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A Typology of the Sources of Council Sustainability

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Abstract: The long-run sustainability of Australian local councils has come under intense scrutiny over the past few years. Two federal government reports, several state-based local government inquiries, a national commissioned report, an embryonic but growing academic literature and numerous conferences by peak local government bodies all attest to deep misgivings over the current condition of Australian local government. Various approaches to the analysis of local government sustainability have been developed, most of which focus heavily on the financial dimensions of the problem. This has led to a plethora of putative policy solutions to the problem. This paper provides a synoptic review of previous work in the area and advances a typology of local government sustainability as a potentially useful analytical tool for conceptualizing the problem of local government sustainability.

Keywords: Governance; local finance; local government; sustainability.

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Introduction

The last two decades of the twentieth century witnessed strong concern over the operational effectiveness of Australian local government. Policy measures to address this concern rested primarily on structural reform, particularly in South Australia, Tasmania and Victoria, but also included redrafted Local Government Acts in all jurisdictions, the application of New Public Management techniques to most local councils, and performance monitoring by state Departments of Local Government.

The new century has seen a shift in the fulcrum of concern to the question of local council sustainability, especially financial sustainability, in the light of an apparently deepening financial crisis in Australian local government. The first official indication of this shift in emphasis came in the form of the landmark Commonwealth Grants Commission (CGC 2001) report into the underlying causes of financial distress. This report was followed by a Commonwealth House of Representatives Standing Committee on Economics, Finance and Public Administration (Hawker Report) (2003), entitled *Rates and Taxes: A Fair Share for Responsible Local Government,* initially set up to investigate the problem of 'cost-shifting', but subsequently broadened to consider virtually the entire spectrum of Australian local government activity, including sustainability.

In addition to these federal government investigations, several state-based inquiries initiated by state local government associations have ensued. For instance, the South Australian Financial Sustainability Review Board's (2005) *Rising to the Challenge* report attempted to define the concept of financial sustainability and then assess South Australian councils against this measure. Similarly, the Independent Inquiry into the Financial Sustainability of NSW Local Government's (2006) produced a comprehensive Final Report entitled *Are Councils Sustainable* that also sought to determine financial sustainability in NSW local government. Finally, both the ongoing Queensland Local Government Association (LGAQ) (2006) *Size, Shape and Sustainability* (SSS) program and the Western Australian Local Government Association (WALGA) (2006) *Systemic Sustainability Study*: *In Your Hands - Shaping the Future of Local Government in Western Australia* Inquiry grappled with financial sustainability in their respective local government systems.

At the national level, the Australian Local Government Association (ALGA) commissioned a report which was undertaken by the commercial company PriceWaterhouseCoopers (PWC) (2006), entitled the *National Financial Sustainability Study of Local Government,* which considered the problem of financial sustainability in local government across the nation. These deliberations were augmented by the *Local Government National Report, 2004-05*, prepared by the Local Government Section of the Department of Transport and Regional Services (DOTARS) (2006), which highlighted the significance now placed long-run financial sustainability by state government policy makers by considering the notion of a 'structural gap' induced by 'the unbalanced growth of revenues and expenditures' that results in fiscal distress in local government.

Finally, an embryonic but growing academic literature has arisen on the problems confronting Australian local councils. This literature has three main strands. In the first place, scholars have critically examined the percipicaty of the methods adopted in the state-based inquiries and the PWC (2006) report and advanced broader definitions of sustainability in local government (Dollery *et al.* 2006b; Dollery and Crase 2006). Secondly, the predictive capacity of performance monitoring of local council outcomes has been assessed (see Murray and Dollery 2005; 2006; Walker and Jones 2006; and Dollery 2006). Thirdly, scholars have considered the problem of 'local government failure' and developed a taxonomic approach to its causes (see, for example, Dollery and Wallis 2001; Byrnes and Dollery 2002).

In this paper, we provide a brief synoptic review of these various approaches to the question of local government sustainability. In essence, we argue that while much has been learned about the causes of the current financial crisis in

Australian local government, operational methods of defining and measuring sustainability, and the shortcomings of these methods, a comprehensive conceptual framework for developing remedial policy is still incomplete. An important reason for this deficiency in the literature on Australian local government sustainability seems to be the excessive emphasis that many analysts have accorded financial sustainability to the exclusion of other forms of sustainability (Dollery *et al.* 2006b). This is problematic because observed council 'failures' in real-world Australian local government jurisdictions are often due to non-financial factors, most frequently conflict-riddled elected councils and concomitant policy deadlock.

One way of approaching the design of a comprehensive conceptual framework for analysing the question of local government sustainability is to invoke the methodology developed in welfare economics. The famous market failure paradigm has long served as a fruitful technique for diagnosing the ills of competitive markets and an analogous conceptual framework in the form of the theory of government failure has performed essentially the same role in the analysis of public sector organisations (see, for example, Wallis and Dollery 1999). This approach has already been employed in the literature on Australian local government by Byrnes and Dollery (2002) but – as we shall see – their taxonomy of local government failure suffered from the principal defect that it focused exclusively on the 'internal' workings of local councils, without considering the external environment.

What is therefore required is a typology of local government sustainability that simultaneously embraces both internal factors and external forces that impinge on the long-run sustainability of municipal authorities. A taxonomy of this kind could prove most useful in not only diagnosing the problems of contemporary Australian local government, but also in developing a prognosis and possible policy remediation. In this paper, we thus attempt to construct a typology of the sources of local council sustainability.

The paper itself is divided into four main sections. Section 2 critically examines the CGC (2001) report, the Hawker Report (2003), the various state-based inquiries and the PWC (2006) national report. Section 3 considers salient aspects of the embryonic Australian academic literature on sustainability. Section 4 develops a typology of local government sustainability using stylized empirical characteristics of Australian local councils. The paper ends in section 5 with some brief observations on the implications of the taxonomy.

Official Approaches to Local Government Sustainability

The genesis of contemporary concern with local government sustainability in Australia can be traced back to the Commonwealth Grants Commission (CGC 2001) annual report *Review of the Operation of Local Government (Financial Assistance) Act 1995.* In this pioneering document, the CGC (2001, 52-53) identified five main reasons for the acute level of financial stress faced by many local authorities, especially in non-metropolitan areas. These factors include the devolution of responsibility for service delivery from higher tiers of government; 'cost-shifting'; increasing the complexity and standard of local government services by state governments; 'raised community expectations' of municipal services; and 'policy choice' involving the voluntary improvement and expansion of municipal services.

This analysis is by no means complete. For example, as Johnson (2003) has observed, the CGC list does not include the fact that local councils have also added to these financial problems by artificially holding their rates and charges at unsustainably low levels. The CGC (2001) list also ignores 'internal' governance and management factors that are potentially crucial. Nevertheless, the CGC report did serve to lay the foundations for subsequent investigations into local government sustainability.

Although originally intended to focus exclusively on the problem of cost-shifting, the Hawker Report (2003) *Rates and Taxes: A Fair Share for*

Responsible Local Government steadily added to its terms of reference and eventually considered almost the entire spectrum of local government activity. *Rates and Taxes* ultimately consisted of six substantive chapters dealing with the roles and responsibilities of Australian local government, cost shifting, the maintenance of municipal infrastructure, capacity building, including performance monitoring and structural reform, the funding of local government, and the question of inter-governmental financial relations and the need for a 'Summit' respectively.

The Final Report contained eighteen specific recommendations dealing with 'roles and responsibilities' (three recommendations), 'cost shifting' (five recommendations), 'infrastructure' (two recommendations), 'capacity building in our regions' (four recommendations), 'Commonwealth funding of local government' (two recommendations), and the 'way forward' (two recommendations). Characterised by a singular lack of original research and reliant solely on submissions by interested bodies for its information, the Hawker Report nonetheless reiterated many of the concerns raised in the CGC (2001) report and thereby added impetus to the growing awareness of financial distress in Australian local government.

However, the chief methodological underpinnings of the contemporary emphasis on financial sustainability came in the form of the South Australian Financial Sustainability Review Board (FSRB) (2005) *Rising to the Challenge* report. This document embodied the 'accounting' approach to local government sustainability developed by Access Economics that undertook the primary research for the report. It can thus be considered together with the Independent Inquiry into the Financial Sustainability of NSW Local Government's (LGI) (2006) *Are Councils Sustainable* and the Western Australian Local Government Association's (WALGA) (2006) *Systemic Sustainability Study* since these reports also employed Access Economics, which prepared essentially the same accounting analysis of their respective local government systems (see Access Economics 2006a; 2006b).

In essence, all three inquiries adopted the approach of first proposed in the FRSB (2005, 10) report that proposed the following definition of financial sustainability in local government:

> 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).

This measure of financial sustainability has serious shortcomings. For example, it does not place sufficient weight on the 'external' environment in which local authorities operate; no account is taken of demographic trends, distance, population composition, topographical factors, and the like, all of which are 'non-discretionary' in the sense that individual councils have no control over these forces (Worthington and Dollery 2000). In addition, internal governance and management are neglected, except indirectly in the form of adequate asset management.

In a broader approach to the question of sustainability, the Local Government Association of Queensland (LGAQ) has developed a local government reform program embodying a *Size, Shape and Sustainability* Review Framework, sustainability indicators, 'options for change', 'Independent Review Facilitators', and funding arrangements for state government support. The reform program itself is outlined in the *Size, Shape and Sustainability: Guidelines Kit* (LGAQ 2006).

The *Guidelines Kit* sets out four 'categories of indicators' of sustainability that must be employed in the self-assessment exercise that lies at the heart of the LGAQ reform program: 'Financial and resource base'; 'community of interest'; 'planning'; and 'standards of governance'. Moreover, councils are requested to consider issues not included in the *Guidelines Kit.* It is thus immediately apparent that the program is far broader than its SALGA, NSW LGSA and WALGA counterparts. However, this advantage is offset by the fact that no precise definition of unsustainability is advanced.

At the national level, the PriceWaterhouseCoopers (PWC) (2006) *National Financial Sustainability Study of Local Government* report was commissioned by the Australian Local Government Association to determine 'key financial issues' affecting financial sustainability and develop recommendations for improving sustainability. Three main problems prevented the PWC (2006, 6-7) from using a common sustainability index across all Australian councils: 'Mixed approaches to measuring and recording financial data' and 'inconsistencies between states'; 'infrequent' asset valuations and differences in assumed asset lives; and 'incomplete' financial and asset management records, especially in smaller councils.

These problems obliged the PWC report to adopt two techniques in their assessment of financial. Firstly, the PWC applied financial ratio analysis to a sample of 100 local councils appropriately weighted by state and stratified in proportion to the number of councils in each of the DOTARS seven categories. Secondly, PWC 'extrapolated' from the Access Economics and Municipal Association of Victoria (MAV) (2005) approaches in the (FSRB 2005), LGI (2006) and WALGA (2006) state inquiries and the MAV 'viability index'.

The PWC (2006, 95) defined 'financial sustainability' as follows: 'The financial sustainability of a council is determined by its ability to manage expected financial requirements and financial risks and shocks over the long term without the use of disruptive revenue or expenditure measures'. This definition involved two elements: Councils should maintain 'healthy finances', given current expenditure and revenue policies and foreseeable future developments; and councils must ensure infrastructure expenditure 'matches' asset planning. It is evident that this approach is very similar to the Access

Economics methodology underlying the SA, NSW and WA inquiries and accordingly suffers from the same shortcomings.

Academic Approaches to Local Government Sustainability

We have already observed that a small but growing academic literature exists on the problems confronting Australian local councils with three main strands. In the first place, scholars have critically examined the methods adopted in the state-based inquiries and the PWC (2006) report and advanced broader definitions of sustainability in local government (see Dollery *et al.* 2006b; Dollery and Crase 2006). The major conclusions from this exploratory work have already been considered above and essentially amount to a claim that the accounting approach to sustainability is too narrow.

Secondly, a literature has been constructed on the predictive capacity of Key Performance Indicators (KPIs) for diagnosing local council unsustainability used by the Department of Local Government in NSW and *mutatis mutandum* other Australian local government jurisdictions (see Woodbury *et al.* 2003). For example, Murray and Dollery (2006, 59) explored the basis of performance appraisal in NSW and the approach used to classify individual councils as ‘at risk’. They concluded that:

> Monitoring lists within NSW are created through an analysis of financial and corporate results, which at best can be described as a measure of financial soundness. However, the present construction methods provide little to indicate that an adequate analysis has occurred. It seems that the monitoring lists are being constructed on a primarily subjective basis. Moreover, as a means of attributing financial soundness or otherwise to councils, the present monitoring lists must be treated with a considerable degree of caution. This is due in part to councils lacking control over their own revenue levels owing to rate capping and the application of restrictive regulations and statutes over user charges and fees.

In addition, Murray and Dollery (2005) explored the manner in which NSW local councils are assessed by the NSW Department of Local Government and identified as either 'at risk' or not 'at risk'. They argued that the Department used KPIs drawn from its comparative performance tables from information supplied by individual municipalities. In its construction of 'monitoring lists', the Department subjectively considers these indicators as well as other information to determine whether a council should be classified as 'at risk' or not 'at risk'.

Murray and Dollery (2005, 332) undertook an econometric evaluation of these lists to determine whether 'the indicators employed and the results published by the DLG are sufficiently robust to withstand analytical scrutiny'. They asked the question: 'Are municipal councils deemed to be "at risk" on the basis of the DLG analysis of selected key performance indicators (KPIs) really "at risk" or have they merely been erroneously classified as "at risk"'? In other words, Murray and Dollery (2005) approached the problem of the efficacy of KPIs in predicting council performance from an empirical angle buy examining whether councils with poor KPIs end up as being considered 'at risk'. Their results undermine the adequacy of KPI analysis for local government. Murray and Dollery (2005, 342-3) observed that 'the findings of our paper suggest that those councils that have been publicly identified as "at risk" may in fact not be in a parlous financial state at all'.

If KPI analysis is a poor predictor of actual council financial performance, then the question arises as to what factors really do explain local government financial failure? Murray and Dollery (2005, 343) 'speculated' that 'governance issues (broadly defined)' appear to have been the most 'critical factors' in most recent NSW local government 'failure episodes' since 'failed entrepreneurial projects by councils or councils in partnership with private organizations; factional "infighting" amongst elected councillors and the attendant resignation of frustrated experienced professional staff; a preponderance of ill-informed and unwise elected councillors; poor quality professional staff, especially in rural and remote areas; and a lack of adequate internal controls all seem to have played a critical role in municipal failure'.

Walker and Jones (2006) developed two main criticisms of Murray and Dollery (2005; 2006). Firstly, they argued that by assuming published KPIs represented the basis of the NSW 'watch list' of 'at risk' councils, Murray and Dollery (2006) had attacked 'a straw man', since the NSW Department of Local Government did not rely exclusively on published KPIs to determine which councils 'at risk', but also employed other sources of information; a argument accepted by Dollery (2006) in a rejoinder to Walker and Jones (2006). Secondly, Walker and Jones (2006) advanced various criticisms at the econometric analysis by Murray and Dollery (2005).

However, the major contribution of the Walker and Jones (2006) paper lay in the development of an alternative approach to financial sustainability in Australian local government. They argued that 'if the basic operating objectives of local councils are to provide services to the community', then 'it follows that a relevant concept of council distress' would be 'an inability to deliver services at pre-existing levels' In other words, financial sustainability should be defined as the capacity of councils to deliver some current level of service provision to their residents. It is immediately apparent that this definition differs from the methodology developed in both the state-based inquiries based on the Access Economics approach. However, Dollery (2006, 360) argued that this definition is flawed since it requires the user to heroically assume that '"yesteryear's" levels of service will be acceptable to "tomorrow's" local government community'. He observed that 'it is easy to think of instances where this procedure will fail' and cited the example of the environmental regulation of local councils and the continual 'raising the bar' that has occurred.

Finally, drawing on the 'local government failure' approach first advanced by Dollery and Wallis (2001), Byrnes and Dollery (2002) developed a taxonomic system embodying five main sources of local government failure: 'Voter apathy', where constituents are typically disinterested in their local councils;

'asymmetric information and councillor capture', where part-time elected councillors are dominated by better informed professional bureaucrats; 'iron triangles', where elected standing committees, bureaucrats and private contractors develop informal collusive arrangements excluding potential competitors; 'fiscal illusion', where voters cannot determine whether they receive 'value for money' from council services due to the fiscal complexities involved; and 'political entrepreneurship', where councillors intent on political office in higher tiers of government use municipal activities to advance their careers. Byrnes and Dollery (2002) assessed this typology using evidence from NSW local government and found significant empirical support for their typology.

However, the Byrnes and Dollery (2002) typology is open to criticism that it considers only 'internal' factors to the exclusion of the external environment. For instance, important financial considerations, such as the value of grants, revenue from rates, etc., are ignored. Moreover, demographic, spatial and other influences are entirely neglected.

Taxonomy of Local Government Sustainability

Given the deficiencies in the Byrnes and Dollery (2002) typology, as well as the demonstrated success of the 'institutional failure' approach to policy analysis, there are thus firm grounds for developing a new taxonomy of Australian local government failure that considers both 'external' and 'internal' factors that influence the long-run sustainability of local councils in Australia. We thus now attempt to construct a new typology along these lines.

The exploratory taxonomy developed in this paper hinges on five main sources of local government sustainability: Demographic factors; council revenue; expenditure; financial management; and governance. It is immediately evident that this constellation of influences combines both 'external' and 'internal' factors thereby removing a central objection to the earlier Byrnes and Dollery (2002) typology. Each of these elements of the tentative new typology is now considered in turn, using the contemporary milieu of NSW local government to provide illustrative examples.

Demographic factors

The claim that demographic characteristics play a decisive role in local government sustainability is uncontroversial. After all population trends have profound implications for the composition of local government services, its sources of revenue, infrastructure utilization and future infrastructure needs, expenditure patterns and almost all other aspects of local governance. While local councils can exert some influence over population flows and population density directly and indirectly through efforts to attract or deter new residents, planning regulations, local economic growth strategies, and so forth, in the main demographic characteristics should be considered ‘non-discretionary’ variables in the sense that they lie beyond the control of individual municipalities.

A few examples can serve to illustrate the contention that important linkages exist between local government sustainability and demographic trends:

- Population relative to the local housing stock can have a powerful impact on housing prices. For instance, a shrinking population and a stagnant housing stock can lead to declining in property prices and falling rate revenue as well as *vice versa*.
- Infrastructure utilization is related to population since physical infrastructure, by its very nature, is a fixed asset. For example, roads are rarely ripped up in response to a population decline while a population trend increase is typically required to justify connecting new homes to water and sewerage systems. Similarly, rapidly changing population size is a critical factor in determining the need for expensive new infrastructure.
- Population density and the rate of growth population are not only intrinsically intertwined but also represent key determinants of local government sustainability; a point emphasized in the South Australian FSRB (2005) *Rising to the Challenge* report. This report established

> that regardless of whether a given council was located in a metropolitan zone or a regional area in South Australia, the rate of growth in population seemed to determine the extent of its operating deficit. Moreover, net financial liabilities were also closely related to population growth. Population density had the same predictive capacity.

While these examples illustrate the pervasive impact of demographic change on local government, its effects are further complicated by the fact that recent Australian population trends are both complex and spatially uneven (Burnley and Murphy 2002, 149). For instance, in the context of NSW local government, whereas general population growth has centred on the coastal fringe and areas immediately adjacent to Sydney, Sydney itself has seen consistent net out-migration. Growth has also occurred in North and South NSW coastal communities, resort and retirement areas, some larger regional centres, along the Hume Highway between Sydney and Melbourne, selected mining towns, and in regions with significant indigenous populations (Hugo 2002, 5). The one constant in NSW population movements has been an almost universal loss of population in the sheep and wheat belts of the state.

These complicating factors are further exacerbated by associated changes in population densities. For example, low-income household movement has clearly been an important component in migration to coastal regions in NSW (Hugo and Bell 1998). This has important ramifications for local government largely due to the range of partially council-funded concessions in place for low-income recipients. For instance, pensioner concessions represent a significant drain on the resources of local government in particular areas and Dollery *et al.* (2007) found that the councils in NSW that had the lowest per capita incomes also had the highest per capita expenditure on pensioner rebates. If potentially poor ‘baby boomers’ retire on the coast, where average incomes are already relatively low, this will have serious implications for the future financial sustainability of coastal councils.

Population change is thus multifaceted and may have far-reaching effects on local government sustainability. Given long-standing out-migration trends from the NSW sheep and wheat belts, some rural shires will never be financially sustainable because of low population densities and negligible or even negative population growth rates.

This raises a central policy conundrum requiring explicit value judgment. What weight should be accorded rural local councils in their role as the only local democratic institution? Put differently, which is more important: the financial sustainability of a council or its role as a local voice in Australian democracy?

Council Revenue

Australian local government has three main sources of revenue: Property taxes; fees and charges; and intergovernmental grants. By international standards, this is a comparatively narrow range of potential sources of finance. Moreover, Dollery *et al.* (2006c, 30) have observed that 'there are two broad revenue pressures' confronting Australian local councils; 'legislative restrictions on its ability to raise revenue' and 'limited access to a sufficiently broad range of revenue', including the 'holy grail of a growth tax'. It must therefore be acknowledged that not only do Australian councils survive on a relatively narrow revenue base, but that even within this narrow range, most revenue raising has important 'non-discretionary' elements.

These general propositions can be readily illustrated in the financial milieu of NSW local government. For example, Figure 1 demonstrates that local government income in New South Wales has not kept pace with either the growth in state or federal income or growth in the economy of the State and national GDP; the same cannot be said for either state or federal government income.

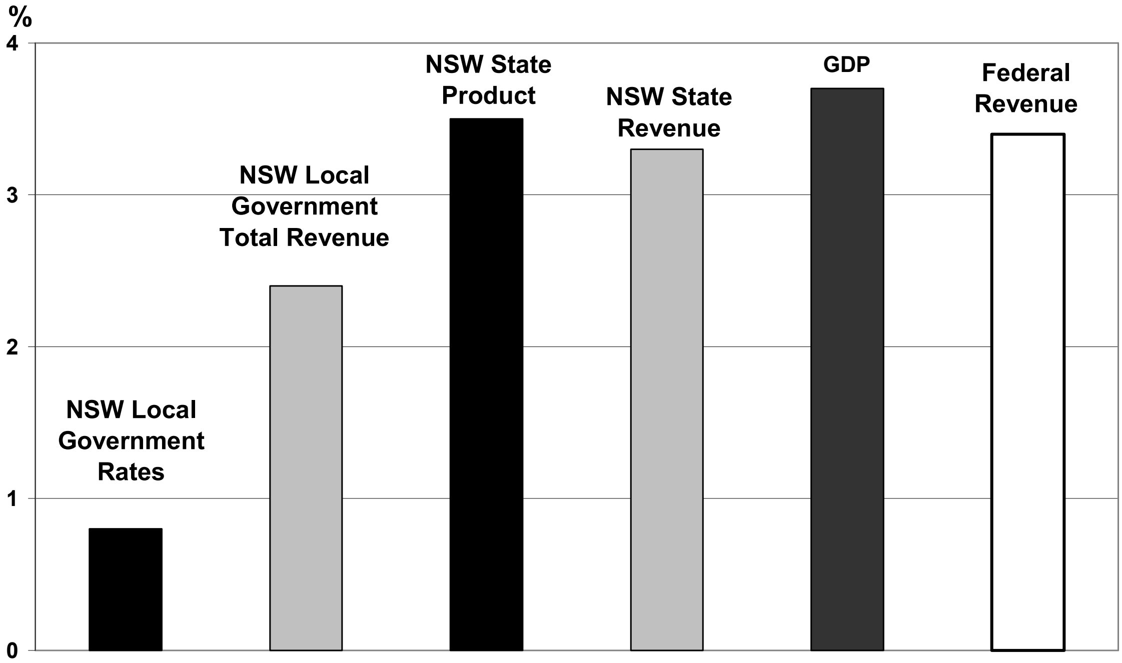

Figure 1: Real Increase in Tax Revenue and State and Domestic Product – 1996 to 2004

Source: Independent Inquiry into Local Government Inquiry (LGI) ('Allan Report') (2006, 197).

Even more important than aggregate local government income is the growth of local government rates since this is often said to quintessentially represent a completely 'discretionary' source of revenue for councils empowered to strike their own rates. Over the period shown in Figure1, aggregate rate income growth has been of the order of 0.8 percent. While it can be argued that NSW is peculiar in the context of Australian local government because its state government has adopted a longstanding policy of rate-capping, evidence on rate revenue growth presented in the state-based inquiries shows a similar picture across all Australian local government jurisdictions relative to consumer price inflation (see, for example, Brooks 2006, 9, Figure 4).

Grants represent the second major source of revenue for local councils, and especially remote, rural and regional municipalities. For years local government has been exhorted by higher levels of government to end its reliance on grants. But to reduce the pejoratively phrased 'grant dependency', local government must either raise its rates or increase income from other sources, such as charges and fees for services provided. However, in both instances NSW local government is restricted. Quite apart from rate-capping, charges are often subject to ministerial control and/or frequently fall under purview of other regulatory bodies (Dollery *et al.* 2006c, 32).

In any event, in a federal system of government afflicted by vertical fiscal imbalance (VFI), where the majority of tax receipts are collected by the Commonwealth and a disproportionate degree of expenditure occurs at subordinate levels of government, grants will always be an important means of equalizing revenue with expenditure. While this structural feature of Australian fiscal federalism appears to have evaded the debate on local government grants, in practice federal government grants direct to local government have emerged as an increasingly important source of revenue for local government, especially the *Roads To Recovery (R2R)* Program (Dollery *et al.* 2006d). However, this form of financial relief has also become more tied to specific projects.

The trend towards more specific grants, taken together with the inevitability of a system of local government grant disbursement in a federal system characterized by VFI, places local council autonomy under threat and once again raises the question of the value accorded local democracy. Indeed, it might not be alarmist to argue that that tied grants essentially reduce local government to expenditure agencies devoid of decision-making power, thereby violating the principle of subsidiarity in fiscal federalism.

Finally, almost all local government systems are troubled by horizontal fiscal imbalance (HFI) and Australian local government jurisdictions are no exception. In essence, HFI implies that different councils have different revenue raising abilities and the costs of service provision vary between councils. Unless HFI is addressed, marked differences in local services between different councils will emerge. In Australia this almost inevitably implies that people in poor remote, rural and regional areas will enjoy a far lower level of service provision than their metropolitan counterparts. This problem has traditionally been tackled in Australian states and territories through ‘equalization grants’ by state-based local government grants commissions. However, the decline in the real value of these grants across Australia has threatened this system and thus bred a growing differentiation in local service provision (Brooks 2006).

Council Expenditure

The third element in our proposed taxonomy of local government sustainability focuses on the expenditure dimension of local government activity. A critical feature of the cost structure of contemporary Australian local government resides in the impact of cost-shifting; a factor recognized by the CGC (2001), the Hawker Report (2003) and the LGI (2006). While the monetary magnitudes involved in cost-shifting are difficult, if not impossible, to compute with any degree of precision, in the context of NSW local government the phenomenon is undoubtedly significant. For example, the LGI (2006, 69) commissioned a survey in order to gain some quantitative measure of its impact. The results of this exercise are summarized in Figure 2.

Figure 2 shows that the drain on resources associated with cost-shifting is far from trivial for all councils, and especially metropolitan councils.

The chief problem with cost-shifting is not the shifting of expenditure functions *per se* but rather the lack of adequate accompanying funding. It often makes perfect sense for local government to carry out various functions, such as engaging rural doctors or managing the local rural Fire Service since local councils typically possess superior information on local needs. The problem is that adequate matching funding is usually not transferred along with the functional responsibilities. Accordingly, unfunded cost-shifting by higher levels of government all but guarantee that many councils will be unsustainable in the long run.

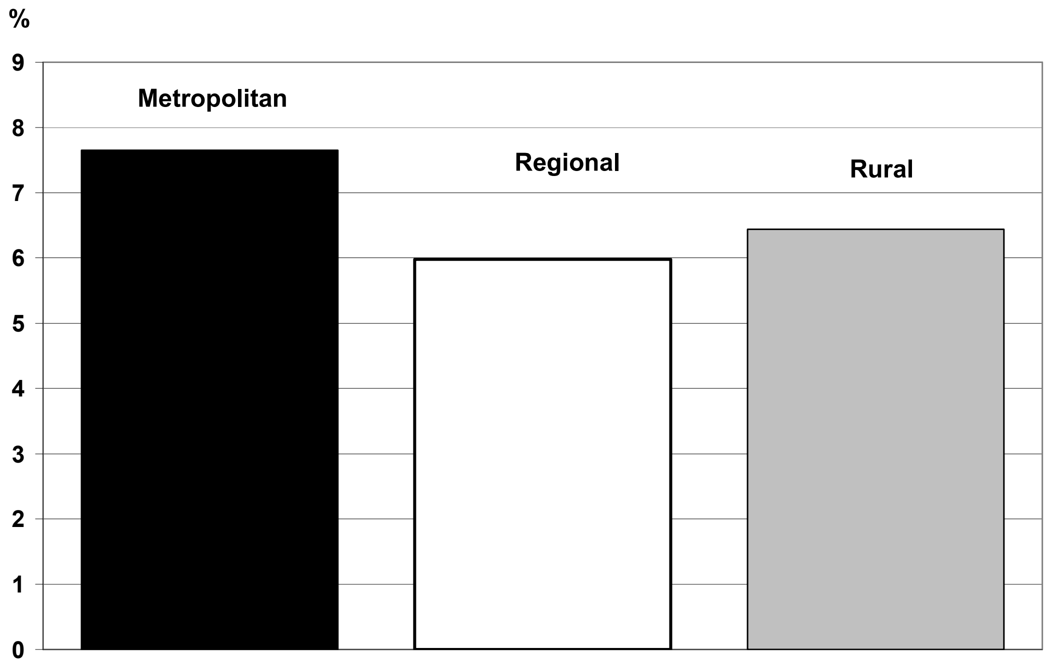

Figure 2: Cost Shifting Expense as a Percentage of Total Ordinary Revenue – By Council Category

Source: Independent Inquiry into Local Government Inquiry (LGI) ('Allan Report') (2006, 69).

Financial Management

All state-based inquiries as well as the PWC (2006) national report identified a severe local infrastructure depletion problem in Australian local government. Two aspects of this problem are important in the present context. Firstly, all of these inquiries found that inadequate financial management, and particularly asset management, had played a significant role in the creation of this problem. In the NSW context, the Allan Report (2006) sets out in great detail the requirements for satisfactory financial management system and how this system should be implemented. The problems involved should not be underestimated. In particular, it is very difficult to place a value on an asset that cannot be sold. Secondly, the infrastructure problem is so large that many local authorities will never be able to bear the financial burden of rectifying it, leading to calls for alternative methods of financing reconstruction, including a Commonwealth infrastructure fund (Dollery *et al.* 2006a).

In order to understand how the local infrastructure crisis has arisen, it must be acknowledged that most local infrastructure was simply given to local government in the immediate post-World War Two era. Local government thus did not finance its development and the local government revenue model was never designed to pay for its renewal. In the same vein, it should also be acknowledged that a significant proportion of the stock of local infrastructure is reaching the end of its economic life largely around the same time. Since local councils are already struggling to remain solvent in their day-to-day operations, it is widely recognized that local government cannot fund all of the infrastructure renewal programs that will be required over the next decade. Indeed, for each year that the problem is left unattended, the financial burden grows by around $400 to $600m in NSW alone (LGI 2006). While arguments rage over how to determine the extent of the infrastructure renewal task, attention may drift from the much more important task of implementing systems that will put aside reserves so that a future crisis will not reoccur. The long-run sustainability of local government should thus rest on the management of renewed local infrastructure and not the funding of current asset renewal.

Governance

In order to develop our exploratory typological framework for evaluating sustainability in contemporary Australian local government, we have considered local government demographics, revenue, expenditure and cost-shifting and financial management. These three elements focus exclusively on the 'external' environment facing local councils, while financial management combines features of both the 'internal' and 'external' context. By contrast, governance deals solely with the internal dynamics of municipal operations.

The need for an internal perspective is warranted by the fact that the overwhelming majority of council 'failures', as epitomized by the dissolution of local authorities by their respective Department of Local Government, are caused by internal factors, especially conflicted elected bodies. An excellent starting point for a diagnostic analysis of governance is the taxonomy of 'local government failure' advanced by Dollery and Wallis (2001) and Byrnes and Dollery (2002). As we have seen, the Byrnes and Dollery (2002) fivefold typology of 'voter apathy', 'asymmetric information and councillor capture', 'iron triangles', 'fiscal illusion' and 'political entrepreneurship' encompasses most internal sources of unsustainability. In addition to this capstone, Dollery *et al.* (2006b) have identified three critical dimensions of local government sustainability: local democracy, local social capital and local capacity.

Local democracy refers to the sense in which local government can be differentiated from other levels of government; the very existence of local government suggests that it will make decisions differently from higher tiers of government by giving a voice to local preferences. This is sometimes encapsulated by the term 'vibrancy'. If a council fails to embrace local preferences, then there is little reason for it to exist and its ongoing sustainability as an 'independent' entity comes into question.

Although the notion of 'social capital' is beset by conceptual problems (Quibria 2003), in the municipal context we contend that social capital engenders a local civic awareness that manifests itself in community projects, ranging local social associations and sports clubs to local business initiatives. Moreover, local social capital breeds a 'sense of community' and a 'sense of place' that derive from living in a small and distinctive local government area, with community size and community social capital therefore intrinsically linked. It follows that if a council does not play a positive role in facilitating the formation of social capital, its long-term sustainability must be called into question.

Finally, local government capacity influences local council sustainability. Dollery *et al.* (2006b) argue that local government cannot command the respect of its constituents if it is unable to formulate agreed policy and implement decisions effectively. Local government capacity thus has three features: Functioning elected leadership; adequate administrative and technical expertise; and the ability to make autonomous decisions. These three attributes of local government capacity are thus crucial to council sustainability.

Concluding Remarks

The tentative typology for examining local government sustainability advanced in this paper is thus not only much broader than its Dollery and Wallis (2001) and Byrnes and Dollery (2002) predecessors, but also overcomes the 'internal' bias of these earlier attempts to provide an analytical framework for assessing local government failure. Because it combines all the major elements involved in the long-run sustainability it has the added advantage of greater explanatory power.

A common thread running through the discussion of demographic factors, council revenue, expenditure, as well as part of financial management was the 'non-discretionary' nature of the external environment in which Australian local government is placed. Constraints imposed by higher tiers of government in the Australian federation thus account for a good deal of non-sustainability amongst local councils. Accordingly, all the state-based inquiries and the PWC (2006) report all found that large numbers of Australian municipalities are unsustainable if present trends continue. This serves to illustrate a dismal truth about Australian local government; unless dramatic change occurs, unsustainability will become the rule rather than the exception.

All taxonomic systems of institutional failure run the risk of instilling a bias towards 'perfection' in the analysis of real-world organizations and our exploratory taxonomy is no different. This problem has long been recognized in the theory of market failure where Demsetz (1969, 1) coined the term 'Nirvana fallacy' to describe the danger that 'much public policy economics implicitly presents the relevant choice as between an ideal norm and an existing "imperfect" institutional arrangement'. This can lead to unnecessary and costly policy intervention bound to fall short. It is thus imperative to bear in mind Ronald Coase's (1964, 195) dictum that 'until we realise that we are choosing between social arrangements that are all more or less failures, we are not likely to make much headway'.

A beneficial aspect of our exploratory taxonomy is that it obliges policy makers to recognize that due to the predominantly 'non-discretionary' nature of demographic factors, council revenue, expenditure, as well as part of financial management, there are environmental limits on the extent to which individual local councils can be held responsible for their own long-term sustainability. Moreover, given the high degree of VFI in Australian fiscal federalism and the fact that additional expenditure responsibilities can be loaded on local government, it is inevitable that higher tiers of government will always have to assist local councils financially, and in the short-run, this means that immediate local infrastructure crisis will have to be resolved by extensive subsidies from the Commonwealth and state governments. In other words, in the absence of additional taxation powers, local government sustainability is inextricably dependent on fiscal transfers from higher levels of government. For the majority of Australian local authorities, self-secured long-term sustainability is simply not feasible.

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