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A Comparative Perspective on Financial Sustainability in Australian Local Government

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Abstract: The problem of determining the financial sustainability of local councils in Australia has attracted the attention of several recent official inquiries and generated an embryonic academic literature. However, these efforts have thus far occurred in isolation and no attempt has been made to consider the different approaches to the problem in comparative perspective. This paper seeks to remedy this neglect by considering the work of public inquiries in South Australia, New South Wales and Queensland as well as the nascent academic literature. It is argued that not only has no generally agreed approach has been achieved, but that the inherent difficulties in designing a satisfactory method of measuring sustainability make any consensus in future most unlikely.

Keywords: financial sustainability; performance indicators; local government

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Introduction

Over the past few years, Australian local government policy makers have become increasingly concerned with the question of the 'financial sustainability' of individual local councils. Quite apart from forming the central theme of numerous local government conferences across Australia, this concern has also manifested itself in several recent public inquiries into local government systems. For instance, the South Australian Financial Sustainability Review Board's (2005b) *Rising to the Challenge* 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. Moreover, both the ongoing Queensland Local Government Association (LGAQ) (2006) *Size, Shape and Sustainability* (SSS) project and the current Western Australian Local Government Association (WALGA) (2006) *Systemic Sustainability Study*: *In Your Hands - Shaping the Future of Local Government in Western Australia* Inquiry are grappling with financial sustainability in their respective local government systems. In addition, the *Local Government National Report, 2004-05*, prepared by the Local Government Section of the Department of Transport and Regional Services (DOTARS) (2006, 61), 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, the academic literature has also explored the problem of financial sustainability of Australian local government from an empirical perspective (see Murray and Dollery 2005; 2006; Walker and Jones 2006 and Dollery 2006).

A fundamental problem faced by all these attempts at tackling financial sustainability in local government resides in providing a precise definition for the concept and determining how to measure financial sustainability from available data. Although all these documents are unanimous that large numbers of local authorities in Australia suffer from acute and worsening financial distress, no consensus has yet been reached on how best to define and measure the concept. This lack of agreement has far-reaching policy ramifications. If no widely accepted meaning can be attached to the term financial sustainability, then firm policy conclusions on the optimal method of alleviating the problem obviously remain allusive.

Despite the undoubted problems posed by the current financial crisis experienced in Australian local government, most obviously evidenced in inadequate local infrastructure investment and maintenance, and the attendant urgent need to develop accurate and robust benchmarks for local government sustainability, no attempt has yet been made to consider and evaluate the various efforts at defining and measuring financial sustainability in a comparative manner. Accordingly, in order to address this urgent need, in this paper we will examine the approaches to financial sustainability developed by the South Australian Financial Sustainability Review Board's (2005b) *Rising to the Challenge,* the Financial Sustainability of NSW Local Government's (2006) *Are Councils Sustainable,* the Queensland government's (2006) *Size, Shape and Sustainability* manual, and the Murray and Dollery (2005; 2006) and Walker and Jones (2006) methodology. Since the WALGA (2006) *Systemic Sustainability Study* is still in its infancy, it will not be considered.

The paper itself is divided into seven main parts. Section 2 provides a synoptic discussion of the generic problems associated with local government performance measurement and Key Performance Indicators. Section 3 considers the work of the South Australian Financial Sustainability Review Board (2005b). Section 4 focuses on the relevant parts of the Independent Inquiry into the Financial Sustainability of NSW Local Government's (2006) Final Report. Section 5 examines the criteria advanced in the Queensland (2006) *Size, Shape and Sustainability* manual. Section 6 deals with the approach developed by Murray and Dollery and the Walker and Jones (2006) method is assessed in section 7. The paper ends with some brief evaluative comments in section 8.

Local Government Performance Measurement and Key Performance Indicators

In the Australian local government milieu, all state and territory governments have enacted Local Government Acts that grant local councils enabling powers and prescribe the nature of their activities. These Acts also provide state Departments of Local Government with oversight powers over the conduct of local authorities. Under this legislative matrix, state governments must also periodically assess the financial soundness of councils within their local government systems and take action when fiscal and other circumstances demand intervention.

Financial oversight by state government agencies of local councils is a thorny question since it inevitably involves developing methods of appraising the financial performance of municipalities. The conceptual and measurement difficulties revolving around the creation and implementation of satisfactory performance measurement cannot be overstated. In the first place, despite a voluminous literature on the question, summarized by Honadle *et al.* (2004) in their *Fiscal Health for Local Governments,* there is no agreed definition of what constitutes 'financial sustainability' over the long term in local government. Indeed, Honadle *et al.* (2004, 18) observe that there is not even 'consensus about the terminology surrounding fiscal health'! Definitions abound. In the United States, writers use a bewildering array of terms, including 'fiscal health' (Berry 1994), 'financial condition' (Lin and Raman 1998), 'fiscal strain' (Clark and Appleton 1989), 'fiscal stress' (Pagano and Moore 1985), 'fiscal capacity' (Johnson and Roswick 1991), and 'fiscal crisis' (Campbell 1991). By contrast, in Australia the term 'financial sustainability' has recently become fashionable and acquired widespread usage, even though it still lacks any concrete meaning.

It easy to appreciate how conceptual difficulties of this kind arise and persist in the financial assessment of local government. For instance, should financial soundness refer to short term or long run time periods and how long should time horizons be? Similarly, should the financial circumstances of a given council be judged exclusively in the light of financial magnitudes, such as operating expenditure, operating revenue, indebtedness, and the like, or should the yardstick reside in standards of service provision and community expectations? On analogous grounds, should financial performance be gauged in its own terms or relative to operational effectiveness? What weight should be accorded to governance efficacy relative to external factors beyond the control of councils?

Secondly, aside from these fundamental disputes surrounding the definition of financially troubled municipal entities, further intractable problems arise in measuring financial performance. The first attempt at systematically evaluating the fiscal standing of local government was undertaken by the American Advisory Commission on Intergovernmental Relations (ACIR) in 1973 which devised six early 'warning signs' of 'local financial emergencies' in the form of financial indicators. This set in train a rapidly growing literature on the development of indicators for local government in the United States (see, for instance, Kloha *et al.* 2005) that culminated

in the construction of comparative indicators, typically in the guise of financial ratios, as perhaps best exemplified by Brown (1993; 1996).

Parallel developments have occurred in Australian local government. Woodbury *et al.* (2003, 78) have provided a systematic analysis of Australian local government performance measurement systems. They observed that in Australia 'a key strategy in improving local government performance over the past decade has been the development of performance measures for use in the benchmarking of services' in order 'to measure performance and assess the efficiencies of councils'. Woodbury *et al.* (2003, 79) have summarized these developments as follows:

> A number of Australian states and territories have required councils to provide information on key service areas. Although this has varied somewhat between the states, more detailed and better-defined data continues to be collected each year. It was not until 1995 that national performance indicators were first proposed at the Local Government Ministers' Conference and since then the National Office of Local Government has facilitated a voluntary process of developing and adopting standard performance measures and indicators with the states, peak industry bodies and technical committees. No efficiency measures for councils services are currently compared Australia wide since indicators and definitions vary from state to state.

As a result, 'each state now either releases comparative performance data for local government on an annual basis or is in the process of doing so'. In effect, the methodologies developed in the South Australian Financial Sustainability Review Board's (2005b) *Rising to the Challenge,* the Financial Sustainability of NSW Local Government's (2006) *Are Councils Sustainable,* the Queensland government's (2006) *Size, Shape and Sustainability* manual, and in the Murray and Dollery (2005; 2006) and Walker and Jones (2006) approaches all seek to find the allusive satisfactory comparative measures of local government financial performance.

The aim of constructing comparative indicators that can be applied to a whole local government system is certainly laudable. Policy makers seek some kind of 'objective' measurement tool that will enable them to compare the performance of individual councils and make recommendations that are unbiased. In the Australian context, this approach has been described by Woodbury *et al.* (2003, 78) as follows:

> [P]erformance has been exclusively assessed by either comparing performance indicators against data for similar councils, primarily the 'average council' figure for that state, or by comparing current performance with earlier indicators for a given council. Little effort has been directed at explaining why there are differences between councils, determining what constitutes 'best practice' levels of efficiency, or how state governments can best apply direct pressure to force inefficient councils to improve performance (through linking grant funding to economic performance).

However, as Woodbury *et al.* (2003) suggest, efforts at compiling and applying indexes of comparative indicators are fraught with difficulties.

Kloha *et al.* (2005, 316-17) have identified some of the problems inherent in all system-wide sets of local government comparative financial indicators. Firstly, almost all indexes of comparative indicator indexes contain 'too many variables' that limit the 'ability to assess which are the most important or to combine them into a more useable and easily understood composite'. Secondly, the 'exclusion of key variables' consequent upon 'focusing almost exclusively on balance sheet data seems to hinder an indicator's ability to give early warning of distress'. An additional problem resides in 'ambiguous expectations' since 'some indicators include variables that may have differing interpretations'. A 'failure to allow for diverse preferences' typically derives from the application of average financial ratio values to every local council in strident deviance of preference differences on the part of residents of different local authorities. In the fifth place, an emphasis on the 'relative rather than absolute' values of indicators serves to punish councils whose absolute values are satisfactory but nevertheless fall at the bottom end of a given scale. An inability 'to focus on one locality' is a further problem that plagues systems of comparative indicators since 'ratios for all local governments must be computed before the relative fiscal health of a single government can be determined' with onerous cost implications. Finally, acquiring accurate data is always a costly problem.

These specific problems inherent in almost all sets of local government financial performance indicators are amplified when we consider wider conceptual anomalies. For instance, in *The Financial Analysis of Governments,* Berne and Schramm (1986, 93) stress that 'the judgment factor will never be replaced entirely by cookbook

formulae' offered by the apparent 'objectivity' of quantitative financial ratios in comparative local government performance indicators. Similarly, in direct reference to Australian performance indicators, Worthington and Dollery (2000) pointedly emphasised the significance of 'nondiscretionary variables' in performance indicators that cannot be altered by the behaviour of a given council. Nondiscretionary variables include items such as pensioner rate rebates, non-rateable properties in a local government area, the proportion of non-English speaking and Aboriginal people, and a host of other economic and social factors that cannot be influenced by a council.

South Australian Financial Sustainability Review Board

The South Australian Financial Sustainability Review Board (FSRB) was set up as an independent body by the South Australian Local Government Association on the 14th February 2005. Its chief task was to assess 'the financial position and prospects of councils in South Australia' by considering three central questions. Firstly, does local council expenditure on service provision and local infrastructure meet with current and future revenues flows? Secondly, what is the optimal manner of remedying a potential 'mismatch' between expenditure and revenue. Finally, should grants from higher tiers of government be directed reducing any such financial mismatch?

The Inquiry itself published three documents: A discussion paper entitled *Local Government in South Australia: Assessing Financial Sustainability* in March 2005; an *Interim Report* (2005a) published on 30th May 2005; and a Final Report *Rising to the Challenge: Towards Financially Sustainable Local Government in South Australia* (2005b) released on 17th August 2005.

A central question tackled by the FRSB considered the problem of defining 'financial sustainability' as a method of assessing the long-term solvency of South Australian councils. The FRSB (2005b, 7) argued that although 'the term "financial sustainability" has a well-understood meaning among Commonwealth and state governments, involving a local council 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 comparable agreement existed on the meaning and content of 'financial sustainability' Australian local government.

After due consideration, the FRSB (2005b, 10) proposed that 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).

In order to determine whether or not a given local authority met with this definition, the FRSB (2005b, 15) advanced a quadrilateral set of key financial indicators 'for assessing a council's financial sustainability'. These indicators were: 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'.

On the basis of these considerations, the FSRB (2005b, 19-20) drew its to its major conclusion (in the form of Recommendation 2.3(1)) in which it determined a 'statement of principles' governing 'key financial sustainability indicators' founded on the following six ingredients:

- A local council is financially sustainable financial 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 specified local authority '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 of a local council 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 local authority'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 municipality 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, net borrowing of a local council 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'.

These principles formed the benchmarks that the FSRB employed to assess South Australian councils.

Independent Inquiry into the Financial Sustainability of NSW Local Government

The Local Government and Shires Associations of NSW (LGSA) commissioned an Independent Inquiry into the Financial Sustainability of Local Government in NSW (LGI) composed of an independent panel consisting of three persons highly experienced public policy making under the leadership of Professor Percy Allan. The aims of the Inquiry were fourfold: To determine the current financial position and performance of NSW local government sector; to gauge the adequacy of existing NSW local government physical infrastructure and service delivery; to assess the

financial capacity of local government to meet its statutory obligations, expected functions and likely future challenges; and to identify possible financial, administrative, governance and intergovernmental reforms that could address any problems. To this end, the Inquiry published three public documents: A *Background and Issues Paper* presented in October 2005*; A Findings and Options Report* released in February 2006; and a *Final Report* published in early May 2006.

It is thus evident that the LGI represented a much broader investigation than the South Australian FSRB Inquiry since it roamed far beyond the narrow question of financial sustainability of the latter investigation. However, the Independent Inquiry itself explicitly acknowledged that the thorny issue of financial sustainability lay 'at the heart of this Inquiry' (LGI 2006, 267). In the present context, we will focus exclusively on the deliberations of the Inquiry with respect to financial sustainability.

In Chapter 11, the Inquiry set out the 'key financial aggregates necessary for the analysis of a council's financial position and performance' (LGI 2006, 267). These are reproduced in Table 1 below.

After discussing the 'realities' of financial reporting by NSW councils, and bemoaning inadequacies in financial information, the Inquiry contended that 'each council's financial reports should be accompanied by disclosure of relevant key financial performance indicators (financial KPIs)' (LGI 2006, 271). The financial KPIs employed must provide information on the following financial dimensions of a council's operations (LGI 2006, 272):

- 'A council's *financial position,* which involves the state of its balance sheet, and so the relative level -and composition -of its assets and liabilities'; and
- 'A council's annual *financial performance,* which involves the state of its annual operating statement, and especially the size of relevant annual surpluses or deficits'.

These financial KPIs should bear 'a strong predictive relationship with the degree to which a council's finances are likely to be sustainable in the long term, being based upon generally-accepted key analytical balances'. The 'principal choices' of KPIs identified by the Inquiry are reproduced in Table 2 below (LGI 2006, 272).

Table 1: Key Financial Aggregates

Income items	Expense items	Capital flows	Asset items	Liabilities items
Rates revenue Fees and charges Grant from other governments for non-capital purposes Other operating revenues Interest Gain from the disposal of assets Gain from interests in joint ventures/ associates Gain on revaluation of non-financial assets	Operating costs (employee expenses, superannuation, other non-employee expenses, current grant expenses, subsidy expenses and capital grant expenses) Borrowing costs Loss from the disposal of assets Loss from interests in joint ventures/ associates Depreciation	Capital expenditure, distinguishing between capital expenditure on: (i) The renewal or rehabilitation of existing assets; and (ii) New or enhanced assets Grants from other governments for capital purposes Other grants and contributions provided for capital purposes Assets donations Revenue from disposals of non-financial assets	Cash and investment securities – externally restricted Cash and investment securities – other Other financial assets (receivables, investments accounted for using equity method, other) Non-financial assets (property, plant and equipments, inventories)	Interest bearing liabilities Other liabilities (provisions, other) Memo item: infrastructure renewal backlog

Source: LGI (2006, 267, Table 11.1).

Table 2: Key Analytical Balances

Analytical balances	Definition	Denominator for comparative ratio
Net debt	Interest-bearing financial liabilities less holdings of cash and securities other than externally restricted cash and Securities	Total operating revenue
Net financial liabilities	Total liabilities less financial assets net of holdings of externally restricted cash and securities	Non-financial assets plus holdings of externally restricted cash and securities
Net interest expense	Annual interest expense less interest earnings on holdings of cash and securities other than externally restricted cash and securities	Total operating revenue
Operating surplus/(deficit)	Operating revenue before capital amounts less operating expenses less depreciation expense less net interest Expense	Own-source revenue
Net borrowing/ (lending)	Capital expenditure less capital revenues less depreciation expense less operating surplus/(deficit)	Annual capital expenditure on new or enhanced assets
Annual renewals deficiency	Annual depreciation expense less annual capital expenditure on existing Assets	Annual capital expenditure on renewal or rehabilitation of existing assets
Renewals backlog	Cumulative past annual renewals Deficiencies	Non-financial assets

Source: LGI (2006, 272, Table 11.2).

Drawing on these financial KPIs, the Inquiry prescribed 'benchmark values' based on the 'average' NSW council, with upper and lower 'safe' limits. The Report noted that 'these values should be adjusted on account of each council's individual circumstances' (LGI 2006, 273), such as whether the local council in question is 'developed' or 'developing' or whether it is 'growing' or 'declining'. These 'indicative benchmark values' are reproduced in Table 3 below.

With respect to Table 3, the LGI (2006, 274) stressed that 'if used, each of these ratios should be adhered to, not just some of them'.

In section 11.4 of the Final Report, the LGI (2006, 276) addressed the conditions that must be met should a council wish to be classified as 'currently healthy' in financial terms: A given council should be 'a modest net debtor' with borrowings or debt

making up only 'a minority of the total capital invested in the council's infrastructure and other assets' and at the same time 'the associated expense burden should not be a substantial proportion of the council's annual operating revenues'.

Table 3: Indicative Benchmark Values for Council Financial KPIs

Financial Key Performance Indicators	Average Council Data	Proposed Council Target	Proposed Upper Limit	Proposed Lower Limit
Net debt as % of total revenue	10.5%	100%	150%	50%
Net financial liabilities as % of total capital employed	2.2%	10%	15%	5%
Net interest expense as % of total revenue	0.6%	15%	20%	7%
For general government activities: Operating surplus as % of own-source revenue	-4.5%	5%	10%	0%
For commercial activities only: EBIT as % of non-financial assets	0.9%	5%	7%	3%
Net borrowing as % of capital expenditure on new or enhanced assets	1.3%	50%	60%	30%
Annual renewals deficiency as % of renewals capital expenditure	40.2%	0%	10%	-10%
Infrastructure backlog ($M) as % of total infrastructure assets (estimated at fair value)	8.1%	0%	1%	0%

Source: LGI (2006, 273, Table 11.3).

This represents a minimum requirement. In addition, 'for a council's financial performance to be assessed as "currently healthy"' and to 'involve a margin of comfort to cope with the usual assortment of financial risks and financial shocks' the council must meet three further criteria: In the first place, the council in question should 'generally be running an operating surplus rather than an operating deficit'. Secondly, the local authority should not exhibit a 'significant infrastructure renewal backlog' and its capital expenditure over the financial year on infrastructure renewal and replacement should 'on average over time be about the same level as the council's depreciation expenses'. Finally, 'annual net borrowing should not be putting any pressure on the council's targeted net financial liabilities ratio'.

Chapter 11 of the Final Report (LGI 2006, 283) conceded that the concept of financial sustainability is a 'controversial issue'. It concluded that 'a council's finances should be considered sustainable in the long term only if its financial capacity is

sufficient – for the foreseeable future – to allow the council to meet its expected financial adjustments over time without having to introduce substantial or disruptive revenue (and expenditure) adjustments'.

Bearing in mind the earlier discussion on the conclusions of the South Australian Financial Sustainability Review Board Final Report regarding financial sustainability, the similarities between it and the LGI in this respect are startling. The high degree of commonality between the two conclusions can perhaps best be explained by the fact that both have their origins in the work of Access Economics (2006). It should thus not be interpreted as indicative of any emerging consensus on the meaning and content of financial sustainability in the Australian municipal context.

The Queensland Size, Shape and Sustainability Approach

In 2004, the Local Government Association of Queensland (LGAQ) resolved to consider the pressures confronting councils in Queensland and to explore the need for local government reform to ensure the long-run viability of local councils. As a consequence of this decision, a Discussion Paper entitled *Size, Shape and Sustainability of Queensland Local Government* was released on 3rd March 2005 and a Special Conference of the LGAQ held in Brisbane in early June 2005, which formulated a *Communique* approving a 'comprehensive reform blueprint'. A 'ten point Action Plan' followed from the *Communique* that was subsequently endorsed by both the LGAQ Executive and the Queensland Minister for Local Government and Planning. The Action Plan provided for a local government reform program embodying the *Size, Shape and Sustainability* (SSS) Review Framework, sustainability indicators, 'options for change', 'Independent Review Facilitators' (IRF), 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* (LGAQ 2006, 6, Chapter 1) noted that, as part of the overall reform program, local councils must 'assess their current and future sustainability against a number of key indicators'. It argued that 'the use of indicators for SSS will assist councils determine how their councils are performing'. In particular, the SSS indicators may 'help identify where there might be present or future vulnerabilities, opportunities, and strengths'. These latter three terms are defined in some detail: 'Vulnerabilities' consist of 'risks or weaknesses within specific areas of council

operations'; 'opportunities' focus on 'areas within council operations that could be improved'; and 'strengths' consider excellence in council operations and areas where a given council could 'provide assistance/benefit to other councils'.

The *Guidelines Kit* (LGAQ 2006, 4, Chapter 3) set out five criteria that indicators should fulfill: 'Relevant' and 'limited' in number; 'capable of relating to other indicators'; 'easy to understand' 'reliable' in the sense of providing trustworthy information; and based on 'accessible information'. It should immediately be noted that while the *Guidelines Kit* (LGAQ 2006, 8) concedes that 'some indicators are qualitative in nature and will [thus] be scored based on judgment and local knowledge', and thereby does at least recognize some of the generic problems associated with performance indicators outlined earlier in this paper, it nonetheless neglects to mention the problem of discretionary and non-discretionary variables.

Each of the indicators must be scored on a 1 to 5 cardinal scale, with high scores indicating satisfactory outcomes. Prescribed IRF persons will 'oversee' the application of individual council data to the indicators. However, the *Guidelines Kit* does not explain the process whereby IRF personnel are selected and appointed. This raises obvious and unfortunate difficulties with the independence of the IRF process.

Four categories of indicators are prescribed in the *Guidelines Kit* and set out in detail in Chapter 3. We will briefly list and comment on these categories of indicators below:

Category #1: Financial and Resource Base

1. Financial forecasts
2. Revenue base
3. Rating capacity
4. Asset sustainability
5. Levels of service
6. Human resourcing
7. Cross border use of council services

These seven indicator groups derive from the Queensland Treasury Corporation's (QTC) 'Financial Sustainability Review' and must form part of the overall *Size, Shape*

and Sustainability exercise. Two indicator groups contain more than a single indicator. For example, 'revenue base' includes three specific indicators dealing population growth, age dependency, and population size respectively. An aggregate score for revenue base is obtained by averaging the score for each of these specific indicators. This is unfortunate since population growth, population age structure and population base all have quite different effects on council service, expenditure and revenue patterns.

A second unusual feature of these financial and resource base indicators resides in the fact that whereas some of them require subjective judgment, other indicators simply report ratios taken from 'objective' data. This means that the scores obtained for different indicator groups are not directly comparable since they are based on completely different assessment criteria.

Thirdly, in contrast to both the South Australian Financial Sustainability Review Board's (2005b) *Rising to the Challenge* and the Financial Sustainability of NSW Local Government's (2006) *Are Councils Sustainable,* the resultant scores represent absolute and not relative perceptions of financial sustainability since the data are not expressed in comparative terms.

Fourthly, insufficient justification is provided for the selection and range of the indicator groups. For example, unlike the Financial Sustainability of NSW Local Government's (2006) *Are Councils Sustainable,* no distinction is drawn between a council's financial position (i.e. the state of its balance sheet and the level and composition of its assets and its liabilities) and the annual financial performance of a council (i.e. the state of its annual operating statement and the magnitude of relevant annual surpluses or deficits). This has serious implications for the usefulness of the data that is gathered through the exercise.

In the fifth place, the indicator groupings under 'financial and resource base' confuse inputs into council operations with the outputs from council activities. For example, 'asset sustainability' clearly deals with council assets employed to produce serve outcomes whereas 'service levels' obviously represents a final output. Since the analysis of production functions is premised on the distinction between inputs and outputs, economists always separate these two categories for fear of comparing apples with oranges!

Finally, some indicators are approached in a puzzling manner. For instance, the adequacy of 'levels of service' should be gauged on the basis of council 'monitoring and reporting', 'future' needs, and 'community expectations' and adjudged by reference to 'customer complaints', 'community surveys', 'various legislative requirements', like Total Management Plans (TMPs), and Strategic Management Plans. The suggested data sets immediately bias scoring towards large councils that do not have intimate interaction with small communities characteristic of small councils and thus must use these indirect measurement and planning systems. Similarly, the existence of these instruments rather than their efficacy can boost council scores. These and other problems mean that the scores that eventuate will not properly reflect community satisfaction with service provision.

Category #2: Community of Interest

1. Service centre and community linkages
2. Community engagement

These two indicator groups follow the same pattern as the 'financial and resource base' exercise since the indicator group 'service centre and community linkages' contain more than one indicator by combining the scores for 'service centre linkages' and 'community linkages'. For the same reasons, this is unfortunate because the two indicators seek to measure different phenomena and an aggregate score is obtained by averaging the score for each of these specific indicators.

A second problem once again resides in the fact that no rationale is provided for the apparently arbitrary choice of indicators. 'Community of interest' is a complex and multi-faceted phenomenon that is very difficult to measure in any meaningful way. For instance, numerous councils combine urban, semi-urban and rural populations with divergent and often competing needs for local services. This aspect has been ignored. Similarly, no mention is made of the important psychological construct of 'sense of place' that is critical in the 'well-being' of small communities. This is typically critical in cases where small settled communities have coexisted alongside much larger councils for long periods of time. A much better way of tackling the question of community of interest is to formally survey public opinion with a statistically reliable sample. A survey of this kind can also gather valuable information

on many other aspects of council performance, not least satisfaction with service provision.

Category #3: Planning

1. Service coordination and efficiency
2. Growth management

Unlike the indicator groups under 'financial and resource base' and 'community of interest', the two planning category indicators do not combine different aspects of local government under a single averaged score and thus is not open to the same objections. However, both deal with the phenomenon of inter-jurisdictional externalities between adjacent local government areas. For example, 'service coordination and efficiency' is centrally concerned with the question of the duplication and coordination of local government infrastructure across council boundaries. The *Guidelines Kit* (2006, 18, Chapter 3) explicitly acknowledges that 'where difficulties exist in coordinating infrastructure services across council areas and/or regions, then structural reforms options may be needed', without indicating what kind of options may be appropriate. In this sense, the 'service coordination and efficiency' indicator duplicates to a significant degree the earlier 'cross border use of council services' under the 'financial and resource base' indicator groupings. The difference between the two apparently rests on an artificial distinction between local infrastructure and the services flowing from local government infrastructure. It is thus by no means obvious why these two indicators are not grouped together.

Category #4: Standards of Governance

1. Decision making and management
2. Accountability

Unfortunately, in common with the indicator categories 'financial and resource base' and 'community of interest', the two 'standards of governance' indicators both combine different aspects of local government under a single averaged score and can thus be attacked on the same grounds. For instance, while there is no denying that 'corporate planning', 'risk management', and 'delegations' are all important dimensions of organisational functioning, experience suggests that harmonious relationships between councillors is one the most critical predictive factors for

explaining the smooth running of local authorities. This aspect is entirely ignored by the *Guidelines Kit.*

'Accountability' also comprises two separate aspects of 'performance management' and 'internal audit process' is thereby lays itself open to criticism since it averages scores again. It can also be attacked on grounds that both these dimensions of accountability deal with 'internal' processes rather than 'external' public perceptions of accountability required by democratic entities.

This brief assessment of the indicator groupings contained in the *Size, Shape and Sustainability* exercise thus suggest that there is considerable room for improvement. At the very least, there is an urgent need for the Local Government Association of Queensland to explain the rationale for its selection of indicators and for indicators combining more than one conceptually different aspect of local government to be separated.

On a more positive note, a saving grace of the *Size, Shape and Sustainability* indicator exercise resides in its flexibility. The *Guidelines Kit* (2006, 6, Chapter 3) specifically notes that 'if the Review Group of Councils believe there are other indicators that are applicable to their circumstances (for example, environmental management and economic development), then it is entirely appropriate at the discretion of the Review Group to add to the sustainability indicator list'. This allows councils to take action to limit the weaknesses inherent in the indicator groupings.

The Murray and Dollery Approach

In two separate papers published in academic journals, (the late) David Murray and Brian Dollery (2005; 2006) approached the controversial question of financial sustainability in Australian local government from a rather different perspective. In their paper in *Public Administration Today,* Murray and Dollery (2006) explored the basis of performance appraisal in NSW and the approach adopted by the NSW Department of Local Government in classifying individual councils as 'at risk'.

Given the harsh consequences that can result from being classified as an 'at risk' council in NSW that may include detailed scrutiny by the NSW Department of Local Government and even possible dissolution of the council, Murray and Dollery (2006,

47) sought to determine whether the performance measurement system employed in NSW operated in a effective way. To this end, they considered three main questions: How are financially struggling councils identified? Is the methodology that is employed to this end sufficiently robust to withstand scrutiny? Finally, do the monitoring lists provide a true indication of financial performance to the extent that the financial accountability of councils is discharged?

This involved an assessment of how 'monitoring lists' of financial troubled councils are constructed and the subsequent identification of 'at risk' councils. Murray and Dollery (2006, 59) drew the following conclusions from their analysis:

> 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. Consequently, the ability of NSW local governments manage their accountability requirements to the Parliament and the citizenry can perhaps best be described as a compromise, which present monitoring lists fail to address.

In a complementary paper published in *Economic Papers,* 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 NSW Department of Local Government conducted this assessment on the basis of an analysis of KPIs drawn from comparative performance tables published by the NSW Department of Local Government from information supplied by individual municipalities. In its construction of 'monitoring lists', the NSW Department of Local Government subjectively considers these indicators as well as other information in order 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 ask 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'.

The results obtained by Murray and Dollery (2005) bring into question the adequacy of KPI analysis for local government. Murray and Dollery (2005, 342-3) drew the following conclusion from their econometric analysis:

> [T]he 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. This has the potential for opening up a political 'can of worms' for both the NSW Government and the NSW DLG since those councils that have been labeled as 'at risk' could seek legal redress. Moreover, local authorities which have been branded 'at risk' may have been subject to subsequent close scrutiny, and even dismissal, when their actual financial soundness is in fact no worse than other councils within the same assigned classification category.

This finding led Murray and Dollery (2005, 343) to ask the question: 'If the current NSW DLG methodology does not reliably identify "at risk" councils, what might be the important indicators of financial risk?' In an effort to answer this question, they 'speculated' along the following lines: 'It has been argued that one important indicator is whether the council faces cost disabilities in the provision of its services due to population dispersion, age/sex distribution of its population, difficult terrain/climate, urban congestion, economies of scale, etc.' Moreover, 'these are the types of cost disability developed and measured by the Commonwealth Grants Commission in its equalization model' and 'they are commonly also used by state government grants commissions in distributing funds to local governments'. In addition, 'another important indicator would be whether the local government faces revenue disabilities, such as a weak property tax base'. In sum, 'one would expect that councils' facing cost and revenue disabilities to be at most financial risk'. In other words, all KPIs do

is imperfectly measure the effects of diversity amongst local councils that have long been recognized by policy makers. Furthermore, their predictive capacity for ascertaining potential 'local government failure' is very low in any event. This obviously undermines the whole basis for using KPI analysis to evaluate the financial sustainability of local councils.

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? While Murray and Dollery (2005, 343) noted that 'although the resolution of this question goes well beyond the scope of the present paper', they nonetheless 'speculate' on what factors really determine local government failure. They observe 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'. Finally, Murray and Dollery (2005, 343) stressed that 'certainly council size *per se* appears to have been unimportant'.

Walker and Jones Approach

In a subsequent attempt to empirically investigate the question of fiscal stress in Australian local government, Walker and Jones (2006) developed two main criticisms of the approach adopted by 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 draw exclusively on published KPIs to determine which councils 'at risk', but also employed other sources of information, such as the annual 'state of the environment' report and the report on the condition of infrastructure by each council. This criticism was 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). For instance, they argued that the dependent

variable employed in the regressions cannot be taken as exogenous since Murray and Dollery (2005) had chosen only ten of the full list of thirty published KPIs, and there was multicollinearity present among the independent variables. Similarly, they claimed that results were 'misinterpreted'. Criticisms of this kind represent the 'stock in trade' of disputes in econometrics and can be leveled at almost all estimation exercises.

However, the major contribution of the Walker and Jones (2006) paper lay in the development of an alternative approach to the question of fiscal distress and financial sustainability in Australian local government. Walker and Jones (2006) defined council fiscal distress in the context of 'maintaining service delivery at pre-existing levels'. In essence, Walker and Jones (2006) argue 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, in terms of this approach 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 South Australian Financial Sustainability Review Board's (2005b) *Rising to the Challenge* and the Independent Inquiry into the Financial Sustainability of NSW Local Government's (LGI) (2006) *Are Councils Sustainable?*

In his Rejoinder to Walker and Murray (2006), Dollery (2006) argued that their 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'. Moreover, Dollery (2006) observed that 'it is easy to think of instances where this procedure will fail'. In particular, he cited the example of the environmental regulation of local councils and the continual 'raising the bar' that has occurred. Obviously, there had to be financial resources to meet these rising regulatory standards. Conversely, the absence of additional resources would inevitably lead to financial unsustainability.

Secondly, Dollery (2006) argued that there were problems with the way Walker and Jones (2006) excluded water and wastewater services from their calculations on the basis that 'water and sewerage operations are largely insulated from general operations'. Dollery (2006) considered this a most 'dubious claim' since 'closer

scrutiny of the operation of many NSW local governments' indicated that 'many local authorities establish "internal contracts" for the provision of services across units, often embedding significant cross-subsidies in these contracts'.

Conclusion

What general lessons can be drawn from this analysis of Australian attempts at defining and placing operational meaning on financial sustainability in local government? At least three major inferences emerge from these attempts to measure the sustainability of local councils in Australia. In the first place, experience abroad strongly suggests that it is not possible to define sustainability with any degree of precision. Since the concept cannot be given precise meaning, it cannot be captured adequately through performance indicators. This means that other techniques are needed to augment the current prescribed indicators in the different Australian state systems, particularly public opinion surveys aimed at soliciting the views of the relevant communities. Put differently, a local council may be sustainable if the community is reasonably content with its performance!

Secondly, immense diversity between local councils in any given local government jurisdiction precludes the use of a 'one-size-fits-all' method of assessing municipalities. Not only are the expectations and needs of residents of metropolitan, regional, rural and remote councils quite different, the problems faced by these different categories of councils are also varied. A given and fixed set of indicators cannot hope to cope with these subtleties.

Thirdly, where indicators are to be employed, effort and resources should be invested *ex ante* to determine the predictive capacity of the proposed set of indicators. In other words, to what extent do a particular set of indicators actually predict good, bad, or indifferent council performance? This is an empirical issue that can only be settled by resorting to available data along the lines of the statistical exercise undertaken by Murray and Dollery (2005). Needless to add, this evaluative type of pretest or trial program should be used before embarking on expensive system-wide performance measurement programs.

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