About this Overview
(Volume 1)

This first volume sets out our main findings, interpretations and recommendations. It is capable of being read on a stand-alone basis.

The Key Points section highlights the main conclusions arising from this Inquiry.

The Executive Summary section outlines our key findings, and our interpretations of those findings, and outlines our main recommendations.

The Findings section provides a listing of all our findings. Our ‘findings’ involve, on either an empirical basis or on the basis of our judgment/opinion, a conclusion regarding the degree to which circumstances or policies of SA councils depart from those that would ensure a council’s financial sustainability.

The Recommendations section provides a listing of all our recommendations. Our ‘recommendations’ involve a program of actions to be implemented in South Australia, either by the LGA or by councils individually or collectively, aimed at correcting circumstances or policies that depart significantly from those that would ensure a council’s financial sustainability.

About Volume 2

Details of the descriptions and analysis underpinning the views expressed in this Overview volume are provided in a second volume of our report.

Volume 2 includes discussion of:

- the meaning and importance of financial sustainability;
- the key indicators of a council’s financial sustainability;
- data sources and deficiencies;
- the current state of council finances;
- the outlook for council finances;
- the extent of any financial sustainability problems;
- limits imposed on council revenue raising;
- cost pressures from other spheres of government;
- shortfalls in grants from the other spheres of government;
- council revenue and financing policies;
- council service provision policies;
- council asset and liability management policies;
- financial governance; and
- first steps.
About the Inquiry

This Inquiry into the sustainability of the long-term financial performance and position of councils in South Australia has been commissioned by the State’s Local Government Association (LGA).

The full text of the Inquiry’s Terms of Reference is provided at Appendix A of the volume 2.

The Inquiry commenced on Monday, 14 February 2005.

On 8 March 2005, the Review Board published a Discussion Paper. 42 submissions were received from councils and other interested parties.

On 30 May 2005, the Review Board published an Interim Report. 23 submissions were received from councils and other interested parties.

During June 2005, public hearings/forums were conducted with councils and other interested parties focussing on the findings and opinions put forward in the Interim Report.

About the Review Board

The Inquiry was undertaken at arm’s length from the LGA by the Financial Sustainability Review Board, comprising:

- Bill Cossey, chairperson;
- Juliet Brown; and
- Wayne Jackson.

By undertaking our investigations independently of the LGA, and with a membership that has no direct involvement with local government in the State, we have sought to act as an ‘honest broker’ on key matters where different positions are evident about, and within, local government.

Acknowledgement

We acknowledge, with great appreciation, the contribution of the local government sector in South Australia to the Inquiry.

Local government is a complex entity. The complexity makes it difficult to write a report that addresses the sector as a whole. There are councils in South Australia that are already pursuing the directions proposed in this report; there are others that are not. The sector-wide nature of the Inquiry has meant that it is not appropriate that we single out individual councils for praise or criticism.

The criticism made of the sector in this report in no way aims to decry the commitment of people involved. We recognise that, in many councils, elected members have not had the benefit of the type of information they need to develop the policies necessary to ensure the financial sustainability of their councils.

The dedication shown by elected members and senior managers in serving their communities has been evident to us throughout this Inquiry. Their task is a challenging one, particularly given the complex set of legislative, policy and financial arrangements applying to local government and the fact that not all councils are alike.
Key Points

- The financial sustainability of councils is vital in the interests of ratepayers, the community and the State. It is an important pillar of efficient and effective local government.

- Of those SA councils whose long-term finances are sustainable, only some seem to have the types of policies and practices in place that lock-in their financial sustainability. We commend these particular councils for their efforts, as they provide the example that all councils should follow.

- Of most concern to us is our finding that the long-term finances of many SA councils are not sustainable, as evidenced by their:
  - high operating deficits (which look set only to get bigger in future); and
  - substantial infrastructure renewal and replacement backlogs.

- Independent advice prepared for the Inquiry suggests that 26 of South Australia’s 68 councils are in the financially unsustainable category, covering about one-third of the State’s population. [See chart on next page.]

- For these councils, unless their spending is cut or other governments come to the rescue, rates increases – which should always be the last resort – are inevitable. And the increases would need to be substantial. The current or prospective financial performance and position of these councils is not strong enough to absorb likely future developments and unanticipated financial shocks.

- As these councils include both larger and smaller ones, we do not see further amalgamations as a panacea. Amalgamation of itself does not necessarily address the more fundamental problems currently impacting on council finances.

- More equitable funding arrangements with the other spheres of government are warranted, but may go only part way to putting council finances onto a sustainable basis.

- We are convinced too that the Commonwealth and SA governments are more likely to ‘come to the party’ after councils have made a substantial start towards securing their own long-term financial futures.

- More strategic expenditure decisions by local government – and more rigorous funding policies – are at least as important as increased grants revenue.

- The same is true of financial governance reforms. A widespread need exists to increase expertise and understanding regarding financial governance among elected members as well as at the officer level. A cash accounting mindset and a short-term (one-year) planning horizon both still overwhelmingly prevail.
Strengthened policy frameworks and improved financial governance are essential across the local government sector if:

- ratepayers are to get the stability and predictability in per-property rates they expect;
- the community is to understand the true costs of current infrastructure and service commitments;
- councils are to have the financial capacity to deliver on those key outcomes in South Australia’s Strategic Plan that are reliant on an efficient and effective local government sector; and
- the local government sector is to be positioned to negotiate with the State government on level terms, including to clarify roles and responsibilities and to agree joint activities.

Financial Sustainability Review Board
August 2005

SA Councils by Financial Sustainability Category

Number of SA Councils (68 in total)
Executive Summary

This Final Report sets out our findings regarding the state of the local government sector’s finances in South Australia and our recommendations for ensuring that council finances become – and remain – sustainable in the long term.

The conditions necessary for a council’s finances to be sustainable

Ultimately, a council’s finances are sustainable in the long term only if they are strong enough to allow the council to manage likely developments and unexpected financial shocks over the long-term financial planning period without having to introduce substantial or disruptive revenue (or expenditure) adjustments during that period.

This requires the council’s finances:

- to be currently or prospectively in good shape; and
- to be likely to remain in good shape if the council’s present spending and revenue policies continue unchanged; and
- to involve a margin of comfort sufficient to absorb the impact of any unexpected developments without the necessity for substantial increases in rates.

The state of SA’s local government finances

At first glance, council balance sheets in South Australia are strong because of the low level of council debt.

But their annual operating statements tell a different story.

Currently, significant operating deficits predominate among councils, and there appear to be substantial infrastructure renewal/replacement backlogs.

Moreover, without any policy adjustment on the part of councils, we believe that the sector’s annual financial performance – and eventually its financial position – will only deteriorate further in future with population shifts and ageing along with increasing environmental imposts, even if impacts on individual councils may differ.

Based on the advice we have received from our independent advisers, the current annual financial performance and position of 26 of South Australia’s 68 councils appear unsustainable over the medium- to long-term. Only about one-third of SA councils are in a moderately comfortable (or better) position.

We are not certain, however, that the local government sector universally shares this view. We think that the local sector as a whole needs to develop a common understanding of the general state of the council finances before it can meet the challenges involved.

Our financial sustainability analysis recommendations focus on:

- the SA local government sector adopting:
  - a standard definition of ‘financial sustainability’;
  - the achievement and maintenance of the financial sustainability of SA councils, both collectively and individually, as one of its key objectives; and
  - a standard set of key financial indicators for financial sustainability (and financial governance) purposes;
the LGA encouraging and supporting soundly-based depreciation and other asset accounting policies that promote comparability in the measurement of councils’ financial performance and position;

the LGA developing and publishing a statement providing guidance to elected members on the setting of quantitative target values for the key financial sustainability indicators;

the LGA developing and publishing a “Financial Sustainability Checklist” for the guidance of individual councils; and

annual performance monitoring to include reporting of the latest value, a recent history and the three-year projections of the key financial sustainability indicators, and a comparison of actual values with targeted or benchmark values.

The factors contributing to the state of council finances

To us, there appear to be a number of factors contributing to the prevalence of operating deficits and their frequent co-existence with substantial infrastructure renewal/replacement backlogs:

- relatively low (and falling) levels of Commonwealth and State government funding;
- cost pressures on councils as a result of the increasing cost of complying with escalating regulations and real or apparent cost shifting primarily by the State government;
- a State-government freeze on council rates revenue in the late 1990s;
- ratepayer pressure for rates increases below those necessary to fund increasing service levels;
- past policies responsible for service levels and standards in excess of those which could be sustainably funded by councils themselves;
- deficiencies evident in asset management practices and associated depreciation and asset valuation policies; and
- a widespread reluctance to borrow even when it is prudent to do so.

Many of these contributing factors are the consequence of deficiencies in council spending and funding policy frameworks which in turn typically reflect weaknesses in what we term a council’s ‘financial governance’ practices and policies.

Differences in council size (and whether a council was formed by amalgamation or not) and location (urban/rural) seem to play a relatively minor role in explaining the incidence of operating deficits and substantial infrastructure renewal/replacement backlogs.

The role of other spheres of government

Financial assistance grants from the Commonwealth are below levels necessary to equalise the financial capacities of councils. And their annual growth falls short of that of both local government costs and tax collections at the national level. Recent welcome increases in Commonwealth road funding have only partially addressed such deficiencies.

The net result is that SA councils are unable to deliver levels of services similar to those possible by councils in the more populous States unless per-property rates are higher than in those States.

Funding from the State government in South Australia is also among the lowest in the nation. This is explained only in part by differences in the responsibilities assigned to local government across the States.
Of as much importance is the role played by State government restrictions on council revenue raising and in lifting council spending through increased compliance burdens and real or apparent cost shifting. The confusion that exists on the respective roles of the different spheres of government also results in some duplication in service delivery among the governments.

We have no doubt that, if these various deficiencies in inter-governmental financial relations were addressed, then the long-term financial performance and position of the local government sector would improve, at least in the short term.

Our **inter-governmental reform** recommendations focus on:

- the LGA pursuing with the State Government both the progressive deregulation of council fees and charges and the development of a legislative framework under which councils have direct access to a fair share of developer contributions;
- the LGA documenting further the various revenue-raising constraints associated with the ‘wealth tax’ and ‘single tax’ nature of the local government sector’s tax power relative to the sector’s range of expenditure responsibilities;
- the LGA seeking the State Government’s agreement to a systematic review of overlapping service delivery activities between the State and local government sectors in South Australia;
- the LGA developing a bilateral inter-governmental agreement with the SA Government, as a basis for progressing consideration of reform of the State government’s funding of local government;
- the local government sector actively committing to South Australia’s Strategic Plan and the State Government’s Strategic Infrastructure Plan, in exchange for a commitment on the part of the State Government to work towards strengthening councils’ financial capacities so that local government can be an effective partner in achieving State-wide objectives and outcomes; and
- establishing a legislative basis for high-level negotiations between the State and local government (such as the Minister’s Local Government Forum) and for the resultant State-Local agreements.

**Responses within the control of local government**

No matter how strong the case may be, we are convinced that the Commonwealth and the State government are likely to inject additional resources into the local government sector only after councils have first taken significant steps to secure their own long-term financial futures.

Councils need to take the initial steps along the path of improved financial sustainability.

With the exception of a couple of years in the late 1990s, council rates have grown strongly in recent years.

But ramping up rates revenue should be the last resort, in recognition of the importance to ratepayers of the stability and predictability of rates.

Expenditure decisions by local government that are more strategic and which lower the cost of providing core services are at least as important as increased grants or rates revenue.

Nor do we see further amalgamations at this stage as a panacea. They are unlikely to be effective by themselves in addressing the current financial sustainability challenge facing SA councils.
Fundamentally, there is a need to address shortcomings in the financial governance policies and practices evident throughout much of the local government sector. In many councils:

- a cash accounting mindset still prevails;
- the planning horizon remains predominantly short term, with the setting of appropriate long-term financial goals and targets in its infancy and budgetary frameworks, and associated internal reporting and monitoring, not having the requisite medium to longer-term focus; and
- the transparency of financial reporting is not at a standard achieved at other spheres of government.

Complementing reforms in these areas, councils need to adopt a policy framework for service provision which clearly specifies their policies regarding the number and nature of services to be delivered and the methods for delivery. Councils can deliver services directly, resource share with neighbouring councils, advocate to the other spheres of government for services to be delivered, contract out services to the private or community sector or fund community groups.

Likewise, councils need to adopt a more rigorous policy framework for funding their services and infrastructure, to guide council decisions regarding revenue and financing. Such a framework should address issues such as ‘user pays’, and how any grants shortfalls will be covered in relation to services provided through grants funding.

We believe that local government has everything to gain by embracing a raft of financial governance and related policy reforms, and nothing to lose.

Our financial governance and policy framework recommendations focus on:

- possible amendments to the Local Government Act:
  - stating the principal role of councils and of members of councils to include ensuring the sustainability of their council’s long-term financial performance and position; and
  - obliging councils to target both an annual operating surplus and a net infrastructure renewal/replacement balance, to be achieved by all councils over their planning cycle and within a set time frame, say five years;
- each council developing and publishing both:
  - a ‘service provision and delivery policy statement’ regarding the number and nature of services to be delivered and the methods for delivery, and
  - a ‘revenue and financing policy statement’ regarding the funding of both operating expenses and capital expenditures, along the lines of the statements required under law of councils in New Zealand;
- councils considering further resource-sharing initiatives, especially involving the smaller councils, ranging from working together more effectively to more formalised regional groups, area integration and whole-of-sector initiatives;
- incorporating into the LGA’s governance principles adherence to best-practice financial governance policies and procedures contained in the CPA Australia/LGMA’s Excellence in Governance manual; and
- the local government sector accepting that elected members require specific training in support of their financial governance responsibilities.

Financial Sustainability Review Board
August 2005
Findings

In this section, the numbers in the margin before the bracketed number indicate the relevant section and subsection in Volume 2 containing the description and analysis underlying the finding repeated here. The full number is the finding number.

Nature Of The Issues

What is Financial Sustainability?

1.1 (1) There is no general agreement within the local government sector as to the meaning of the term ‘financial sustainability’.

1.1 (2) The term ‘financial sustainability’ has a well-understood meaning among the Commonwealth and State governments, involving a government being able to manage likely developments and unexpected financial shocks in future periods without having at some stage to introduce significant and economically or socially destabilising revenue or expenditure adjustments.

1.1 (3) References to financial (or fiscal) sustainability relate to the long-term financial performance and position of individual councils, rather than to the finances of the local government sector in aggregate.

1.2 (1) The sustainability of a council’s long-term financial performance and position is essential for ratepayers, in that it:

(i) ensures a reasonable degree of stability and predictability in the overall rate burden; and

(ii) promotes a fair sharing in the distribution of council resources and the attendant taxation between current and future ratepayers (‘intergenerational equity’).

1.2 (2) The sustainability of a council’s financial performance and position is also essential to the community, in that it ensures continuation of delivery of essential community services and the efficient operation of infrastructure.

1.2 (3) The sustainability of a council’s financial performance and position is essential to the State government, in that it ensures that the local government sector has the financial capacity to play the sector’s appropriate role in implementing key State-wide plans such as South Australia’s Strategic Plan and the State Government’s Strategic Infrastructure Plan.

What are the Key Indicators of a Council’s Financial Sustainability?

2.2 (1) A wide range of indicators of a council’s financial performance and position is presently in use in the SA local government sector.

2.2 (2) Councils generally focus on the (net) debt measure as an indicator of their financial position, but it does not include all council obligations to other sectors.

2.2 (3) Councils often headline different concepts of an ‘operating surplus’, depending upon whether capital revenues are taken into account.

2.2 (4) Few councils report separately on capital expenditure on the renewal or replacement of existing assets.
There is little focus within the SA local government sector on a council’s net overall funding result.

While the indicators currently in use may have their place, only a few key indicators of a council’s financial performance and position are necessary when monitoring a council’s financial sustainability.

A general consensus does not currently exist within the SA local government sector about the meaning to be attached to persistent operating deficits or to persistent shortfalls in capital expenditure on the renewal or replacement of existing assets against annual depreciation expense.

Operating deficits involve services consumed by current ratepayers being paid for either (a) by borrowing and so by future ratepayers or (b) by avoiding essential renewal or replacement of existing assets and so shifting this burden onto future ratepayers.

Persistent shortfalls in capital expenditure on the renewal or replacement of existing assets against annual depreciation expense involve shifting current ratepayers’ share of the funding of infrastructure renewal or replacement onto future ratepayers.

**What are the Data Issues?**

Doubts exist about the comparability of asset lives used by councils for the purpose of calculating annual depreciation expense.

The infrastructure assets of councils are generally subject to five-yearly (rather than annual) revaluations, which can give rise to discontinuities in annual depreciation.

Doubts exist about the comparability among councils of accounting for the impact of maintenance programs on extending the useful life of existing non-financial assets.

Some doubts exist regarding the current auditing of council accounts, within the requirements of the *Local Government Act* and Australian Accounting Standards. The main problem is the lack of comparability and consistency in accounting approach across the local government sector.

Councils’ holdings of financial assets are generally subject to substantial within-year variations, which can make the year-end (30 June) observation atypical of average holdings of such assets throughout the year.

However significant all these data issues might be to some individual councils, the currently available data on operating deficits cannot be overlooked. They reflect accounts that have been audited and made public. They stand until replaced by better data which may, or may not, change the overall picture.

There are no comprehensive council-by-council figures on capital expenditure on the renewal or replacement of existing assets and so on the extent of any infrastructure renewal/replacement backlog.

In the absence of data on a council’s capital expenditure on the renewal or replacement of existing assets, proxy measures must be relied upon to indicate the council’s net outlays on existing assets and any infrastructure renewal/replacement backlog.
Extent Of The Problem

What is the Current State of Council Finances?

4.2 (1) For the sector as a whole, net financial liabilities at 30 June 2004 (of $369 million) represent:
   (i) about 4% of the depreciated value of councils’ non-financial assets; and
   (ii) 34% of total revenue.
   This represents a low level of financial gearing by councils on average.

4.2 (2) Only 15 (or about 22% of) SA councils are estimated to have net financial liabilities at 30 June 2004 greater than 10% of the depreciated value of their non-financial assets. At that time, nine (or about 13% of) SA councils had negative net financial liabilities ratios.

4.3 (1) Currently, in aggregate, councils’ recorded annual operating deficits are significant, amounting to $49.2 million in the 2003-04 year.

4.3 (2) Only 18 (or nearly 30% of) SA councils recorded operating surpluses in 2003-04.

4.3 (3) For the SA councils recording operating deficits in 2003-04, their average deficits were the equivalent of 12½% of their annual rates revenue.

4.4 (1) Currently, in aggregate, councils spend less on the renewal or replacement of their existing assets than these assets depreciate each year.

4.4 (2) In the 2003-04 year, councils’ negative net outlays on the renewal or replacement of existing assets are estimated to have amounted to just over $20 million.

4.4 (3) These negative net outlays are estimated to have been falling in recent years, coming down from in excess of $30 million per annum in the late 1990s.

4.4 (4) Over the last 10 years, these negative net outlays have accumulated into an infrastructure renewal/replacement backlog that is estimated to be in excess of $300 million.

4.4 (5) Only 28 (or about 40% of) SA councils are estimated to have recorded positive net outlays on the renewal or replacement of existing assets in 2003-04.

4.4 (6) For the SA councils estimated to have recorded negative net outlays on the renewal or replacement of existing assets in 2003-04:
   (i) their aggregate negative net outlays are estimated to be the equivalent of about 25% of their annual depreciation expense; and
   (ii) their accumulated infrastructure renewal/replacement backlog over the last 10 years is estimated to be the equivalent of around 5% of the depreciated value of those councils’ non-financial assets.

4.5 (1) Councils in aggregate exhibited a net overall funding surplus in the 2003-04 year of $2.8 million. This involves the local government sector being a net lender that year to other sectors of the economy.

4.5 (2) 39 (or about 60% of) SA councils recorded net borrowing in 2003-04.

What is the Long-Term Outlook for Council Finances?

5.2 (1) Under no-policy-change assumptions, and given ageing and shifting population and increasing environmental management standards, the recent trend reduction in councils’ annual operating deficits, on average, is expected first to slow down over the next five years but then reverse by the end of a 20 year forecasting period.
Councils’ net financial liabilities in aggregate look likely to almost halve as a proportion of non-financial assets over the first 15 years of the forecasting period before beginning to grow again in the final years of that period.

How Widespread is any Financial Sustainability Problem?

Councils could maintain operating deficits of as high as 10% of their rates revenue without necessarily being financially unsustainable, with such deficits capable of being phased-out over a five year period through manageable annual per-property rates increases. Only deficits that are larger than 10% of rates revenue would necessitate rates increases that qualify as “substantial”. Only councils with operating deficits currently or prospectively in excess of 10% of their rates revenue have, for the purposes of this Inquiry, been classified as financially unsustainable.

When a council eliminates its infrastructure renewal/replacement backlog by additional borrowing, its operating deficit would increase by the additional annual interest cost arising from the resultant additional debt. Assessing whether a council is financially sustainable must allow for this potential addition to the council’s actual or prospective operating deficit.

A six-fold categorisation of the sustainability of a council’s long-term financial performance and position has been suggested by the Inquiry’s independent advisers:

“category 1–sustainable with a very substantial margin of comfort”
“category 2–sustainable with a substantial margin of comfort”
“category 3–sustainable with a moderate margin of comfort”
“category 4–sustainable with a minimum margin of comfort”
“category 5–sustainable currently but vulnerable in the short- to medium term”
“category 6–unsustainable”.

Based upon data and estimates available to the Inquiry, 33 councils in South Australia may be classified as either unsustainable (category 6) or vulnerable (category 5). These councils account for just over 50% of the State’s population. 30% of metro councils and 40% of country councils are in these categories.

A further 10 councils in South Australia have only a ‘minimum’ margin of comfort (category 4). These councils account for 12% of the State’s population.

Only 25 councils in South Australia could be categorised as having a very substantial, a substantial or a moderate margin of comfort (categories 1, 2 and 3). These councils account for 35% of the State’s population.

Sources Of The Problem

Does a Council’s Size or Location Matter?

Based upon an analysis undertaken for the Inquiry, the metropolitan/country distinction of itself seems to play a relatively minor role in explaining the observed differences in the sustainability of the long-term financial performance and position of councils.

The size and density of councils also seem to play little role in explaining observed differences in the sustainability of the long-term financial performance and position of councils.

Relative growth rates play a larger role in explaining the observed differences.
6.5 (4) As relative growth rates, size and density of councils altogether explain only a fraction of the differences observed in the sustainability of the long-term financial performance and position of councils, other financial characteristics must be more important contributors.

**Are Rates (or Other Own-Source Revenues) Too Low?**

10.1 (1) Councils do not automatically reap windfall revenues from rising property values.

10.1 (2) Local government’s use of taxation on property requires regular year-to-year resetting of the per-property rate of tax, because property values (the “tax base” of council rates) increase year-on-year in ways that are unrelated to the cost of providing council services.

10.1 (3) Over the last five years, on a per-property basis, the rate of increase in the average rates bill has been about twice the rate of increase in the CPI. This has been sufficient to finance some increases in levels of service as well as cover underlying cost increases on a no-policy-change basis.

10.1 (4) Restricting the increase in per-property rates to around the CPI would be insufficient to fund underlying cost increases on a no-policy-change basis.

10.1 (5) An increase in rates by the deficit councils averaging 12½% over and above CPI-based increases – the amount necessary to eliminate their operating deficits – represents a ‘substantial’ increase in a number of respects, and is unlikely to be an acceptable option from the ratepayer perspective even if phased-in over a number of years.

10.1 (6) The real-terms rates freeze imposed by the State government at the time on all councils in the State for the 1997-98 and 1998-99 financial years assumed savings from boundary reforms and other efficiencies that were greater than in fact materialised. This is estimated to have led to a shortfall in total council revenue of around $20 million.

10.2 (1) During the 1990s, SA councils substantially raised their cost recovery effort, in line with wider adoption of ‘user pays’ pricing of services under Australia’s microeconomic reform program.

10.3 (1) Few councils appear to have developed or implemented a rigorous policy framework for funding their services and infrastructure, stating (for example) the role to be played by ‘user pays’ and how any grants shortfalls are to be covered for services provided through grants funding.

**What is the Influence of Other Governments on Council Revenues?**

7.1 (1) The local government sector is only allowed access to a single form of taxation, namely taxation on property (i.e., council rates).

7.1 (2) Local government’s use of taxation on property to distribute the tax burden across ratepayers risks a range of inequities on account of differences between a ratepayer’s wealth and the ratepayer’s ability to pay council rates.

7.1 (3) There does not seem to be any substantial remaining constraints on a council’s rates flexibility in amended chapter 10 of the *Local Government Act*, with the flexibilities that councils will have available under the Act addressing most of the inequities that would be implied by a uniform rate on property values.
7.1 (4) State-legislated concession arrangements have a significant impact on councils’ rates income, although for most councils the exemption from State government payroll tax is understood to largely negate any disadvantage.

7.2 (1) There are significant State government limits on councils’ non-rates revenue-raising ability. These include a reluctance by State authorities to allow regulated fees and charges to recover, or keep pace with, council costs.

7.3 (1) Councils have limited means to access contributions from developers, resulting in SA councils having the lowest level of developer contributions in Australia. This has the effect of shifting the cost of providing infrastructure for new and infill development from developers and purchasers of land onto all ratepayers.

Is Spending Too High?

11.1 (1) In recent years, council operating expenses have grown faster than population and the CPI, and have paralleled growth in State income. In the main, this is because salary increases for all employment categories have exceeded CPI.

11.1 (2) This history is indicative of an increase in service standards as well as an underlying increase in the per-unit costs of service delivery.

11.1 (3) There is a low level of information available to, and understanding within, the community of the real costs of current service commitments.

11.2 (1) Amalgamation brings with it significant costs and often exaggerated benefits. There are many intermediate forms of cooperation/integration among councils, with amalgamation being the most extreme (and confronting) form of integration.

11.3 (1) Few councils appear to have developed or implemented a policy framework clearly specifying their policies regarding the number and nature of services to be delivered and the methods for delivery.

11.3 (2) Many councils do not sufficiently define service levels and quality and quantity standards for the range of services they deliver, which makes it difficult to assess the efficiency and effectiveness with which services are being delivered.

11.3 (3) Relatively few SA councils regularly undertake reviews of existing programs and of the consistency of new policy proposals with the council’s accepted roles and functions.

Is Council Borrowing (and Debt) Too Low?

12.1 (1) Currently, in aggregate, council spending on infrastructure – particularly on the renewal or replacement of existing assets – is too low.

12.1 (2) It is increasingly becoming a backlog issue, as negative net outlays on the renewal or replacement of existing assets have been shrinking.

12.1 (3) Councils’ reluctance to borrowing (and aversion to debt) seems to be the main cause of the sector’s infrastructure renewal/replacement backlog problem, with internally-available capital revenue being diverted to financing operating deficits.

12.1 (4) Council members do not always have a good understanding of the assets employed to deliver essential services or a full appreciation of asset lifecycle costs.

12.1 (5) If ratepayers and the community were aware of the long-term ramifications of an unduly low level of debt (and artificially constrained rates increases) – that is, deferral of vital renewal and replacement of infrastructure – they would most likely...
think again before pressuring councils to avoid borrowing or, if there were no other option, to keep rates increases at artificially low levels.

What is the Influence of Other Governments on Council Spending?

8.1 (1) Decisions made by other spheres of government have played a part in pushing councils’ operating expenses up over time.

8.1 (2) Compliance costs imposed on councils by State regulatory authorities (especially environmental and land management) are substantial and growing.

8.1 (3) The withdrawal of services by the State government from regional South Australia has often left country councils feeling that they have little apparent choice other than to take over some of the roles concerned.

8.1 (4) True ‘cost shifting’ involves the pursuit of a policy agenda by another sphere of government without consultation with the councils affected, or with only token consultation or despite significant concerns being expressed by councils, which has the effect of increasing council spending without compensatory funding. While there is some evidence of true cost shifting, not all that is claimed to be cost shifting by some within local government qualifies as such.

8.1 (5) South Australia’s Strategic Plan will put pressure on council resources.

8.1 (6) In the past, some councils seem to have been too willing to take on additional functions when prompted by the State government or to take over services being wound down by the other spheres of government without fully understanding the cost implications.

8.2 (1) The nature of current inter-governmental arrangements in Australia gives rise to confusion in the respective roles and responsibilities of the State and Local spheres of government.

8.2 (2) A State-Local agreement could add detail and more operational arrangements to a national tripartite inter-governmental agreement (IGA).

8.2 (3) Work undertaken in South Australia to date aimed at clarifying State/Local relationships and improving effectiveness in areas of joint involvement has been largely informal and formative in nature, dependent on the Government (even Minister) in office at the time and without any legislative basis.

Are Commonwealth and State Grants Too Low?

9.1 (1) Funding levels are now clearly below earlier peaks. Over the last decade, funding has remained below the levels of the previous two decades.

9.1 (2) If the level of funding of local government in South Australia returned to the level evident in 1992-93, which is only half-way to the peak a decade earlier, then the amount of additional funding involved now would be around $50 million per annum.

9.2 (1) The level, escalation and distribution of financial assistance grants from the Commonwealth to local government each fail important fiscal equity tests.

9.3 (1) South Australia’s disproportionately low historical share of the identified roads grants component of financial assistance grants from the Commonwealth looks set to be corrected, and needs to be.

9.4 (1) Higher specific purpose payment (SPP) funding from the Commonwealth would come with attendant risks and uncertain benefits for the local government sector.
In per capita terms, the current level of grants from the State government in South Australia is the lowest among the mainland States.

Per capita grants from the State have not kept pace with inflation over the last couple of decades.

If the level of State government funding of local government in South Australia rose to levels apparent in other States, then the amount of additional funding involved could be in the order of $10 million per annum.

Few councils appear to have developed or implemented a policy framework stating how any grants shortfalls that arise are to be covered with respect to services provided through grants funding.

**What Role Does Financial Governance Play?**

The recent CPA Australia/LGMA *Excellence in Governance for Local Government* publication includes a useful statement of best practice principles for financial governance.

There are some councils that are already leading the way on the financial governance front, thereby providing an indication of what could be achieved by all SA councils.

The absence of articulated service provision and funding policy frameworks is explained, in large part, by inadequacies in councils’ financial governance frameworks.

Poor financial governance – and associated inadequacies in service provision and funding policy frameworks – invariably leads to inadequate control on growth in operating expenses, a neglect of essential capital spending, revenue raising that is inflexible and inequitable, and a low level of understanding within the community of the real costs of current infrastructure and service commitments.

The expertise and understanding among elected members as well as senior officers regarding financial governance needs significant upgrading. A cash accounting mindset and short-term (one-year) planning horizon still overwhelmingly prevail.

Some councils are reluctant to develop effective internal audit committee arrangements, which would include external participation and exclude the mayor being chair and the CEO being a member.

The LGA education and training program for elected members and staff includes a ‘governance checklist’ for councils to use to assess their governance performance and address areas and/or issues of concern, but does not directly focus on financial governance. The LGA’s *Framework for Local Government Financial Management* does not deal specifically with financial governance issues.
Recommendations

In this section, the numbers in the margin before the bracketed number indicate the relevant section and subsection in Volume 2 containing the description and analysis underlying the finding repeated here. The full number is the recommendation number.

Defining Financial Sustainability

1.1 (1) That the SA local government sector adopts a standard definition of ‘financial sustainability’, including for use under the proposed amended sections 122(1)(ab) and 122(4a) of the Local Government Act 1999, based upon the following definition:

“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 in 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).”

1.1 (2) That the LGA proposes that local government’s preferred definition of financial sustainability be included in the Local Government Act 1999 as the definition of “the sustainability of a council’s long-term financial performance and position”.

1.2 (1) That the local government sector adopts as one of its key objectives the achievement and maintenance of the financial sustainability of SA councils, both collectively and individually.

1.2 (2) That the LGA considers proposing that an object along the following lines be added to the objects of the Local Government Act 1999 (at section 3):

“to promote the achievement and maintenance of the sustainability of councils’ long-term financial performance and position”.

Measuring Financial Sustainability

2.2 (1) That the local government sector adopts a standard set of key financial indicators for use in assessing a council’s financial sustainability, comprising:

(i) the net financial liabilities measure of a council’s financial position, as the key indicator of the council’s indebtedness to other sectors of the economy;

(ii) the operating surplus/(deficit) measure of a council’s annual operating financial performance, as the key indicator of the intergenerational equity of the funding of the council’s operations;

(iii) [what the Review Board terms] the net outlays on the renewal or replacement of existing assets measure of a council’s annual capital financial performance, as a key indicator of the intergenerational equity of the funding of the council’s infrastructure renewal or replacement activities; and

(iv) the net borrowing/(lending) measure [or what some councils term the “overall funding surplus/(deficit)” measure] of a council’s overall annual fiscal performance, 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.

2.3 (1) That the LGA adopts a statement of principles regarding the interpretation by the SA local government sector of the key financial sustainability indicators based upon the following:
(i) A council’s financial position is sustainable if its net financial liabilities are at levels at which the associated interest payments (less interest income) can be met comfortably from a council’s annual income (i.e., by current ratepayers) without the prospects of rates increases which ratepayers would find unacceptable (or disruptive service cuts).

(ii) A council’s net financial liabilities 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.

(iii) A council’s annual operating financial performance is sustainable if operating deficits will be avoided over the medium- to long-term, because such deficits inevitably involve services consumed by current ratepayers being paid for either (a) by borrowing and so by future ratepayers or (b) by deferring funding responsibility for the renewal or replacement of existing assets onto future ratepayers.

(iv) A council’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.

(v) A council’s annual capital financial performance 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.

(vi) A council’s net borrowing 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.

3.2 (1) That the LGA work with auditors, with input from offices such as that of the SA Auditor-General, to establish what might be described as a ‘model’ specification for a council audit aimed at – in a manner consistent with Australian Accounting Standards – improving the consistency and comparability of accounting policies impacting upon the measurement of the key financial sustainability indicators, especially depreciation and other asset accounting policies.

3.2 (2) That, where they are not currently doing so, each council revalues its non-financial assets annually by applying a price escalator such as the CPI in the annual roll-forward calculation, with a more rigorous adjustment taking place at least at five-yearly intervals to reflect actual changes in market values.

3.3 (1) That each council records and reports its annual capital expenditure distinguishing between capital expenditure on:
   (i) the renewal or replacement of existing assets; and
   (ii) acquiring new assets or upgrading the council’s existing assets.

3.3 (2) That each council annually quantifies its infrastructure renewal/replacement backlog, and publishes it as a note to its annual financial statements.

6.6 (1) That councils target the following goals for its annual financial performance:
   (i) a council’s operating surplus on average over the planning cycle should be a small positive;
   (ii) a council’s capital expenditure on the renewal or replacement of existing assets on average over the planning cycle should be equal to the council’s depreciation expenses; and
(iii) a council’s annual net borrowing, when expressed as a percentage of the council’s annual net increase in non-financial assets, on average over the planning cycle should be no larger than the net financial liabilities-to-assets ratio being targeted by the council.

6.6 (2) That the LGA develops and publishes a “Financial Sustainability Checklist” for the guidance of individual councils, similar in style (rather than identical in content) to the NSW Local Government Managers’ Association publication entitled The Local Government Financial Health Check.

6.6 (3) That, in addition to their inclusion in the long-term financial plans being required by amendments to the Local Government Act 1999, annual performance monitoring undertaken by individual councils and by the LGA (including by its annual performance measurement project) both include reporting of:

(i) the latest value, a recent history and the three-year projections of the key financial sustainability indicators; and

(ii) a comparison of actual values with targeted or benchmark values.

6.6 (4) That the LGA tables at each annual general meeting a brief update report providing the latest values, history, projections and comparisons for the key financial sustainability indicators both (a) at the whole-of-sector level and (b) in aggregate, for those councils that recorded operating deficits in 2003-04.

Financial Governance Improvements


13.3 (2) That the LGA’s ‘governance checklist’ be supplemented by a clear statement of the role and accountabilities of elected members for financial governance in general, and for the sustainability of the long-term financial performance and position of their councils in particular.

13.3 (3) That the local government sector accepts the principle that elected members should receive specific training in support of their financial governance responsibilities.

13.3 (4) That the LGA provides an extensive education and training program for elected members and staff designed to keep them up-to-date with key changes to best practice financial governance in local government.

13.3 (5) That, in support of their elected members, council CEOs and senior managers accept as their duty:

(i) providing frank and fearless advice to elected members on all matters pertaining to financial governance and accountability;

(ii) putting in place appropriate systems to achieve and maintain financial sustainability and accountability; and

(iii) managing the organisation in ways that can achieve the goals set by elected members.

13.3 (6) That the LGA develops and publishes a statement providing guidance to elected members on the setting of quantitative target values for the key financial sustainability indicators.

13.3 (8) That the LGA, in consultation with the Office of Local Government (and the SA Local Government Grants Commission), develops and publishes a ‘Uniform Reporting Code of Practice’, aimed at achieving a degree of fiscal transparency
broadly equivalent to the uniform reporting framework implemented Australia-wide at the State government level.

13.3 (9) That each council undertakes all internal financial reporting of its planned and actual financial performance and position in a format and on a basis that is fully consistent with the external financial reporting standards and codes applying to the council.

13.3 (10) That each council establishes an audit committee that has external membership and does not include the council’s mayor as chair or its CEO as a member.

13.3 (11) That councils adopt as one of the functions assigned to the audit committee the review of the effectiveness of: (a) the council’s financial governance arrangements, and (b) the council’s planning and monitoring processes in ensuring the sustainability of the council’s long-term finances.

13.3 (12) That country councils or smaller councils give consideration to establishing regional or joint audit committees aimed at pooling scarce resources and increasing the level of expertise available to individual councils.

13.3 (13) That the LGA develops and publishes guidance for councils in the conduct of what some have termed “economy and efficiency audits”, being reviews aimed at assessing the effectiveness of a range of governance and management arrangements, including a council’s policies and practices relating to financial governance.

Policy Framework Improvements

13.3 (7) That councils implement, throughout their financial governance and financial management frameworks, a clear distinction between the circumstances and outcomes associated with:

   (i) continuation of a council’s present spending and funding policies and associated efficiency and effort levels (“no-policy-change”); and
   (ii) modifications or changes to the council’s present spending and funding policies (“policy change”).

(a) Revenue and financing policies

10.3 (1) That each council develops and publishes a ‘revenue and financing policy statement’ regarding the funding of both operating expenses and capital expenditures, along the lines of the statements required under law of councils in New Zealand.

10.3 (2) That each council expresses its year-on-year no-policy-change (per-property) rates policy in a CPI+X% form, where the X% factor is the percentage increase in per-property rates in addition to the annual CPI change necessary to maintain the council’s annual operating surplus target if its spending policies remain unchanged.

10.3 (3) That each council makes more explicit its side-constraints on the annual movement in an individual ratepayer’s per-property rates bill, by expressing such a policy in CPI+S% form, where the S% factor is the maximum annual no-policy-change percentage increase in the ratepayer’s rates bill including the X% factor.

10.3 (4) That councils move toward quantifying their tax expenditures (i.e., foregone rates revenue due to rebates or concessions), and the proportion due to State government policy/regulation.

10.3 (5) That councils move towards quantifying their community service obligations (CSOs, i.e., foregone non-rates revenue due to policy-imposed restraints on the recovery of costs), and the proportion of such CSOs due to State government policy/regulation.
(b) Service levels and resource allocation policies

11.2 (1) That, in canvassing alternative methods of delivery, councils consider further resource-sharing initiatives, especially involving the smaller councils, ranging from working together more effectively to more formalised regional groups, area integration and whole-of-sector initiatives.

11.3 (1) That each council develops and publishes a policy framework clearly specifying its policies regarding the number and nature of services to be delivered and the methods for delivery. This framework should define service levels and quality and quantity standards for the range of services they deliver.

11.3 (2) That councils subject their existing service programs to regular review, to demonstrate that:

(i) the services provided are appropriate and effective in achieving the policy outcomes sought for the community; and

(ii) the expenditure involved is at levels incurred by a prudent service provider intent on achieving the lowest sustainable cost of delivering council services.

11.3 (3) That councils subject proposals for new or additional services to review, to demonstrate that:

(i) the new or additional services will be appropriate and effective in achieving the policy outcomes sought for the community; and

(ii) the method of provision will achieve the lowest sustainable cost of delivering the services involved.

11.3 (4) That the LGA develops and publishes guidance for councils to be used when a council reviews the appropriateness, effectiveness and efficiency of the council’s current services or of any new or proposed additional services.

11.3 (5) That councils, as a matter of course, publish the results of the outcomes of their service reviews and their experience with efficiency initiatives such as resource sharing, and the dollar value of savings achieved.

(c) Asset and liabilities management policies

12.2 (1) That councils make prudent use of borrowing to finance the acquisition of new infrastructure assets and the upgrading of existing infrastructure assets and, where considered appropriate, to fund the elimination of any major backlog in the renewal or replacement of existing assets.

12.3 (1) That the local government sector in South Australia progressively adopts asset management policies and practices among councils that broadly correspond to the best practice asset management framework implemented in Queensland.

12.3 (2) That councils progressively implement the active management of their interest rate exposures, including by use of appropriate borrowing and investing instruments and best practice treasury management policies.

Inter-Governmental Relations Reforms

7.1 (1) That, in preparation for participation in the forthcoming Productivity Commission review of council revenues announced by the Commonwealth in its response to the Hawker Committee’s recommendations, the LGA documents further the various revenue-raising constraints imposed by:

(i) State government restraints, both legislative and political, on the revenue-raising capacity of local government in the State; and
7.2 (1) That the LGA pursues with the State Government the progressive deregulation of council fees and charges, commencing with ensuring that regulated fees and charges are escalated annually to keep pace with council costs.

7.3 (1) That the LGA pursues with the State Government the development of a legislative framework under which councils have direct access to developer contributions similar to that available to councils in other States and/or utility service providers in South Australia such as ETSA Utilities and SA Water.

11.2 (2) That the LGA pursues with the State Government the identification and removal of any remaining legislative barriers (or disincentives) to functional cooperation and integration among councils.

8.1 (1) That the LGA seeks the State Government’s agreement to all future regulatory or service changes proposed by State instrumentalities that have a material direct impact upon local government being subject to rigorous and transparent cost-benefit analysis by the State before implementation.

8.1 (2) That the LGA seeks the State Government’s agreement to mapping out with local government which of the targets in South Australia’s Strategic Plan are dependent upon the actions of councils and how local government is to contribute to these targets being achieved.

8.1 (3) That the LGA seeks a commitment on the part of the State Government to work towards strengthening councils’ financial capacities so that local government can be an effective partner in achieving State-wide objectives and outcomes, in exchange for the local government sector committing to the pursuit of agreed strategies for achieving all relevant targets in South Australia’s Strategic Plan.

8.2 (1) That the LGA seeks the State Government’s agreement to the Minister’s Local Government Forum undertaking a systematic review of ‘grey areas’ regarding the respective service delivery roles and responsibilities of the State and local government sectors in South Australia and of any consequent overlaps and gaps in service provision.

8.2 (2) That, in parallel with negotiations taking place at the national level on a tripartite inter-governmental agreement (IGA) on local government relations, the LGA develop a bilateral inter-governmental agreement with the SA Government, capable of application in the State as a basis for progressing consideration of reforms in the State government’s funding of local government.

8.2 (3) That the LGA ask the State Government to require its CEOs to include the potential role of, and impact on, local government in pursuit of South Australia’s Strategic Plan targets as part of those CEOs’ presentations to the Executive Committee of Cabinet, with the Office of Local Government acting as the coordinator of prior discussions by the CEOs with the local government sector.

8.2 (4) That the LGA propose that local government be represented on the Executive Committee of Cabinet by the LGA President as that Committee considers strategies for the pursuit of South Australia’s Strategic Plan targets.

8.2 (5) That the LGA pursues with the State Government effective means of ensuring greater co-ordination and consistency in how State agencies and programs relate to local government, including by:

(i) the possible relocation of the Office of Local Government to the Department of Premier and Cabinet (without assigning the Local Government ministry to
the Premier) with a clear understanding that it is to have a co-ordination role in relation to improving agency relationships with local government;

(ii) improving the effectiveness of local government impact statements prepared as part of the Cabinet submission process;

(iii) establishing a legislative basis for agreements between the LGA and the State Government which could assist in ensuring (a) such arrangements are able to continue appropriate key elements beyond the life of one term of Government (State or local) and (b) Parliamentary scrutiny of such arrangements; and

(iv) establishing a legislative basis for high-level negotiations between the State and local government (such as the Minister’s Local Government Forum).

**First Steps**

14.1 (1) That the LGA provides the necessary leadership in financial governance improvement principally through:

(i) developing and publishing appropriate statements of principle and standards/codes of practice; and

(ii) actively coordinating the related activities of the various professional groupings within the State’s local government sector.

14.1 (2) That the LGA considers proposing an amendment to the *Local Government Act 1999* to the effect of including, in the sections stating the principal role of councils and of members of councils, the roles of:

(i) ensuring that the council’s revenues, expenses, assets, liabilities, investments and general financial dealings are managed prudently and in a manner that promotes the current and future interests of the community; and

(ii) in the council’s strategic management plans and in its annual business plan and budget, adequately and effectively providing for the meeting of the expenditure needs of the council identified in those plans and budgets in a way that ensures the sustainability of the council’s long-term financial performance and position.

14.1 (3) That the LGA considers proposing an amendment to the *Local Government Act 1999* aimed at obliging councils to target an annual operating surplus along the following lines:

(i) A council will ensure that each year’s projected income is set at least at a level sufficient to meet that year’s projected expenses.

(ii) Despite (i), a council may set its projected income at a level different from that required under (i) if the council resolves that it is financially prudent to do so, having regard to:

(a) abnormal annual expenses in the year in question associated with implementing financial governance (or accountability) improvements or with addressing any backlog in programs aimed at maintaining the service capacity and integrity of a council’s non-financial assets throughout their useful life;

(b) the impact of the business cycle or asset price cycle upon the council’s revenue bases, whereby a balance between annual projected income and annual projected expenses can be expected on a moving (say, five year) average basis; and

(c) the role played by income and expenses associated with the council’s business (commercial) undertakings, which are subject to accountability considerations that are different from those applying to the council’s tax-supported (or ‘general government’) activities.
14.1 (4) That the LGA considers proposing an amendment to the *Local Government Act 1999* aimed at obliging councils to target an infrastructure renewal/replacement balance along the following lines:

(i) A council will ensure that each year’s projected capital expenditure on the renewal or replacement of existing assets is set at least at a level sufficient to cover that year’s projected depreciation expense.

(ii) Despite (i), a council may set its projected capital expenditure on the renewal or replacement of existing assets at a level different from that required under (i) if the council resolves that it is financially prudent to do so, having regard to:

(a) abnormal annual depreciation expense in the year in question associated with any asset revaluation;

(b) spending necessary to address any backlog in the renewal or replacement of existing assets; and

(c) lumpiness in the council’s capital works program which may nevertheless see a balance between annual projected capital expenditure on the renewal or replacement of existing assets and projected annual depreciation expense on a moving (say, five year) average basis.

14.1 (5) That all councils achieve such operating and infrastructure renewal/replacement targets over their planning cycle and within a specified time frame, say five years.

14.2 (1) After the local government sector has formally considered all the above recommendations, that the LGA establish a process whereby it can periodically report progress in implementing the recommendations adopted by the sector.

14.2 (2) That, following its 12 months’ review of progress and if any significant shortfalls are apparent, the LGA considers the role to be played by either:

(i) additional legislative change in support of needed financial governance improvements; and/or

(ii) implementation of external monitoring of the financial sustainability of individual councils for a limited period of say three years, to be undertaken at arms’ length from councils.

14.3 (1) That the LGA considers how best it might resource its own role in progressing the recommendations adopted by the sector, including by identifying to whom within – or outside – the sector it might appropriately delegate some of these roles, and on what basis.

14.3 (2) That the additional upfront costs to councils of financial governance improvement initiatives be managed by:

(i) resource sharing of finance personnel and software at the regional level, on a shared services basis; and

(ii) a mentoring program between councils that have already made substantial progress in this area and those which have not.