However, we agree such mechanisms as using caps is not sustainable and the control limiting a council's general purpose grant annual decrease is adequate."*

The group of smaller population Shires also supported the removal of caps on revenue increases.

Kingston noted that it

> *"Has experienced strong growth in property values and as such is likely to be adversely effected in terms of grant outcomes by removal of the cap . . . Nevertheless, we are supportive of the recommendation on the basis of improved fairness to all councils."*

Swan Hill

> *"A council that is experiencing rapid movement in its property values is likely to be in a superior position to that of a council where property values are depressed or rising at a slower rate."*

Central Goldfields

> *"Council supports the removal of the caps, as capping gives those councils with the greatest capacity to raise rate revenue an unfair advantage."*

Ararat noted:

> *"A municipality that has an increase of 10% in residential assessments and a 3% increase in property valuations has a greater capacity to raise rates than a municipality that has no increase in residential assessments and a 13% increase in property valuations."*

Wodonga noted the distinction in the Discussion Paper between general valuation increases and growth in the property stock, and argued

> *"there should be some attempt to soften the impact of valuation increases which are due to market conditions and not supplementary growth. . . Whatever the outcome, there needs to be some mechanism for softening the changes for individual councils where they have no opportunity to generate increased income."*

The Discussion Paper recommendation relied on an overall control of -6% on grant decreases. However Moira, in supporting the recommendation, suggested this control should be reconsidered

> *"the VGC has a regime which modifies the impacts of any changes in grants, with the annual decrease in any council's General Purpose Grant currently being limited to 6%. Council would advocate this modification factor be increased to 10% as it is an artificial intervention and technically a breach of the National Principles."*

Golden Plains and Glenelg also supported this change.

Corangamite

> *"it needs to be remembered that a 6% decrease in the General Purpose Grant for a rural/smaller council can represent a significant part of its income. It is suggested that different mechanisms are investigated including the reducing of the 6% where populations are less than 20,000."*

5.2.4 Comment and Recommendation

Opinions are clearly divided on this issue, with:

- Strong support for the continuation of the caps on annual revenue increases, especially from metropolitan councils who correctly point out that an increase in average property values does not inherently lead to an increase in council revenues. These councils also argued that if the VGC continues to rely on valuations, it should ensure the goal of stability is achieved by softening the impact of sudden changes; and
- Strong support for the abolition of caps, especially from rural councils who (again correctly) argue that a potential conflict could arise with the National Principles.

In steering a path between these strongly-held positions, further analysis has centred on three key issues:

- The property market now appears to be cooling in Melbourne. In this situation, continued use of caps would be less of a long term distortion to the grants system, and more of a smoothing of the impacts of recent rapid valuation increases;
- In addition, the recommendation below to move to CIV as the valuation base may have adverse impacts for particular councils. The VGC has a long-standing policy of smoothing such impacts, and the revenue caps provide a way to do this; and
- As Ararat and Wodonga noted in their submissions, the current caps make no distinction between increases in average property values (where the metropolitan councils' argument is the strongest) and growth in the property base (where the critics of caps have their strongest position).

In view of the submissions and these points, this Final Report therefore recommends that the VGC continue with the use of caps, but modify the mechanism to take account of growth in the property base. A possible mechanism here is to use caps for each council that are based on:

- The average increase in property valuations across the State (which was 6% for 2002/03 Grants, and 7% for 2003/04 Grants); plus
- The increase in each individual council's property base in the last year – which could be assessed either through the number of assessments, or another measure such as the increase in population.[9]

In combination with the slowing down of the property market, such a mechanism should give a transition path whereby, over time, the underlying strength of the rating base is reflected in standardised rates – but without sudden adjustments. This is consistent with the long-held principle of providing grant stability for councils in transition phases, and does not conflict with the National Principles.

> 2. That the VGC 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.

[9] As it is a more direct measure, there is a good argument to use movements in the number of property assessments, rather than population. However, the VGC has generally preferred to use external variables rather than data from individual councils, and on this ground population increase could be preferred.

5.3 Valuation Base

Councils in Victoria can use one of three different valuation bases in setting rates:

- Capital Improved Value (CIV), the total market value of the property, including buildings.
- Site Value, the market value of the land component only.
- Net Annual Value (NAV), the annual rental value of the property. For residential and farming properties, the legislation sets the NAV as 5% of CIV, while for commercial and industrial properties actual rents are assessed – giving a typical relationship of 8-9% NAV to CIV.

The VGC currently uses NAV as the valuation base to calculate standardised revenues. As noted above, this issue has been raised by a number of councils, who argue that as nearly all councils now rate on CIV, the VGC should also use this basis.

5.3.1 2000/01 Review

The 2000/01 Review discussed whether the VGC's use of NAV for valuations was appropriate. The Issues and Options Paper noted arguments that CIV is preferable as a valuation base, for two reasons:

- 64 out of 78 councils then used CIV; and
- CIV is more readily understood, achieving the goal of simplicity.

The Issues and Options Paper countered these with

> *"two very strong arguments for preferring NAV to CIV:*
>
> - *Morton argued in 1996 "Revenue capacity means more than 'capacity to pay' primarily because it includes concepts of both wealth and recurrent income."(p35) He therefore preferred annual value (which includes both components) rather than capital value (which only assesses wealth); and*
> - *Grant outcomes are very sensitive to the choice of valuation base. A change from NAV to CIV would strongly favour councils with significant commercial and industrial properties and would work against those councils that are predominantly residential and/or farming. It can be seriously debated whether this outcome is fair as it effectively means reducing Grants for those councils which are in the greatest need".*

The Issues and Options Paper therefore recommended:

5. The continued use of NAV as the valuation base is advocated: NAV incorporates both a wealth and an income component, and a shift to CIV would favour councils with strong commercial and industrial property bases.

The May 2001 Final Report noted that 18 submissions commented on the NAV versus CIV issue – and 16 supported continued use of NAV. The Final Report therefore recommended that the VGC continue to use NAV.

5.3.2 Discussion Paper

The Discussion Paper noted two significant changes since the 2000/01 Review.

The first is that more councils are now using CIV valuations for setting rates:

Table 7: Council Valuation Bases

	2000/01	2003/04
Councils using CIV	64	72
Councils using NAV	9	6 *
Councils using Site Value	5	1
	78	79

Note: Of these 6 (Melbourne, Port Phillip, Yarra, Glen Eira, Maribyrnong and Whittlesea), the first four are minimum grant councils – and how their standardised rates are calculated has minimal effect on other councils' grants.

There are two important implications here:

- As noted in recent council comments to the VGC (see section 2.3 above), there is now almost universal acceptance of CIV – and some perplexity about why the VGC uses a valuation base which does not reflect council practice or understanding,
- Comparisons of data returns from councils show there is clearly a data quality issue for NAV estimates provided by some councils. CIV valuations, because they are used for rating, are subject to appeal by ratepayers. NAV valuations are not used for any purpose apart from the VGC calculations, and so are not subject to similar rigour.

The second change is the potential impact of a move to CIV. The Issues and Options Paper argued that such a shift "would strongly favour councils with significant commercial and industrial properties and would work against those councils that are predominantly residential and/or farming." The paper argued that the latter group of councils are in fact in the greatest need (analysis supported by the discussion in section 3 above).

This impact would still occur, if the change were made by itself. However, the Discusion Paper also recommended two other changes at the same time:

- The end of caps on annual increases in standardised revenues; and
- The inclusion of other revenues.

These two recommendations will favour those, especially rural, councils in the greatest need. A move to CIV at the same time will lessen the trend to some extent, but would not reverse it.

The Discussion Paper therefore recommended that the VGC move to the CIV valuation base for standardised rate revenue calculations.

5.3.3 Responses

Opinion was split on this recommendation. Metropolitan submissions were narrowly 6:8 against, while regional and rural submissions had a 14:9 majority in favour. However, several of the latter submissions gave only conditional support for the change. Noting that the shift to CIV could disadvantage some rural councils, these submissions agreed to the change so long as other recommendations in the Discussion Paper were also adopted.

Submissions from	Supporting recommendation	Opposing recommendation	No comment
Metropolitan councils	6	8	3
Regional and rural councils	14	9	1
All submissions (incl MAV)	20	17	5

Many opponents of the recommendation noted that this issue had been discussed in the 2000 broad Review – which recommended that the VGC stay with NAV. These submissions asked: why change now?

The Discussion Paper also suggested that some data quality issues exist with NAV estimates. One council took umbrage at this suggestion

> *"Each council is required to provide accurate valuation returns that include the reporting of NAV. Any issues regarding NAV data integrity should be referred to the Valuer-General's office, in the context of the valuation best practice requirement, and not as a justification for moving to CIV [for VGC assessment]".*

On the substantive recommendation, the group of smaller population Shires argued "The discussion paper is not convincing as to the reason to change to CIV."

Hindmarsh (and others) referred to the Discussion Paper's comments on the 1996 Morton Report, which preferred NAV as including concepts of both wealth and recurrent income. They also noted that "a change from NAV to CIV would strongly favour councils with significant commercial and industrial properties and would work against those councils that are predominantly residential and/or farming."

Mount Alexander

> *"The Commission have recognised that rural councils are already disadvantaged against the metro councils and this change will increase that disadvantage substantially."*

Golden Plains strongly opposed the move to CIV. It disagreed with the Discussion Paper's analysis of reasons for the move, in particular disputing the suggestion that there may be data quality problems with NAV data:

> *"Council believes that the arguments espoused in the discussion paper for the move to the CIV basis are flawed, and we strongly urge the VGC to uphold the interests of equity and fairness over simplicity and popularity. Just because the majority of councils use CIV for rating purposes does not mean that CIV is therefore the best measure of assessing revenue capacity."*

Frankston did not support a move to CIV, on three grounds:

- *"Revenue capacity means more than "capacity to pay" primarily because it includes concepts of both wealth and recurrent income, and NAV encompasses both concepts*
- *Such a change would dramatically impact on rural communities in Victoria which are in greatest need*
- *Previously when this issue was canvassed there was an overwhelming support by the majority of municipalities for the retention of NAV"*

Mornington Peninsula did not support the proposed change:

> *"A change in the valuation base does not give a Council a greater capacity to levy rates; it simply redistributes the burden between classes of ratepayers. A move to CIV would (presumably) benefit councils with a high commercial and industrial rate base, (presumably again) at the detriment of those councils who don't. The significant issue, however, is that there is no change in capacity to raise rates and charges through any change in valuation base."*

Corangamite supported the proposed move

> *"With the majority of councils now using CIV as their valuation base it seems logical that the change occurs."*

Greater Geelong

> *"A move to CIV valuations will provide a robust and accurate base for the standard revenue calculations."*

Ararat agreed with the proposed move to CIV, while acknowledging:

> *"this option will adversely effect councils such as Ararat in the short term, but does provide more transparency. CIV valuations would appear to have far greater acceptance and understanding in the broader community than NAV."*

Swan Hill

> *"While NAV in ideal conditions is probably a better measure of ability to pay, the almost universal lack of use of this measure combined with difficulty in understanding how it is calculated and artificial limits placed on its calculation make it difficult to justify its continued use within the Grants Commission formula."*

Yarra Ranges gave conditional support for the change

> *"We understand the drive for the VGC to move to using CIV instead of NAV. However, we would only support this if other offsetting factors were taken into account, in particular factors such as 'capacity to pay' and 'fees and charges'."*

Mansfield was more sceptical:

> *"the paper is also recommending two other changes that will lessen the potential impact of a change to CIV. . . However, as neither of these recommendations is assured of being adopted those councils recognised as having the greatest need may potentially be disadvantaged by this proposal without any assured off-setting changes to the grant methodology."*

"In relation to the proposal to move to CIV", Wellington

> *"would only support this move if the recommendation to end the cap on annual increases in standardised revenues is also proceeded with and if other revenue is included."*

5.3.4 Comment and Recommendation

Opinion was clearly divided on this issue as well. However, it is worth noting:

- The majority of submissions supported the argument in the Discussion Paper that a move to CIV would improve transparency and simplicity in the grants system;
- The major concern about the proposed move to CIV (amongst both supporters and opponents of the move) was the impact on equity:
  - A number of opponents were concerned about immediate impacts on grants; and
  - Some submissions were prepared to support the change to CIV, so long as other changes (in particular, the inclusion of other revenues and changes to revenue caps) were made;

This Final Report does recommend the inclusion of other revenues, as noted in section 7. It also proposes changes to the revenue cap system to address its most serious problem but maintains the smoothing component, which should allay to some extent the fears of immediate impacts on grants.

These changes address the key concerns expressed in submissions about the move to CIV. With such changes, this Report therefore confirms the recommendation in the Discussion Paper:

3. That the VGC move to the CIV valuation base for standardised rate revenue calculations.

5.4 Capacity to Pay

The Brief for this project noted:

> *"The current method of calculating standardised revenue focuses only on relative valuations and does not take account of factors such as the relative socio-economic status or income of ratepayers, which impact on each council's relative capacity to raise revenue from their community."*

The main argument against the use of any valuation method is that it does not take into account the actual ability of ratepayers to pay the rates; only measures of income would do this. Councils argue that although many residents are asset rich they can be income poor, and rising property prices do not mean that they can increase their rates accordingly. Therefore there is some merit in assessing the income capacity of a municipality – and, as noted in section 3.2 above, some other states are moving in this direction.

There are two issues to be looked at here:

- The best measure to use
- Issues in applying that measure

5.4.1 2000/01 Review

In the 2000/01 Review, both the Issues and Options Paper and the Final Report discussed socio-economic status and income of residents[10]. These reports noted several possible measures are available from the Census at the local government area, including household income and Socio-Economic Indexes.

The Issues and Options Paper noted that the VGC at that stage used as a cost adjustor the SEIFA index of relative socio-economic disadvantage[11]. This index was also used by most other Grants bodies (including NSW), and the Commonwealth Grants Commission until its 1999 review.

In response, some submissions argued that "Council costs are not greatly increased by the presence of disadvantaged in the community". Both from council experience and a recent report from the Department of Human Services on *The Burden of Disease*, the Final Report argued that council costs are affected by socio-economic status.

The Final Report then discussed the appropriate measure to use in assessing socio-economic status. It noted that the SEIFA index of relative socio-economic disadvantage is poorly correlated with household income, especially in rural areas. The Issues and Options Paper had suggested a composite index, of SEIFA, household income and low English fluency.

The Final Report reviewed this issue further, looking in particular at two of the five ABS SEIFA indices:

- The index of relative socio-economic disadvantage (IRSED – the index then used by the VGC), and
- The Index of Economic Resources.

The Report argued that the Index of Economic Resources provides a better indicator of Council costs than the current IRSED figures. This was indicated by the most important components of the two indices[12]:

- IRSED: persons aged 15 and over without qualifications; families with income less than $15,600; % unemployed; % workers classified as 'labourer and related workers'; persons aged 15 and over who left school at or under 15 years.
- Economic resources: households owning or purchasing dwelling; dwellings with 4 or more bedrooms; families with income more than $78,000; single parents with income more than $31,200; mortgages more than $1,300 per month; and rent more than $249 per week.

The IRSED index is more strongly affected by occupational status and educational qualification, while the Economic Resources index is affected by incomes and family type (in fact, the index of Economic Resources is very similar to the combination of the IRSED index and household income). It therefore recommended that the VGC use the index of Economic Resources as the socio-economic measure.

The VGC adopted this recommendation, and has incorporated the Index of Economic Resources into its cost adjustor model.

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[10] Albeit with the discussion looking at the expenditure side rather than the revenue side of the model.
[11] The SEIFA index is compiled by the Australian Bureau of Statistics after each Census. The data from the 2001 Census was released late in 2003.
[12] Provided in ABS Information Paper "Socio-Economic Indexes for Areas" (1996 Census) catalogue no. 2039.0, October 1998.

5.4.2 Discussion Paper

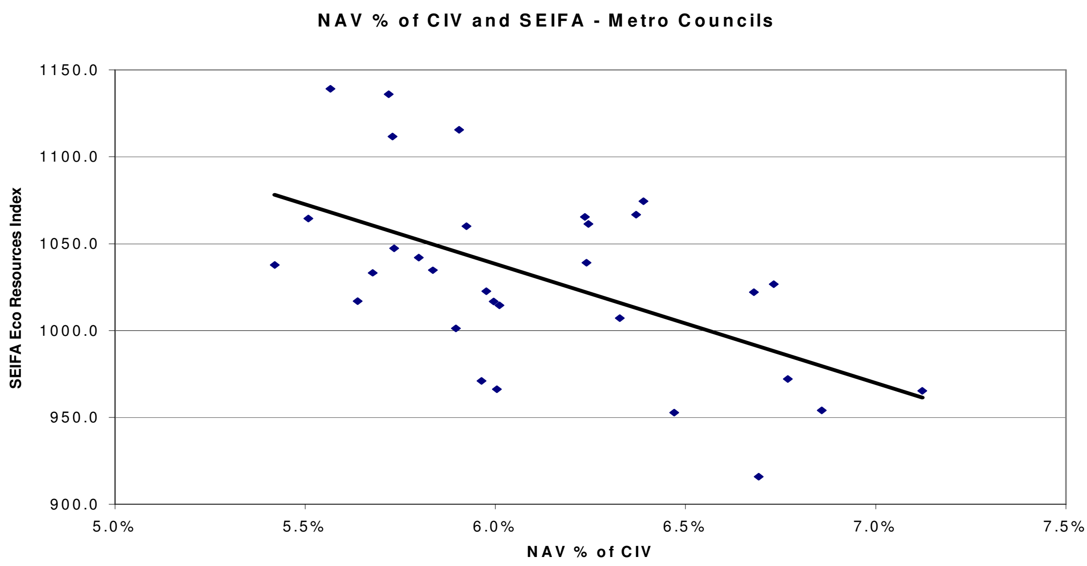
The Discussion Paper, referring to the analysis in the 2000/01 Review, argued that the Index of Economic Resources would be the appropriate measure to use, if the VGC wished to consider socio-economic status on the revenues side. However, the Paper also noted that there are still some important issues in applying such a measure.

The relationship between any socio-economic measure and capacity to pay local government rates is a complex one, for a number of reasons. These include:

- As frequently pointed out by councils, pensioners can be in wealth rich – cash poor situations. As council rates are struck on house value, some pensioners face rate bills large in proportion to their incomes. However, it is worth noting that many councils with high proportions of aged people are well-resourced inner Melbourne councils;
- If a capacity to pay influence were added to the calculations, it would require separating the different property classes – with the issues noted above in section 5.1.2. Presumably commercial properties would not be included in any adjustment for household capacity to pay. Farming properties are problematic. While most are run by individual families, the ownership structures vary considerably, including family ownership, trusts, and companies[13] – further complicating the picture even without the variability of farm incomes discussed in section 5.1.2.
- Even with just residential properties, some 30% of households across the State rent rather than own their properties – and this 30% tends to be lower-income. Questions can be raised whether a socio-economic measure reflecting a lot of low income households who rent is appropriate in assessing rates on the owners of properties.

For these reasons, applying the Index of Economic Resources to council rates is not a simple matter. It is also worth noting that the move to CIV recommended above will have some benefits for councils with lower ratings on this measure – particularly in the metropolitan area, as shown in the following graph:

Chart 3:



[13] These structures can have different tax implications for council rates. Equity issues are complicated between one household which may have a slightly lower income than another, but is able to claim its council rates against tax.

As noted in section 5.3.2, a move to using CIV as the valuation base tends to assist those councils with significant commercial and industrial properties. The above graph maps the relationship for the metropolitan area between the Index of Economic Resources and each council's ratio of NAV valuation to CIV (as residential properties have NAV:CIV fixed at 5%, a higher percentage shows a greater proportion of property values in the commercial and industrial categories). The lower the rating on the Economic Resources Index, the higher is the NAV:CIV ratio – and the greater benefit the council will receive from the move to CIV.

From this discussion, the Discussion Paper recommended that no specific adjustment for socio-economic status be included in the revenue assessment.

5.4.3 Responses

There were clear majorities in favour of this recommendation, amongst both metropolitan and regional and rural submissions. Many submissions argued that capacity to pay should ideally be included in the methodology, but accepted the Discussion Paper argument that there is no simple way of doing this.

Submissions from	Supporting recommendation	Opposing recommendation	No comment
Metropolitan councils	10	3	4
Regional and rural councils	17	5	2
All submissions (incl MAV)	28	8	6

Ararat disagreed

> *"Property rates are fundamentally a wealth tax, which take no account of the ratepayers' capacity to pay. The ABS weekly household income should be used as a cost adjustor to factor the capacity of ratepayers to pay into the grant formula."*

As did Baw Baw, describing itself as

> *"a regional council that has been drought affected for some years. We have had significant logging right restrictions placed on the region causing job loss. Incomes in the municipality are below the state average and also below that of the regional Victorian average. As a consequence Council is under considerable pressure not to raise rates and must look for other sources of income."*

Maribyrnong:

> *"We strongly believe that an indicator such as SEIFA disadvantage index should be incorporated into the measure. Although there are limitations with this indicator, it is the only measure which provides some indication on areas level of disadvantage and residents' capacity to pay."*

However, other councils joined Greater Shepparton in expressing

> *"concern that the lack of reliable figures (eg Census data every five years) causes added complexities and may result in the quest for a 'perfect system' being less attainable."*

Yarra Ranges

> *"After considering this issue we strongly feel that the community's capacity to pay should influence the revenue side of any effective model. However, we also acknowledge the current difficulties in sourcing suitable measures. . . In lieu of this, we therefore reluctantly agree that the VGC continue with the present system at this stage, but would request that the VGC commits resources to identifying and developing measures that reflect the differences between different communities' capacity to pay."*

5.4.4 Recommendation

While many submissions saw advantages in including a capacity to pay component, there seems general agreement that there is no simple way of doing this. While the VGC should continue to monitor this, this Report confirms the recommendation in the Discussion Paper:

4. That no specific adjustment for socio-economic status be included in the revenue assessment at this time.

6. Grant Revenue Capacity

6.1 2000/01 Review

The treatment of other grants was a key issue in the 2000/01 Review. The fourth National Principle states

> *In allocating general purpose grants, other relevant grant support provided to councils to meet any of the expenditure needs assessed is to be taken into account.*

Most LGGCs meet this principle by using the "Inclusion" method in calculating Net Standardised Expenditure. In each expenditure area, grants associated with that area are subtracted from Gross Standardised Expenditure.

Prior to the 2000/01 Review, the VGC used a discounting method to achieve this goal. In each expenditure area for each council, a discount factor was calculated based on the proportion of expenditure in that area which was funded from grants. Thus if a council received grants equivalent to 40% of its expenditure on family services, its discount factor in that area would be 60% (= 1.00 – 40%).

The Issues and Options Paper noted a number of problems with this approach. It made two recommendations:

8. *The continued treatment of other Government grants through discount factors on the expenditure side (ie the inclusion approach) is supported*

9. *An average discount factor for all councils is strongly preferred, rather than the current use of individual council discount factors. If this is done, the discounting system would not rely on the individual (and variable) data from councils. A number of current inappropriate effects would not occur. In addition, the complexity of the system would be reduced significantly.*

The Final Report noted that most councils supported the first of these recommendations, but there was a range of views, both for and against, in response to the second recommendation. That Report analysed in some detail the arguments against the recommendation, arguing in response that the use of individual discount factors had an unfortunate effort positive effect – thus breaching the second National Principle of effort neutrality.

The Final Report also noted a concern expressed by the Commonwealth Grants Commission (in its review that subsequently led to the CGC 2001 report) about the VGC's discount formula. Along with the use of average grant figures, the Final Report proposed a technical change to address this concern, recommending:

6. *The VGC will recast its formula for calculating discounted standardised expenditure to subtract other grant support after cost adjustors have been applied to standardised expenditure.*

6.2 Discussion Paper

The Discussion Paper noted that the VGC adopted these recommendations from the 2000/01 review, and adjusted accordingly its methodology for calculating Net Standardised Expenditure. As noted in section 2.2, the VGC now calculates Gross Standardised Expenditure for each category, and then subtracts a standard grant per unit. For the 2003/04 grants, the following standardised grants per unit were applied:

Table 8: Standard Grants, By Expenditure Function 2003/04

Expenditure Function	*Major Cost Driver*	*Standard grants per unit*
Governance	Population (with base 20,000)	$0.46
Family & Community Services	Population	$26.70
Aged Services	Population > 60 years	$169.08
Recreation & Culture	Population	$5.60
Waste Management	No. of Dwellings	$0.43
Local Roads & Bridges	% of Local Roads Pool	n.a.
Traffic & Street Management	Population	$1.71
Other Infrastructure Services	Population (with base 15,000)	$1.54
Business & Economic Services	Population (with base 15,000)	$3.83

For this Report, two questions can be asked of this approach:

- Does the approach seem appropriate in the light of implementation over the past two years? And
- As this aspect of the methodology deals with revenues rather than expenditure, might it not be more appropriate to add the above amounts to standardised revenue, rather than subtract them from standardised expenditure?

The new approach addresses the issues identified in the 2000/01 review, and also the concern about the methodology expressed by the CGC. No significant problems with this approach have arisen in the past two years, and there have been few council comments on it in annual submissions to the VGC. There seems no basis for a further change.

On the second point, while these grants are indeed revenues, they are associated with specific expenditure areas. Applying the above unit grants on the revenue side of the equation would complicate the calculations, without adding to the equity of the outcomes. Any attempt to simplify the grants per unit with inclusion on the revenue side could well reduce equity in the system.

The Discussion Paper therefore recommended that the VGC continue with its current method of assessing other grants under the inclusion approach in Standardised Expenditure.

6.3 Responses

This was the most popular recommendation in the Discussion Paper. All submissions expressing a view supported it.

Submissions from	Supporting recommendation	Opposing recommendation	No comment
Metropolitan councils	13	0	4
Regional and rural councils	22	0	2
All submissions (incl MAV)	36	0	6

Typical comments were:

Central Goldfields

> *"Council believes the current approach of including Special Purpose Grants is relevant and fair to all recipients."*

West Wimmera

> *"The continued use for assessing other grants of the inclusion approach in standardised expenditure is also supported, as the majority of these grants are attached to particular expenditure areas."*

6.4 Recommendation

In light of this response, this Report therefore confirms the recommendation in the Discussion Paper:

> 5. That the VGC continue with its current method of assessing other grants under the inclusion approach in Standardised Expenditure.

7. Grant Revenue Capacity

In its Review of the Operation of the *Local Government (Financial Assistance) Act* 1995 (completed in June 2001), the Commonwealth Grants Commission reviewed the structure and operation of Grants Commissions' general purpose allocation models at some length.

In relation to the assessment of non-rate revenue capacity, the CGC noted the growing importance of non-rate revenue sources for councils and argued that it would be preferable to:

> *"…assess the full-range of non-rate revenue, because it is more in keeping with a comprehensive assessment of needs. If two LGBs [councils] are identical in all respects except that the first has access to significant user charges, then it would be unfair to ignore that revenue source. To do so would place the first LGB in a more advantageous position than the other."*
>
> (page 131)

and

> *"LGGCs should choose methods of assessing revenue capacity that are consistent with their assumptions about whether an influence is a policy or non-policy influence . . . . different methods can produce very different measures of revenue capacity.*
>
> *All else being equal, revenue equalisation should reduce the grants of LGBs that have a greater capacity to raise non-rate revenue, and increase the grants to LGBs that have a lesser capacity."*
>
> (pages 132-4)

The CGC noted that the reason that most Grants Commissions did not assess non-rate revenue was simplicity. Grants Commissions also argued that the councils with the greatest non-rate revenue capacity were already receiving minimum grants and the inclusion of non-rate revenue would not alter their grant outcomes.

Following from the CGC recommendation, this section discusses the possibility of including a component for other revenues in the VGC revenue assessment.

7.1 2000/01 Review

The Issues and Options Paper noted that the most important single source of user charges for local government in Victoria was parking fees and fines. However, it also noted some significant issues in incorporating even this measure – let alone other sources. It therefore recommended:

10. Parking revenues should be considered in revenue assessment. However, there are some important implementation issues to be addressed.

11. The complexity and variability of other revenue sources militates against including them in standardised revenue assessment. As their contribution to total revenue is relatively small, their inclusion would increase the system's complexity without greatly improving its performance.

In the consultation process, council opinions were split on parking revenues. One council provided considerable detail on the specifics of its parking revenues, and argued in principle:

> *"This proposal appears to fly completely in the face of the effort neutrality principle. Considerable caution has to be shown in adopting changes to the methodology which directly conflict with the basic principles of the Grants Commission system."*

Many submissions supported another council's contention:

> *"Council does not support the inclusion of parking revenues in the assessment of revenue as it would be virtually impossible to develop a fair and equitable methodology to determine the average parking revenue."*

Such concerns about parking revenues also informed views on other revenue sources, with the majority supporting the view:

> *"We agree that other revenues should not be considered as they are rather small and will only add complexity to a system which needs to be simplified where possible."*

Following this discussion, the Final Report noted

> *"As noted above, the Issues and Options Paper recommended that the VGC should continue to exclude other income in the assessment process. This recommendation was further supported by the analysis of parking revenues presented by several Councils. The information provided there suggested that any system using these revenues would both be complex, and involve considerable arbitrary elements.*
>
> *"This view was also taken in relation to other revenue sources. They vary considerably between Councils, and adopting a standard approach would be extremely difficult."*

The Final Report therefore recommended:

7. *Revenue assessment will not include parking revenues.*

8. *While the VGC will consider further ways of including all revenues, it will continue to exclude other revenues in the short term.*

7.2 Discussion Paper

7.2.1 Overview of Other Revenues

In view of the recommendation from the 2001 Commonwealth Grants Commission review, the Discussion Paper gave further consideration to this issue. This started with the pattern of revenues across councils.

In 2001/02, councils received $675 million in fees, fines and charges. One council – the City of Melbourne – received a remarkable $117 million of this (because of this unique performance, which distorts the averages for other councils, Melbourne is excluded from the following discussion).

The other 78 councils received $558 million in fees, fines and charges. A small proportion of this came from activities undertaken by only a few councils: for examples, 21 councils received a total of $1.5 million revenue from aerodromes, and a further 11 councils received

$5 million from property undertakings. However, the vast bulk of the revenues ($530 million in total) came from activities undertaken by most councils.

There are, broadly, three patterns in these revenues:

Table 9: Local Government Fees, Fines & Charges 2001/02

Associated with activity centres		
	Family and community (primarily fees for child care)	$58 m
	Recreation and culture	$104 m
	Car parking fees and fines	$96 m
Activities spread fairly evenly across the State		
	Governance and administration	$37 m
	Community development	$39 m
	Building control	$22 m
Activities with an emphasis on regional and rural Victoria		
	Aged care (primarily HACC fees, but also some residential care facilities)	$57 m
	sanitation (excluding garbage charges, which are included in the rate figures discussed above),	$50 m
	Infrastructure services	$29 m
	Tourism and area promotion	$13 m
	Markets and saleyards	$8 m
	Business undertakings (excluding property-related)	$18m

Across Victoria, the three broad groups give the following pattern of revenues per head of population:

Table 10: Local Government Fees, Fines & Charges 2001/02

	Activity Centres	Evenly Spread	Rural Emphasis	Total
Total revenues* ($m)	258	98	174	530
Revenues per head of population ($)				
Metro Central*	111	22	19	152
Metro Developed	44	17	23	84
Metro Fringe	28	22	26	76
Regional Urban	36	23	66	125
Regional Centres	71	23	57	151
Rural Agricultural	18	21	109	148
VICTORIA*	54	20	36	110

Note: * The Totals and Metro Central figures exclude the City of Melbourne.

While most councils raise some revenues in all these categories, there is considerable variation between councils:

- Three councils, Port Phillip, Stonnington, and Yarra (all of whom are minimum grant councils) collect half ($48 million) of the total $96 million in car parking revenues,
- Indigo Shire collects almost one third ($6 million) of the total $18 million in Business undertakings (excluding property). This is due to revenues from a resource sharing arrangement between several councils in North East Victoria. Indigo keeps the books for the joint venture, and hence records all of the revenues (but also all the expenses).

Similar patterns appear for a small number of other rural councils in infrastructure services.

- Campaspe and Warrnambool together collect one third ($5 million) of the total $15 million in tourism revenues, reflecting primarily the two council-run tourism attractions of the Port of Echuca and Flagstaff Hill (again, there are substantial expenses associated with these attractions);
- In waste management, some councils run regional waste management facilities, with again all the revenues and expenses being included in those councils' accounts.

Overall, councils (excluding Melbourne) raise an average of some $110 per head in fees and charges, with three broad patterns:

- Revenues averaging $54 per head which show a marked emphasis to business and activity centres (albeit with a strong influence from car parking revenues collected by a small number of councils);
- Revenues averaging $20 per head which are spread reasonably evenly across all councils; and
- Revenues averaging $36 per head which have a strong regional and especially rural emphasis. These revenues are frequently associated with activities which the councils provide because there is no private sector provision in the area. Examples include residential aged care facilities, markets and saleyards, and the tourism projects noted above (although again, this figure is inflated somewhat by revenues from a small group of councils).

In its cost adjustors for standardised expenditure calculations, the VGC has two which together produce a roughly similar pattern to total other revenues:

- The regional significance cost adjustor has a higher value for regional centres and inner metropolitan, and lower values for metro developed, metro fringe, and rural agricultural councils;
- The scale cost adjustor[14] has higher values for the small rural agricultural councils.

These patterns are relevant for any consideration of whether and how such revenues should be included in standardised revenue assessment.

7.2.2 Suggested Measures

From this, the Discussion Paper concluded that most councils do raise significant fees and charges. However, in a number of areas, a small number of councils collect a large proportion of the total. This can be seen as reflecting either:

- Particular circumstances for a few councils (which, consistent with the above treatment of the City of Melbourne revenues, should not affect the general picture for all councils); and/or
- Policy decisions by those few councils (in which case, on the CGC argument that LGGCs should distinguish between policy and non-policy driven revenue sources, the revenues should be excluded).

[14] At first glance, the "remoteness" indicator would more closely align with the issues discussed in looking at the variables. However, the remoteness indicator gives the same value for nearly all metropolitan councils, so does not give any differentiation across the metropolitan area.

Considerable effort could be spent untangling the precise implications of such factors – although this could well lead to further controversy rather than clarification.

Based on this, the Discussion Paper suggested:

- Consistent with the CGC recommendation, the VGC process should take some account of council revenues from fees and charges;
- The state-wide average of $110 per head in such fees and charges includes significant revenues which stem from circumstances applying to only a few councils, and from council policy decisions. It would therefore be inappropriate to apply the full $110 figure;
- An appropriate approach is to allow half of the $110 figure. Depending on how particular revenues are assessed, it seems likely that the true policy neutral figure would be somewhere between say $40 and say $70 – and neither extreme would produce a significantly different figure from the $55 per head figure being suggested;
- The $55 a head figure should be scaled by the application of the regional significance and scale cost adjustors.

7.2.3 Possible Impacts

The introduction of other revenues in the assessment has two impacts on grants, depending on

- The pattern of other revenues – the Discussion Paper proposed to use a state average of $55, adjusted by each council's ratings on the regional significance and scale variables;
- The size of the council's current Raw Grant.

The second point can be illustrated by looking at the impact of adding $50 to the revenue side for three councils (all figures in $ per head, 2003/04 allocation figures).

Table 11: Council Grant Calculation - Example

Council	Net Standardised Expenditure ($ / head) (NSE)	Current Standardised Revenue ($ / head) (R)	Raw Grant (=NSE – R)	Raw Grant + $50 other revenue	% Change Raw Grant	% Change Final Grant
A	630	231	399	348	-12.8%	2.1%
B	505	215	290	240	-17.2%	-2.2%
C	506	415	91	41	-54.9%	-16.7%

Note that changes of –16.7% in underlying grants would be smoothed by the –6% cap the VGC applies to movements in total General Purpose Grants from year to year.

The figures show considerable impact sensitivity depending on the current size of the raw grant. Councils with a small raw grant (ie standardised revenue close to NSE) will see a strong reduction in their raw grant, and a consequent reduction in the final grant. Councils with a larger raw grant now will see much smaller decreases in the raw grant, with some even seeing an increase in their final grant.

Such a pattern can be justified on equity grounds. It was argued in section 3.2 above that the VGC General Purpose Grants currently mitigate some but far from all of the difference between councils on the expenditure/revenue equation. Councils with small raw grants tend to be metropolitan councils which overwhelmingly strike rates at less than the standardised rate level. Conversely, councils with large raw grant gaps tend to be in rural areas and strike rates at well above the standardised rate.

The Discussion Paper argued that as well as meeting the principle of including more revenues spelt out by the CGC, this proposal also therefore meets the equity goal. The Paper recommended:

> *That the VGC include a revenue component for user fees and charges, averaging $55 per head across Victoria, weighted by each council's ratings on the regional significance and scale cost adjustors.*

7.3 Responses

The Discussion Paper recommendation was opposed 8:4 by metropolitan submissions, but supported 17:5 by regional and rural submissions. However, both supporters and opponents had doubts about the way the $55 figure was calculated, many criticising it as arbitrary and/or unclear:

- Many opponents accepted in principle that other revenues should be included, but indicated opposition until a better methodology could be developed and discussed;
- Many supporters of the inclusion of other revenues were concerned about the $55 figure, and urged the VGC to develop a more robust basis for this measure.

Submissions from	Supporting recommendation	Opposing recommendation	No comment
Metropolitan councils	4	8	5
Regional and rural councils	17	5	2
All submissions (incl MAV)	21	14	7

The critical issue then was not whether other revenues should be included per se, but whether a reasonable and acceptable methodology could be found to include these revenues.

Opposition

The metropolitan group of councils argued

> *"The case for a flat figure of $100 then reduced to $55 per capita seems arbitrary and has not been fully explained. This proposal will make significant changes to grants. The reasons for this action need better explanation."*

Kingston

> *"has reservations regarding the recommendation to include other grant revenues in the assessment of grants on the basis that the proposed figure to adjust new grants is arbitrary . . . this change should not be adopted on the basis that it lacks transparency that is inherent in the other adjustors utilised by the Commission."*

Murrindindi also disagreed with the proposal:

> *"This goes against the principle of effort neutrality and may penalise councils who generate substantial revenues through entrepreneurial undertakings."*

Support

Frankston supported the recommendation

> *"Fees and charges are a major source of revenue for each local authority and the variation in the ability to raise such fees between local authorities should be acknowledged in the assessment of 'needs'."*

Darebin

> *"a Council's ability to raise other revenue such as fees and charges does impact on its ability to raise revenue. We therefore support the consideration of other revenues in the revenue assessment calculation. However, the obstacle in regard to this consideration is the ability to develop a fair and equitable methodology."*

Ballarat gave 'cautious support':

> *"This has not been fully explained as to objectives or methodology. The reasons for including fees and charges need explanation as is the reason for selecting the figure of $55. Why is it then necessary to select expenditure cost adjustors to vary outcomes? The VGC needs to consult with councils and give some broad outcome guidelines."*

Complexities

For Greater Shepparton the doubts swung the balance the other way:

> *"Whilst option iii has conceptual merit, it seems somewhat arbitrary to utilise the figure of $55 per head, which equates to around half of the state-wide average. We would advocate further investigation into the inclusion of other revenues, with the objective of developing more robust and reliable options for consideration."*

Baw Baw:

> *"Where significant anomalies arise because a council has undertaken a business enterprise that has become profitable we believe the effects of this revenue should be removed where these revenues are one-off anomalies. Whilst we believe other revenues need to be included (such as car parking), based on the effort neutrality principle, we agree that other 'one-off' anomalies should be removed."*

Moira argued

> *"if saleyards have been included in the "other revenue" for rural agricultural municipalities* [they are included] *then the offset of the expenditure should be acknowledged. The saleyard within Moira Shire for example is a "breakeven" activity undertaken by Council to support the local farming community."*

Cost Adjustors

Swan Hill

> *"Council believes it is appropriate to adjust the Other Revenues component for the capacity to pay as fees and charges have some element of choice."*

Mount Alexander suggested removing the Scale cost adjustor, and replacing it with the socio-economic index adjustor, reflecting communities' varying ability to pay fees and charges.

Whittlesea

> *"The VGC needs to fully explain the reasoning as to why the user fees and charges figure selected is $55 per head and not something higher or lower. The cost adjustor suggested to be applied also need further explanation as to why it is seen as appropriate for calculating user fees and charges."*

Yarra Ranges argued for population dispersion to be used as a cost adjustor.

Implementation

Moira suggested that the VGC should determine the revenue component more accurately than "on average" – perhaps by removing the top six and bottom six municipalities to derive a less skewed average.

Golden Plains agreed "with the CGC position that other revenue should be taken into account", and

> *"believes that the value used for other income should be expressed as a formula rather than a specified dollar amount. For example, the figure could be defined as "half of the state-wide average of fees and charges excluding City of Melbourne revenues." As soon as a dollar figure is codified, the question everyone will be asking is will it be updated each year. Codifying a formula rather than a figure will provide much greater transparency to the process."*

And the MAV suggested two possible approaches:

> *"compare net standardised expenditure for each function with cost adjustors, against actual revenue for the same function, or against standardised revenue for each function. . . The models outlined above are based on a holistic assessment of actual revenues collected, by function, and it is believed that this is a more transparent and logical approach."*

7.4 Further Work on Other Revenues

As was noted in the comments above, the recommendation did not inspire councils – with most submissions being sceptical if not opposing it. In particular, submissions felt that the choice of $55 was arbitrary.

Further work has therefore been undertaken to develop an improved way of including other revenues. As well as responding to the general comments of submissions, this has especially drawn on the implementation suggestions from Moira, Golden Plains and the MAV.

Moira suggested that the VGC should determine the revenue component more accurately than "on average" – perhaps by removing the top six and bottom six municipalities to derive a less skewed average. The value of this suggestion can be illustrated by looking at the distribution of revenues received in family services.

Chart 4:

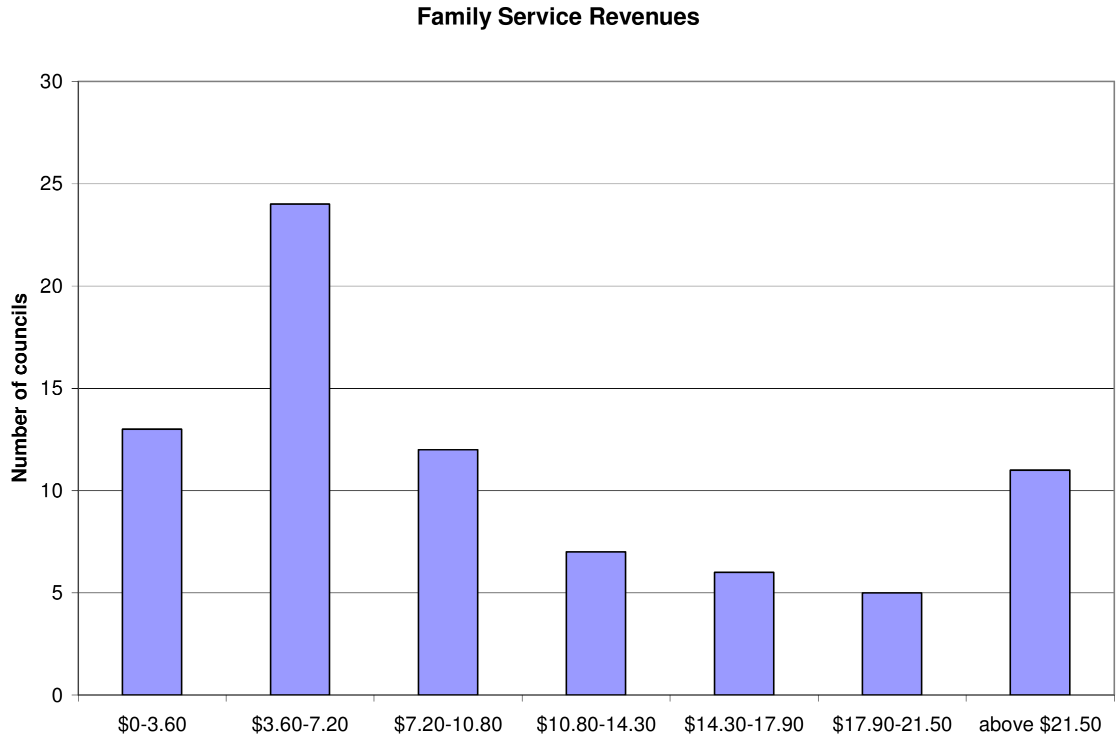


Chart 4 shows that 13 councils had family services revenues between $0 and $3.60, 24 councils had revenues between $3.60 and $7.20, and so on, with 11 councils having revenues greater than $21.50.

If all revenues are averaged, to give the mean revenue, this can be strongly affected by those councils with high revenues. In the family services case, the mean revenue was $11.95, despite the fact that 51 of the 77 councils (two-thirds) had revenues less than this number. In addition, as pointed out in the Discussion Paper, the use of the mean faces the problem of the data for all councils being affected by revenues collected by a small number of councils, who could well be in unusual situations.

Moira suggested that this problem could be addressed by removing say six councils from the top and bottom of the distribution. However, the choice of a specific number to take off the top and bottom is again a somewhat arbitrary choice. The intent of the suggestion can be achieved by using median data for revenues – or the value for the middle council. In the family services case, the median figure is $7.52; which, as evident from the graph, gives a more accurate picture of the revenue situation facing most councils. Such use of the median also addresses Golden Plains' argument that the figure should be set by formula rather than as a somewhat arbitrary $ figure[15].

A key implementation suggestion from the MAV was the comparison of expenditure for each function (after cost adjustors) with actual revenue for the same function – effectively an extension of the inclusion approach for Specific Purpose Payments.

In principle, this is consistent with the approach suggested by the Commonwealth Grants Commission for Financial Assistance Grants to the States. The CGC has indicated it prefers a "tax by tax" approach rather than a global agglomeration of individual taxes, and bases this

[15] Median figures are also used in the annual *Local Government in Victoria* report

preference on the argument that it is closer to "what States do."[16] Where such taxes are related to specific expenditure areas, a netting approach is suggested.

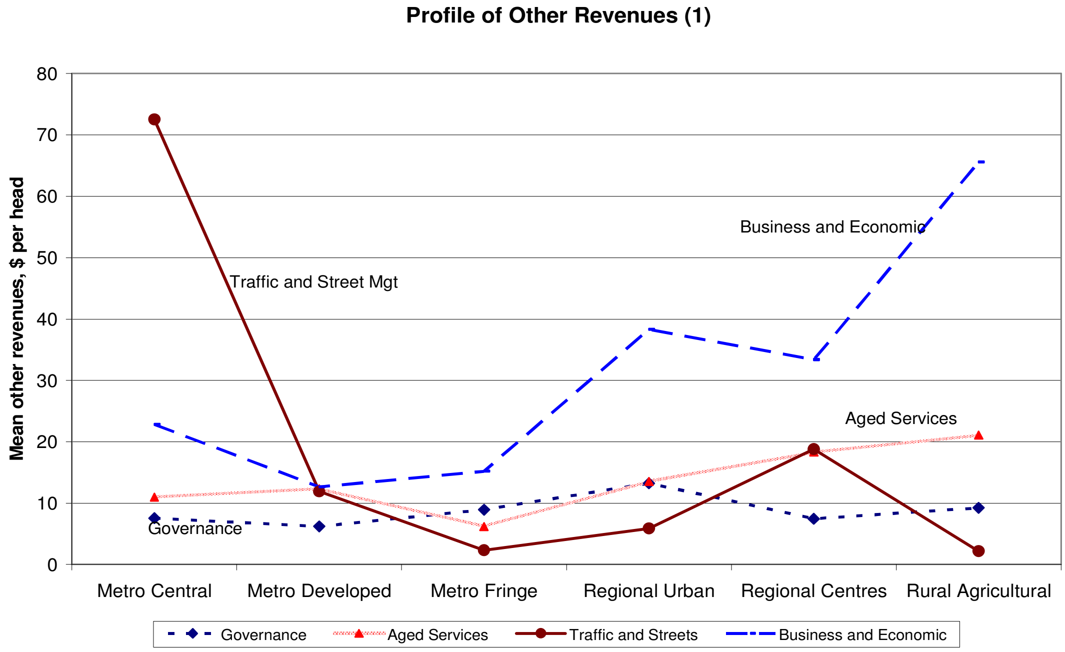
In looking at "what councils do", as noted in section 7.2.1, there is considerable variation in the pattern of other revenues across councils. To some extent, this indicates policy decisions by individual councils. However, as is apparent from the graphs below, there are also significant differences by type of council, indicating some structural differences in councils' raising of revenues.

The graphs show mean revenues per head for eight of the nine expenditure functions used by the VGC[17].

The first graph (Chart 5) shows revenues in four expenditure functions:

- *Governance*, where the mean revenue is fairly stable, but highest for regional urban and rural agricultural councils (a pattern mirrored in the scale cost adjustor used by the VGC);
- *Traffic and Street Management* (which is primarily the revenues from car parking), where mean revenue is highest for Metro central and Regional Centre councils (a pattern mirrored in the regional significance cost adjustor used by the VGC);
- *Aged services*, where mean revenues are somewhat higher for rural agricultural and regional centre councils, but generally similar elsewhere; and
- *Business and Economic services*, which shows an increasing pattern across the council groups.

Chart 5:

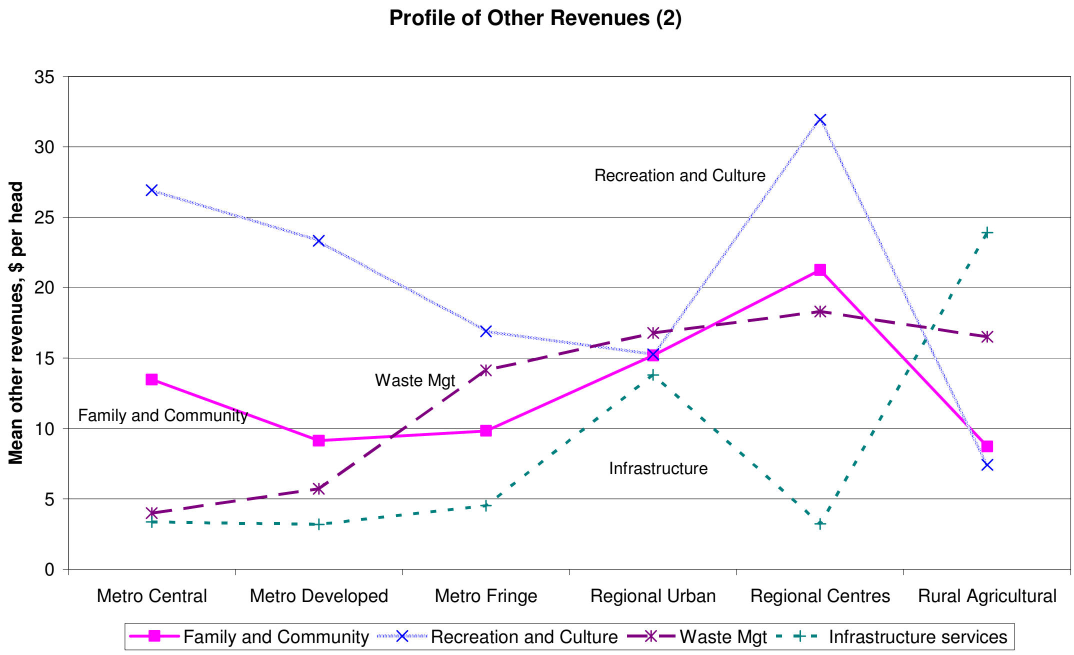


[16] Commonwealth Grants Commission *Guidelines for Implementing Horizontal Fiscal Equalisation* Information Paper CGC 2001/2, p44-50.
[17] The one category excluded from the graphs is local roads, which has a very small mean revenue, at $2.

The second graph (Chart 6) also shows some variations:

- *Recreation and culture* revenues are strongest amongst regional centre and metro central councils (the regional significance pattern);
- *Family and community* revenues also show a regional significance pattern;
- *Waste Management* revenues are low in the metro central and developed councils, but then higher for all other council groups. The metro fringe mean figure is however distorted by a few councils which run regional tipping sites. Excluding these, the pattern is similar to that for scale.
- *Other Infrastructure services* shows a strong scale pattern, with strongest revenues for rural agricultural and regional urban.

Chart 6:



These graphs show the patterns of revenues across Victoria, and some interesting variations in the abilities of councils to raise revenues in each of these areas.

As was argued in the Discussion Paper, the mean revenue figures can be somewhat misleading, as they include the large revenues collected by one or two councils. In developing a methodology for these revenues it is therefore recommended that the VGC use the median revenue figure for each expenditure category, and weight this by the cost adjustor that most closely matches the patterns observed in the above graphs.

This provides the following data:

Table 12: Proposed Adjustors

Category	*Median* $	*Mean* $	*Proposed adjustor*
Governance	7	8	Nil
Family and Community	8	12	Regional significance
Aged	12	12	Nil
Recreation	12	22	Regional significance
Waste Management	6	10	Scale
Local roads	0.6	2	Regional significance
Traffic and Streets	2	21	Regional significance
Other Infrastructure	2	6	Scale
Business and Economic	20	23	Scale
Total	71	116	

Note: The above figures are based on the same data used in the Discussion Paper and cited above. The data source is other revenues reported to the VGC by Victorian Councils for 2001/02, excluding the City of Melbourne. That earlier discussion excluded some unusual revenues – and calculated a mean figure for the State of $110. As the use of median figures excludes outlying data, such an exclusion is not necessary here, and the above mean incorporates all other revenues in 2001/02 for the 77 councils[18].

For most categories the use of the median figure can be readily justified. The median is generally between 50% and 90% of the mean figure, as would be expected with the removal of any unusual high figures. However, in two functions there are clearly very skewed distributions: other infrastructure and traffic and street management, and a question arises whether these should be treated differently. In particular, as car parking revenues are the single largest source of other revenues for Victorian councils, it may seem strange to include traffic and street management at the median figure of $2.

There are two strong arguments why the median should nonetheless be used:

- It is consistent with the approach used for the other functions. If an adjustment were made here, it might be both arbitrary in itself and lead to queries why similar adjustments in the methodology were not made for other functions;
- While car parking is indeed the single most important source of other revenues for local councils in Victoria, $110 million of the $152 million total is collected by the seven minimum grant councils – for whom there is no impact on the grant whichever figure is used. If these councils' data is removed from the calculations, the median remains at 2, but the mean drops from 21 to 10.

A further comment is necessary on the use of the cost adjustors. Some submissions suggested that other cost adjustors should be also used, with the socio-economic adjustor especially recommended.

An issue specifically arises with the socio-economic adjustor. In a number of areas, both councils and the private sector provide services. However, the provision of private services appears to have an emphasis on metropolitan and wealthier areas[19]. Thus a council in a less affluent area may well be more likely to provide more services, and have higher revenues. Such considerations militate against the use of the socio-economic adjustor.

[18] The total is 77 as the City of Melbourne is excluded, and the data were collected prior to the division of Delatite Shire into Benalla and Mansfield.

[19] A similar situation could occur for example for swimming pools, where the greater number of private pools in well-off areas can reduce the demand for a council to provide public facilities

Charts 5 and 6 showed that there are indeed considerable differences between council groups in the patterns of revenue collected (and the variations can be even greater when data for individual councils is considered). It is therefore desirable to use adjustors that mirror some of the variation between councils – and the most effective way to do this is to use only one adjustor, preferably the one that best matches the pattern of variation across councils. The Discussion Paper recommended the use of the regional significance and scale cost adjustors. These appear to be a useful starting point for VGC consideration – with the prospect that even more appropriate adjustors may be found.

7.5 Recommendation

Taking into account the suggestions made by submissions, and from this additional analysis, this Report recommends

6. That the VGC include a revenue component for user fees and charges, by including in each expenditure function the median other revenues for that function, weighted by appropriate adjustors.

8. Implementation Issues

As noted in many submissions, the recommended changes in revenue assessment methodology will have impacts on council grants. A final issue is how such changes are to be managed.

In discussing the use of revenue caps, the Discussion Paper noted the VGC's policy of smoothing movements in overall grants from year to year. This policy was explicitly discussed in the 2000/01 Review of General Purpose grant methodology, and received strong support from councils.

The discussion of rate revenue caps noted the suggestion (from Moira, Golden Plains and Glenelg) that the current cap on decreases of –6% should be increased to –10%. While the VGC may wish to keep this issue under review, it appears that there is currently strong support from councils for the –6% figure. This, and the modified rate revenue cap suggested in this report, will provide a transition path for councils as the new methodology is introduced.

Appendix 1: Summary of Submissions

	Use of valuations		End rev caps		Valuation base		No adjust capacity/pay		Same SPP treatment		Incl fees & charges	
	✓	✗	✓	✗	CIV	NAV	✓	✗	✓	✗	✓	✗
MAV		✗					✓		✓			✗
Metro Councils	5	7	3	10	6	8	10	3	13	0	4	8
Metro Group		✗		✗					✓			✗
Bayside		✗		✗		NAV	✓		✓			✗
Cardinia	✓		✓			NAV	✓		✓		✓	
Darebin		✗		✗	CIV			✗	✓			
Frankston						NAV					✓	
Kingston	✓		✓		CIV		✓		✓			✗
Knox		✗		✗	CIV		✓		✓			✗
Manningham				✗			✓		✓		✓	
Maribyrnong					CIV			✗				
Monash	✓			✗		NAV	✓		✓			
Moonee Valley		✗		✗		NAV	✓		✓			✗
Moreland		✗		✗	CIV		✓		✓			
Mornington						NAV						✗
Nillumbik		✗		✗		NAV	✓		✓			✗
Whittlesea	✓			✗		NAV		✗	✓			✗
Yarra Ranges	✓		✓		CIV		✓		✓		✓	
Non metro	21	2	18	4	14	9	17	5	22	0	17	5
Smaller Popn	✓		✓			NAV		✗	✓		✓	
Ararat	✓		✓		CIV			✗	✓		✓	
Ballarat		✗		✗	CIV		✓		✓		✓	
Baw Baw	✓		✓								✓	
Cent Goldfields	✓		✓			NAV		✗	✓		✓	
Corangamite	✓				CIV		✓		✓		✓	
East Gippsland	✓		✓		CIV		✓		✓		✓	
Glenelg	✓		✓		CIV		✓		✓		✓	
Golden Plains	✓		✓			NAV	✓		✓		✓	
Gtr Geelong	✓			✗	CIV		✓		✓			✗
Gtr Shepparton	✓		✓		CIV		✓		✓			✗
Hindmarsh	✓		✓			NAV	✓		✓		✓	
Horsham	✓		✓		CIV		✓		✓		✓	
Mansfield	✓		✓			NAV		✗	✓		✓	
Mildura	✓			✗	CIV		✓		✓			
Moira	✓		✓		CIV		✓		✓			✗
Mt Alexander						NAV					✓	
Murrindindi	✓		✓		CIV		✓		✓			✗
Sthn Grampians	✓		✓			NAV		✗	✓			
Surf Coast		✗		✗		NAV	✓		✓			✗
Swan Hill	✓		✓		CIV		✓		✓		✓	
Wellington	✓		✓		CIV		✓		✓		✓	
West Wimmera	✓		✓			NAV	✓		✓		✓	
Wodonga	✓		✓		CIV		✓		✓		✓	
SUMMARY												
Metro Councils	5	7	3	10	6	8	10	3	13	0	4	8
Non-Metro	21	2	18	4	14	9	17	5	22	0	17	5
All submissions	26	10	21	14	20	17	28	8	36	0	21	14

Appendix 2: References

Morton (1996) *Assessment of Revenue Raising Capacity of Local Government*, Commissioned for the Local Ministers Conference, May

Commonwealth Grants Commission (2001) *Review of the operation of the Local Government (Financial Assistance) Act 1995*, June

National Office of Local Government (1999) *Annual Report 1998/99,* especially Appendix A: National Principles for allocating General Purpose and Local Roads Grants

Victoria Grants Commission (2000) *Review of General Purpose Grants: Issues and Options Paper* Prepared for the VGC by Milbur and SGS Economics and Planning, September

\- (2001) *Review of General Purpose Grants: Final Report* Prepared for the VGC by Milbur and SGS Economics and Planning, May

Appendix 3: Background on Revenue Methodologies

The following discussion of revenue methodologies and rationales appeared as chapter 3 in the Discussion Paper.

The Commonwealth Government provides an annual total of just over $1 billion in General Purpose Grants to local government across Australia. Local Government Grants Commissions (LGGCs) allocate the funds in each State. While each LGGC is bound by the National Principles, the methodologies differ between the States, and have also developed over time.

It is therefore of value to this review to survey briefly the differing approaches taken.

A3.1 Previous Reviews

A3.1.1 Prior to 2000

At the start of Federal funding for local government in 1973, the Commonwealth Grants Commission used valuation bases as the sole measure of revenue capacity in its allocation process (Morton, 1996, p6). When LGGCs became responsible for grants allocation within each State in the late 1970s, they all continued assessing revenue capacity by using the valuation base and this has been the approach since.

The Commonwealth Grants Commission revisited the revenue capacity issue in 1991, and argued then that revenue capacities from three classes of ratepayers should be assessed separately:

- For commercial and industrial ratepayers, property values were judged the best measure;
- For most residential property, household income was a better measure; and
- For farming properties, average farm income over a period was more appropriate.

This issue was further considered in a 1996 comprehensive review of the revenue raising capacity of local government (Morton, 1996). This looked at the way that each LGGC considered revenues, and was especially critical of those States which use unimproved (site) value as their valuation base, arguing they:

> *"Are unlikely to provide any reasonable estimate of revenue raising capacity between councils because they are not a reasonable indicator of cash flow, or of wealth, or of permanent income" (Morton, p ii)*

Morton therefore preferred Victoria's use of Net Annual Value.

While Morton had some sympathy with the wider approach suggested by the Commonwealth Grants Commission, he noted some serious problems. First, it is always a vexed issue on how to combine widely differing measures. Second, there are data problems with each of the alternative assessments:

> *"The ABS personal income figures are self-assessed and are available in income ranges without an aggregate figure. Assumptions are needed to estimate the gross income. The figures are also only updated at five year intervals . . . Retail turnover*

does not include all establishments of a commercial and industrial nature, and therefore does not fully cover the sectors that are to be represented by this datA3. This data is also only updated at five year intervals[20]. Agricultural production statistics which are generally available are of a gross nature, and do not net out the costs of production which vary substantially from sector to sector" (Morton, p 45)

Faced with such problems, it is not surprising that Morton supported the decision of LGGCs to continue with the use of a simple valuation base, concluding:

"the simple fact is that it is not possible to accurately assess the relative revenue capacity of local governments" (Morton, p iii)

In other words, Morton preferred a simple valuation based system as he felt that more complex approaches would reduce transparency without demonstrably improving equity outcomes.

A3.1.2 2001 Commonwealth Review

In June 2001, the Commonwealth Grants Commission (CGC) reported to the Commonwealth Government on its review of the operation of the Local Government (Financial Assistance) Act 1995 (CGC, 2001).

The Commission had been asked to examine and report on how well Local Government Grants Commissions' (LGGCs') policies and methods concurred with the National Principles – in particular that of full horizontal equalisation.

The CGC found that generally the current arrangements had led to a distribution of funds in line with the National Principles, but made a number of recommendations for LGGCs to consider. It also specifically addressed revenue raising capacity, identifying a range of issues.

Current Approaches

While the proportion of local government revenues coming from rates has declined over time, rates are still the most important local government income source (contributing some 50% of total council revenues in Victoria).

Rate revenues therefore form the major input for the assessment of revenue capacity by LGGCs. Indeed, the only other revenues considered in the methodologies are Special Purpose Grants, which are required to be included under the fourth National Principle.

As outlined in section 3.2 of this paper, LGGC's have different ways of calculating revenue standards and assessing revenue capacity. Three different approaches are used:

- valuations;
- regression analysis; or
- personal income.

Under each approach assessed revenue capacity can be different, and therefore result in different grant allocations.

The CGC is responsible for allocating Commonwealth Financial Assistance Grants to State Governments, and used its methodology as a benchmark for discussing the different approaches taken by the LGGCs in assessing council revenues.

[20] In fact, data problems have led to the discontinuance of this series by the ABS

The review noted several different methods of assessing revenue capacity, with a key issue being the role of policy decisions by councils. To what extent do differences in revenue reflect different situations facing councils (in which case the differences should be considered in assessing standardised revenues) – or do they reflect policy decisions made by individual councils (in which case, the differences should be excluded from the assessment).

CGC Comments on the State Methodologies

NSW, Victoria, SA and Tasmania use the valuations approach, with a standard rate in the dollar across the State. This implicitly assumes that decisions to strike rates higher or lower than the standard rate are policy decisions. The CGC expressed some concern about the NSW approach of discounting its revenue assessment by 70%.

QLD and WA use the regression approach, due to dissatisfaction with the valuation method. This analysis uses actual revenues, and effectively assumes that no revenue decisions are policy-driven. However, the regression technique can produce revenue capacity results that are inconsistent with what LGBs actually do, especially if there are significant revenue differences between similar councils. A further issue is the complexity of the results, which raise the question of transparency.

The CGC noted that NT uses the personal income approach. This is necessary as most land in the Territory is non-rateable, although it produces lower assessed revenue capacity than with the valuation approach, and this has effects on the distribution of grants across councils.

Assessment of Non-Rate Revenue

The CGC noted the growing importance of non-rate revenue sources for councils. However, LGGC methodologies only include rates and specific purpose grants, excluding user fees and charges, which are the other major source of revenues. The CGC argued that it would be preferable to:

> *"…assess the full-range of non-rate revenue, because it is more in keeping with a comprehensive assessment of needs. If two councils are identical in all respects except that the first has access to significant user charges, then it would be unfair to ignore that revenue source. To do so would place the first council in a more advantageous position than the other." (page 131)*

The CGC noted two reasons advanced by LGGCs against the inclusion of user charges:

- User charges vary considerably between councils, and including them would complicate the methodology considerably;
- This increase in complexity would create little additional value in outcomes. The councils collecting the most in user charges tend to be minimum grant councils, so the new methodology would have no impact on their grants in any case.

As is noted in section 7.1 below, the VGC 2000/01 Review specifically looked at car parking revenues, which are the largest user charges in VictoriA3. The VGC decided against including these revenues, primarily because:

- Most car parking revenues are received by councils on the minimum grant in any case; and
- Concerns arose about conflict with the principle of effort neutrality.

The CGC review noted this discussion, but suggested that other revenues should be included, and discussed some effort-neutral ways of doing this.

As is indicated in the next section, LGGCs in other states are now considering a number of issues from the CGC review.

A3.2 Other States' Mechanisms

In each State across Australia, Grants Commissions use different methods to calculate revenue raising capacity. The following discussion outlines the methods they use, and details any reviews recently or currently undertaken on the revenue side of the model.

A3.2.1 New South Wales

The Commission uses the valuation approach. The calculation of revenue involves determining each council's theoretical revenue raising capacity by comparing land values per property to a State standard and applying the State standard rate-in-the-dollar. For comparative purposes the Commission uses valuation data that has been calculated to a common base date for all councils. To reduce fluctuations the valuations are averaged over three years and non-rateable properties are excluded. Included in the calculation is all net rates levied, ex gratia payments, garbage changes and pensioner subsidies. Separate calculations are made for urban (residential and business) and non-urban (farmland and mining) properties.

The revenue assessments are discounted to achieve equilibrium with the expenditure assessments. As the model does not include all expenditure, the revenue side of the model needs to be artificially reduced.

A3.2.2 Queensland

The Queensland Local Government Grants Commission is in the process of implementing a new methodology. Previously revenue capacity for rate revenue was based largely on rates, reflecting the pattern that across the state total rate revenue represents 70% of local government revenue. The methodology included:

- total number of rateable properties;
- gross value of rural production;
- personal income;
- residual retail sales; and
- unimproved capital value.

Fees and Charges were also included.

Due to some of the data no longer being available the Commission had to review the methodology used and did so as part of a total review of the allocation methodology.

Based on the review revenue capacity will now be assessed by;

- rates,
- garbage revenue,
- other fees and charges, and
- other grant support.

Rates are based on three categories: residential, commercial & industrial, and rural. Assessed rating capacity is determined by applying the State average rate in the dollar to each individual council valuation categories, with an adjustment made for average family income.

Garbage revenue is total actual revenue raised divided by the total number of urban properties, and the average multiped by the number of urban properties in a council area to provide a figure for each council. Other grant support is also included.

The Commission has decided to continue researching the issue of rating capacity, with the work to be completed in time for the 2004/05 grant allocation.

A3.2.3 South Australia

The Commission uses the valuation approach and estimates each council's revenue by applying the State average rate in the dollar to the difference between the council's improved capital values per capita and those for the State as a whole, and multiplying this back by the council's population. The State average rate in the dollar is the ratio of total rate revenue to total improved capital values of rateable property. The result shows how much less (or more) rate revenue a council would be able to raise than the average for the State as a whole if it applied the State average rate in the dollar to the capital values of its rateable properties. The calculation is repeated for each of five land use categories, namely;

- residential;
- commercial;
- industrial;
- rural; and
- other.

To overcome fluctuations in the base data, valuations, rate revenue and population are averaged over three years.

The South Australian Local Government Grants Commission released a discussion paper on Revenue Raising Capacity, December 2002 and identified the following factors that are not taken into account with the current methodology:

- Councils' use of minimum rates, fixed charges, rate alterations, rebates, remissions and postponements or other measures available to them under the rating provisions of the Local Government Act;
- measures of ratepayers' incomes or capacity to pay;
- measures of communities' social or economic disadvantage;
- other measures and influences in relation to Councils' capacity to raise revenue;

- revenue raised other than from rates and grants such as user fees and charges and commercial activities.

The SALGGC is considering the application of SEIFA and personal income in their model, they would represent 20% and valuations 80% of revenue raising capacity.

A3.2.4 Tasmania

The Tasmanian Commission uses the valuation approach and assess annual values as the basis for assessing revenue rasing capacity. Valuations are adjusted to take into account properties that are partially exempt from rates (that is liable for service charges only). Each council's theoretical revenue raising capacity is determined by applying a State rate-in-the-dollar to each Council's adjusted annual value base. The calculated standardised revenue figures are averaged over three years.

Tasmania is currently considering how to include other revenues, incorporating them on a proportional basis related to the pattern of valuations.

A3.2.5 Western Australia

The Western Australian Local Government Grants Commission currently assesses revenue based on four rate categories. For all categories the valuations and the number of assessments are considered.

The four rate categories are;

- residential and commercial/industrial rates;
- mining rates;
- agricultural rates; and
- pastoral rates.

In addition fees from building control and recreation & culture are also included and netted against the expenditure for these functions. Revenue from those functions has been included as the Commission consider they are the most important user pays items.

The WA LGGC has commenced a review of its methodology and released a draft report in December 2002. The review considered Revenue Capacity Assessments and concluded:

- To maintain the current rate revenue assessments, but give further attention to:
  - Some issues in the mining rates assessment; and
  - The possibility of using a single rate revenue assessment based on a single basis of valuation.
- To cease netting out revenues from expenditure in some categories, and calculate a single non-rate revenue item for these categories.
- To include in the revenue assessment all ex gratia rates received, as well as other significant revenues received (eg from mining companies).
- To further consider the scope for assessing the revenues and expenditures associated with airport operations.

A3.2.6 Northern Territory

In the Territory the Commission determines revenue raising capacity on the basis on ABS personal income for those Councils where it is relevant, the Northern Territory Operational Subsidy is taken into account. This is done as a large portion of land is unrateable. The Northern Territory has a much lower reliance on rates and a greater reliance on grants.

The Review of the Operation of the Local Government (Financial Assistance) Act 1995 noted that the methodology used produces;

- A lower assessed revenue capacity for the municipal LGBs than would be produced by a valuation approach; and
- A higher assessed revenue capacity for other LGBs.

A3.3 Conclusions

Rates represent the main source of council revenue valuations, and they are generally used to determine revenue raising capacity. But most Commissions are aware that this has short comings as other major revenue sources (fees, charges, fines, etc) are excluded and the issue of individual capacity to pay is not considered.

The CGC review contains three main suggestions for this Paper:

- LGGCs should be more explicit in assumptions about the influence of policy and non-policy influences in assessing revenue capacity;
- While the valuations approach is a reasonable way of assessing rate revenues, an approach distinguishing between property classes may have advantages;
- LGGCs should include the full range of non-rate revenue in their calculations.

As outlined in this section, most LGGCs are considering improvements to their revenue methodologies, with:

- Rates on differing property groups assessed separately;
- Measures of socio-economic status being included;
- Other revenues also being included.

Appendix 4: Residential Rates, Household Income

The following table compares for each council its median household income at the 2001 Census with its average residential rate per assessment in 2000-01.

	Income	Rates			Income	Rate	
Alpine (S)	588	607	103%	Manningham (C)	1109	663	60%
Ararat (RC)	589	538	91%	Maribyrnong (C)	682	719	105%
Ballarat (C)	656	623	95%	Maroondah (C)	905	589	65%
Banyule (C)	933	639	68%	Melbourne (C)	929	840	90%
Bass Coast (S)	493	461	93%	Melton (S)	938	757	81%
Baw Baw S)	682	640	94%	Mildura (RC)	648	552	85%
Bayside (C)	1130	753	67%	Mitchell (S)	778	649	83%
Boroondara (C)	1217	832	68%	Moira (S)	628	645	103%
Brimbank (C)	808	640	79%	Monash (C)	943	574	61%
Buloke (S)	538	356	66%	Moonee Valley (C)	872	682	78%
Campaspe(S)	667	610	91%	Moorabool (S)	813	687	84%
Cardinia (S)	863	633	73%	Moreland (C)	721	615	85%
Casey (C)	924	594	64%	Mornington Pen (S)	702	524	75%
Central Goldfields (S)	478	533	111%	Mt Alexander (S)	531	595	112%
Colac-Otway (S)	618	683	111%	Moyne (S)	668	545	82%
Corangamite (S)	624	419	67%	Murrindindi (S)	631	563	89%
Darebin (C)	701	582	83%	Nillumbik (S)	1260	928	74%
Delatite (S)	605	617	102%	Nthn Grampians (S)	586	631	108%
East Gippsland (S)	516	615	119%	Port Phillip (C)	970	668	69%
Frankston (C)	768	576	75%	Pyrenees(S)	499	394	79%
Gannawarra (S)	581	397	68%	Queenscliffe (B)	618	790	128%
Glen Eira (C)	899	580	65%	South Gippsland (S)	612	516	84%
Glenelg (S)	637	366	57%	Sthn Grampians (S)	613	504	82%
Golden Plains (S)	777	401	52%	Stonnington (C)	1124	708	63%
Greater Bendigo (C)	644	595	92%	Strathbogie (S)	541	575	106%
Grtr Dandenong (C)	670	482	72%	Surf Coast (S)	782	667	85%
Greater Geelong (C)	685	588	86%	Swan Hill (RC)	623	601	96%
Grtr Shepparton (C)	712	644	91%	Towong (S)	647	492	76%
Hepburn (S)	536	451	84%	Wangaratta (RC)	647	584	90%
Hindmarsh (S)	554	369	67%	Warrnambool (C)	658	657	100%
Hobsons Bay (C)	825	549	67%	Wellington (S)	630	458	73%
Horsham (RC)	648	577	89%	West Wimmera (S)	564	298	53%
Hume (C)	871	544	62%	Whitehorse (C)	914	527	58%
Indigo (S)	725	585	81%	Whittlesea (C)	882	663	75%
Kingston (C)	838	566	68%	Wodonga (RC)	751	784	104%
Knox (C)	991	555	56%	Wyndham (C)	954	823	86%
Latrobe (C)	626	599	96%	Yarra (C)	974	775	80%
Loddon (S)	500	365	73%	Yarra Ranges (S)	886	747	84%
Macedon Ranges (S)	903	802	89%	Yarriambiack (S)	572	320	56%