PRICEWATERHOUSECOOPERS

Working for a Sustainable Future

Overview

National Financial Sustainability Study of Local Government

Commissioned by the Australian Local Government Association

November 2006

Photos credits

All photos from relevant local council websites.

Cover page – Blacktown library (NSW), Brisbane Botanic Gardens (QLD), Redfern Community Centre (NSW) & Alice Springs Swimming Centre (NT)

Page 2 – Mosman community transport (NSW), Mandurah Performing Arts Centre (WA)

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1 Introduction

The Australian Local Government Association (ALGA) commissioned PricewaterhouseCoopers (PwC) to complete this national study on the financial sustainability of local government. This Overview provides a summary level outline of the full study which is available at http://www.alga.asn.au

The study identifies that local government is responding to rising community expectations by providing a growing range of essential services and infrastructure that underpin local communities. This expansion in roles and service quality, together with growth in input prices generally exceeding the average rate of revenue growth, has seen a significant number of councils develop financial operating deficits. To moderate the size of these deficits, some councils have deferred or reduced expenditure on infrastructure renewals. Many local councils across the country now have sizable financial sustainability challenges, which require major reforms in the way councils are funded and the way they operate. In the absence of reforms, councils may have no option but to cut back on the level of local community services and infrastructure.

This National Financial Sustainability of Local Government report has drawn upon studies by Access Economics for state local government associations in Western Australia, South Australia and New South Wales, as well as detailed analysis by the Municipal Association of Victoria (MAV). This research has been complemented by PwC financial analysis of 100 Australian councils. The finding of the PwC analysis is that, without reforms, up to 30% of local government councils might not be sustainable. This is broadly consistent with the results of the state-based reports that between 25% and 40% of councils in those states could be financially unsustainable.

The PwC report calls for a range of reforms to deal with the national total backlog in local government infrastructure renewal work, estimated at $14.5 billion. This backlog has resulted from the growing gap between councils' revenue base and the funding required to both deliver a broader range of services, as well as maintain and renew the infrastructure which supports these services.

PwC has based its reform recommendations on a 'twin track' approach for improving financial sustainability through the pursuit of further internal efficiency reforms and changes to inter-government funding.

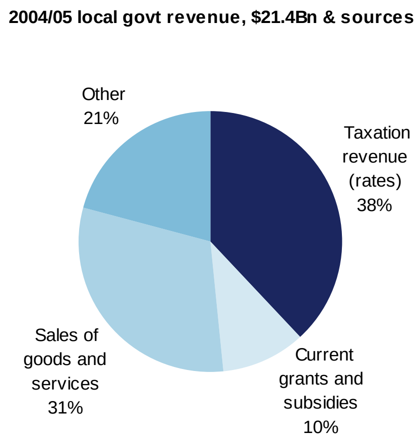
The report's major recommendations include the establishment by the Australian Government of a Local Community Infrastructure Renewals Fund (LCIRF) and greater support from state/territory governments to help local councils with sustainability challenges to better meet the needs of their communities.

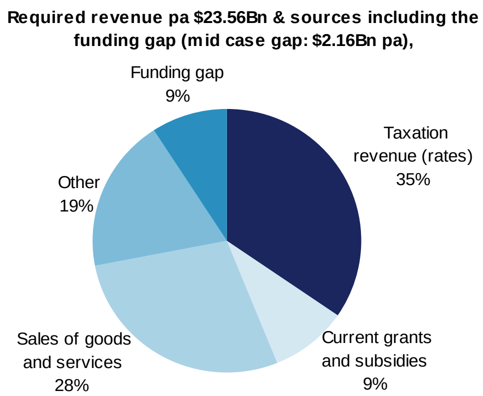
1.1 Stronger more vibrant communities where local government is financially sustainable

1.1.1 Growing backlog in building renewals

Most community centres, aged care facilities, health clinics and sport and recreation facilities were established in the 1950s (or earlier). This infrastructure is not being sufficiently upgraded because of a lack of funds.

Detailed analysis of 441 councils completed over 2005/06 across four states by Access Economics (for NSW, South Australia and Western Australia) and in Victoria (by the MAV) found that the average infrastructure renewal backlog per council is $20.8 million. If this average result applies across all 700 councils the aggregate national renewals backlog is approximately $14.5 billion. The estimated funding gap to clear both this backlog and to cover the annual underspend on renewals is estimated at $3.1 million per council per annum or $2.16 billion nationally. The pie charts below compare the actual 2004-05 local government revenue base with the revenue base required for financial sustainability.





This 9% funding gap must be covered. This will be best achieved through a combination of initiatives including further increases in efficiency, higher user charges and rates, as well as further grants support from other spheres of government.

The sustainability problem around Australia is typically more acute in smaller councils, mostly in rural or remote areas, but in some cases metropolitan areas. These smaller councils often have constrained own-source revenue streams and lack economies of scale, compounded by less depth in financial and asset management capabilities.

Some larger councils, however, also have financial sustainability problems arising from factors such as significant expansion into new services, suppression of rates rises to improve voter appeal, and less effective cost management whereby the level of expenditure controls and budgeting processes may not have been adequate.

The study notes that the need to improve the sustainability of local government is not limited to Australia. Local government sectors in comparable countries suffer from similar issues associated with frequent operating deficits, backlogs of infrastructure renewal projects and expanding scope of services. Those countries are also taking action to address their problems.

Purpose of the PwC study

The study has been undertaken to help ALGA draw up a plan to put local councils on a sound financial footing with targeted support from other spheres of government. ALGA commissioned the study to:

- Assess current and long-term viability of local government nationally and by council types
- Identify the key financial issues affecting financial sustainability
- Develop recommendations for improved financial sustainability (e.g. financial skills and potential sources of additional revenue)
- Investigate the merit of reforming inter-government funding to develop a new model to improve sustainability.

The study assesses key characteristics that contribute to the low level of financial sustainability of councils, and identifies a range of internal and funding reform options that would improve the long-term sustainability of the sector as a whole.

1.1.2 Local government is big business

Local government in Australia is a dynamic and extremely diverse sector consisting of more than 700 councils. These range from the Brisbane City Council (population 950,000 and annual expenditure of approximately $1.7 billion) to councils like Jerilderie Shire (population 1,908 and annual expenditure $6.8 million).

Local government has an annual expenditure of around $20 billion, which represents around 2% of GDP, and employs around 1.3% of the Australian labour force. Local government provides essential services and infrastructure that underpin local and regional communities. For the numerous regional and more remote communities, local government is often the only institutional presence and one of the key drivers of economic activity.

The key benefits of local government, as outlined by the Australian Government, include:

- Wide and established national network of public administration, including a significant presence in rural and regional Australia
- Strong links and accountability to the communities it represents
- Practical service orientation and good organisational skills which make it capable of innovative, speedy and flexible responses

- Links between local government and local business and industry which put councils in a good position to foster a 'bottom up' approach to regional development

- Information provider to support Commonwealth regional policy development and implementation

- Ideal entry point to get information on other governments' services and programs.

1.1.3 Many councils have already greatly improved efficiency

A sizeable proportion of councils, including the vast majority of the larger ones, have made significant progress in recent years in making themselves more efficient.

Efficiency reforms have been achieved through the following approaches:

- Outsourcing non-core operations, which was formalised in Victoria by the compulsory competitive tending (CCT) policy during the 1990s

- Structural reforms that have included mandatory and voluntary amalgamations in NSW, Victoria, South Australia and Tasmania to consolidate the local government sector

- Corporatisation of commercial services to increase the returns to local government, for example the recent Local Government Infrastructure Services initiative in Queensland

- Regional delivery of services such as waste removal, purchasing and procurement, road and infrastructure maintenance and recruitment

- Shared services where either a council or the state association becomes the lead service provider, particularly for corporate services such as finance and HR.

Thirty years ago there were a much higher number of councils in Australia; more than 100 councils have been consolidated over the past 20 years. The local government sector in Victoria, for instance, undertook a series of amalgamations between 1992 and 1995 which reduced the number of councils from 210 to 78.

Over recent years the local government sector has achieved a range of significant efficiency initiatives, examples of which are provided below.

Examples of Local government efficiency initiatives

Over recent years the local government sector has achieved a range of significant efficiency initiatives, which include:

- Twelve Councils in the Hunter region of NSW have formed Hunter Councils Ltd to provide a powerful platform for the councils to drive efficiencies and cost savings via joint purchasing programs (eg traffic signage and advertising), regional planning processes, a common human resources team and a joint staff training team.
- The Roads Alliance between the Local Government Association of Queensland (LGAQ), Queensland Main Roads and 124 councils is responsible for $150 million in road construction and maintenance annually. The alliance has formed 14 Regional Road Groups which provides a platform for better decisions on road infrastructure investments, the use of road funds, project scheduling and resource-sharing across agencies.
- In South Australia, 67 of the 68 councils collaborated in a joint purchasing contract for electricity and thereby achieved significant cost savings over prices previously obtained under individual contracts.
- LGAQ provides a large range of shared corporate services for councils including IT (eg hosted web applications, community portals, online information) , joint procurement of a range of software packages, insurance and workers compensation as well as IR and HR expertise.
- The MAV has developed a Step Program to improve the asset management capacity and management of community assets of councils. The program provides councils with a framework to support them in seeking to reach best practice in asset management and then facilitate continuous improvement into the future.

1.1.4 Caught in a cost squeeze

While more can be done to achieve greater cost efficiencies, this will not be enough to balance the books of many councils caught in a costs versus revenue squeeze, often not of their own making.

Over the past 30 years, the range of functions undertaken by local government in Australia has expanded beyond the physical infrastructure of roads and waste to include a variety of important social and human services. This has come about through a combination of community pressure, state and Australian Government inducements and the withdrawal of services by other levels of government.

A key finding of this study is that some councils often spend scarce resources attempting to address service and infrastructure gaps that are actually regional or state issues. Both state and local government need to better recognise when such issues are beyond the capacity or responsibility of an individual council. Such issues are better solved with resources and input from other regional councils, local government associations, and state and Australian levels of government.

Cost shifting is another phenomenon making life difficult for local government. This occurs in two forms. The first is when local government agrees to provide a service on behalf of another sphere of government, but funding is later reduced or stopped. The second is when another sphere of government ceases to provide a service and local government steps in as a response to community demands. The Inter-Governmental Agreement on Cost Shifting, coupled with greater caution by councils prior to expanding services, may moderate recent levels of service expansion.

A recent trend observed by the local government sector is the increasing cost of providing services. For example, the Local Government Association of Queensland commissioned an independent economist to develop a local government cost index. For 2005, the index was 5.7% - about double the Brisbane CPI.

This was driven by the growth of costs in construction, which represents 40% of local government expenditure in Queensland.

Managing these demands is particularly challenging for councils with a restricted revenue base. For the 60% of councils that are rural and remote, static or declining populations have tended to translate into static or declining revenue.

1.1.5 Evidence of financial stress

The results of recently completed sustainability studies commissioned and funded by state local government associations in South Australia, New South Wales and Western Australia provided some of the impetus for the national level study by PwC. Each of these state studies was managed by an independent board, with the analysis undertaken by Access Economics (Access). South Australia was the first state to complete its study, with the results published in August 2005. This was followed by NSW in May 2006 and interim report in WA in August 2006.

The MAV has also led the efficiency reform process, undertaking considerable analysis of long-term sustainability of local government in Victoria. Based on 2004/05 data, MAV concluded that 10% of the 79 councils in Victoria were unsustainable.

PwC collated the results of the MAV study and the three separate Access studies, producing the overall finding that around 35% of councils in these states were not financially sustainable. Access found that the proportion of unsustainable councils varied between 25% in New South Wales and 58% in Western Australia.

The aggregate backlog for all 700 local councils across the country could be $14.5 billion with an annual underspend on renewals of $1.1 billion. This creates a funding gap of $2.16 billion per annum to clear the backlog and correct the underspend.

This deferral tendency by some councils arises because the other two broad categories of infrastructure – water/sewerage and roads – have specific user charges to fund renewals or Australian Government grants, for example Roads to Recovery (R2R), to support periodic upgrading. But even with R2R, many rural councils still face ongoing challenges funding the adequate renewal of local roads.

1.1.6 PwC's financial ratio analysis of 100 councils

PwC gathered data on 100 councils across Australia and stratified this to match both the proportion of councils per state/territory and the proportion of councils in each of the seven classification size categories developed by the Department of Transport and Regional Services (DOTARS). The PwC results are slightly more positive than the Access results as data constraints meant that PwC analysis included all grants whereas the Access results excluded capital grants. Whilst capital grants fluctuate and are arguably not a certain revenue stream, many councils have come to depend on them and their use by governments is growing. Therefore retaining capital grants within the analysis potentially provides a more realistic picture of sustainability.

The PwC results indicate that:

- Approximately 36% of councils have an interest coverage ratio (EBIT/interest) of less than 3. The interest coverage level of 3 generally represents a threshold where credit risk begins to be more significant and a large unexpected event with adverse cash flow implications can place pressure on the ability to meet interest payments.

- Councils have a median operating surplus of 10% of total revenue, but some 16% of councils have an operating deficit of over 10% of revenue. Such councils have a tendency to defer renewals expenditure which creates a risk of developing maintenance backlogs.

- The median sustainability ratio (capex/depreciation) in this sample was 1.8:1. Some 8% of councils have a sustainability ratio of less than 1. A ratio of less than 1 indicates that the capital being consumed in an accounting sense exceeds the capital being replaced into the asset base.

- Councils have a median current ratio (current assets/current liabilities) of 2.6, however 21% are less than 1. The ratio of 1 is a key threshold for testing liquidity issues. In particular the urban fringe, urban development, rural remote and rural agricultural categories all have potential liquidity problems, with 12-50% of councils less than 1.

- Councils across the nation have a median of 48% of costs covered by rates, ranging from 25–66%. Of concern is the fact that 87% and 54% respectively of rural remote and rural agricultural councils have rates covering less than 40% of costs, creating a dependence on government grants.

1.1.7 Synthesising the state-based reports and the PwC analysis

The results of the Access and MAV state-based sustainability studies and the PwC analysis confirm that a significant part of the local government sector has financial sustainability problems.

The PwC analysis of 100 councils estimates that 10–30% of Australia's councils have sustainability issues. This result broadly reflects the state-based reports that between 25% and 40% of councils on those states could be unsustainable.

The combined studies indicate that local government needs to generate more cash flow to adequately maintain and renew infrastructure.

The recent sustainability inquiries have significantly improved the understanding of this problem by local government and lent impetus to the process of efficiency reform. However, despite making sizeable improvements in efficiency, many councils (more often rural, remote and urban fringe) will need to either cut back on services or downsize their asset base to be sustainable, unless additional revenue can be secured.

Common findings across these studies are that councils with sustainability issues are likely to be developing infrastructure backlogs, and unlikely to be able to clear them unless the funding gap is closed.

Further broad conclusions can be drawn from the PwC analysis, when the survey results are segmented into the seven DOTARS council categories:

- The majority of larger metropolitan councils are generally viable or have the ability to improve their own financial sustainability. Some metropolitan councils have often become over-stretched due to service expansions and rising costs. Further use of community consultations and use of flexible user-pays systems may assist in effective prioritisation of local government services and infrastructure.

- Urban fringe councils are mixed as some have large viability issues while others are in a strong position. Hence, only some of these councils appear to need additional government funding to restore sustainability.

- Rural remote and rural agricultural have more pronounced viability problems. These councils typically appear to have relatively larger scope for internal reforms; but they often battle against lack of scale, so most require extra funding for the renewal of community infrastructure.

1.1.8 Portrait of councils feeling the pinch

The characteristics of councils with financial sustainability problems include:

- Minimal (or negative) revenue growth

- Cost growth which has exceeded revenue growth. Expenditures have been rising by an average of CPI plus 2–3% per annum. This cost growth is mainly due a combination of factors including the rising skill level required for most senior roles and hence the higher level of remuneration (award wage rises of typically 4% pa for most mid to lower level roles); stronger cost escalations in the maintenance and construction sectors; and service diversification

- Increasing involvement in non-core service provision due to rising community demands, coupled with a related tendency by some councils to step in to provide a non-traditional service

- A tendency by some councils to run operating deficits creating a need to defer or underspend on renewal of infrastructure, particularly community infrastructure

- Limited access for some councils to the strong financial and asset management skills which are critical to identifying sustainability problems, optimising renewals expenditure and improving revenue streams

- Limited access, for a small proportion of councils, to rate revenue due to relatively small populations reducing the size of the rates income stream coupled with constraints on the size of annual rates increases.

2 Recommendations

2.1 Steps to further efficiency gains

Thanks to efficiency improvements in recent years, many councils need only focus on continued improvement through productivity gains. But others still have scope for improving their efficiency and effectiveness.

The report's recommendations to improve internal performance practices are targeted at four key objectives: improving efficiency, effectiveness and scale; expanding own-source revenue; setting clear and appropriate priorities; and deepening asset management and financial capacity.

The recommendations are:

- Further realise the gains from greater economies of scale and reduce unit costs via approaches such as regional or shared service provision, outsourcing, use of state-wide purchasing agreements etc.
- Work with state government to remove or relax legislative impediments and improve the capacity of local government to raise revenue from its own sources
- Establish a robust long-term service plan which defines what council will provide and how services will be undertaken
- Exercise caution prior to stepping in to attempt to resolve regional, state or national issues without a sound funding plan
- Secure long-term funding (not just capital grants) prior to new services and infrastructure
- Work with other spheres of government to facilitate improved asset management and financial skills through government-funded programs (e.g. the Size, Shape and Sustainability Review in Queensland and the MAV Step Program), to lift the skills in all councils to a reasonable base level
- Use total asset management plans and systems to better manage asset renewals and replacement, and integrate into broader long-term council objectives
- Undertake more regular asset condition reporting for key infrastructure
- Develop nationally consistent Local Government Body financial and asset management data. There is a need for a new national program to improve the consistency and quality of local government data to enable more robust and accurate analysis and planning and to produce a uniform national approach to measuring viability and financial sustainability. Ideally this would be led by the Australian Government.

2.2 Reforms to inter-government transfers

These need to be primarily targeted to assist councils with sustainability challenges.

The recommendations are:

- **Establish a new Local Community Infrastructure Renewals Fund:** this fund would support councils in the more timely funding of renewals work across a range of community infrastructure assets including community centres, aged care facilities, libraries, health clinics and sport and recreation facilities. The fund could be distributed based on relative need and use the R2R or Financial Assistance Grants (FAGs) General Purpose distribution methods, or perhaps through a new or hybrid approach. The size of LCIRF could be set so as to provide a similar level of renewals support as provided by R2R, which is around $200–$250 million pa.

- **Revise the escalation methodology for FAGs** from a mix of population growth and CPI to a new escalation formula tailored to local government cost movements (e.g. a combination of the Australian Bureau of Statistics (ABS) Wage Cost Index and Construction Cost Index coupled with population growth).

- **Make funding for R2R permanent:** this program has delivered substantial benefits and there would be significant merit in extending its duration and further augmenting the funding levels (including escalating the program size by the ABS Construction Cost Index).

- **State governments to provide funding support to encourage the local council efficiency and asset management reforms:** a significant proportion of councils have inadequate in-house skills to improve efficiency and to establish robust asset management and financial plans. There would be significant benefit in state governments providing partial funding to aid the development of tailored state-based reform programs. This program might be along the lines of the support provided by the Queensland Government ($25m over five years) in the *Size, Shape and Sustainability Program*, and the *Step Program* developed by MAV.

2.3 How the LCIRF would enhance local communities

Establishment of the LCIRF would allow individual councils to more quickly rectify a range of community infrastructure deficiencies.

The fund would focus on the renewal and replacement of existing assets rather than the development of new facilities. The ability to access such a fund would also enable some councils to avoid developing backlogs, and in some cases bring forward some projects to reduce whole-of-life costs.

As part of the study a number of councillors and local government managers identified a list of the types of projects which could be completed with the support of an LCIRF, including:

- Renewal and refurbishment of community centres and public halls

- Refurbishment of base depots for home and community care activities

- Upgrading of senior citizen centres

- Renewal and refurbishment of theatres, galleries and museums
- Enhancement of main streets and public squares
- Upgrading of boat ramps, jetties and wharves
- Upgrading of recreational facilities, including swimming pools and playing fields
- Improvement of park equipment, such as playgrounds, benches and BBQs
- Renewal of foreshore paths, seawalls, walking trails, board walks
- Upgrading and major maintenance of airports, aerodromes and air strips
- Refurbishment of tourism information centres
- Upgrading of libraries and information centres
- Refurbishment of kitchen and council facilities which provide Meals on Wheels.

The LCIRF would in general not be used to support the development of new facilities. However, under some circumstances, new facilities may be warranted - for example it may be financially more appropriate to establish a new multi-purpose social hub providing childcare, maternal and child health as well as a kindergarten to replace a series of older single-purpose facilities.

3 Better Funding, Better Communities

Additional funding would assist local government to meets its obligations to flexibly gauge and respond to changing community demands. This would:

- Strengthen local communities by ensuring an adequate standard of facilities for the ongoing provision of a range of significant social and recreational services
- Encourage more participation in community activities through greater choice and consultation, thus promoting increased community cohesion and safety, particularly in rural areas
- Enable the implementation of local programs to accommodate cultural diversity, access and equity and equal opportunity, and involve minority groups
- Support a sustainable environmental strategy for each community
- Enhance business and community links with regional areas to promote regional equity and development
- Promote further economic development and the generation of employment benefits through links with the business community
- Improve the quality of life of local residents through the support and alignment of health and welfare agencies within the area
- Support local recreation, arts and culture and an appreciation of heritage in order to promote vibrant and active communities.