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by

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Local Government Amalgamation and the South Australian *Rising to the Challenge* Inquiry

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Abstract

Although municipal amalgamation has enjoyed prominence as the primary engine of structural reform in Australian local government for at least the past century, mounting evidence concerning its adverse consequences has lead to a growing scepticism over its efficacy as a suitable method of enhancing the operational efficiency of local councils. The results of an exhaustive enquiry into the financial sustainability of South Australian by the Financial Sustainability Review Board in 2005 provides further damning evidence on the inability of amalgamation to improve the financial standing of fiscally distressed local authorities in that state. This paper examines those aspects of the deliberations of the Review Board that shed empirical light on the impact of amalgamation on the financial viability of South Australian local government and considers its wider implications for amalgamation as an efficacious instrument of municipal reform in Australia.

Key Words: Amalgamation; Financial Sustainability Review Board; local government.

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1. INTRODUCTION

Council amalgamation has always been the preferred instrument of Australian state and territory governments in their efforts to improve the operational efficiency of local authorities (Vince, 1997). This remarkable state of affairs has persisted for more than a century to the present day, despite no thorough empirical evaluation of the efficacy of the various amalgamation programs, international evidence that casts doubt on the economic benefits typically claimed for consolidation, and growing concern amongst the Australian local government community on the consequences of amalgamation.

However, despite some recent efforts aimed at justifying continued reliance on municipal amalgamation as the primary engine of structural reform, such as the Commonwealth House of Representatives 'Hawker Report' (Dollery, 2005) and the so-called 'Facilitator Reports' in the New South Wales compulsory amalgamation process (Dollery et al., 2005a), the tide appears to have at last turned against amalgamation. For instance, in an apparently Damascene conversion, the previously rampantly pro-amalgamation New South Wales state government now provides material and political support for alternative models to amalgamation, like the New England Regional Alliance of Councils (NERAC) and the Wellington model. Similarly, although Queensland and Western Australia are presently engaged in the early stages of their respective local government reform programs, in both cases the two state governments seem to have ruled out the prospect of forced amalgamation.

Increasing scepticism among the Australian municipal community on the purported efficacy of amalgamation as a means of improving the economic efficiency of local government appears to have at least two recent roots. In the first place, anecdotal evidence on extravagant resource wastage, plummeting morale and organizational chaos in the wake of the New South Wales amalgamation process abounds, even though as yet these views have neither been systematically documented nor subjected to any critical scrutiny at this early stage. Secondly, the recent independent Financial Sustainability Review Board (FSRB) (2005a; 2005b), commissioned by the South Australian Local Government Association, presents evidence that serves indirectly to undermine the case for amalgamation. The present paper considers those aspects of the deliberations of FSRB that shed light on the potency of council amalgamations to enhance municipal 'financial sustainability'.

The paper itself is divided into four main sections. Section 2 provides a synoptic summary of the chief claims advanced by advocates of municipal amalgamation. Section 3 briefly describes the background to the South Australian Inquiry and the principles it developed to assess the financial sustainability of actual councils. With this conception of financial sustainability in mind, section 4 outlines those aspects of the analysis conducted by the Review Board that pertain to the relationship between council size and council financial sustainability. The paper ends with some short concluding comments on the implications of this evaluation for the Australian municipal amalgamation debate.

2. THE CASE FOR AMALGAMATION

Dollery and Crase (2004a) and Dollery et al. (2006) have provided detailed analyses of the theoretical arguments surrounding council consolidation in the Australian institutional milieu. They identified five major arguments marshalled in favour of municipal amalgamation: Economies of scale; scope economies; administrative and technical capacity; administration and compliance costs; and the coincidence of natural and council boundaries, sometimes termed 'eco-civic regionalization'. This section of the paper seeks to provide a synoptic outline of these major arguments.

In the first place, economies of scale refer to a decrease in average cost as the quantity of output rises and are frequently cited as a major reason for local government amalgamations. In the context of the optimal size of municipalities, economies of scale imply a decrease in the cost per person for a given amount of service as the population served increases. Thus, the larger the jurisdictional unit, the lower will be the per capita costs of service provision. Whether or not

Australian local government service provision exhibits scale economies is ultimately an empirical question that has been examined by Byrnes and Dollery (2002); they concluded that the evidence was at best mixed.

Secondly, economies of scope refer to the economic advantages that flow from providing a broad range of goods and services in a single organization, like a municipal council. In particular, economies of scope arise when the cost of producing a given set of services in a single organization is lower than the cost of those services being produced by a number of specialized organizations. The standard explanation for this lower cost of production derives from the fact that a single organization can attribute the cost of fixed inputs or 'overheads', like central administrative staff, computing facilities, and so forth, across many of the services it produces. Thus, where related services are provided by a single council, lower total production costs may follow. Almost nothing is known about the empirical characteristics of scope economies in Australian local government, although conceptual confusion between scale economies and scope economies is widespread (Dollery and Fleming, 2005).

Thirdly, a proposition often advanced in the Australian debate over amalgamation is that larger councils tend to possess greater levels of administrative and other expertise, in part due to the fact that their size permits the employment of specialist skills that cannot be acquired readily by smaller municipalities. Given the increasing burden placed on Australian local government by its state and federal counterparts, through cost shifting and other activities, it is held that this confers a significant advantage on larger municipal units because it enables them to accomplish a wider and more complex range of tasks in a more efficient manner. It should be noted that while this argument has undoubted merit, small councils can also pool their resources to acquire the skills in question, at no greater cost than to single and larger councils, through cooperative arrangements, like strategic alliances (Dollery et al., 2005b).

A fourth argument put forward in support of local government amalgamation is that larger consolidated councils economize on their direct costs of administration and the compliance costs imposed on individuals who participate in the municipal political process. Administrative costs include the compensation paid to elected and appointed officials and staff and the overheads (buildings, supplies, utilities, etc.) required to support those officials. Compliance costs include the costs incurred by municipal voters to keep informed on issues and candidate positions and the potential cost of registering an opinion by participating in hearings, meetings, voting, and other activities. Fewer local governments may reduce these costs in aggregate. This is analogous to arguing that there are economies of scale in the administration of government, just as there may be scale economies in the production of public services. However, it could just as easily be argued that administrators become less effective the further removed they are from their constituents and the operations they are supposed to coordinate. Administrative economies thus become an empirical issue about which nothing is known in the Australian municipal setting.

Finally, a new argument advanced in the NSW debate on municipal amalgamation rests on the proposition that economic, environmental and other largely unspecified advantages accrue from an alignment of local government boundaries with natural boundaries (Dollery and Crase, 2004b). However, it is difficult to understand why natural or ecological boundaries should coincide exactly with local government boundaries. After all, the fact that the same argument could be raised with respect to national, state and metropolitan council boundaries, but never is broached in these broader contexts, surely demonstrates its spurious nature. Moreover, this notion has many additional shortcomings: it ignores the cultural and historical legacy embodied in existing council boundaries; it neglects the critical concept of the economic ‘community of interest’ of the people involved; it disregards that massive costs that would derive from drastic restructuring of council boundaries and headquarters, and it overlooks the impact of council boundaries on the efficient delivery of council services, especially since environmental considerations form only a small part of overall municipal responsibilities.

In addition to these theoretical arguments, Australian advocates of local government amalgamation typically assert that existing empirical evidence tends to bolster the case for 'bigger is better' in local government. For instance, the 1997-98 *Local Government National Report* (NoLG, 1998: 51-52) argued that the Commonwealth government funded structural reform in local government that included amalgamation for three main reasons. Firstly, 'larger councils have a more secure and adequate financial base; are better able to plan and to contribute to economic development; are more effective community advocates; and interact more effectively with government and business'. This argument rests on the proposition that small councils lack administrative and other forms of capacity compared with larger merged municipalities.

Secondly, since the Commonwealth Financial Assistance Grants (FAGS) constitute around ten per cent of council revenue, the Commonwealth government 'wants councils to deliver value-for-money services to local communities', and since 'structural reform delivers economies of scale and permits councils to employ a wider range of professionals', amalgamation generates a wider mix of services and improved service quality. However, this contention seems to confuse the existence of substantial scale economies in service delivery with the separate concept of administrative capacity.

The *Report* also argued that structural reform must proceed since 'without change, councils face the possibility of an ever-diminishing role as individual services are contracted to the private or voluntary sectors, while other concerns, such as the environment, are addressed by special interest groups or agencies'. Moreover, these factors can 'undermine local democracy and reduce service integration'.

The 1998-99 *Local Government National Report* (NoLG, 1999: 51) added an additional argument. In essence, structural reform means that 'money stays in the community' since 'money that would have been spent on council depots or stores or on administration can be spent instead on service improvement or infrastructure for the benefit of the local community'.

At the factual level, the 1997-98 *Local Government National Report* (NoLG, 1998: 52) argued that amalgamation had yielded substantial savings. For example, the Victorian government's 1993 structural reforms had saved around '$160 million a year or about $1 billion over the four years since amalgamation'. Similarly, recurrent savings in South Australia could be 'estimated at $20 million per annum'. It must be noted that the Report did acknowledge that 'it is difficult to isolate the impacts of amalgamations in Victoria from the impacts of other elements of the reform process' (NoLG, 1998: 56) – a reservation echoed by Percy Allan (2003).

Given the paucity of empirical knowledge on the economic and other consequences of municipal amalgamation in Australia, it is thus important to consider any new work on this controversial question. As we noted earlier, the South Australian FSRB (2005b) has just completed an exhaustive analysis of the problem of local government financial sustainability in that state that sheds some empirical light on the question of amalgamation.

3. FINANCIAL SUSTAINABILITY IN SOUTH AUSTRALIAN LOCAL GOVERNMENT

FSRB was established as an independent body by the South Australian Local Government Association on 14 February 2005 to investigate 'the financial position and prospects of councils in South Australia' by addressing three main issues: (1) Does council spending on services and infrastructure accord with current and future municipal revenues? (2) How should any perceived 'mismatch' between expenditure and revenue be rectified, and in particular for the purposes of this paper 'how much would increased cooperation, and in some cases, further amalgamation, help?'(3) Should grants from higher tiers of government be employed to diminish any financial mismatch?

The FSRB published a discussion paper entitled *Local Government in South Australia: Assessing Financial Sustainability* in March 2005, an *Interim*

Report (2005a), released on 30th May 2005, and a *Final Report* entitled *Rising to the Challenge: Towards Financially Sustainable Local Government in South Australia* (2005b) published on 17th August 2005.

A critical element of the deliberations of the Review Board dealt with the thorny question of defining 'financial sustainability' as a benchmark for evaluating the long-term viability of South Australian councils. The Board (2005b: 7) conceded that although 'the term "financial sustainability" has a well-understood meaning among Commonwealth and State governments, involving a government being able to manage likely developments and unexpected financial shocks in future periods with having at some stage to introduce significant and economically or socially destabilizing revenue or expenditure adjustments', no consensus existed in the Australian local government community on the meaning of 'financial sustainability'. The Board (2005b: 10) proposed that the following definition be added to the South Australian *Local Government Act 1999*:

> 'A council's long-term financial performance and position is sustainable where: (i) continuation of the council's present spending and funding policies; (ii) likely developments in the council's revenue-raising capacity and the demand for and costs of its services and infrastructure; and (iii) normal financial risks and financial

shocks, altogether are unlikely to necessitate substantial increases in council rates (or, alternatively, disruptive service cuts)'.

The Review Board (2005b: 15) further proposed a fourfold 'standard set of key financial indicators for assessing a council's financial sustainability': Net financial liabilities as the 'key indicator of the council's indebtedness to other sectors of the economy'; operating surplus or deficit as the 'key indicator of the intergenerational equity of the funding of the council's operations'; net outlays on the renewal or replacement of existing assets as the 'key indicator of the intergenerational equity of the funding of the council's infrastructure renewal or replacement activities'; and net borrowing or lending as the 'key indicator of the impact of the council's annual transactions – both operating and capital – upon the council's indebtedness to other sectors of the economy'.

This led the Review Board (2005b: 19-20) to its major Recommendation 2.3(1), where it finally recommended the adoption of a 'statement of principles' by the South Australian Local Government Association governing 'key financial sustainability indicators' based on the following six elements:

- A local authority's financial position is sustainable if 'its net financial liabilities are at levels at which the associated interest payments (less interest income) can be met comfortably from a council's annual income (i.e. by current ratepayers) without the prospects of rates increases which ratepayers would find unacceptable (or disruptive service cuts)';

- The net financial liabilities of a given council 'can be too low where they are (a) associated with current ratepayers being asked to bear an inequitable proportion of the cost of future service potential or (b) below levels that include more than enough room to absorb unexpected financial risks or financial shocks';
- Annual operating financial performance is sustainable 'if operating deficits will be avoided over the medium- to long-term, because such deficits inevitably involve services consumed by current ratepayers being paid for either (a) by borrowing and so by future ratepayers or (b) by deferring funding responsibility for the renewal or replacement of existing assets onto future ratepayers';
- A municipality's operating surplus can be too high 'where it (a) is associated with current ratepayers being asked to bear an inequitable proportion of the cost of the council's future service potential or (b) is above a level that includes more than enough room to absorb unexpected financial risks or financial shocks';
- The annual capital financial performance of a council is sustainable 'if capital expenditure on the renewal or replacement of existing assets on

average approximates the level of the council's annual depreciation expense, because any shortfall of such capital expenditure against annual depreciation expense would involve future ratepayers being left with an excessive burden when it comes to replacing or renewing the council's non-financial assets'; and

- Finally, the net borrowing of a local authority can be too low 'where, over the planning period, it results in the council's net financial liabilities as a ratio of non-financial assets falling well below the targeted ratio'.

Moreover, these principles formed the benchmarks against which the FSRB evaluated actual South Australian local government.

In Chapter 5 of the *Final Report,* the Review Board (2005b) modelled projections of the South Australian local government sector over a 20-year period to assess the future financial sustainability of councils. These projections were made on the basis of three sets of assumptions: Economic and demographic assumptions on various key annual growth estimates, like residential population growth rates for each council, inflation and interest rates; Expenditure assumptions, including constant capital expenditure/financing ratios, constant employee/resident ratios for each council, and road lengths remain unchanged (with some exceptions for rapidly growing councils); and income assumptions, such as constant real rate increases, user charge cost recovery ratios remain unchanged, and ‘other own-source revenues grown in line with state income (commercial income) or AWE (statutory charges and other operating expenses)’ (FSRB, 2005b: 38).

For our present purposes, a critical aspect of these projections is that they differentiate between different types of local authority amongst the 68 South Australian councils. The generic classification system adopted is set out in Appendix H; it has 11 separate categories of council. The basis for this taxonomic system was developed in the *Interim Report* (FSRB, 2005a: 5): ‘We have opted to use a classification based on the three-fold distinctions between: the density of council areas (distinguishing between three sub-groupings of ‘dense’, ‘fringe’ and ‘sparse’ councils); the size of council (distinguishing between three sub-groupings of ‘large’, ‘medium’ and ‘small’ councils); and the relative growth rate of resident population (distinguishing between three sub-groups of ‘fast’, ‘average’ and ‘slow’ growing councils)’.

Several caveats are added to this basic typology: ‘This classification still suffers from several categories containing only one council. We have chosen to avoid disclosing individual council figures by comparing the finances of groups of councils based on individual characteristics (i.e., either based on density or size or growth rate) rather than on their combined characteristics. We also have chosen in some instances to use the metropolitan/country split used by the Grants

Commission, rather than the ACLG distinction between urban and rural councils. Broadly, metropolitan councils and regional centre councils are the councils with a shorter length of road per staff member' (FSRB, 2005a: 5).

Although the wisdom of adopting this comparatively complex taxonomic system is open to question, it has the decided advantage of discriminating between different types of councils according to various criteria. It can thus shed light on the vexed question of whether 'bigger is better' as advocates of amalgamation in Australia contend.

4. EVIDENCE FROM THE REVIEW BOARD

The FSRB (2005b: 44) makes a 'preliminary assessment' of the financial sustainability of councils using a 'six-fold categorisation of the sustainability of a council's long-term financial performance and position that has been suggested by the Inquiry's independent advisers'. These categories can be summarized as follows:

- Category 1 – sustainable with a very substantial margin of comfort;
- Category 2 – sustainable with a substantial margin of comfort;
- Category 3 – sustainable with a moderate margin of comfort;
- Category 4 – sustainable with a minimum margin of comfort;
- Category 5 – sustainable currently but vulnerable in future; and

- Category 6 – unsustainable.

The results of this exercise are replicated in Table 1 below:

Table 1: Financial Sustainability by Types of Councils

Type of council[(a)]	Size	Density	Growth	Financial Sustainability Category No.: 1	2	3	4	5	6
Group 1	large	dense	fast	1	-	-	-	1	3
Group 2	large	dense	average	-	3	1	2	2	4
Group 3	medium	dense	average	1	-	-	2	1	-
Group 4	large	fringe	fast	-	-	1	1	1	1
Group 5	medium	fringe	fast	2	2	-	1	-	-
Group 6	medium	fringe	average	-	2	-	-	1	2
Group 7	small	fringe	average	-	-	1	1	1	-
Group 8	medium	sparse	average	1	-	2	2	-	4
Group 9	small	sparse	fast	-	2	-	-	-	2
Group 10	small	sparse	fast	3	1	-	-	-	1
Group 11	small	sparse	slow	2	-	-	4	-	9
Metro				2	3	1	3	4	5
Country				8	7	4	7	3	21
Total				**10**	**10**	**5**	**10**	**7**	**26**

Source: FSRB (2005b, Table 6.4.2).

Notes: (a) The council grouping used here is that suggested by the Review Board in its Interim Report (FSRB, 2005a). This classification is reproduced at Appendix H.

The major policy recommendation offered by the Report prescribes financial governance improvements for all councils. Nonetheless, with respect to council type and classification in Table 1, the FSRB (2005b: 45) drew the following alarming conclusion: 'Based upon data and estimates available to the Inquiry, 33 councils in South Australia may be classified as either unsustainable (category 6) or vulnerable (category 5). These councils account for just over 50 percent of the State's population. Thirty percent of metro councils and 40 percent of country councils are in these categories'.

Using the same taxonomic method for council classification, but invoking individual headings, such as ‘fastest’, ‘slowest’, etc., the FSRB (2005b: 47-49) presented salient evidence on how these factors affected both the ‘operating surplus ratio’ and the ‘net financial liabilities ratio’. This evidence is reproduced in summary here.

Figure 1 and Figure 2 present the findings of the Review Board for current and projected operating surplus by council type.

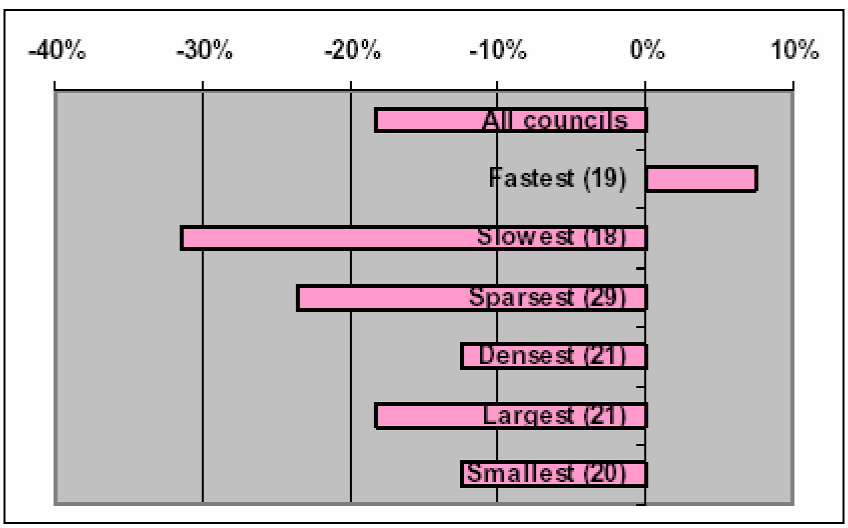

Figure 1: Operating Surplus Ratio by Type of Council, 2003-04
Source: FSRB (2005b, Chart 6.5.4).

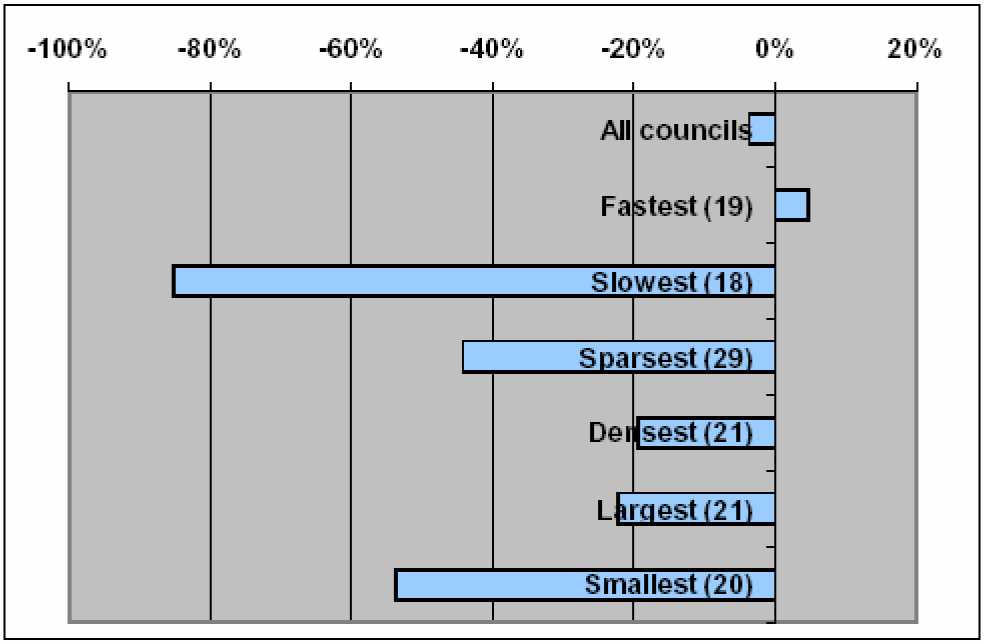

Figure 2: Operating Surplus Ratio by Type of Council, 2023-24
Source: FSRB (2005b, Chart 6.5.5).

With relevance to the 'bigger is better' controversy, the Review Board (2005b: 48) interpreted the results in Figure 1 to indicate that 'size does not seem to matter much, however, with both the larger and smaller councils both typically registering operating deficits in 2003-04'. Moreover, 'the same is true for the density characteristics, with both the denser and sparser groupings also both registering operating deficits that year'.

Figure 3 and Figure 4 present the findings of the Review Board for current and projected net financial liabilities by council type.

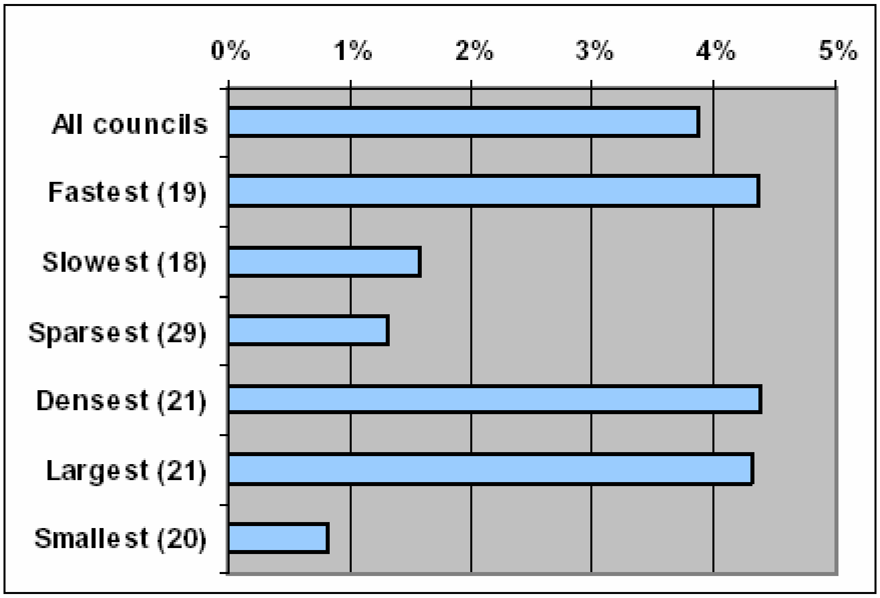

Figure 3: Net Financial Liabilities Ratio by Type of Council, 2003-04
Source: FSRB (2005b, Chart 6.5.6).

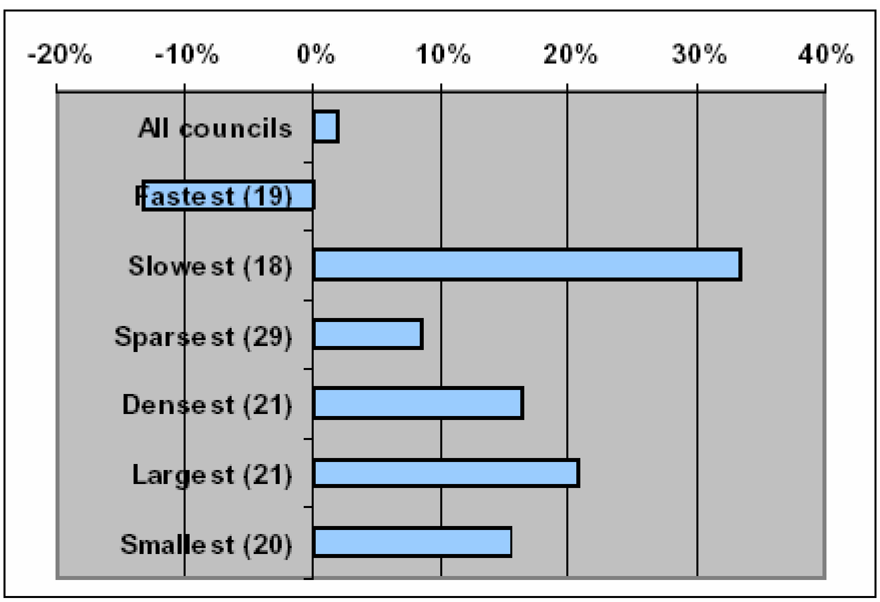

Figure 4: Net Financial Liabilities Ratio by Type of Council, 2023-24
Source: FSRB (2005b, Chart 6.5.7).

On the basis of this statistical analysis, the FSRB (2005b: 49) drew four main conclusions on the relationship between council type and council financial sustainability:

- The 'metropolitan/country distinction of itself seems to play a relatively minor role in explaining the observed differences in the sustainability of the long-term financial performance and position of councils';
- The 'size and density of councils also seem to play little role in explaining observed differences in the sustainability of the long-term financial performance and position of councils';
- 'Relative growth rates play a larger role in explaining the observed differences'; and
- Because 'relative growth rates, size and density of councils altogether explain only a fraction of the differences observed in the sustainability of the long-term financial performance and position of councils, other financial characteristics must be more important contributors'.

A final aspect of *Rising to the Challenge: Towards Financially Sustainable Local Government in South Australia* has further relevance to the present context. The Review Board noted that the architects of the earlier structural reform program in South Australia, which reduced the number of councils from 118 to 68, had claimed that the reform process had achieved 'recurrent savings' of $19.4

million per annum and a 'one-off estimated savings of $3.9 million'. However, the Board (2005b: 85) observed caustically that 'whether the on-going savings have in fact continued is a moot point.' It argued that 'fewer, larger councils are not the instant or easy fix that many would like to believe, especially in non-metropolitan areas dominated by the "tyranny of distance" and other impediments'.

These considerations led the Board to conclude that 'amalgamation brings with it significant costs and often exaggerated benefits' and that 'there are many intermediate forms of cooperation/integration among councils, with amalgamation being the most extreme (and confronting) form of integration'. Furthermore, 'there are other ways to overcome this disparity between councils' capacity to fund service delivery', including 'shared service models, strategic alliances and virtual local governments, possible in part through the advent and ubiquity of broadband capacity and application service provider (ASP) technology.' In essence, it stressed that 'collaboration between councils can and should be a major contributor to councils being financially sustainable in the future'.

5. CONCLUDING REMARKS

Although the RSRB was primarily aimed at establishing the basis for determining financial sustainability of South Australian councils and assessing the degree to which the resultant criteria would be met in future, and prescribed improved financial governance as the preferred policy option, we have seen it can also shed light on the relationship between council type and council sustainability. With the sole and partial exception of small, sparse and slow growing rural shires, it demonstrated that there is no systematic relationship between council size and council sustainability, at least in the South Australian local government milieu. This finding severely undermines claims by advocates of municipal amalgamation that 'bigger is better' in Australian local government. Moreover, empirical evidence of this kind supports the view – as the Board itself pointed out - that alternative methods of enhancing the effectiveness of local authorities should be actively pursued, including alternative models of local government involving resource sharing and regional alliances.

While the findings of the Review Board obviously cannot be regarded as definitive in the Australian debate over municipal amalgamation, they nevertheless amount to an additional presumption against the use of amalgamation as a potentially effective instrument of local government reform. Considered in conjunction with other limited Australian evidence, as well as existing international empirical studies, especially work in Canada and the United States (Dollery et al., 2006), the onus of proof would now appear to fall against advocates of amalgamation in Australia. For instance, Murray and Dollery (2005) have demonstrated that there is no relationship between councils considered 'at risk' on the New South Wales Department of Local Government's 'watch list' and council size. Similarly, Byrnes and Dollery (2002) have cast doubt on the extent of economies of scale in Australian local government.

It need hardly be added that further empirical research is urgently needed to determine the outcomes of earlier Australian episodes of amalgamation, particularly the drastic Victorian experience in the 1990s. The most obvious candidate for work along these lines would be the recent New South Wales forced amalgamation program, but given the infancy of many of the new 'super councils' in that state, it is still too early to adequately evaluate outcomes with any degree of confidence. However, research has begun at the Centre for Local Government at the University of New England, involving both case studies and broader statistical investigations, and it is hoped the results of this work will be published over the next few years.

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