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Financial Sustainability in Australian Local Government: Problems and Solutions

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Abstract: The dawn of the new millennium has given rise to the emergence of acute financial distress in all Australian local government state and territory jurisdictions as repeatedly demonstrated by numerous national and state-based inquiries into the financial sustainability of local councils. In essence, these documents left no doubt that local authorities across Australia were in desperate financial straits and that the burden of the financial crisis had fallen most heavily on local government infrastructure.

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Introduction

The dawn of the new millennium has given rise to the emergence of acute financial distress in all Australian local government state and territory jurisdictions as repeatedly demonstrated by numerous national and state-based inquiries into the financial sustainability of local councils. For instance, at the federal level, the Commonwealth Grants Commission (CGC) Report (2001) identified various causes of financial distress, including 'cost shifting', higher legislated service provision standards, reduced real value of grants and constraints on revenue-raising. The *Local Government National Report, 2004-05*, prepared by the Local Government Section of the Department of Transport and Regional Services (DOTARS) (2006, 61), stressed the problem of long-run financial sustainability by considering the notion of a 'structural gap' induced by 'the unbalanced growth of revenues and expenditures' that resulted in fiscal distress in local government. The Commonwealth House of Representatives Standing Committee on Economics, Finance and Public Administration's (Hawker Report) (2004) *Rates and Taxes: A Fair Share for Responsible Local Government* Report, originally designed to investigate cost shifting, considered numerous other sources of financial pressure. Finally, the PriceWaterhouseCoopers (PWC) (2006) *National Financial Sustainability Study of Local Government* Report examined financial sustainability in local government and concluded that only substantial federal government financial assistance could ameliorate the problem, especially in the area of local infrastructure. In essence, these documents left no doubt that local authorities across Australia were in desperate financial straits and that the burden of the financial crisis had fallen most heavily on local government infrastructure.

In analogous fashion, at the state level, we have seen the publication of the South Australian Financial Sustainability Review Board's (FSRB) (2005) *Rising to the Challenge* Report, the Independent Inquiry into the Financial Sustainability of NSW Local Government's (2006) Final Report entitled *Are Councils Sustainable*, the now defunct Queensland Local Government Association's (LGAQ) (2006), *Size, Shape and Sustainability* Report, the

Western Australian Local Government Association's (WALGA) (2006) *Systemic Sustainability Study,* and the Local Government Association of Tasmania's (LGAT) (2007) *Review of the Financial Sustainability of Local Government in Tasmania.* These inquiries have all echoed the findings of the national reports for their respective state jurisdictions, particularly the serious local government infrastructure backlog.

Finally, an embryonic academic literature has also explored the problems of financial sustainability of Australian local government. Some of this work has sought to determine the empirical basis for local council unsustainablity, such as Murray and Dollery (2005; 2006), Walker and Jones (2006) and Dollery (2006). Other scholars have tried to locate financial sustainability within the broader concept of 'overall sustainability' in local government.

Against this background, the present paper has two major aims. In the first place, we seek to get some idea of the extent and degree of financial distress in Australian local government by examining the findings of the PWC (2006) Report. Secondly, we briefly consider the main policy recommendations that have been advanced in various published sources for dealing with financial unsustainability in Australian local government.

Financial Distress in Australian Local Government

The Australian Local Government Association (ALGA) commissioned the PWC (2006) *National Financial Sustainability Study of Local Government* to examine the main forces affecting financial sustainability and to develop recommendations for improving local government sustainability. In contrast to the state-based inquiries funded by the respective state local government associations, the PWC (2006) Report took a national perspective on financial sustainability in local government.

At the outset, the PWC (2006, 6-7) Report went to great pains to stress the difficulties involved in assessing the 'financial viability' of local councils. The

Report identified three main obstacles which prevented the development of a common sustainability index which could be used as a benchmark to evaluate local councils in all Australian jurisdictions. Firstly, different state local government systems employed ‘mixed approaches to measuring and recording financial data’ with significant ‘inconsistencies’ between different states. Secondly, asset valuation was both infrequent and typically made different assumptions about the longevity of local government assets. Finally, ‘incomplete’ financial and asset management records, especially in smaller councils, rendered accurate comparisons impossible.

As a consequence, the PWC Report adopted two separate methods in their evaluation of the financial viability of local councils. In the first place, the PWC Report applied financial ratio analysis to a sample of 100 local councils weighted by the number and type of local council in each state. Secondly, the PWC Report used the Access Economics and Municipal Association of Victoria (MAV) (2005) approaches by employing the Key Performance Indicators (KPIs) developed in the (FSRB 2005), the LGI (2006) and WALGA (2006) state inquiries as well as the MAV ‘viability index’.

All the national and state-based inquiries into the financial distress suffered by Australian local government have experienced difficulties in developing an adequate definition of financial sustainability and the PWC Report is no exception. After considerable reflection, the PWC (2006, 95) finally settled on the following definition: ‘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’. In addition, the PWC Report stressed two critical aspects of financial sustainability: (a) local municipalities must maintain ‘healthy finances’ in the light of current expenditure and revenue policies and foreseeable future developments in outlays and income; (b) local councils should be careful to match asset planning with infrastructure expenditure.

In the PWC Report, this view of financial sustainability in local government led to the development of five financial KPIs that could be applied to actual local councils to determine their financial sustainability. The first indicator consisted of 'operating surplus' defined as 'total operating revenue less total operating expenses'. For example, if the operating deficit of a particular local council exceeded 10 per cent of its total revenue, then this would place it at considerable financial risk. In its sample of 100 Australian local councils, the PWC Report found that 16 per cent of all councils could be classified as unsustainable. 'Interest coverage' represented the second KPI. It measures a local municipality's capacity to pay interest on its own debt, which is calculated as the ratio of 'Earnings Before Interest and Tax' (EBIT) to 'borrowing costs'. The PWC Report considered ratio value below 3 as indicative of financial unsustainability and found that about 36 per cent of its sample was financially unsustainable. Thirdly, the PWC Report constructed a 'sustainability ratio', consisting of the ratio of capital expenditure to depreciation, which measured changes in the asset base of local councils. In terns of this indicator, if the ratio is less than 1, then the asset base of the council in question is falling. In the PWC Report sample of 100 local councils, only 8 per cent of councils fell below 1. The fourth financial KPI resides in the 'current ratio' which consists of the ratio of current assets to current liabilities. It is intended to measure a council's capacity to meet its short-term debt obligations, in which a sustainable council is defined as having a current ratio at least equal to 1. In its sample, the PWC Report found that 21 per cent of councils fell below this level. Finally, 'rates coverage', defined as total rates revenue as a percentage of total costs, represented the fifth KPI. The PWC Report set 40 per cent coverage as its benchmark and established that 52 per cent of all councils in its sample fell below this figure, particularly amongst rural councils.

In its assessment of financial sustainability in Australian local government, the PWC Report drew three main conclusions from its analysis of its sample of local councils in terms of the type of local council:

(i) Most ‘large’ metropolitan councils are largely financially sustainable, although some of these councils are ‘stretched’ due to ‘service expansion’;
(ii)‘Urban fringe’ local councils exhibit ‘mixed’ financial sustainability, but ‘only some’ councils need ‘additional’ funding;
(iii) ‘Rural remote’ and ‘rural agricultural’ local authorities demonstrated ‘pronounced’ sustainability problems with financial sustainability, and most of these councils required ‘extra funding’ for the urgent replacement of ‘existing community infrastructure’.

As we saw earlier, the second method by the authors of the PWC report was based on the extrapolation of the KPIs developed in the (FSRB 2005), LGI (2006) and WALGA (2006) state inquiries and the MAV ‘viability index’ to all Australian local councils in order to ascertain local infrastructure sustainability. The results of this analysis were most interesting. According to the PWC Report 20 to 40 per cent of all local councils could be classified as financially unsustainable. In state terms, the PWC Report concludes that NSW local government has the most acute ‘financial viability issues’. For Australian local government as a whole, the average local council expenditure shortfall on local infrastructure renewal lay between $1.3million and $1.7 million per annum. Finally, to remedy the annual infrastructure shortfall, together with the historically accumulated local infrastructure backlog, the PWC Report found that on average, local councils would each have to outlay an additional $2.6 million to $3.3 million per year.

Finally, on the basis of the findings of both approaches adopted in their analysis of local government financial sustainability, the authors of the PWC Report sought to draw some general conclusions. These were twofold: (a) about 40 per cent of all Australian local councils could not be considered financially sustainable; and (b) in addition, around 10 to 30 per cent’ of all Australian local councils confronted ‘sizeable’ challenges with financial sustainability.

Proposed Policy Solutions to Financial Distress

While a high degree of unanimity exists amongst the local government policy community that Australian local government is in a state of financial crisis, no analogous consensus can found on the best policy response to meet this crisis. In essence, three separate kinds of policy options have been proposed to deal with the problem of financial unsustainablity.

In the first place, some local government policy makers still cling to structural reform as a ‘silver bullet’ to deal with the ills of Australian local government, as best exemplified in the current forced amalgamation program underway in Queensland, on grounds that ‘bigger is better’ in local government. The sheer longevity of this argument and its insularity from empirical reality are noteworthy, since its obvious flaw resides in the fact that those states which have already embarked on substantial structural reform are still afflicted by financial unsustainability (Dollery *et al.* 2008). A variation of this policy prescription is that ‘internal reform’ of local councils is necessary, especially in asset management.

A second line of policy prescription has focused on the need for greater transfers from higher tiers of government to local government. It is possible to identify three strands of this general argument. Firstly, some authorities, like the Allan Report (2006), have called for an increase in the real value grants from the various state local government grants commissions. Secondly, others have recommended the establishment of a federal government local government asset infrastructure fund, such as Dollery *et al.* (2007) and the PWC Report (2006). A third option, a close substitute for the second recommendation, advocates the creation of state-based local infrastructure funds, like WALGA (2006).

A third generic policy approach has recommended greater borrowing by local councils. While this general approach has been advised in several public inquiries, most notably the Allan Report (2006), Byrnes *et al.* (2007) have developed a sophisticated method of raising relatively low-priced finance for local infrastructure by means of a fixed-interest bond issue on the Australian capital market using asset-backed securities created by local councils.

In addition to these three general proposals, other possibilities exist. For example, the revenue-raising activities of local councils are presently constrained by regulation on rate-capping (in NSW), as well as fees and charges. These regulations could be relaxed to allow local councils greater latitude in securing more income. Similarly, local government could be given additional sources of revenue, such as environmental taxes.

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