FinPro
Local Government Finance Professionals

NEED FOR A MORE SUSTAINABLE FUTURE FOR LOCAL GOVERNMENT

Submission to Legislative Council Economy and Infrastructure Committee Inquiry into Local Government Funding and Service Delivery in Victoria

MAY 2024

Prepared by the AEC Group

Executive Summary

About FinPro

Local Government Finance Professionals (FinPro) is the peak body servicing local government finance professionals in Victoria. An incorporated association, FinPro has over 800 members, representing all Victorian councils, five regional library corporations and over 20 other organisations.

Key Considerations

Local government enables the economic, social and cultural development of the municipal area it represents, supports individuals and groups, and provides a wide range of services for the wellbeing of the local community.

Residents and customers are at the centre of local government planning. The sector is on a daily basis supporting customers with financial hardship and cost of living pressures, rebuilding communities post COVID, dealing with impacts of climate change and sustainability of environment, and addressing the housing challenge. There is an overarching responsibility of local government to protect and enhance the liveability and wellbeing of the community which is often not adequately acknowledged in the considerations of core services and funding of the sector.

As the delivery level of government for services that impact households and communities, local government can help achieve state and national government priorities through related core service delivery – but only if there is adequate funding provided to local government.

Long term sustainability of local government is key to community development and meeting service delivery objectives, and it therefore critical that the Committee has an accurate understanding and appreciation of the financial sustainability of local government in Victoria . It is critical because the current financial position and future sustainability of local government underpins, and is impacted by, the matters outlined in the Terms of Reference for the Inquiry.

A literature review is provided in the Appendix to this report that summarises published assessments by Local Government Victoria (LGV) and the Essential Services Commission (ESC), as well as other relevant published literature. FinPro disagrees with the analysis and assessment of 2023-24 council budgets published by Local Government Victoria. The financial position of local government has been described as “sound” and even “good” in assessments provided by LGV, which has been reinforced by comments made in publications by the ESC and recent comments and correspondence from the Minister Local Government.

The considerations of the Committee as outlined in the Terms of Reference will be impacted significantly by whether the members of the Committee hold a perspective that local government in Victoria is either sound (as held by LGV) or alternatively in a less than sound and deteriorating position (as outlined in this submission by FinPro). A determination of the capacity to deliver on core service objectives and whether the revenue structure of local government is sufficient will be significantly impacted by whether local government is considered financially sustainable or not.

It is important to note that the Victorian Auditor General Office (VAGO), in the recently published report on the 2022-23 audited statements for the local government sector, comments that the “financial position” of local government is “sound”. FinPro do not believe VAGO are stating that the general finances of local government are “sound” nor “good.”

The context of the assessment that the financial position of local government is sound is in the body of the report and relates to the consideration of the Statement of Financial Position (or balance sheet) items for local government. The balance sheets of local government should be sound because of the high value of assets owned by councils and relatively small liabilities (including borrowings). A large majority of the value in assets held by local government cannot be sold and transferred to cash. The cash held by councils also includes large reserves that must be quarantined for developer contributions, unexpended grants, residential bond payments and other commitments.

Unrestricted cash is the most important consideration when looking at the financial sustainability of councils, not total cash. A sound financial position can be reported in the balance sheet even though a council is reporting large operating deficits, experiencing deterioration in assets and struggling to maintain service levels to the community. VAGO raises such risks to the long term financial sustainability in the same report as indicating that the financial position of local government is sound. This is the reality for many Victorian councils.

In this report, FinPro provides analysis and an assessment that the sustainability of the local government sector is deteriorating using the same data used by LGV and ESC, with the rate cap system being a major contributor to the deterioration. Changes need to be made to the rate cap system to avoid a further deterioration in the sustainability of local government.

An incorrect assessment of the sustainability of local government can have a critical impact in the setting of the rate cap by the Minister. If the view is that local government is sustainable then the rate cap will be set lower than necessary. If in fact local government has significant sustainability issues, such a decision will work to further deteriorate the financial sustainability of local government.

FinPro notes that no adjustment has been applied to recent rate caps set by the Minister, despite an acknowledgement by ESC that previous rate caps have been insufficient to cover actual increases to the cost base of local government and have resulted in a deterioration of cash reserves in local government.

Reference is made by ESC and LGV, as well as the Minister, that local government should consider using more borrowings to fund infrastructure and to address deteriorating cash reserves. Furthermore, ESC and LGV refer councils to the application process through ESC for a higher rate cap if individual councils consider current rate revenue earned to be unsustainable.

FinPro acknowledges that borrowings may be a good funding source for long life assets, particularly assets that are provided to growing communities (and in turn growing local government revenue). However, a minority of councils are in a position with current low borrowings, an adjusted underlying surplus and with growth that enables the council to take on additional borrowings without impacting the long term sustainability of the council. Borrowings are not a sustainable solution for councils that have underlying deficits and with little or no growth as they will only work to further deteriorate financial sustainability.

FinPro suggests that the lack of a risk-based assessment framework for the local government sector and inconsistent use of financial sustainability indicators must be addressed. There is a need for a financial sustainability framework for local government that includes risk-based assessment criteria, with consideration of different risk thresholds across the different council cohorts. More specifically, a sustainability framework should be developed in collaboration with the sector that includes:

1. Financial indicates to measure both the current financial position and future sustainability;
2. Criteria for each financial indicator to enable an assessment of the risk of the performance of each indicator and an assessment of the total risk to long term financial sustainability; and
3. Different ranges for the criteria that is appropriate for the different council cohorts.

This will address the inconsistent use and reporting of indicators, differing interpretations of the indicators and will enable consideration that the risks of financial sustainability are not the same across the different cohorts in the local government sector.

The financial analysis provided by FinPro in this report to the Committee outlines that:

- **A majority of councils have adjusted underlying deficits, with a deteriorating trend evident since 2016-17 across the council cohorts.** Instead of using the adjusted underlying surplus/deficit in its assessment of 2023-24 budgets, LGV used the “accounting operating surplus”, which is inconsistent with its own analysis of 2022-23 budgets where it noted that the adjusted underlying deficit is a better measure of financial performance over time. In the 2022-23 budget analysis, LGV noted while only 7 of 79 councils plan to produce an operating deficit, 55 of 79 plan to produce an adjusted underlying deficit. It is important to note in recent financial performance that the underlying surplus/deficit position of each Council has also been significantly and positively impacted by the prepayment of Financial Assistance Grants – this is not sufficiently considered in recent analysis completed by LGV.
- **Despite increase in total cash, there has been a deterioration in the unrestricted cash position across the local government sector**. This finding by FinPro is consistent with ESC advice to the Minister that cash reserves across the sector were deteriorating.
- **There is insufficient investment in the renewal of existing assets to match the consumption of assets**. If continued, this will lead to further deterioration and increased maintenance and more costly intervention over the medium to long term.

Further exacerbating the deterioration in the underlying financial position of local government is the impact of cost shifting. Cost shifting from the Victorian Government onto local government is having a significant impact on the financial position of the sector. This outcome is inconsistent with the 2014 Victorian State Government and Local Government Agreement which was developed to improve the cooperation between the levels of government and to protect local government from the impact of Victorian Government decisions – including cost shifting. Recent state governments have not adhered to the responsibilities outlined in the agreement, including undertaking impact assessments and consulting with local government prior to making decisions that have a financial impact on local government.

Cost shifting is having a clear impact upon local government's capacity to deliver core services, particularly since 2016/17 with the introduction of rate capping, leaving the sector with the limited ability to raise additional rate revenue to fund new costs incurred as a consequence of cost shifting.

The analysis completed by FinPro clearly indicates that, since the introduction of rate capping in Victoria in 2016/17, the financial position of the local government sector has deteriorated. The current rate cap system is not providing sufficient rate revenue to match the actual increase in the cost base of existing services and infrastructure, as outlined by ESC in providing advice to the Minister. The impact of inadequate rate capping is demonstrated by the impact of the rate peg in NSW, which has led to a large number of NSW councils applying for large special variations to correct the impact of the rate peg and resulting rate shocks across NSW communities.

While FinPro acknowledges the need to consider capacity to pay of the community when setting rates, fees and user charges, councils are well placed to establish differentiation in rate strategies and to develop policy and processes to address financial hardship, which are much more suitable and targeted interventions than unnecessary restrictions placed on the total rate revenue earned by local government to protect the minority of ratepayers that are vulnerable.

The suggestion by LGV, ESC and the Minister that Victorian councils can apply for a higher rate cap if the rate cap set by the Minister is insufficient ignores the administrative and political burden that such an application process places upon the local government sector. Further, placing local government in a position to correct an insufficient rate cap through the higher rate cap process is an inappropriate political shift from the Victorian Government onto Councils. FinPro acknowledges a rate cap is a reasonable policy approach by the State Government and is not advocating for its removal. However, the indicators used and the criteria applied to provide advice to the Minister must be reviewed to avoid the system further impacting on local government financial sustainability.

Vertical fiscal imbalance is a characteristic of the current federation framework, which results in an inability of local government to earn sufficient revenue to fund services, relying on grant funding from the other levels of government. The imbalance is increasing as the Victorian Government restricts the rate revenue earned by local government while at the same time growing its own taxation revenues at a significantly higher rate.

Vertical fiscal imbalance is deteriorating for the local government sector in Victoria. During the period 2016-17 to 2021-22 (five years), the Fair Go Rating System restricted local government's capacity to increase rates (taxation revenue) to a cumulative increase of 16%, while over the same period Victorian Government taxation revenue increased by 34%, more than double that of local government.

As a percentage of total Commonwealth Government taxation revenue (excluding GST), the amount of Financial Assistance Grants made available to local government across Australia has also decreased from 0.76% to 0.57% from 2011/12 to 2021/22.

The current revenue structures for local government places the sector in a difficult financial position to fund contemporary living standards for Victorian communities. While the Commonwealth Government and the Victorian Government is able to earn uncapped taxation revenue that increases with economic and population growth, enabling increased in living standards, the local government sector is reliant upon insufficient rate revenue to meet cost escalation alone and Financial Assistance Grants that have not increased in real terms on a per capita basis since 1995.

In the absence of change, the short, medium and long term financial sustainability of Victorian local government entities cannot be assured. This has a direct impact on local services, and represents a lost opportunity across shared State, Federal and Local Government policy objectives.

Recommendations

FinPro and the sector more broadly are seeking to work collaboratively with the State and Federal Government to ensure the sustainability of local government and the continuation of the role of local government in the delivery of services to community.

The following recommendations are made for the sector to work collaboratively with the State Government to implement:

1 That LGV engages with the sector and establishes a risk-based assessment framework for financial sustainability of local government, including criteria set for different council cohorts, to assist both the state government, Councillors and local governments officers to take action to manage risks to sustainability.

2 That ESC be required to calculate and have regard in advice provided to the Minister to a local government cost index for the Victorian local government when considering advice to the minister on setting the rate cap each year.

3 That ESC be required to consider adjustments to correct historically set rate caps that were insufficient to meet the indexation of local government costs.

4 That LGV engages with the sector and establishes a more detailed report on assets, similar to the required schedule Report on Infrastructure Assets for NSW councils, to ensure transparency in reporting of assets and the capacity of councils to fund the necessary maintenance and capital investments.

5 That the Minister Local Government, LGV and local government peak bodies reengage with a model like the Victorian State-Local Government Agreement established in 2014, which seeks to enable consultation, co-design, and a fair balance of cost apportioning to achieve the best outcomes across policy domains. Recent engagement has not adhered to the responsibilities or intent of the agreement, and in some cases had significant costs shifted to local government.

The following recommendations and specific notifications for the Committee to consider:

1 That the Committee notes the FinPro analysis of the financial position of local government, which is in contrast to other assessments outlined in this report that local government is in a sound financial position.

2 That the Committee notes the analysis provided by FinPro that a majority of councils have a deteriorating underlying adjusted deficit, deteriorating unrestricted cash and investing insufficient cash to asset renewals, resulting in an increased risk to financial sustainability of the local government sector.

3 That the Committee notes the combination of a deteriorating financial position and cost shifting is impacting on the capacity of local government sector to deliver core services That the Committee notes that the vertical fiscal imbalance that exists results in the local government sector being vulnerable to policy settings of other levels of government, including the allocation of grant funding, which is exacerbated in Victoria by the further restriction placed on local government by the Victorian Government through the rate capping system.

4 That the Committee notes there is a significant difference in the rate cap calculated for Victorian councils compared to NSW councils for 2024/25. The rate peg set for NSW councils will be 4.5%, while the rate cap set for Victorian councils will be 2.75%. Applied across the total rate revenue base for Victorian councils, the difference equates to over $138 million in lost rate revenue for local government in Victoria. FinPro requests the Committee to recommend to the Minister for Local Government to seek the development of a Local Government Cost Index, for use in the annual rate cap calculation.

5 That the Committee notes the administrative and in particular the political challenges faced by councils seeking a higher rate cap under the Fair Go Rate System and the likely outcome that Victorian communities will experience significant rate shocks in future years when significant rate increases will be required.

6 That the Committee notes that, unlike the Commonwealth and Victorian governments, the revenue base of local government does not grow in line with economic growth, due to the impact of rate capping and the Financial Assistance Grant funding model – due to rates and operating grants contributing 80% of revenue in the local government sector. This means while the Commonwealth and Victorian Governments can respond to demands for higher living standards as the economy grows (e.g., additional funding for better health services and better education), the local government sector is significantly constrained to meet the demand of the community for higher living standards.

7 That the Committee notes that, between 2011/12 and 2021/22, Commonwealth Government taxation revenue (excluding GST) increased by 65% (or 31% in the five years to 2021/22) and Victorian Government taxation revenue increased by 98% (or 34% in the five years to 2021/22) yet Victorian local government taxation revenue (municipal rates) only increased by 54% (or 16% in the five years to 2021/22).

8 That the Committee notes that as a percentage of total Commonwealth Government taxation revenue (excluding GST), the amount of Financial Assistance Grants made available to local government decreased from 0.76% to 0.57% from 2011/12 to 2021/22.

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1. Introduction

1.1 About FinPro

Local Government Finance Professionals (FinPro) is the peak body servicing Local Government Finance Professionals in Victoria. An Incorporated Association, FinPro has over 800 members, representing all Victorian Local Governments, 5 regional library corporations and over 20 other organisations.

1.2 Background

On 3 May 2023, the Legislative Council agreed to the following motion:

> *That this House requires the Economy and Infrastructure Committee to inquire into, consider and report, by 30 June 2024, on local government funding and service delivery in Victoria, including but not limited to —*
>
> - *The effects of cost shifting from the state and federal governments to local councils in an examination of vertical and horizontal fiscal imbalances;*
> - *Whether local councils are adequately delivering on their core service delivery objectives;*
> - *The overall revenue structure of local government;*
> - *Whether the existing revenue structure is sustainable and appropriate or if alternative models of funding would be more sustainable and appropriate; and*
> - *Any other related matters.*

1.3 Approach to Developing the Submission to Committee Inquiry

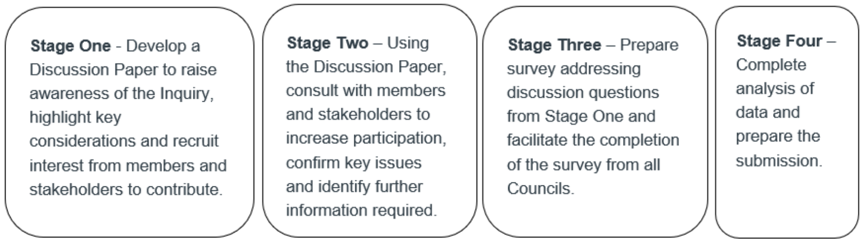
FinPro initiated a four-stage approach to developing a Submission to the Committee Inquiry.

Stage One – Development of a Discussion Paper with background information to identify the key issues the FinPro submission must address.

Stage Two – Engagement with members and stakeholders to identify key issues and information required to prepare an adequate submission.

Stage Three – Survey and information requests to obtain the required information.

Stage Four – Preparation of the FinPro submission.



1.4 Council Groups in the Discussion Paper

To assist with the analysis and presentation of Local Government sector, and to maintain consistency with VAGO and LGV, the 79 councils have been grouped into five cohorts – based predominantly on size, demographics and funding – see Appendix A for a full list of councils in each cohort.

2. Setting the Scene – Assessment of Financial Sustainability of Local Government

As the delivery level of government for services that impact households and communities, local government can help achieve state and national government priorities through related core service delivery – but only if there is adequate funding provided to local government.

Long term sustainability of local government is key to community development and meeting service delivery objectives, and it therefore critical that the Committee has an accurate understanding and appreciation of the financial sustainability of local government in Victoria . It is critical because the current financial position and future sustainability of local government underpins, and is impacted by, the matters outlined in the Terms of Reference for the Inquiry.

In the absence of a more detailed risk based assessment tool, it is the view of FinPro that Local Government Victoria's (LGV) published assessment of council 2023-24 budgets is insufficient in its analysis. As the LGV report is used as a key reference for the assessment by the Essential Services Commission (ESC) of sustainability in the sector, the advice to the Minister provided by ESC is also based on incorrect analysis and assessment. Included as Appendix C is a literature review of relevant documents released by authorities such as LGV, ESC and the Victorian Auditor General's Office (VAGO).

The following sections outlines the assessment of the local government sector's financial sustainability as provided by the LGV, ESC and VAGO, and compares and contrasts this to analysis completed by FinPro.

2.1 Defining Financial Sustainability

2.1.1 Assessing Financial Sustainability

A key limitation to the Committee's consideration and assessment of submissions is the lack of an established definition for financial sustainability and the absence of a risk-based assessment framework for local government in Victoria. Furthermore, there is a lack of appropriate consideration given to the fact that each cohort across the sector experiences different financial challenges and risks to sustainability.

It is the view of FinPro that the assessments provided by LGV and ESC lack a basis upon which the assessment is provided, and that the lack of a sustainability framework results in:

- Inconsistency in the lead sustainability indicators from one year to the next, as evidenced by emphasis of the adjusted underlying result in the analysis of 2022-23 budgets and reliance on the "accounting operating surplus" in the analysis of 2023-24 council budgets.
- No basis for assessing the risk of each indicator to the financial sustainability of local government.
- No consideration of different thresholds or targets for each indicator for the different cohorts of councils.

Without a risk-based assessment framework, there is room for different interpretations of whether local government financial sustainability is sound or not.

It is noted that financial sustainability key performance measures have been developed as part of the Local Government Performance Reporting Framework (LGPRF). However, there is no definition or criteria in the Framework that defines or enables assessment of risk to financial sustainability, nor appreciation that the targeted range for the indicators should be set differently across the cohorts.

The Performance Reporting Indicator Guide (applies to the 2024-25 reporting period) outlines the indicators required to be reported on, as well as the indicators that each council must set targets for and an expected range. FinPro is of the view that the expected range provided in the Guide gives little guidance of whether a council is sustainable or not – for example, the expected range for the operating position is -20% to 20%, a range indicative of a very poor result and a very good result.

The Queensland State Government has recently revised the Local Government Financial Sustainability Framework which includes target bands for each indicator set as appropriate for different tiers of councils (https://www.statedevelopment.qld.gov.au/local-government/for-councils/finance/local-government-sustainability-framework).

VAGO historically provided risk assessment criteria for the financial sustainability indicators, however, this was discontinued in the annual report from 2020-21 onwards. VAGO continues to outline the performance indicators with a broad definition to assist interpretation of the indicator. Table 2.2 outlines the criteria used by VAGO to assess the risk of financial sustainability for local government in reporting on the 2019-20 results.

Due to the lack in an assessment framework for financial sustainability of local government, varying interpretations can be made on the financial position of local government. This is particularly concerning to FinPro given an assessment of local government sustainability is required by the ESC when providing advice to the Minister when setting the cap on the annual increase in average rates, whether an adjustment is required and whether to set a uniform cap or not.

Of further concern for FinPro is that in providing advice on the rate cap for 2024-25, ESC has relied upon the LGV analysis of 2023-24 council budgets, alongside the results of VAGO's 2021-22 audits. The view of FinPro is that the assessment by LGV of the 2023-24 budgets, in the absence of established criteria and a risk matrix, is based on an interpretation of the financial sustainability indicators.

In the absence of an established definition, and for the purposes of the Committee's consideration, FinPro suggests to the Committee that the definition for financial sustainability should be:

> *Demonstrated capability to deliver on required levels of service while maintaining fiscal capital and infrastructure capital over the long term.*

Maintaining fiscal capital refers to the capacity of the council over the longer term to maintain access to sufficient cash – produced and used through operations, investments and financing activities – including maintaining adequate reserves for future liabilities. Maintaining infrastructure capital refers to the capacity of the council to continue to provide assets over the long term that are adequate to provide the required levels of service to the community.

The emphasis should be on maintaining the service capacity of the council over the long term.

Table 2.1 aligns the current and suggested financial sustainability indicators with the two assessments included in the above definition.

Table 2.1 Alignment of Indicators to the Assessment of Sustainability

Assessment	Indicator
Maintaining fiscal capital	Net result margin (%)
	Adjusted underlying result (%) **NEW**
	Liquidity (ratio)
	Internal financing (%)
	Indebtedness (%)
	Unrestricted cash ratio **NEW**
Maintaining infrastructure capital	Capital replacement ratio
	Renewal funding ratio **NEW**
	Asset renewal ratio **NEW**
	Renewal gap ratio

Source: AEC

Included in Table 2.1 are the following suggested changes to the financial indicators:

Adjusted underlying result – the measurement of the current indicator does not consider only normal business (or service) activities as it still includes recognition of some capital and asset related transactions which should be added in the definition to be removed in the measurement of the indicator.

Unrestricted cash ratio – develop a new indicator which more accurately measures the unrestricted cash position of the council and removes the issue with the inclusion (or not) of cash invested in term deposits.

Asset renewal ratio – adjust the current measure to exclude upgrades in the comparison to depreciation. Depreciation is a measure of the consumption of current asset benefits, not upgraded assets, so the measure should exclude the upgrade portion of capital works in the measure to more accurately assess local government performance in replacing existing assets.

Renewal funding ratio – develop a new indicator to measure how much of the planned asset renewals (as indicated by the asset management plan) is able to be funded in the budget or reported period.

Table 2.2. VAGO Risk Assessment Criteria for Financial Sustainability Indicators – Results of 2019-20 Audits

Risk	Net Result	Adjusted underlying result	Liquidity	Indebtedness	Internal financing	Capital replacement	Renewal gap
High	**Less than Negative 10%** Insufficient revenue is being generated to fund operations and asset renewal.	**Less than 0%** Insufficient surplus is being generated to fund operations.	**Less than 0.75** Immediate sustainability issues with insufficient current assets to cover liabilities.	**More than 60%** Potentially long-term concern over an entity's ability to repay debt levels from own-source revenue.	**Less than 75%** Limited cash generated from operations to fund new assets and asset renewal.	**Less than 1.0** Spending on capital works has not kept pace with consumption of assets.	**Less than 0.5** Spending on existing assets has not kept pace with consumption of these assets.
Medium	**Negative 10% to 0%** A risk of long-term run down to cash reserves and inability to fund asset renewals.	**0% to 5%** Surplus being generated to fund operations.	**0.75 to 1.0** Need for caution with cashflow, as issues could arise with meeting obligations as they fall due.	**40% to 60%** Some concern over the ability to repay debt from own-source revenue.	**75% to 100%** May not be generating sufficient cash from operations to fund new assets.	**1.0 to 1.5** May indicate spending on asset renewal is insufficient.	**0.5 to 1.0** May indicate insufficient spending on renewal of existing assets.
Low	**More than 0%** Generating surpluses consistently.	**More than 5%** Generating strong surpluses to fund operations.	**More than 1.0** No immediate issues with repaying short-term liabilities as they fall due.	**40% or less** No concern over the ability to repay debt from own-source revenue.	**More than 100%** Generating enough cash from operations to fund new assets.	**More than 1.5** Low risk of insufficient spending on asset renewal.	**More than 1.0** Low risk of insufficient spending on asset base.

Source: VAGO Results of 2019-20 Audits: Local Government

2.1.2 State Government Assessment of Local Government Financial Performance

In the following sections, FinPro provides commentary on the assessment published by LGV for the 2022-23 and 2023-24 adopted budgets.

2.1.2.1 Assessment of 2023-24 Budgets by LGV

LGV provides following summary of the financial position of local government:

> *Overall council finances remain sound. A large majority of councils are budgeting for operating surpluses, most have substantial cash and investments and debt levels remain low. 70 of 79 councils adopted a 3.5 per cent rate rise in line with the rate cap and all councils now have separate rates or charges for kerbside waste collection. Capital expenditure levels are consistent with the previous budget year.*[1]

The view of LGV was reinforced by the Minister in a letter responding to FinPro (dated 12th February 2024) which stated that:

> *Continued generalist advocacy and claims by the local government sector of widespread financial unsustainability are difficult to reconcile with facts. From the recently completed annual reporting period it is evident that the local government sector has emerged from the COVID-19 pandemic in good financial shape, with low debt and record levels of cash, while acknowledging that some councils – primarily small rural shires – face some challenges. Further, widespread capital underspend by the sector (averaging 26 per cent in 2022-23 equating to $1.13 billion unspent) continues, a trend preceding the COVID-19 pandemic. In this context, the local government sector, led by FinPro, must specify how it plans to leverage its sound financial position to benefit residents and ratepayers and commit to concrete actions. (The Hon. Melissa Horne MP)*

[1] Local Government Victoria, 2023-24 Council Budgets Summary

The assessment by LGV, reinforced by the Minister, is based on the key conclusions outlined below:

Operating Results

In the published 2023-24 Council Budgets Summary report, LGV states that:

> *To remain financially sustainable councils should aim for small operating surpluses on average over multiple years. This is because continued operating deficits consume and reduce council financial resources over time, resulting in an unsustainable financial position. 71 of 79 Victorian councils are budgeting for an accounting operating surplus in 2023-24, while the remaining 8 councils are budgeting for an accounting operating deficit.*

FinPro agrees that continued deficits consume and reduce council financial resources over time, but the more correct indicator of local government capacity to generate a surplus from normal business operations (as indicated by LGV in the report on 2022-23 budgets) is the adjusted underlying result not the accounting operating result. In contrast to the LGV assessment, FinPro provides analysis later in this report that provides clear trend of a deterioration in the adjusted underlying result for local government, resulting in the consumption and reduction of council financial resources.

The LGV assessment of the 2023-24 operating results is also inconsistent with the VAGO assessment that the 2022–23 audited results indicate the sector's adjusted underlying result deteriorated to 0.15%, compared to 1.41% in 2021–22. VAGO commented that the adjusted underlying result before the pandemic was greater than 4%. This deterioration is also noted in the analysis provided by FinPro later in this report.

It is also highlighted by ESC in the advice to the Minister in setting the 2024-25 rate cap that the increase in costs of local government services over recent financial years has been more than the rate cap set by the Minister, resulting in a deterioration of the cash reserves held by councils. This is recognition that the current rate cap system is impacting on the operating position of the local government sector. The ESC stated that:

> *In our view, the gap between the rate cap and inflation, rising construction costs, and the expectation of future wage increases have the potential to present major cost pressures on councils going forward.*

As indicated above, in the published assessment of the 2023-24 budgets, LGV refers to the "accounting operating surplus" when reporting that 71 of 79 councils are planning for a surplus. This is inconsistent with the analysis and commentary in the report on 2022-23 budgets, in which LGV reported the operating surplus as well as the adjusted underlying result, and a comment that the adjusted underlying result is a better indicator to use to assess the financial position of councils over time.

It is important to note that the LGV notes in the report on 2022-23 budgets that while only 7 out of 79 councils planned to produce an <u>accounting operating deficit</u>, 55 out of 79 planned to produce an <u>adjusted underlying deficit</u>. LGV correctly notes that the adjusted underlying result is a better indicator of financial position because it removes revenue from developer contributions and non-recurrent capital grants in order to measure an entity's ability to generate a surplus in the ordinary course of business.

There is also no commentary from LGV that the operating results in 2022-23 and 2023-24 have been impacted by increased prepayment of the Financial Assistance Grants. As outlined below, VAGO has highlighted that the operating position of local government sector in 2022-23 would have been worse if the Commonwealth Government had not made an increase in the prepayment of grants.

Rate Rises

In the published 2023-24 Council Budgets Summary report, LGV states that:

> *Based on 2023-24 adopted budgets 70 of 79 Victorian councils have adopted a 3.50 per cent rate rise in line with the rate cap … No councils applied to the ESC for a higher cap for 2023-24 and no councils have applied for a higher cap since the 2019-20 budget year. Of the 17 higher cap applications the ESC have assessed since 2016-17, 13 applications have been approved in full or in part.*

The current rate cap system has enabled the rate cap to be set below what is required to meet actual cost base increases (acknowledged by ESC in the advice to the Minister in setting the 2024-25 rate cap). No adjustment has been advised to, or by, the Minister for significant differences in prior year rate caps compared to actual increase in the base costs of the local government sector, despite ESC noting the difference is contributing to the deterioration in council cash reserves.

The application of the rate cap system is resulting in a deterioration in the financial position and long term sustainability of local government, yet the system has not made adjustment for this. Without a change to the system, it is likely the history will repeat in the future setting of the rate cap, further deteriorating the financial position of local government.

Reference to a lack of higher cap applications is not evidence that local government finances are sound. The lack of submissions is evidence that the higher cap application process is too much of an administrative and political burden on local government. Suggesting that councils can simply apply for higher rate cap ignores the political reality that it is the local government elected members that will be impacted by a decision to correct a rate cap that has been set too low over many years.

Rather, it is likely to result in councils deferring a decision until much larger adjustments are required, as evidenced by the impact of the rate peg in NSW. As outlined later in this report, the requirement for NSW councils to seek rectification through an application for a “special variation” has resulted in NSW councils deferring such decisions and later seeking much higher increases in the rates, resulting in larger rate shocks to the community.

Capital Expenditure

In considering capital expenditure of local government it is important to note that in the Victorian Budget 2024-25 highlights the financial sustainability challenges councils currently face in Victoria. Throughout the budget material, the State Government highlights the 22 percent increase in infrastructure costs since 2021. This is an even more challenging weight to bear for local government with rates capped at just 2.75 percent.

In the published 2023-24 Council Budgets Summary report, LGV states that:

> *Collectively, Victorian councils are planning to spend $4.15 billion on capital works in 2023-24, an amount unchanged from 2022-23, though the aggregate numbers mask variability at individual council level. It is also important to note that underspend on capital works remains significant. The Victorian Auditor General identified underspend on capital works of 28.9 per cent for 2021-22, equating to $1.24 billion.*

As indicated by LGV in reference to aggregate numbers masking variability, analysis of total capital works investments using consolidated amounts is inappropriate and leads to an incorrect assessment of the financial position of local government.

There are two key considerations that concerns the sector when assessing the capacity of local government to fund capital works:

1) Investment in the renewal of existing assets in line with asset management plans, and
2) Investment in upgrade of assets and new assets to meet growing demand.

While both are important to all councils, the significance of each is different across the cohorts of councils. The capacity of local government to renew assets is a fundamental need for long term financial sustainability. As outlined later in the FinPro assessment, councils are not renewing existing assets in a sustainable manner. The underspend in capital works will certainly include asset renewals, and is therefore a key concern for all councils, however, as the FinPro analysis shows, if this underspend had not occurred, the cash position of local government would have deteriorated further.

While not a desirable outcome, the underspend in capital works is deferring the short term deterioration of the financial position of local government, and likely deteriorating the longer term financial position.

For a majority of councils – more so the small shires and regional/rural councils – investing in new and upgraded assets is reliant upon grant funding. Uncertainty and other delays in grant funding frequently occurs, often outside the control of local government. Projects cannot start on time until the grant funding is confirmed, which can often be a significant period of time through the financial year.

FinPro acknowledges Councils have to be better at delivering capital works programs (as this is true) but it should be noted that there are a number of factors to take into account to assist in project delivery, including:

- High competition and accessibility for contractors;
- Increased cost of contractors (particularly between project initiation and delivery) and
- Timing and application process of State and Federal Grants.

Cash and Investments

In the published 2023-24 Council Budgets Summary report, LGV states that:

> *Collectively, Victorian councils are budgeting to hold cash and investments worth $5.99 billion as at 30 June 2024 (increased from $5.28 billion as at 30 June 2023). The budgeted cash and investments position largely reflects the accumulation of rates and charges, user fees and bank interest. This is slightly offset by the decision of the Commonwealth Government to bring forward payment of 100 per cent of the 2023-24 estimated financial assistance grant allocations into the 2022-23 financial year. In the previous year only 75 per cent of the allocations were brought forward and paid in advance. The impact of this is that council budgets reflect the estimated financial assistance grants in the 2022-23 forecast actual figures rather than in the 2023-24 budget year. However the estimated collective impact of the brought forward payment is approximately $235 million – only a small percentage of the $5.99 billion total.*

The analysis by LGV considers total cash and investments. Total cash and investments include developer contributions, cash received as a bond and unexpended grant funding, as well as other cash reserves for liabilities. When considering the financial position of local government, the more correct assessment is the amount of unrestricted cash at the discretion of the council.

FinPro provides analysis later in this report that highlights a deterioration in the unrestricted cash position for local government.

Based on a deterioration in the unrestricted cash across the sector, the assessment provided by LGV that increased cash is due to accumulation of rate and charges, user fees and bank interest is unsubstantiated and inconsistent with a deteriorating unrestricted cash position.

2.1.2.2 Assessment of 2022-23 Budgets by LGV

The assessment provided by LGV of the 2022-23 budgets concludes that:

> *The 2022-23 adopted budgets show that Victorian councils collectively remain in a strong and stable financial position.*

The assessment appears to be in contrast with other findings made in the same report. In particular, LGV states that:

> *An adjusted underlying result removes the revenue from developer contributions and non-recurrent capital grants in order to measure an entity's ability to generate a surplus in the ordinary course of business.*
>
> *….*
>
> *An adjusted underlying result is a useful measure of financial performance over time since it excludes items that may fluctuate significantly or not be consistently received. Individually, 7 out of 79 councils are budgeting for an accounting operating deficit whilst 55 out of 79 councils are reporting an adjusted underlying deficit.*

With 55 out of 79 councils budgeting for adjusted underlying deficits, this is most certainly not an indication that the sector is collectively in a strong and stable financial position.

LGV notes that the total planned capital expenditure of $4.15 billion in 2022-23 represented a 0.6% decrease on the prior year but that over the 4-year budget projections, the collective capital spend of $14.23 billion was up on the previous estimate.

In this report LGV states that:

> *The carrying-over of capital works remains common across Victorian councils, reflecting construction delays unforeseen at budget time.*

LGV also notes that Victorian councils were expected to be impacted by supply chain issues and inflationary pressures, particularly with regards to delivery of their significant capital works program.

2.2 VAGO Assessment of Local Government Financial Performance

In the Results of 2022–23 Audits: Local Government report, VAGO provides the following assessment:

> *The sector's financial performance improved slightly. A number of revenue and income streams increased, but growth in councils' expenses outpaced this for another year. Financial performance would have declined had the Australian Government not advanced 100 per cent of the 2023–24 financial assistance grants in 2022–23.*

Councils' balance sheets remain strong and over the short term their financial health is fine. They face longer-term challenges that require sound financial planning and management to maintain this financial health. These challenges include:

- *Continued variability in government funding*
- *Constraints on their ability to grow own-sourced revenue*
- *Persistent inflation, increasing costs of materials and services*
- *Population growth, which increases demand for services*
- *Delivery of large capital works programs to maintain, renew and develop intergenerational assets*
- *Lack of maturity of internal processes and the level of integration between council budgets, asset management plans and the 10-year financial plans.*

VAGO noted that the financial performance would have declined had the Australian Government not advanced 100 percent of the 2023-24 financial assistance grant in 2022-23.

Regarding operating surpluses, VAGO states that:

The adjusted underlying result indicator measures a council's ability to generate a surplus from its ordinary course of business (excluding capital receipts) to fund its capital spending. It is important that councils generate enough money to deliver community services. A longer-term negative trend in this indicator could force councils to reduce the services they offer their communities.

In 2022–23 the sector's adjusted underlying result deteriorated to 0.15 per cent, compared to 1.41 per cent in 2021–22. The adjusted underlying result before the pandemic was greater than 4 per cent.

….

The adjusted underlying surplus includes the advance financial assistance grant payments from the Australian government. Had the total financial assistance grants not remained at the same percentage as the previous year, more councils would be reporting an adjusted underlying deficit.

VAGO provides the following table as a summary of the deterioration of the sector's adjusted underlying result since before the COVID pandemic and that the deterioration would have been larger if not for an increase in earlier grant payments.

Table 2.3. Councils' Adjusted Underlying Result

Adjusted Underlying Result	2022-23 Number of Councils	2018-19 Number of Councils
Surplus	41	56
Deficit	37	23

Source – VAGO (2023)

As evidenced by the table above extracted from the VAGO 2022-23 report, there is a deterioration in the number of councils reporting on underlying operating deficit in 2022-23 compared to the results in 2018-19 (prior to the pandemic). However, as VAGO note, the prepayment of financial assistance grants avoided a much higher number of councils reporting a deficit.

VAGO provides analysis on the capital works expenditure in 2022-23, noting that:

There has been an improvement in the number of councils that met or exceeded (capital works) *budget, coming in at 16 councils. Of the 16 councils that met or exceeded their budget, we note that 12 are from either the small or large shire cohorts, both of which have smaller capital work programs. It appears that, as capital work programs get larger, more councils underspend.*

2.3 Essential Services Commission Assessment of Local Government Financial Performance

The assessment provided by ESC is highly important to the local government sector as it is a required consideration in the ESC advice to the minister in setting the annual rate cap – in particular, the need for an adjustment to consumer price index to ensure local government remains to be sustainable. An incorrect assessment by ESC, or inadequate adjustment for sustainability of local government, has, in the view of FinPro, resulted in previous decisions to set rate caps lower than actual increases in the cost base and has contributed significantly to a deterioration in the financial sustainability of local government.

In forming advice to the Minister for the rate cap to apply for 2024-25, ESC analysed council financial data, price indices and economic forecasts. ESC also reviewed the analysis of 2023-24 budgets completed by LGV (of which FinPro has major concerns as outlined above), alongside the results of 2021-22 audits by VAGO.

The ESC concluded that:

> *While council cash reserves are declining, the sector maintains low levels of debt and stable borrowing levels.*
>
> *Council costs increased at a slower rate than inflation during 2022-23 but as a higher rate than the current rate cap of 3.5%.*
>
> *Construction costs continued to rise but at a slower pace than last year.*
>
> *Expected future wage increases have the potential to raise council costs in the future.*
>
> *Major driving factors of the overall increase in CPI are not key council cost components.*

In the analysis of cash reserves, which ESC noted were declining, it was noted that councils were utilising cash reserves due to low average rate increases relative to actual inflation. Furthermore, ESC noted that:

> *While most councils working capital ratios are still in an appropriate range, the downward trend may not be sustainable in the longer term.*

ESC noted that while cash reserves were deteriorating, debt levels were low, and borrowings to fund assets was a viable option for councils facing reduced cash reserves.

ESC also stated that:

> *While lower rate caps can decrease the overall rate burden on a community, it is a blunt tool and must also be balanced against the long term sustainability of councils. In our view, well-functioning hardship policies and programs can be effective in supporting ratepayers experiencing vulnerability.*

Despite acknowledging a decline in the cash reserves of council, highlighting the historical rate cap was lower than actual cost increases, noting that the downward trend in working capital ratios is not sustainable, highlighting that the local government cost base is not reflected by CPI and indicating lower rate caps need to be balanced against the long term sustainability of councils, ESC provided advice to the Minister that:

- The average rate cap be set equal to the 2024-25 CPI forecast by the Department of Treasury and Finance,
- No adjustment be made, and
- A uniform cap continues across all councils.

FinPro is of the view that this advice is inconsistent with the analysis provided, particularly given ESC acknowledged a deterioration in the local government financial indicators.

The suggestion by ESC that the use of borrowings is a responsible option for councils to address declining cash reserves is inappropriate for the majority of councils. Only councils with an adjusted underlying surplus and a growing revenue base are likely to be in a financial position to use borrowings to fund assets. Most councils are not in this position and rely on grant funding to invest in assets. As ESC noted, the cost base of councils has increased at higher rate than rate revenue and cash reserves are declining, on top of which increased borrowings will increase the deterioration in the sustainability of the council (without an adequate increase in revenue).

2.4 FinPro Assessment of Local Government Financial Performance

The following analysis has been completed substantially upon the same data that LGV and ESC used to make their assessments of the financial position for local government. One major exception is that FinPro has used the VAGO audit data for 2022-23 results to provide a more updated position for some of the following indicators.

Adjusted Underlying Result

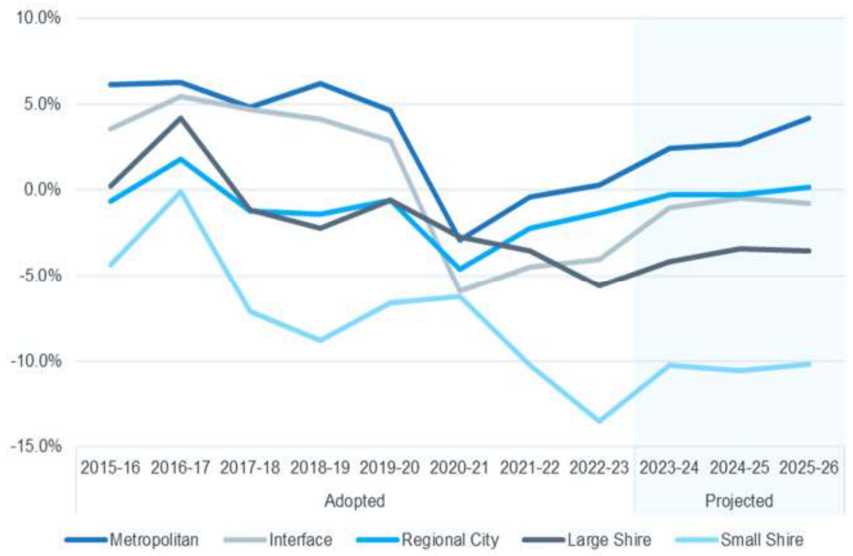
As stated by LGV in the analysis of 2022-23 council budgets, the operating result includes capital revenue, developer contributions and other items that are not reflective of the normal business operations of local government. Delivery of capital works is a core component of local government, but capital expenditure is not reflected in the operating result, therefore including revenue for a capital purpose in an assessment of whether a council is sustainable is misleading.

Therefore, FinPro agrees with the LGV comment in the 2022-23 report that the adjusted underlying result is a more appropriate measure of the operating result of normal business. Furthermore, FinPro agrees with the LGV comment that a small adjusted underlying surplus is required for a council to be sustainable over the medium to long term.

Figure 2.1 highlights the adjusted underlying result ratio for the different council cohorts using the same data that LGV used in its analysis. The ratio is a calculation of the adjusted underlying operating surplus (or deficit) as a percentage of adjusted underlying revenue. This measure is audited and reported in the Local Government Performance Reporting Framework.

The COVID pandemic significantly impacted reported adjusted underlying results, particularly in 2020-21. However, prior to the COVID council budgets had already indicated a deterioration in the adjusted underlying result. Furthermore, most councils adopted a budget for an adjusted underlying deficit in 2022-23. The forward projections indicate an improvement in the projected forward three financial year budgets. However, as LGV outlined in their assessment, most councils are forecasting an increase in expenditure to match projected rate caps, which is unlikely to occur in actuality based on historical outcomes.

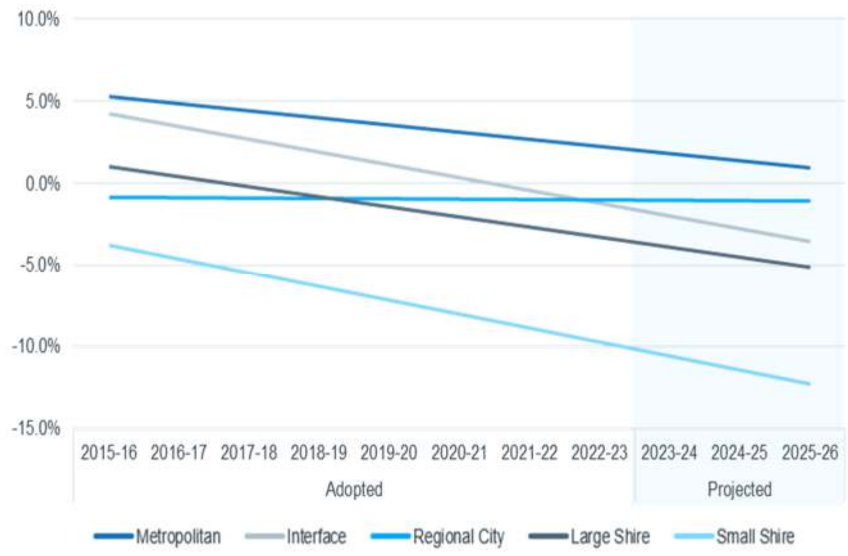
Figure 2.1. Adjusted Underlying Result Ratio



Source: AEC Analysis (unpublished), LGV Budget Summary Report data (various years)
Notes: The Australian Government has provided a prepayment of financial assistance grants over recent financial years. Given the analysis presented here is budgeted not actual, it is unlikely that councils planned to receive further payments of grants in advance.

Figure 2.2 provides the trendline in the adjusted underlying result ratio over the same period. All Council cohorts except for regional city councils show a declining trend in the ratio in the budgets adopted from 2015-16 to 2022-23 and projections through to 2025-26.

Figure 2.2. Adjusted Underlying Result Ratio Trendlines



Source: AEC Analysis (unpublished), LGV Budget Summary Report data (various years)

Figure 2.3 indicates the range of the adopted adjusted underlying ratio in the 2023-24 budget for each cohort and Figure 2.4 highlights the adjusted underlying result and the trend of the result for each council cohort. In contrast to the advice from LGV that councils need to produce a small surplus to be sustainable over the medium to long term, clearly a majority of the local government sector is not planning to produce a surplus with significant deficits instead expected.

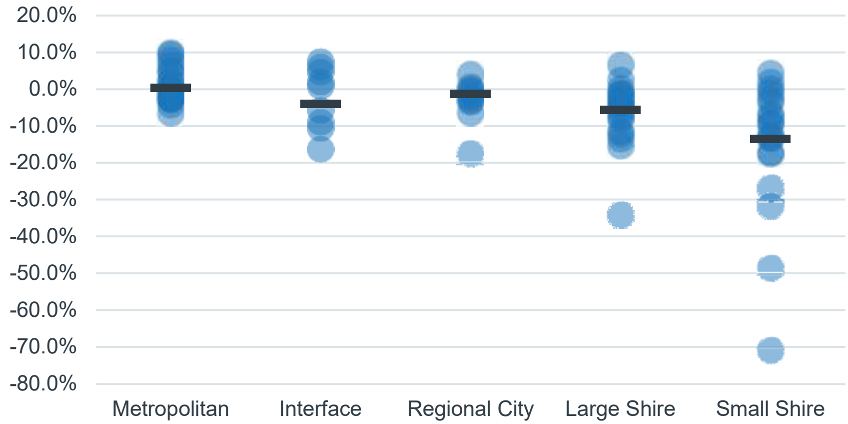
A deteriorating adjusted underlying result is not sustainable, as noted by LGV, and is likely to result in continued deterioration of cash reserves (as indicated by ESC). These outcomes are inconsistent with the conclusion by LGV and supported by the Minister that the local government sector is in a sound financial position.

Further, reliance upon borrowings to address funding shortfalls associated with a deterioration in the adjusted underlying result is not a sustainable solution – additional borrowing without additional revenue will only further deteriorate the adjusted underlying result.

It is important to note that over the long term, councils cannot be expected to continue with adjusted underlying deficits without a deterioration in cash and/or infrastructure. Investing less than required to maintain assets on a consistent basis will ultimately lead to higher maintenance costs and higher costs to renew and bring assets to a satisfactory condition, leading to a further deterioration in financial sustainability. This has been noted by VAGO but has not been appropriately considered by LGV and ESC when concluding that local government is in a sound financial position.

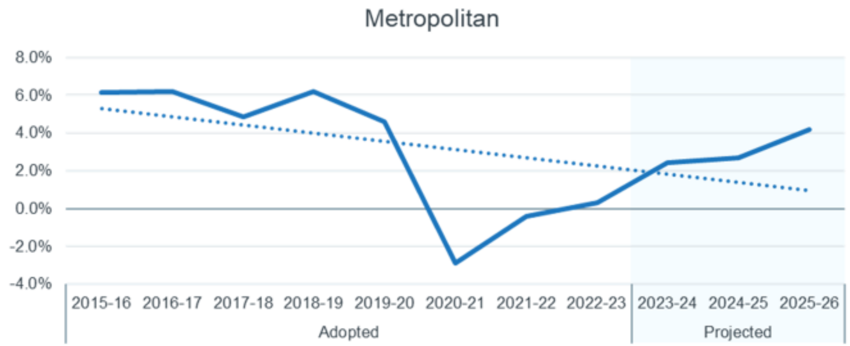
There is a need to identify, highlight and advocate for the nexus between adjusted underlying operating deficits and the deterioration in infrastructure, leading to an increasing deterioration in the financial sustainability of local government.

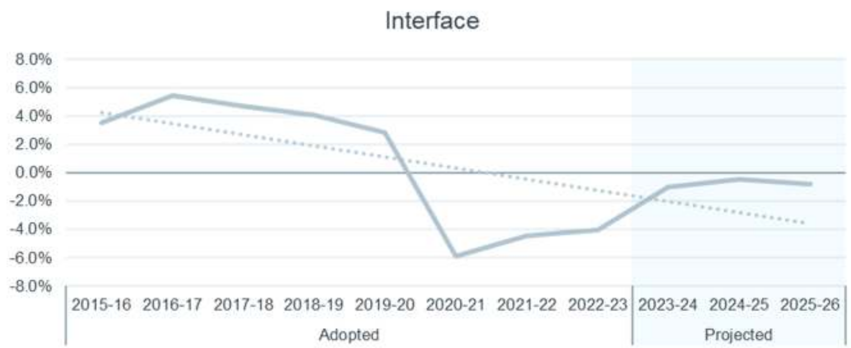
Figure 2.3. Adjusted Underlying Operating Result Ratio – 2022-23 Budget

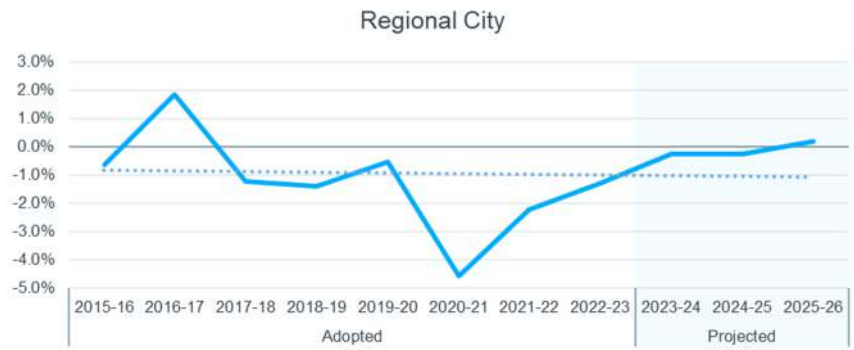


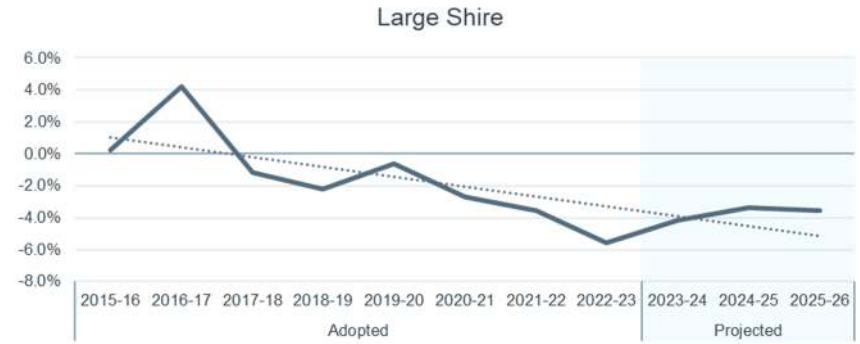
Source: AEC Analysis (unpublished), LGV Budget Summary Report data (2022-23)

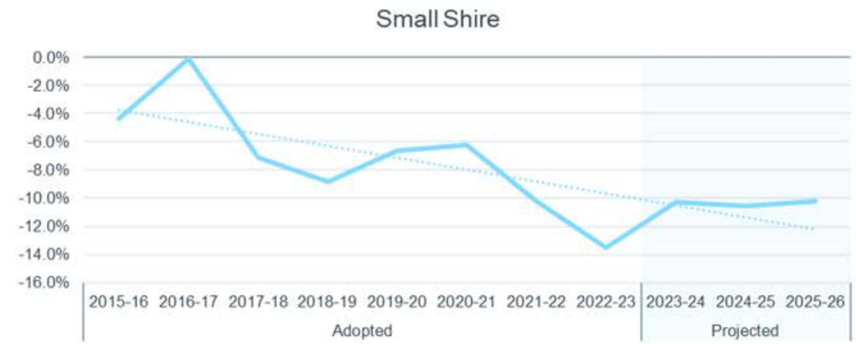
Figure 2.4. Adjusted Underlying Result Ratios by Council Cohort











Source: AEC Analysis (unpublished), LGV Budget Summary Report data (various years)

Unrestricted Cash Position

A key indicator of whether a council is sustainable is not total cash held, nor the trend of total cash held, but rather the ability to maintain adequate unrestricted cash. That is, the balance of cash after all other commitments and obligations to "cash back" reserves is considered.

Unless all financial commitments and obligations are identified and reported, the cash position of a council can be misleading. It is very possible that councils can be accumulating cash and have a deteriorating unrestricted cash balance – for example, due to accumulating developer contributions, grants received in advance and incomplete capital works from the prior year.

The cash holdings of councils across Victoria have historically improved as a consequence of the brought forward payments of the Financial Assistance Grants from the Commonwealth Government. LGV estimates in its analysis of 2023-24 Council Budgets that the prepayment of grants accounted for an improvement in the cash position by $235 million – LGV refers to this as being a small percentage of the total 5.99 billion in cash that Councils are budgeting to hold as at 30 June 2024. However, the $235 million (or 3.9% of $5.99 billion) is additional payment brought forward in 2022-23. The total Financial Assistance Grants payments received in advance as at 30 June 2023 is $746 million (or 12.5% of $5.99 billion) which is not a small percentage. Further, if considered as a proportion of unrestricted cash it increases to an estimated 23.2% of the $3.34 billion of unrestricted cash held across all Councils.

The increase in cash due to the prepayment of grant funding would most likely materially improve the large shire and small shire councils more than the other council cohorts. Unless this cash is held in a reserve, it is important to note that the unrestricted cash position is likely to deteriorate in future when the Australian Government return to historical timing in payment of the grant funding.

In an attempt to assess whether there is a deterioration in unrestricted cash (consistent with the deterioration in the adjusted underlying operating position), FinPro analysed the unrestricted cash ratio reported through the Victorian Local Government Performance Reporting Framework.

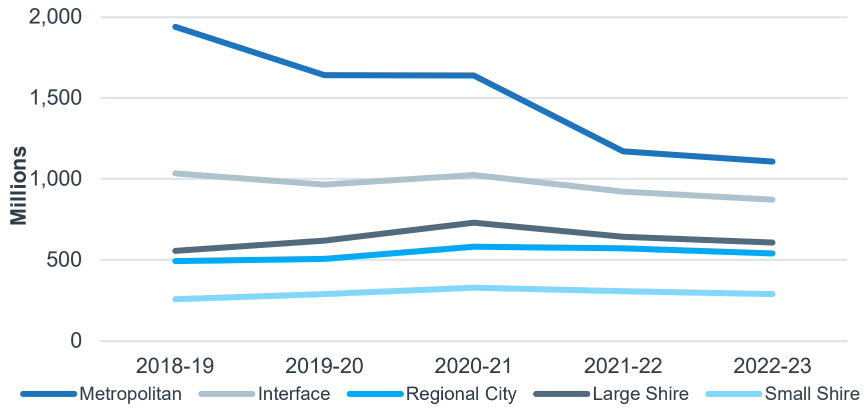
Figures 2.5 and 2.6 illustrate the calculated total unrestricted cash and other financial assets held by all Victorian councils between 2018-19 and 2021-22. The calculation of the unrestricted cash and other financial assets has been performed using the unrestricted cash ratio, cash and other financial asset balances and includes corrections where necessary (FinPro analysed each council's reported position and adjusted in accordance with financial statement notes).

There is a concerning decline in total unrestricted cash and other financial assets for metropolitan and interface councils, with smaller councils maintaining a stable cash position. It must be noted this includes the financial assistance grants received in advance, which, when corrected, will impact the outcomes significantly, deteriorating unrestricted cash for small councils in particular. This impact is not acknowledged by LGV in their assessment that local government in a sound position.

ESC in its advice on the rate cap for 2024-25 was correct in highlighting that in recent years councils have been using cash reserves to sustain service levels.

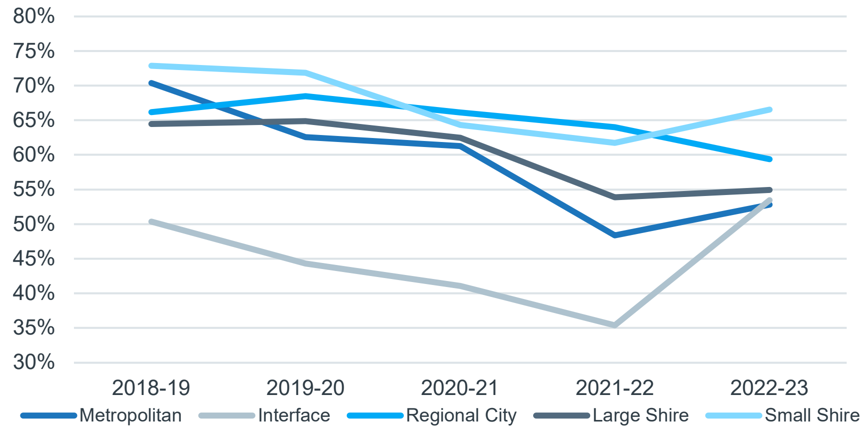
LGV is incorrect in concluding that the increase in total cash is due to the accumulation of rate revenue, interest earned and fees and charges.

Figure 2.5. Total Unrestricted Cash and Other Financial Assets



Source: AEC Analysis (unpublished), LGV Local Government Performance Reporting Framework, VAGO Results of Audits: Local Government – annual report from 2018-19 to 2022-23)

Figure 2.6. Proportion of Cash and Other Financial Assets Unrestricted



Source: AEC Analysis (unpublished), LGV Local Government Performance Reporting Framework, VAGO Results of Audits: Local Government – annual report from 2018-19 to 2022-23)

Use of Borrowings

ESC advice on the rate cap for 2024-25 noted that while council cash reserves are declining, councils maintain a low level of debt and stable borrowing levels. ESC suggested that borrowing to fund the construction of "long-lived" assets can be a viable option for councils facing reduced cash reserves. LGV and the Minister have referred to the low level of debt as an indicator that local government is in a sound financial position.

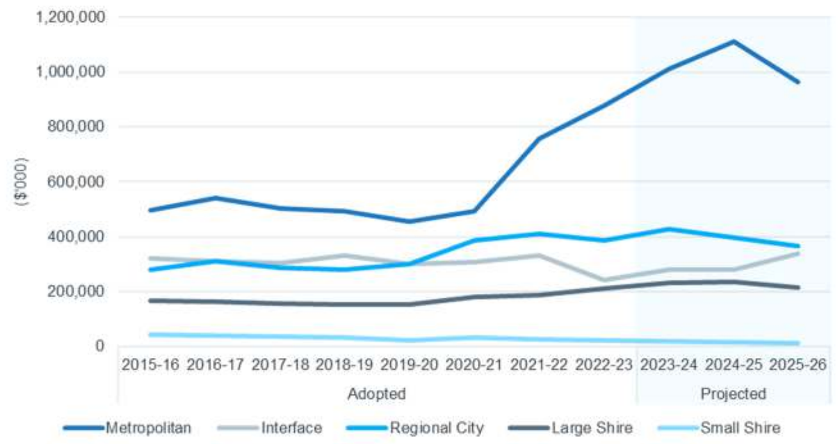
When further analysed, it is evident that the local government sector is using borrowings responsibly and in an affordable manner. Using borrowings to replace operating revenue is not responsible nor is it sustainable.

Analysis of historical and projected borrowings in Figures 2.7 and 2.8 highlights that total borrowings have increased for councils that are in a financial position to use borrowings (particularly metropolitan, large shire and regional cities). While interface councils have maintained historical levels of borrowings, the interface councils will also be receiving significant developer contributions to fund new and upgraded assets. It is worth noting that while unrestricted cash is deteriorating for metropolitan councils, total borrowings are increasing.

Increasing the use of borrowings by local government when facing declining unrestricted cash is fundamentally not sustainable. Additional revenue is necessary to pay for increased borrowings. This is a position that the state government is in and not a position that local government should be planning to achieve.

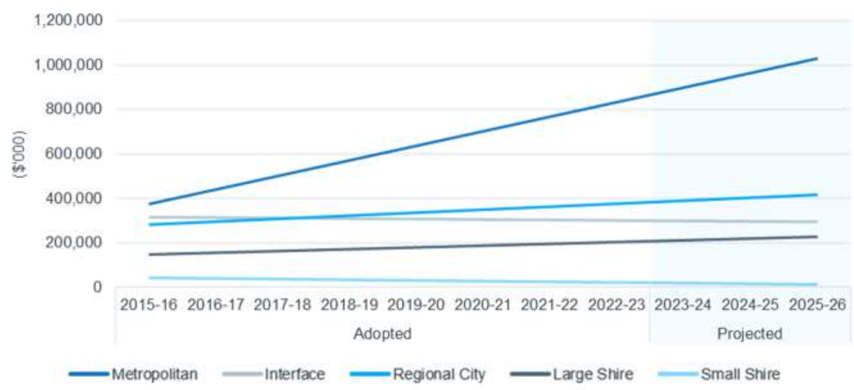
Responses from the council survey indicated that councils are conservative in the use of borrowings due to the additional cost and cash outlay obligations in the future as loans are repaid. The shire councils responded that they have limited ability to increase revenues to fund loan repayments which would then need to be funded by rates revenue, impacting their ability to fund service provision into the future.

Figure 2.7. Total Budgeted Borrowings



Source: AEC Analysis (unpublished), LGV Budget Summary Report data (various years)

Figure 2.8. Total Budgeted Borrowings Trendline



Source: AEC Analysis (unpublished), LGV Budget Summary Report data (various years)

Maintaining Assets

The asset renewal and upgrade ratio is a long-term measure that assesses the spending on infrastructure assets compared to depreciation. It compares the rate of spending on existing assets through renewing, restoring, replacing or upgrading the existing assets with the financial consumption (depreciation) of the assets.

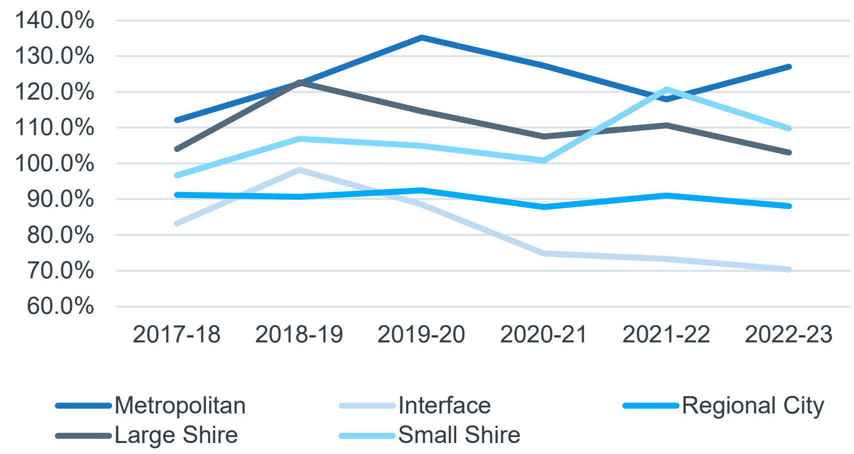
However, due to the inclusion of upgrade capital expenditure, this ratio shows a higher value than would be considered if the indicator considered only expenditure on asset renewal alone. This is particularly the case given a significant portion of upgrades is grant funded or funded through developer contributions.

FinPro is of the view that the local government sector should only be reporting and assessing a council's capacity to fund the renewal of assets, with any asset upgrades being excluded. Furthermore, a separate indicator should be used to assess a council's capacity to fund planned renewals for the year, as outlined in the asset management plans, with this indicator being audited.

There is a significant difference in reporting asset renewals including upgrades versus just asset renewals. Figure 2.9 indicates the renewal ratio including the expenditure on upgrade of assets and Figure 2.10 has been calculated by FinPro by removing the expenditure on upgrades, using the Capital Works Statement for respective financial years, as provided to FinPro by VAGO. While it is acknowledged that a significant portion of expenditure on upgrades is replacing an existing asset, the difference between the two graphs cannot be explained by this alone.

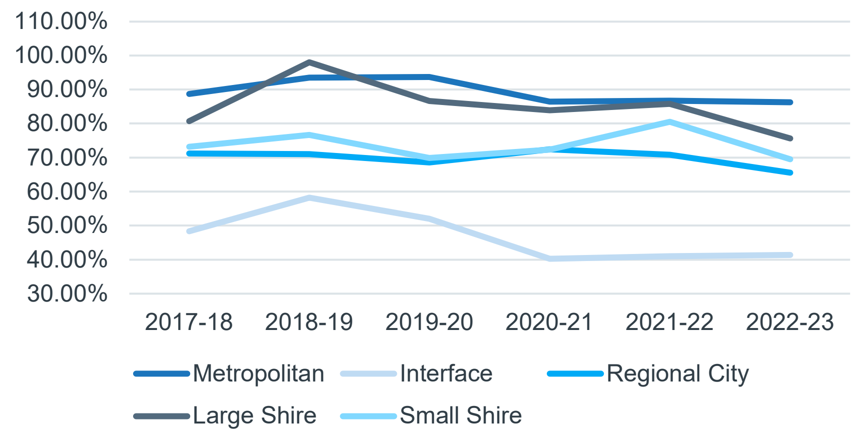
Figure 2.10 indicates that councils across all cohorts are not renewing assets at the same rate as they are consuming the assets (as measured by depreciation expense).

Figure 2.9. Renewal and Upgrade Ratio



Source: AEC Analysis (unpublished), VAGO data

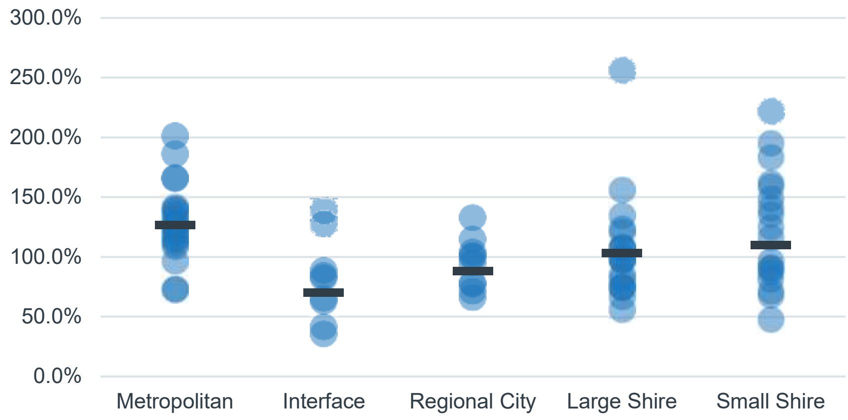
Figure 2.10. Renewal Ratio (excluding upgrades)



Source: AEC Analysis (unpublished), VAGO data

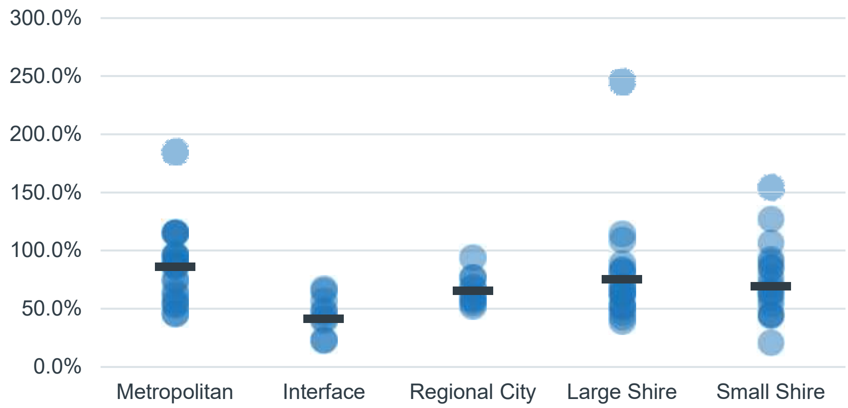
The spread of these two ratios also varies within each council cohort, with the following graphs illustrating the ratio spread for the 2022-23 result and the average for each cohort.

Figure 2.11. Renewal and upgrade ratio



Source: AEC Analysis (unpublished), VAGO data

Figure 2.12. Renewal ratio (excluding upgrades)



Source: AEC Analysis (unpublished), VAGO data

2.5 Risk Assessment of the Sustainability of Local Government

The assessment of the medium to long term financial sustainability of local government provided by FinPro above contrasts with the assessment provided by LGV. Local government in Victoria is not in a "sound position" as indicated by LGV, nor is it in "great shape" as indicated by the Minister.

ESC has raised concerns regarding the historical deterioration of cash reserves, which is not consistent with local government being in a sound position or in great shape.

VAGO has raised concerns with expenditure increasing at a higher rate than revenue and highlights a deterioration in the adjusted underlying result.

FinPro has highlighted that the local government sector has a deteriorating adjusted underlying result, deteriorating unrestricted cash and insufficient investment in the renewal of assets.

Applying the VAGO risk assessment criteria outlined in Table 2.1, high risk of short term and immediate sustainability concerns are indicated by an adjusted underlying result of less than 0% or a liquidity ratio of less than 0.75. Based on the 2023-24 budgets, all council cohorts except metropolitan councils have a trend of adjusted underlying deficits. In the LGV report on 2022-23 budgets, 55 of 79 councils were budgeting for an adjusted underlying deficit.

Furthermore, based on the FinPro analysis, nearly all councils are either at a medium or high risk of not spending sufficiently on existing assts.

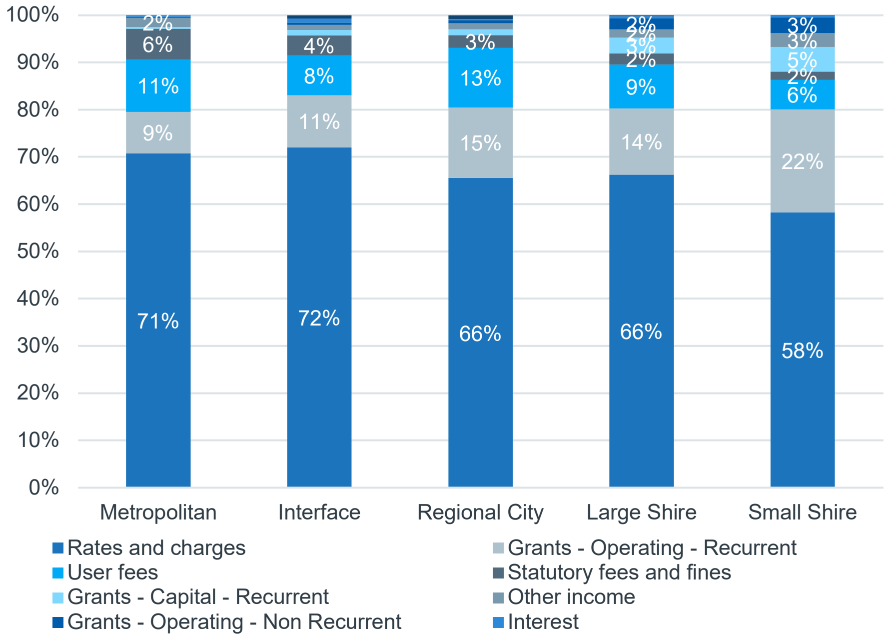
3. Revenue Structures of Local Government

3.1 Overview of Revenue Streams for Local Government

The main source of revenue for Victorian councils is rates and charges, accounting for 69% of total adjusted underlying revenue, followed by recurrent operating grants (11%), user fees (10%) and statutory fees and fines (5%).

Figure 3.1 illustrates the revenue categories for each cohort, with the most notable observation being that all cohorts receive approximately 80% of their revenue from rates and charges and recurrent operating grants (mostly due to the horizontal fiscal equalisation applied to the allocation of Financial Assistance Grants within Victoria, resulting in councils with less capacity to generate revenue through rates receiving more funding through Financial Assistance Grants).

Figure 3.1. 2022-23 Budget - Revenue Categories as a % of Adjusted Underlying Revenue



Source: AEC Analysis (unpublished), LGV 2022-23 Budget Summary Report data

3.2 Vertical and Horizontal Fiscal Imbalance

The first term of reference for the Inquiry addresses the effects of cost shifting from the state and federal governments to local councils in an examination of vertical and horizontal fiscal imbalances.

Vertical and horizontal fiscal imbalance refers to a differential in the capacity of organisations to generate sufficient revenue to support the cost of providing services and infrastructure.

The following discussion highlights the impact of vertical and horizontal fiscal imbalance has upon capacity of local government to generate more revenue to fund increased levels of services imposed upon local government through cost shifting. Cost shifting is further considered in section four of this report.

3.2.1 Vertical Fiscal Imbalance

Australia's federal financial relations are marked by a high degree of vertical fiscal imbalance (VFI), which refers to the significant mismatch between the large spending responsibilities of the states and local government, but with limited revenue capacity, and the Commonwealth Government's capacity to raise much more revenue than it requires for its own expenditure needs. This is further exacerbated for local government in Victoria by rate capping, which restricts the capacity of local government to raise own source revenue, and cost shifting from the state government.

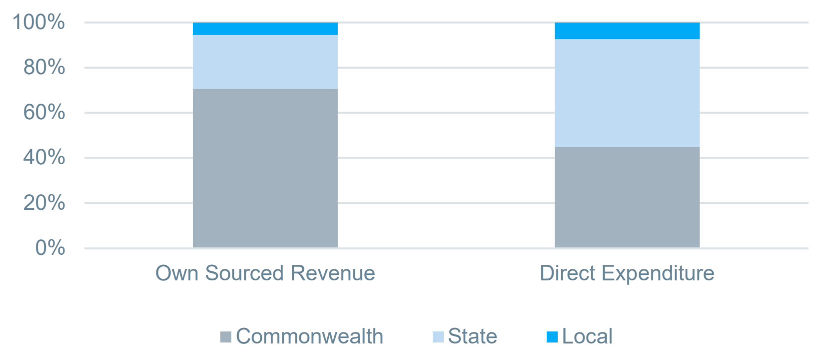
In 2021-22, the Commonwealth Government accounted for around 71% of own-source revenue raised by all levels of government but was responsible for only 45% of government own-purpose spending. State governments accounted for around 24% of own-source revenue, while local government accounted for just 6%. Own-source revenue is revenue excluding grants from other levels of government. Own-purpose spending is spending excluding grants to other levels of government.

The Australian Local Government Association (ALGA) has long advocated that while rates are the only tax available to local government, the Commonwealth Government and states have access to around 125 other taxes (of these, 99 are levied by the Commonwealth Government).

Furthermore, ALGA outlines that around 20% of local government expenditure is spent on maintaining depreciating assets, compared with less than 6% for the states and less than 2% for the Commonwealth Government. It is important that adequate funding is provided by the Commonwealth Government to ensure that councils are allocated a fair share of broad tax revenue for the provision of essential local services and infrastructure.[2]

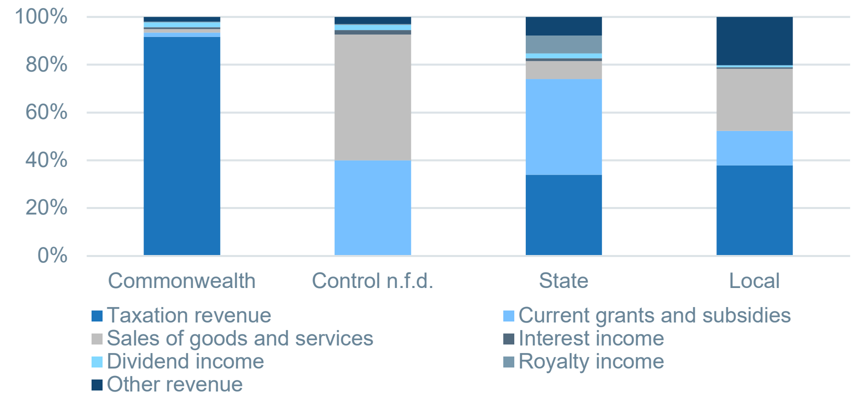
The mismatch of spending responsibilities and revenue-raising capacities between the Commonwealth Government, the states and local government produces a need for large financial transfers between the levels of government to correct the VFI. In 2021-22, the Commonwealth Government's grants to the states totalled $133 billion (equating to just 22% of its total revenue), including grants passed through to local government.

Figure 3.2. Own-source Revenue and Spending by Level of Government – 2021-22



Source – Australian Bureau of Statistics 55120DO001_202122 Government Finance Statistics, Australia, 2021-22

Figure 3.3. All Levels of Government Revenue Sources – 2021-22



Source – Australian Bureau of Statistics 55120DO001_202122 Government Finance Statistics, Australia, 2021-22

Note – Control not further defined (n.f.d) contains units where jurisdiction is shared or unclear e.g. Universities

The extent of VFI has increased since the introduction of the GST in July 2000, as GST payments from the Commonwealth Government have been substituted for revenue formerly raised by the states, such as financial institutions duty, debits tax and revenue replacement payments.

3.2.2 Effect of Vertical Fiscal Imbalance on Local Government

The Council for the Australian Federation (CAF), in its submission to the Commonwealth's Henry Tax Review (Australia's Future Tax System), outlined the following concerns with the effect of vertical fiscal imbalance on State and the local government sector:

- Weakens government accountability to the public by breaking the nexus between a government's decisions on the level of service provision and the

[2] https://alga.com.au/policy-centre/financial-sustainability/current-financial-arrangements/

revenue raised to fund it. For every dollar spent by the states, less than 60 cents is raised directly for those purposes.

- Reduces transparency regarding who is responsible for which government services, allowing governments to avoid responsibility by shifting blame for funding and operational shortfalls to other spheres of government, resulting in public confusion and blame-shifting.
- Creates inefficiencies, including through bureaucratic overlap, duplication and excess and the cost of administering grants between governments.
- Misallocates resources, including the inadequate or inappropriate funding of services and infrastructure.
- Slows the responsiveness of governments to the needs of their communities.

Measures that have been introduced to attempt to improve the fiscal imbalance between the tiers of government include GST distribution, Specific Purpose Payments (SPPs), National Partnership Payments (NPPs) and general revenue assistance. The provision of Financial Assistance Grants by the Commonwealth Government to Local Government – through the States – has been a long standing arrangement, although the funding mechanism has changed over the years.

Local government remains highly vulnerable to changes in the approach from other levels of government to address VFI, best demonstrated by the 2014-15 Federal budget when the Commonwealth Government placed a freeze on the indexation of Financial Assistance Grants for three years. The impact of the freeze has been ongoing, with an accumulated impact of more than $600 million over the three years. Arguably, the biggest impact would have been felt by councils in regional, rural and remote Australia that have the greatest dependency and least capacity to replace the reduced funding with other sources.

ALGA and the individual member local government associations in each jurisdiction have long highlighted that the quantum of Financial Assistance Grants funding is too low for the base and increasing responsibilities of local government, and that the indexation methodology does not sufficiently recognise the true cost pressures on councils.

While both the Commonwealth Government and state taxation revenues increase in line with economic growth, the funding allocated to Financial Assistance Grants for local government grows at a lower rate via the multiplication factor including CPI and population growth. Effectively, the funding made available to local government through Financial Assistance Grants has remained the same on a per capita basis since at least 1995 – in fact, due to the freezing of the indexation for three years, the allocation on a per capita basis will have reduced. Furthermore, as a percentage of total Commonwealth taxation revenue, Financial Assistance Grants have decreased significantly over time.

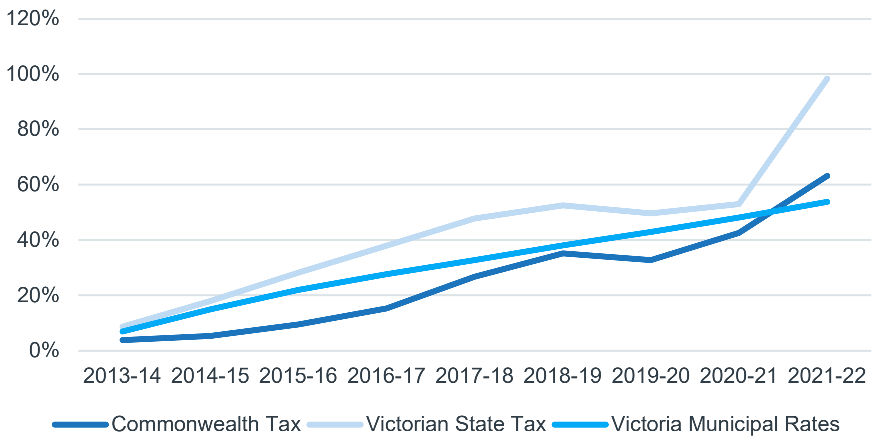
ALGA and the member associations are calling for the Commonwealth Government to:

- Restore Financial Assistance Grants funding to a level equivalent to at least 1% of Commonwealth taxation revenue.
- Ensure the indexation methodology of Financial Assistance Grants reflects the real cost pressures on councils.
- Renegotiate the 2006 IGA to prevent cost-shifting of the Commonwealth Government's and the states' responsibilities onto already resource-constrained councils.
- Thoroughly review the adequacy of the base and indexation methodology of Financial Assistance Grants.

3.3 Comparison of Commonwealth, State and Local Government Taxation Revenue

Of note is that the Commonwealth Government taxation revenue (excluding GST) has increased by 65% over the last 10 years and 31% in the last 5 years, while Victorian Government taxation revenue for the states has increased by 98% over the last 10 years and 34% over the last 5 years. By comparison, local government taxation revenue (municipal rates) has only increased by 54% over the last 10 years and 16% over the last 5 years.

Figure 3.4. Cumulative Increase in Taxation – Commonwealth, State and Local



Source: ABS 55060DO001_202122 Taxation Revenue, Australia, 2021-22

Tables 3.1 and 3.2 highlight the VFI in the revenue earned by each level of government.

Table 3.3 highlights that as a percentage of total Commonwealth tax revenue (excluding GST), the amount of Financial Assistance Grants made available to local government has decreased from 0.76% to 0.57% over the last 10 years.

3.3.1 Horizontal Fiscal Imbalance

The Australian federation also has a horizontal fiscal imbalance, which arises because state and territory Governments, and local governments within the jurisdictions, have different abilities to raise revenue from their tax bases and because the respective costs of providing public services differ.

This imbalance is addressed by a horizontal fiscal equalisation (HFE) policy overseen by the Commonwealth Grants Commission. The impact of HFE is to not give each recipient of grants funding a fixed amount or an amount proportional to the population. Rather, it applies a formula to disburse funds to on a needs-basis and each recipient's ability to raise its own revenue.

Horizontal equalisation is one of the six National Principles for the allocation of the Financial Assistance Grants general purpose grants payable under section 9 of the *Local Government (Financial Assistance) Act 1995. The Local Government (Financial Assistance) Act 1995* defines that the general component of the Financial Assistance Grants will be allocated to councils on a full horizontal equalisation basis.

This is a basis that ensures each council is able to function at a standard not lower than the average standard of other councils. It considers the differences in the expenditure required by those councils to perform their functions and their capacity to raise revenue. Additionally, the amount that a council is allocated cannot be less than 30% of the amount if the state's allocation was distributed on a per capita basis.

The Victorian Local Government Grants Commission (LGGC) has determined a methodology for the allocation of the general purpose grant this is in accordance with the Commonwealth legislation and associated national distribution principles.

For each council, the raw grant is calculated by subtracting the council's standardised revenue from its standardised expenditure. The standardise expenditure is calculated for each council on the basis a council's recurrent expenditure on nine expenditure functions. The nine expenditure functions are: Governance, Family and Community Services, Aged and Disables Services, Recreation and Culture, Waste Management, Traffic and Street Management, Environment, Business and Economic Services, and Local Roads and Bridges.

The expenditure function data is collected for the previous financial year and adjusted using cost adjustors that are designed to reflect differences between councils and allow the commission to take account of the particular characteristics of individual councils which impact on the cost of service provision on a comparable basis.

The twelve cost adjusters used are: aged pensioners, economies of scale, environmental risk, Indigenous population, language, population dispersion, population growth, population less than six years, regional services, remoteness, socio-economic, and tourism.

Table 3.1.Commonwealth Taxation Revenue, 2012 - 2022

Taxation Source	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20	2020-21	2021-22	10-year Increase	5-year Increase
	$m	$m	$m	$m	$m	$m	$m	$m	$m	$m	%	%
Taxation, Commonwealth Government												
Total income taxes levied on individuals	162,642	170,187	183,318	192,054	198,821	212,787	229,749	231,090	237,178	265,655	63%	25%
Total income taxes levied on enterprises	77,691	76,682	73,617	71,289	80,425	97,771	106,895	95,468	113,168	154,734	99%	58%
Total income taxes levied on non-residents	1,464	1,566	1,719	1,831	1,976	1,982	2,099	2,110	1,529	1,637	12%	-17%
Taxes on employers payroll and labour force	646	844	735	670	605	1,107	1,069	1,034	1,683	1,060	64%	-4%
General taxes (sales taxes)	1,149	1,302	1,368	1,503	1,524	1,638	1,682	1,672	2,001	2,096	82%	28%
Goods and services tax (GST)	49,026	53,409	55,553	59,177	61,505	64,062	65,147	64,048	73,297	75,565	54%	18%
Excises and levies												
Crude oil and LPG	17,839	17,767	17,590	17,964	18,428	19,225	19,830	19,392	20,250	18,226	2%	-5%
Other excises	7,871	7,882	6,097	3,660	3,467	3,538	3,659	3,724	4,253	4,336	-45%	23%
Agricultural production taxes	467	481	498	511	543	564	563	469	534	646	38%	15%
Levies on statutory corporations	179	231	209	293	223	233	276	321	334	337	88%	45%
Total excises and levies	**26,356**	**26,360**	**24,394**	**22,428**	**22,661**	**23,561**	**24,326**	**23,906**	**25,371**	**23,545**	**-11%**	**0%**
Taxes on international trade	8,181	9,290	10,896	14,057	14,208	15,690	15,944	19,507	18,123	16,945	107%	8%
Taxes on financial and capital transactions	13	15	15	15	15	15	15	15	15	15	15%	0%
Total taxes on the provision of goods and services	**84,725**	**90,377**	**92,225**	**97,181**	**99,913**	**104,965**	**107,114**	**109,149**	**118,807**	**118,166**	**39%**	**13%**
Taxes on the use of goods and performance of activities	10,170	10,574	3,661	6,289	6,900	8,898	8,922	8,836	8,667	9,384	-8%	5%
Total Taxation on Commonwealth Government	**337,338**	**350,230**	**355,276**	**369,314**	**388,641**	**427,510**	**455,849**	**447,687**	**481,032**	**550,635**	**63%**	**29%**
Total Taxation on Commonwealth Government (Excl GST)	**288,312**	**296,821**	**299,723**	**310,137**	**327,136**	**363,448**	**390,702**	**383,639**	**407,735**	**475,070**	**65%**	**31%**

Source: ABS 55060DO001_202122 Taxation Revenue, Australia, 2021-22

Table 3.2. Victorian State and Local Government Taxation Revenue, 2012 - 2022

Taxation Source	2012-13 $m	2013-14 $m	2014-15 $m	2015-16 $m	2016-17 $m	2017-18 $m	2018-19 $m	2019-20 $m	2020-21 $m	2021-22 $m	10Yr Increase %	5Yr Increase %
Taxation, Victorian State and Local Government												
Taxes on employers payroll and labour force	4,751	4,949	5,135	5,365	5,689	5,964	6,280	5,803	6,274	7,063	49%	18%
Land taxes	1,589	1,659	1,753	1,771	2,501	2,586	3,509	3,447	3,234	4,135	160%	60%
Municipal rates	3,890	4,162	4,468	4,746	4,967	5,165	5,368	5,560	5,760	5,985	54%	16%
Other taxes on property	223	865	852	936	962	1,003	954	1,029	1,015	1,090	389%	9%
Excises and levies	69	112	112	112	112	112	157	157	173	173	151%	54%
Total taxes on gambling	1,745	1,672	1,781	1,834	1,798	1,851	2,007	1,711	1,603	2,023	16%	9%
Total taxes on insurance	1,628	1,067	1,088	1,151	1,218	1,299	1,373	1,484	1,540	1,724	6%	33%
Total taxes on financial and capital transactions	3,436	4,380	5,174	6,155	6,484	7,344	6,439	6,539	6,775	10,874	216%	48%
Total motor vehicle taxes	1,811	1,896	2,117	2,235	2,371	2,479	2,554	2,670	2,686	2,967	64%	20%
Franchise taxes	23	23	23	22	23	24	24	0	4	26	13%	8%
Other taxes on use of goods and performance of activities	354	371	403	450	409	427	532	535	598	935	164%	119%
Total Taxation Victoria State and Local Government	**19,519**	**21,156**	**22,906**	**24,777**	**26,534**	**28,254**	**29,197**	**28,935**	**29,662**	**36,995**	**90%**	**31%**
Total Taxation Victoria State (excluding municipal rates)	**15,629**	**16,994**	**18,438**	**20,031**	**21,567**	**23,089**	**23,829**	**23,375**	**23,902**	**31,010**	**98%**	**34%**

Source: ABS 55060DO001_202122 Taxation Revenue, Australia, 2021-22

Table 3.3. Comparison of Commonwealth Taxation Revenue and Financial Assistance Grant Funding, , 2012 - 2022

Taxation Source	2012-13 $m	2013-14 $m	2014-15 $m	2015-16 $m	2016-17 $m	2017-18 $m	2018-19 $m	2019-20 $m	2020-21 $m	2021-22 $m	10Yr Increase %	5Yr Increase %
Total Taxation on Commonwealth Government (Excl GST)	288,312	296,821	299,723	310,137	327,136	363,448	390,702	383,639	407,735	475,070	65%	31%
Financial Assistance Grant funding (national)	2,203	2,288	2,288	2,289	2,289	2,369	2,457	2,517	2,555	2,696	22%	14%
Percentage of Total Commonwealth Taxation (excl GST)	**0.76%**	**0.77%**	**0.76%**	**0.74%**	**0.70%**	**0.65%**	**0.63%**	**0.66%**	**0.63%**	**0.57%**		

Source: ABS 55060DO001_202122 Taxation Revenue, Australia, 2021-22, AEC Analysis of Financial Assistance Grants

The standardised revenue includes both rates revenue and fees and charges revenue. The standardised rate revenue is calculated by multiplying a council's three-year average valuation base by the three-year average rate per capita across all Victorian councils. The standardised fees and charges for each of the nine functional areas is collected and various revenue adjustors are applied to take account of the differences between councils in their capacity to generate fees and charges due to their unique characteristics.

The LGGC then considers the minimum grant requirements of the Commonwealth legislation to ensure councils receive at least 30% of the per capita average for the general purpose grant pool for Victorian councils.

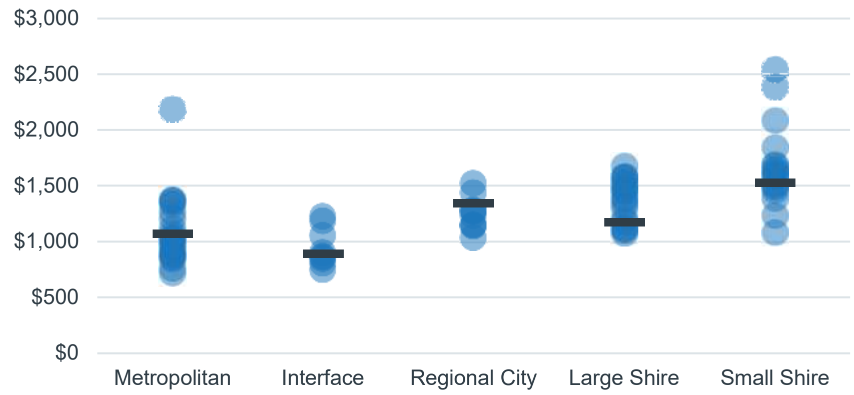
FinPro's view is that the horizontal equalisation methodology applied by the Victorian LGGC is effective and results in a fair outcome for most councils.

3.4 Rate Capping

The *Local Government Act 1989* (Victoria) states that the Minister for Local Government may set the rate cap that specifies the maximum that councils can increase rates for the forthcoming financial year. The actual increase in the average rates differs significantly across the sector, with the range of the average rate from the highest being $2,534 to the lowest at $1,276.

Figure 3.5 below shows the total rates can charges per capita in 2022-23 financial year for all Victorian councils, by sector. While as a percentage of total revenue the impact of rate capping will impact metropolitan, interface and regional city councils the highest, rate capping has the most impact on the increases of an individual rate assessment for ratepayers in small shire councils.

Figure 3.5. Total Rates and Charges - per capita – 2022-23



Source – VAGO Report on 2022-23 Audits – data set provided

The Minister is required under the legislation to request and have regard to any advice received for the purposes of setting the average rate cap from ESC. Each year, the average rate cap recommended by ESC must be based on the forecast change in the CPI over the rating year to which the cap relates, plus or minus any adjustment.

ESC's current practice is to use the forecast CPI for Melbourne, as determined by the Department of Treasury and Finance (DTF) in its budget update in December each year and consider if any adjustments are necessary. The factors that are reviewed when considering adjustments in the recommendation should include the financial sustainability of the sector, changes in council costs, expectations of future wage rises and recent economic forecasts.

It is FinPro's view that ESC has not adequately considered the financial sustainability of the sector since the introduction of the Fair Go Rating System, and while ESC has acknowledged the rate cap has recently been set below the actual increased cost base for local government, it has failed to advise the Minister that an adjustment is necessary to protect the sustainability of local government. FinPro is also concerned that the analysis undertaken by LGV of 2023-24 council adopted budgets has influenced the advice of ESC, when the assessment provided by FinPro of the same data indicates a deterioration in the financial sustainability of local government.

In a 2022 published report (The Sustainability Gap – The Financial Health of Victorian Councils), the Municipal Associated of Victoria (MAV) and FinPro jointly raised the following concerns with the Victorian rate cap system:

- Since the introduction of the rate cap, the November/December forecasts (and thus the rate cap) have varied from actual CPI figures by an average of 1.44%, representing a change in council rate bases in the order of $100 million.
- CPI is not a good indicator of the costs faced by councils. The largest single expense area for councils is employees, followed by depreciation (cost of asset consumption). While often criticised, this reflects retaining key services in-house rather than outsourcing, something strongly supported by local communities. Neither wages nor civil construction costs are accurately reflected by CPI.
- The current methodology results in a rate cap which does not accurately reflect council expenses and the longer this continues, the greater the problem becomes, as the erosion of the rate base becomes a compounding problem. Cumulatively, over the first four years of rate capping, the gap between the cost base increase and the rate cap was 4.0% for the sector, and larger for interface councils and small rural councils of 11.1% and 9.0%, respectively.
- A year-by-year rate cap also diminishes the ability of councils to manage their rate base over time. If a council increases their rate base by less than the cap in one year, they will not necessarily be able to recoup that over time, without a rate cap variation. This can lead to a growing, permanent gap between lower and higher rating councils.

In the ESC advice on the rate cap for 2024-25, ESC noted that due to the rate capping framework being forward-looking, differences between the rate cap and actual inflation should be expected, however, the differences for 2021-22 and 2022-23 were larger than in previous years, with the Melbourne CPI at 4% in 2021-22 and 7% in 2022-23 versus the 1.5% and 1.75% rate caps for the respective financial years. ESC has also calculated local government cost indices adopted in other jurisdictions (represented in Table 3.2 and Figure 3.4), along with the actual CPI for Melbourne and the forecast CPI and WPI during the time period.

In summary, ESC states that:

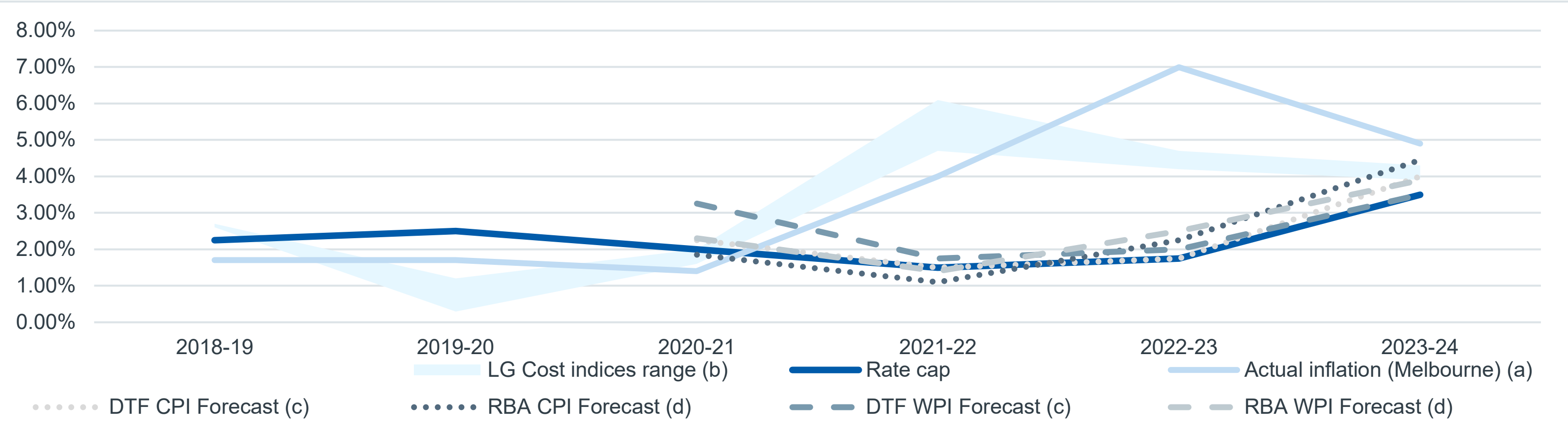
> *In our view, the gap between the rate cap and inflation, rising construction costs, and the expectation of future wage increases have the potential to present major cost pressures on councils going forward.*

Table 3.4. Rate Cap, CPI, Cost Indices and Forecasts (%) (report extract)

Measure	2018-19	2019-20	2020-21	2021-22	2022-23	2023-24	2024-25	2025-26
Rate Cap	2.25	2.5	2.0	1.5	1.75	3.5	2.75[f]	TBD
CPI Melbourne (a)	1.7	1.7	1.4	4.0	7.0	4.9	-	-
Cost Indices (b)	2.6 to 2.7	0.3 to 1.2	1.6 to 2.0	4.7 to 6.1	4.2 to 4.7	3.9 to 4.3	-	-
DTF CPI Forecast (c)			2.25	1.5	1.75	4.0	2.75	2.5
RBA CPI Forecast (d)			1.85	1.1	2.25	4.45	3.4	2.9
DTF WPI Forecast (c)			3.25	1.75	2.0	3.5	3.5	3.25
RBA WPI Forecast (d)			2.3	1.4	2.5	3.9	3.7	2.9

Source: Essential Services Commission – The Outcomes of Rate Capping
(a) ABS as of September 2023
(b) Recalculated Local Government cost indices from New South Wales, South Australia and Tasmania
(c) Melbourne CPI and WPI Victoria sourced from Department of Treasury and Finance Budget Update
(d) Australia CPI and WPI sources from RBA Forecast Tables – Statement on Monetary Policy
(e) Rate Cap for 2024-25 has been determined at 2.75 in line with the DTF CPI forecast without adjustment
(f) In the ESC report, the 2024-25 was “TBD” – now that the Minister has approved the rate cap for 2024-25 AEC has updated this in the table.

Figure 3.6. Rate Cap, CPI, Cost Indices and Forecasts



Source: Essential Services Commission – The Outcomes of Rate Capping
(a) ABS as at September 2023
(b) Recalculated Local Government cost indices from New South Wales, South Australia and Tasmania
(c) Melbourne CPI and WPI Victoria sourced from Department of Treasury and Finance Budget Update
(d) Australia CPI and WPI sources from RBA Forecast Tables – Statement on Monetary Policy

3.5 Overview of Rate Capping in NSW

The Independent Pricing and Regulatory Tribunal of NSW (IPART) reviews NSW council rates and charges and sets the maximum increase a council can apply to their general rate income. In 2023, IPART released a report into a review of the rate peg methodology with submissions from NSW councils identifying the following concerns with the rate peg methodology:

- The local government cost index (LGCI) needs to be changed so that it better reflects the actual costs of local government.
- There was significant volatility in the rate peg associated with the lag between when the change in the LGCI is measured and when councils apply the resulting rate peg to their rates income.
- Differences in the cost bases across individual councils and/or council types.
- The methodology failing to reflect actual council labour costs, including the need to compete with private and public sector employers to attract and retain staff.
- The population factor needs to better reflect changes in councils' base costs associated with population growth.
- Changes in costs due to external factors outside of councils' control, such as the Emergency Services Levy contribution, managing the risks of climate change and natural disasters, and cyber security threats.

The review resulted in changes to the methodology for setting the rate peg, with the new methodology for calculating the 2024-25 rate peg having four elements:

- Base Cost Change
- Population Factor
- Productivity Factor, and
- Emergency Services Levy Factor.

In recent years, the local government sector has raised concerns about how the annual change to councils' cost base was measured. There was up to a two-year lag between the indices used and the when the rate peg was applied. IPART will now measure the annual base cost change for three groups of councils to better account for the diversity of the base costs: metropolitan, regional and rural.

Furthermore, the new methodology will be forward-looking rather than the historical LGCI approach and comprise of three elements: employee costs, asset costs and other operating costs. Employee costs will be measured by the Local Government State Award increases and superannuation guarantee increases. Asset costs will be measured by the Reserve Bank of Australia's (RBA) forecast change in the CPI adjusted to reflect the change in the PPI for Road and Bridge Construction. Other operating costs will be measured from the RBA's forecast change in CPI.

The population factor maintains the amount of rates collected per person in areas that have a growing population. The population factor was introduced in 2022-23 as the additional income from supplementary valuations did not keep pace with population growth. The new methodology continues to add a population factor acknowledging the need to maintain rates collected per person in areas with growing populations.

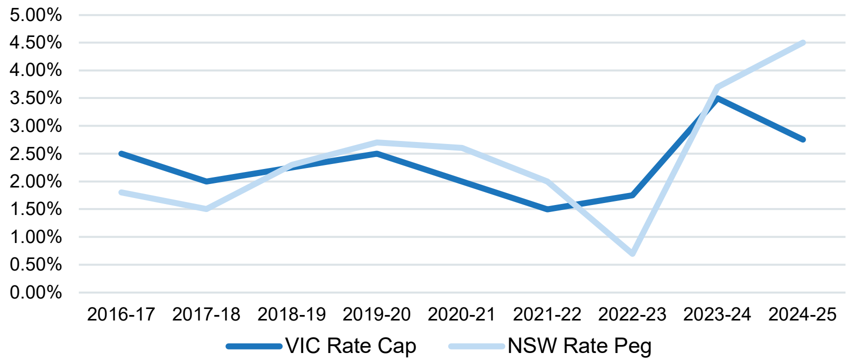
The productivity factor was incorporated to reflect the year-on-year productivity gains that could be expected of councils as service delivery becomes more efficient over time. Since 2018-19, the productivity factor has been set at zero as a default as improvements in productivity are already reflected in the price indexes used. This default remains at zero unless there is evidence to depart from this approach.

NSW councils are required to pay a contribution towards of the cost of emergency services and this cost can increase by more than the traditional rate peg. The emergency services levy factor is council specific to enable councils to recover this additional cost through rates rather than reducing service costs in other areas.

3.6 Comparing the Victorian Rate Cap and New South Wales Rate Peg

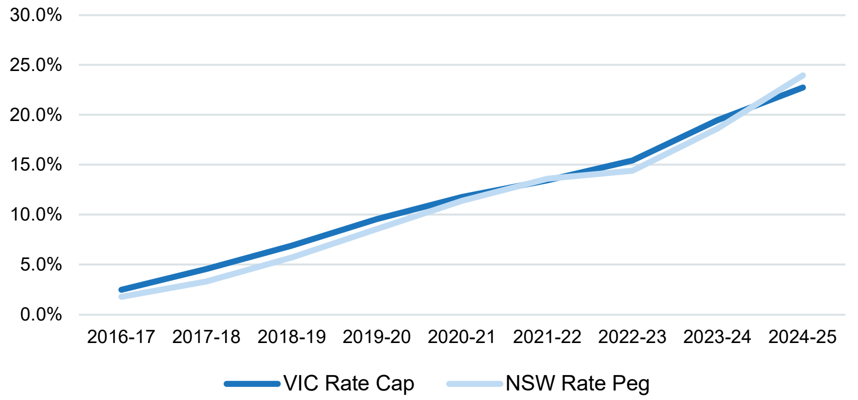
The following figures compare the annual rate caps and pegs set in Victoria and New South Wales since 2016-17. There is a significant difference in the rate caps and pegs in some years, most noticeably in the latest restriction set for the 2024-25 financial year with 4.5% set in NSW and 2.75% set in Victoria. Applied across the total rate revenue base for Victorian councils, this difference equates to over $138 million.

Figure 3.7. Annual Rate Cap / Peg Increases for Victoria and New South Wales



Source: Essential Services Commission (website) and C and IPART NSW (website)

Figure 3.8. Cumulative Rate Cap / Peg Increases for Victoria and New South Wales



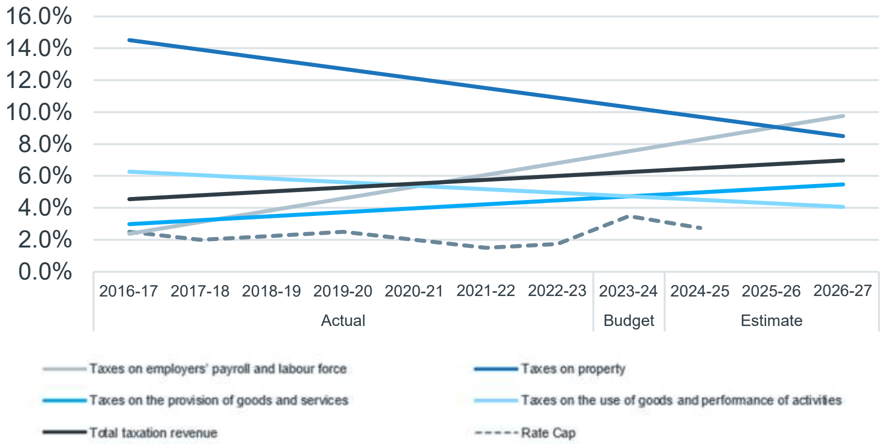
Source: Essential Services Commission (website) and IPART NSW (website)

3.7 Comparing the Victorian Rate Cap and Victorian Government Tax Revenue Increases

One of the objectives of the rate cap was to put downward pressure on rate increases as council rates are a significant contributor to the cost of living (as confirmed by the Local Government Rate Capping Mechanism Review in December 2021). However, the Victorian Government has not been consistent with applying the same downward pressure on the taxation revenue itself collects.

Victorian Government taxes have increased significantly more than the capacity afforded to local government to increase rating revenue. The total taxation revenue received by the Victorian Government has increased annually by 6.2% from 2015-16 to 2022-23, adjusted for population growth. In comparison, the rate cap increased an average of 2.1% annually over the same time period. Figure 3.8 illustrates trendlines for the various taxation streams (adjusted for growth) and the rate cap. Most notable is the rising increase in payroll tax revenue.

Figure 3.9. Annual Victorian Tax Revenue increase trendline (adjusted for growth) and Annual Rate Cap Increase



Source: Department of Treasury and Finance (website) Essential Services Commission (website)

3.8 Comparing Victorian Higher Rate Cap Applications and New South Wales Special Rate Variations

ESC and LGV have referred to the ability for local government to apply for a higher rate cap as a suitable mechanism to protect the financial sustainability of councils that require a larger increase in rate revenue. Councils in NSW have a similar application process where a council can apply to IPART for a rate increase higher than the set rate peg. Observations can be made and learnings taken for the Victorian sector from the NSW experience.

FinPro is of the view that the Fair Go Rating System in Victoria needs to learn from the impact rate pegging has had in NSW, which has seen a deterioration in the financial sustainability of local government. This is evidenced by the high number of councils applying for a special variation and the significant quantum of increases approved – resulting in large rate shocks to local communities. The same outcome is highly likely to occur in Victoria due to the current Fair Go Rating System.

Recent approved special variations for councils in NSW include cumulative rate increased in excess of a 65% increase in the general rate. This is a situation that can be avoided in Victoria by correcting the impact the Fair Go Rating System is having on local government in Victoria.

Tables 3.5 and 3.6 compares the number of approved higher rate increases (including applications covering multiple years) and the average higher rate increases approved for Victoria and NSW. Please note that the NSW figures exclude the additional special variations in 2022-23.

Table 3.5. Number of approved higher rate increases

	2016-17	2017-18	2018-19	2019-20	2020-21	2021-22	2022-23	2023-24
Victoria	6	4	4	4	3	0	0	0
% of Councils	7.6%	5.1%	5.1%	5.1%	3.8%	0.0%	0.0%	0.0%
NSW	13	11	18	24	12	12	11	23
% of Councils	10.2%	8.6%	14.1%	18.8%	9.4%	9.4%	8.6%	18.0%

Source: Essential Services Commission (website) and IPART NSW (website)

Table 3.6. Average approved higher rate increases

	2016-17	2017-18	2018-19	2019-20	2020-21	2021-22	2022-23	2023-24
Victoria	4.1%	4.1%	3.8%	6.9%	4.5%	0.0%	0.0%	0.0%
NSW	6.0%	5.9%	7.3%	7.1%	7.5%	8.3%	9.3%	16.3%

Source: Essential Services Commission (website) and IPART NSW (website)

3.9 Local Government Cost Index

The current method for setting the rate cap in Victoria relies upon the Melbourne CPI, which ESC has stated does not reflect the cost factors of local government. ESC has also stated that the historical gap between the rate cap applied based on the forecast of the Melbourne CPI and the actual increase in costs has potential to present major cost pressures on councils going forward.

FinPro's view is that there is a need to introduce a Local government Cost Index for the setting of the Victorian rate cap, similar to the outcome of the recent review in NSW of the rate pegging system. The following analysis completed by FinPro uses a Victorian version of the revised NSW methodology to calculate the base cost change. Please note that the Victorian calculation does not include a population factor and is just the base cost calculation. The calculation is based on three elements: employee costs, asset costs and other operating costs. The following steps are proposed to calculate the index.

Step One – Build a data set of the total employee costs, depreciation (asset costs) and other operating costs by council for historical financial years

Step Two – Calculate cost index weightings for each council cohort being the proportion of total operating costs for three cost components (employee costs, depreciation and other operating costs for each council) and use the average cost over past three financial years to avoid the impact of annual anomalies.

Step Three – For each relevant year, identify the Cost Price Index (CPI), Wages Price Index (WPI) and Road and Bridge Construction Index (RBCI).

Step Four – Calculate the three-factor cost index for each council cohort by applying the cost index weighting to CPI, WPI and BCI, respectively.

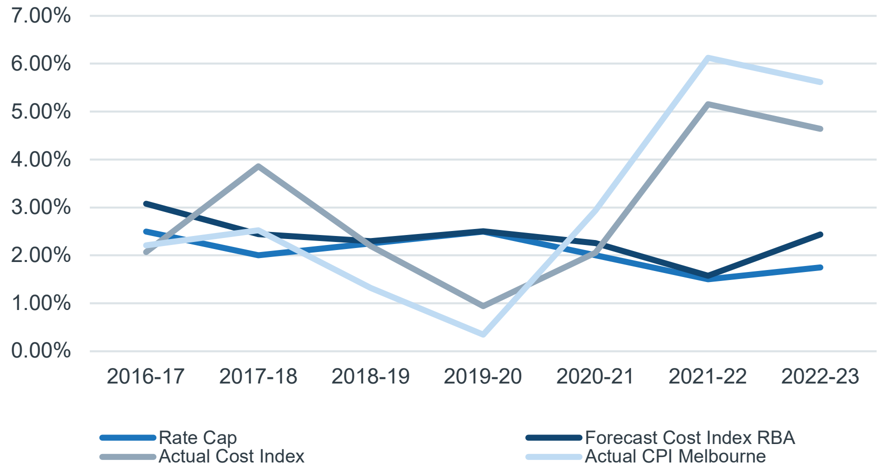
The calculation illustrated below uses:

- Employee costs measured by the wage price index (WPI) for Victoria and superannuation guarantee increases.
- Asset costs measured by the CPI for Melbourne adjusted to reflect the change in the PPI for Road and Bridge Construction.
- All other operating costs measured by the CPI for Melbourne.

Figure 3.9 compares the calculated local government cost index (Actual Cost Index) for local government in Victoria compared to the Melbourne CPI and the rate cap for each historical year. While the Melbourne CPI is higher than the Actual Cost Index for local government in recent years – during which household living costs have increased significantly – the calculated local government cost index is higher in previous financial years. The financial years prior to COVID are likely to be more representative of cost escalation in future years, and therefore a local government cost index, as suggested by FinPro, would more accurately reflect the cost base of local government compared to Melbourne CPI.

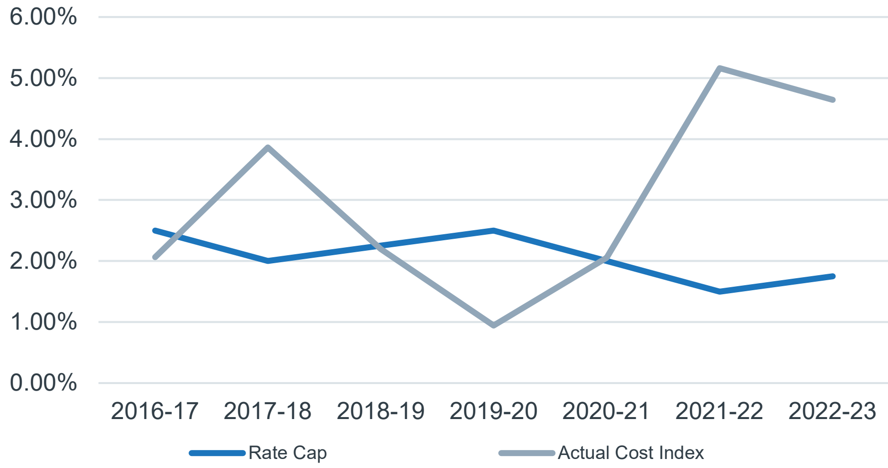
The cumulative impact is outlined in Figure 3.9. Since 2016/17 (start of the Fair Go Rating System) the rate cap has resulted in a cumulative increase of 15.43%, while the local government cost index (Actual Cost Index) has increased by 22.93%.

Figure 3.10. Annual Cost Indices



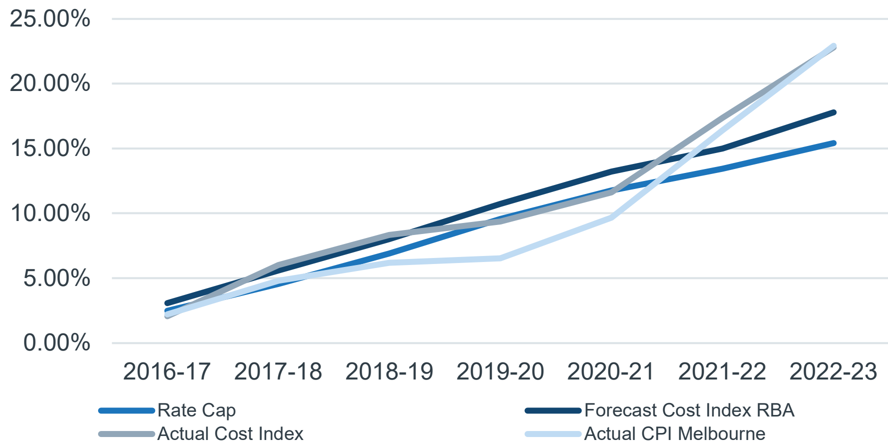
Source: ABS (website), Essential Services Commission (website), RBA (website)

Figure 3.11 Rate Cap Compared to Actual Cost Index



Source: ABS (website), Essential Services Commission (website

Figure 3.12. Cumulative Cost Indices



Source: ABS (website), Essential Services Commission (website), RBA (website)

3.10 Grant Funding

3.10.1 Operating Grants

3.10.1.1 Commonwealth Funded Programs

The largest source of operating grants for councils is from the Commonwealth Government through the Financial Assistance Grants program under the *Local Government (Financial Assistance) Act 1995*. The Financial Assistance Grant program consists of two components:

- A general purpose grant component distributed between States and Territories according to population.
- A local road grant component distributed between States and Territories according to fixed historical shares.

Local Government grants commissions in each state recommend the distribution of the funding under the Financial Assistance Grant program to each council in accordance with the *Local Government (Financial Assistance) Act 1995* and the National Principles for allocating grants, including horizontal fiscal equalisation.

The amount of the grant pool changes annually based on a multiplication factor calculated from changes in population and CPI. In 2014-15, 2015-16 and 2016-17, the Commonwealth Government did not apply the multiplication factor to the Financial Assistance Grant pool and therefore did not index payments. This was referred to the "freeze" of the grants and resulted in significant ongoing lost revenue for councils.

The funding model, based on CPI and population growth, was legislated in 1995 (although the distribution by population was established before the 1995 legislation) and is designed to avoid a reduction in the funding (adjusted for inflation) to local government on a per capita basis. However, the reality is all tiers of government have increasing responsibilities, with significant economic growth and community demand for better services. While the revenue base of other levels of government has grown in real terms through economic growth (e.g. PAYG tax, GST tax, company tax, property taxes, etc.), local government is the only tier of government that has not received a real growth in the funding through Financial Assistance Grants.

Table 3.3 illustrates the allocation of the Victorian Financial Assistance Grants as a percentage of total grants allocated to the state for each council cohort.

Table 3.7. 2023-24 Financial Assistance Grant Allocations by Council Cohort

	General Purpose	Local Roads	General Purpose Per Capita	Local Roads Per Capita
Metropolitan	19%	12%	$33.44	$7.89
Interface	23%	14%	$73.19	$16.13
Regional City	21%	16%	$141.92	$39.90
Large Shire	24%	35%	$223.03	$117.97
Small Shire	14%	22%	$409.56	$238.97

Source: Department of Infrastructure, Transport, Regional Development, Communications and Arts, VAGO

The Victorian LGGC prepares recommendations to the Commonwealth Government for the allocation of the general purpose grants based on an assessment of relative needs, considering population, number of dwellings, valuations, socio-economic disadvantage, population growth, population dispersion, regional significance and tourism. The Victorian LGGC also recommends the allocation of local roads grant based on the relative needs in maintaining their local roads, considering road length, traffic volumes, climate, freight and sub-grades.

3.10.1.2 State Funded Programs

There are a range of state grant programs that fund operational costs of local government.

Some are considered as recurrent in nature, with the largest program for Victorian councils being to assist in funding maternal and child health services provided through local government. Other funding considered recurrent is provided for family and children services, libraries, emergency management, school crossing supervisors and youth services.

Later in this submission, many of the recurrent grant programs are identified by councils as being a cause of cost shifting, with reduced contributions provided by the Victorian Government for the ongoing provision of the services that are essentially a state responsibility.

Other non-recurrent grant funding provided for operational costs are mostly for time limited projects, such as disaster recovery, arts and culture events, community safety projects, recreation services and business support. Often funding from the State Government for non-recurrent purposes is a co-contribution, requiring local government to fund significant portions of the projects/programs.

3.10.2 Capital Grants

Of total operating and capital revenue in 2022-23 council budgets, 1.3% is expected in capital grants. The contribution of capital grants ranges from 0.4% of total revenue for metropolitan councils to 5.2% of total revenue for small shire councils.

Grants received by councils for capital are generally competitive and not recurrent in nature (Roads to Recovery is the exception, and while being considered recurrent in nature, changes to funding are made by the Commonwealth Government). The availability of capital grants to councils is vulnerable to changes in government, government priorities and the financial position of other levels of government

The major capital grants that councils in Victoria receive are listed below.

3.10.2.1 Commonwealth Grant Programs

- Roads to Recovery (RTR):
    - Program supporting the construction and maintenance of the nation's local road infrastructure assets.
    - Ongoing program operating on a five-year funding period, providing some stability and predictability in the source of funding.
    - There is flexibility built into the program, with councils able to decide on the roads projects that deliver on local priorities throughout the funding period.
    - Distribution of funding to each council is determined according to a formula based on the Local Roads Component of the Financial Assistance Grants.
    - From 1 July 2024, a new five-year funding period will commence with increased funding as announced by the Commonwealth Government in November 2023.
    - Available funding will increase until $1 billion is available per year under this ongoing program.
- Local Roads and Community Infrastructure (LRCI):
    - The Commonwealth Government has committed $3.25 billion to the LRCI Program over four phases
    - Every local government is allocated and able to nominate projects for LRCI Program funding.
    - Phase Four funding ($750 million) is available from July 2023 (to be completed by 30 June 2025) and included an additional $250 million targeted to improve rural, regional and outer urban roads.
    - There is no ongoing commitment to this program outside of the current funding round.
- Growing Regions Program:
    - $600 million committed over three years from 2023-24.
    - The Growing Regions Program provides grants of between $500,000 and $15 million to Local Government entities and not-for-profit organisations for capital works projects that deliver community and economic infrastructure projects across regional and rural Australia.
- Bridges Renewal Program (BRP):
    - Has been providing at least $85 million per year to fund the upgrade and replacement of bridges to enhance access for local communities and facilitate higher productivity vehicle access,
    - The existing BRP and the Heavy Vehicle Safety and Productivity Program (HVSPP) will be merged into a single application-based ongoing funding stream for Local Governments – the Safer Local Roads and Infrastructure Program,
    - Funding is to increase gradually so that $200 million will be available per year (from the current $150 million).

3.10.2.2 State Grant Programs

The Victorian Government provides a wide range of grant programs that local government can apply and compete for, often in competition with other not-for-profit organisations.

Given their competitive nature, there is little certainty to councils in receiving state grants. Most grant programs have a limit to the maximum funding provided and requires local government to provide a co-contribution to the project – the percentage of the co-contribution can vary depending on the type of council applying for the grant. With deteriorating unrestricted cash for local government, councils will be more limited in capacity to provide a co-contribution and therefore unable to apply for the grants upon which they have historically depended.

It is also common for councils to invest significantly in the application process, which often require substantial resourcing to prepare a business case with no certainty of receiving the funding. Awarded grants will often not fund administrative costs incurred in managing the grant and the necessary substantial acquittal required at the end of the project.

3.11 Statutory Fees and Fines and User Fees

While statutory fees, fines and other user fees account for 10.2% of total adjusted underlying revenue for local government in Victoria, the extent of their contribution to total adjusted underlying revenue differs markedly across council cohorts. Regional city councils receive 13% of revenue through user fees, fines and charges, while small shire councils only receive 6% of revenue. Different council cohorts have different capacities to generate revenue from services provided.

Statutory fees and fines are set by the State Government and are not set in consideration of individual council costs to deliver the services. Councils do not share the same cost of providing the same service, a factor that contributes to horizontal fiscal imbalance.

Statutory fees and fines represent a smaller portion of total adjusted underlying revenue at 4.7%, with restrictions on fees and fines impacting the metropolitan and interface councils the most (6% and 4% of total adjusted underlying revenue, respectively).

4. Delivery of Core Service Objectives

While the Committee will be considering whether local councils are adequately delivering on their core service delivery objectives, FinPro does not intend to provide a comprehensive response to the Committee's consideration of whether councils are delivering on core services. Rather, FinPro has focused on relevant matters that specifically relate to the financial sustainability of the local government sector, in particular matters that integrate with other discussion points raised in this report.

4.1 The Problem of Defining Core Services

A constraint in preparing the following response is the problem of defining what services are "core" for the local government sector. Past reviews have defined core services as those that all, or a majority of, councils provide. However, as the following sections outline, the relative investment in services differs across the different cohorts of councils, and even within each council cohort.

Furthermore, each council makes decisions on the range and levels of services provided, partly informed by the demand from the community, but also informed by the financial sustainability of the council and whether there is market or government failure in the provision of essential services to their local communities.

The financial sustainability of services, with particular reference to the impact of rate capping and cost shifting, is the main consideration that FinPro has outlined below.

4.2 Local Government Act 2020 (the Act)

While the Act and associated regulations define the obligations and powers of local government authorities, there is no clear definition of what constitutes core services. The Act aims to ensure that local government continues to be constituted as a democratically elected tier of government in Victoria and has the functions and powers necessary to enable councils to perform their role. The Act replaced the previous approach to prescribing how councils must operate to a more principles-based approach.

The Act also required a new planning and reporting framework – Integrated Strategic Planning and Reporting Framework – which requires councils to prepare a 10-Year Financial Plan, 4-Year Budget, Asset Plan, Revenue and Rating Plan and a Workforce Plan. The current Local Government Performance Reporting Framework (LGPRF) is a mandatory system of performance reporting for all Victorian councils, made up of 59 measures from a range of service areas, including roads, planning, animal management and waste.

The role of local government in Victoria, as outlined in Division 1 of the Act, is to provide good governance in its municipal district for the benefit and wellbeing of the municipal community. The Act does not define the role any further than that. In performing this role, a council may perform any duties or functions or exercise any powers conferred on a council by the Act or any other piece of legislation. A council may perform any other function that it determines necessary to enable it to perform the role, subject to any limitations or restrictions imposed under the Act or any other piece of legislation.

While the Act does not define service obligations, there are a wide range of responsibilities or obligations outlined in over 120 pieces of Victorian legislation. Other services typically provided by local government, but not provided by a majority, include maternal and child health, immunisations, home assistance and respite care, homecare needs and events.

In addition to providing services, councils are also responsible for maintaining community infrastructure, such as roads and transport infrastructure, land and improvements, buildings, community and recreational facilities (including parks and gardens) and stormwater drainage. With depreciation an indicator of the consumption of assets and with depreciation being between 35-45% of local government costs, maintaining infrastructure is a core function of local government that needs to be adequately funded.

A deteriorating asset base will result in increased future costs as the frequency of maintenance increases and the cost of eventual intervention to renew the asset base increases. If local government is not funded adequately to complete cyclical preventative maintenance on assets or to renew asset components when needed, logically local government will not be financially sustainable over the medium to long term.

Councils also have extensive roles as regulators, with examples provided below. The role of local government as a regulator has increased over time as a consequence of cost shifting, as well as mandated increased roles and responsibilities for local government through changes to legislation and other increased regulatory requirements.

Table 4.1. Various Regulatory Roles of Local Government

Regulatory role	Example
Enforcing local laws	Creation and enforcement of local laws under the *Local Government Act 2020*
Enforcing or administering State legislation	Enforcing nuisance provisions under the *Public Health and Wellbeing Act 2008*
Acting under delegated powers	Enforcement of requirements for septic tanks delegated from the EPA under the *Environment Protection Act 2017*

Source: MAV – Local Government in Victoria

4.3 Local Government Grants Commission Data on Expenditure by Function, 2021-22

To define a service that may be considered by the Committee Inquiry as a core service, FinPro analysed the Victorian LGGC data on expenditure by service for 2021-22. LGGC defines council services by 60 individual functions categorised into ten functional categories (refer to the Victorian LGGC Questionnaire Manual for definitions of the functional categories and functions). Figure 4.1 outlines the relative cost of the ten functional categories.

While cost is not the sole determinant of importance, it does inform the cost burden that local government is required to manage, including the impact of rising costs on the capacity to continue to deliver services at the desired level of service.

Across all councils, the governance functional category has the highest proportion of expenditure (20.4%) and includes the functions of council operations, public order and safety, financial and fiscal affairs, natural disaster relief, general operation and general administration. This is followed by recreation and culture, business and economic services, and local roads and bridges.

Of the 60 individual functions, local roads and bridges works is allocated the highest spend on average, followed by residential general waste, general administration and parks and reserves.

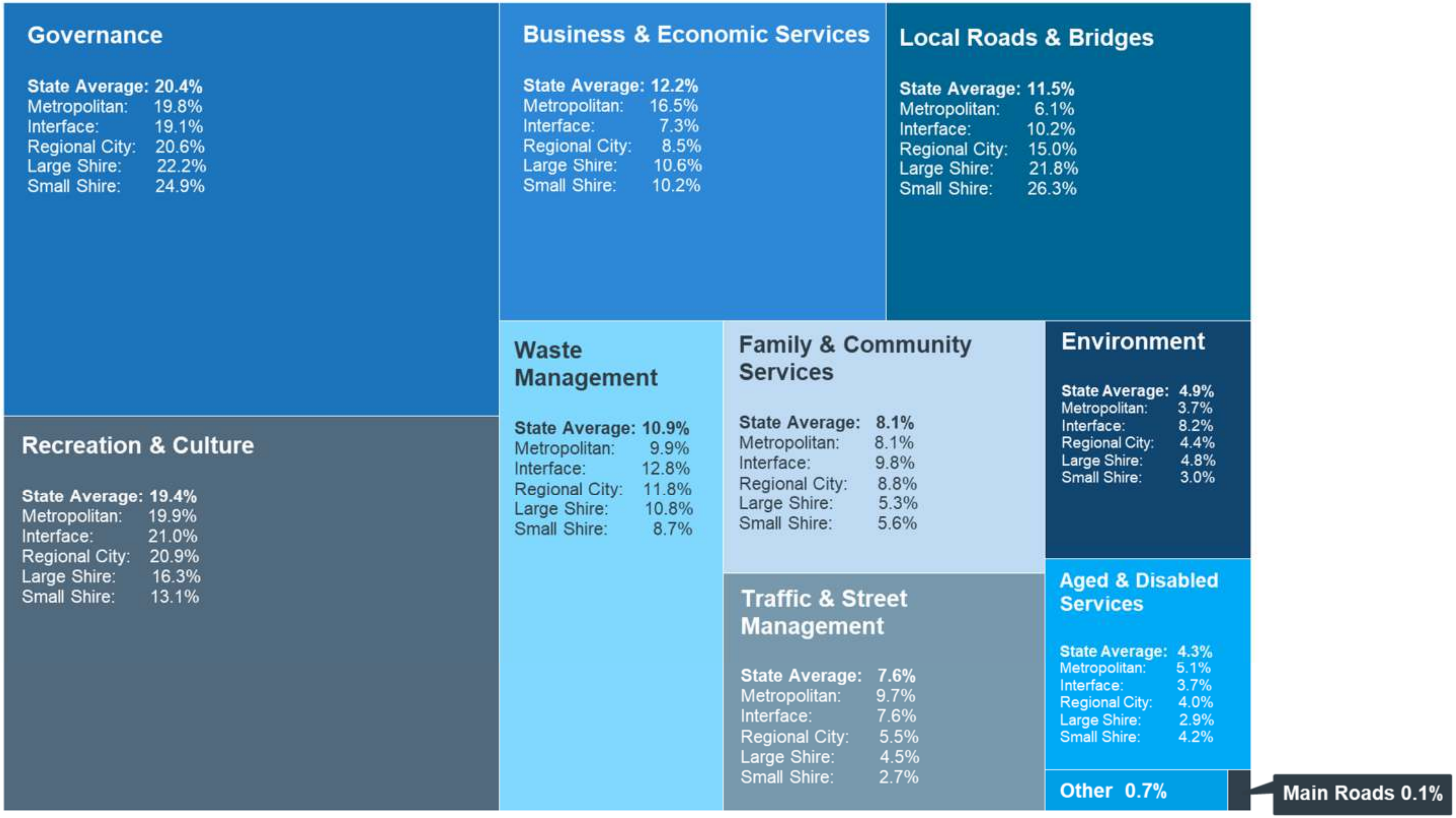
If local government is not adequately funded for the actual increase in cost of providing and maintaining roads and bridges, it can be expected that the level of services of all other services will be impacted given the little discretion it has over the large investment required in roads and bridges. It should also be noted that it is highly likely that across the sector, insufficient investment is being made to maintain roads and bridges although this cannot be reported on due to the lack of reporting on local government assets in Victoria.

Table 4.2 illustrates the top ten functions provided across Victoria and by each cohort. There are significant variances in the relative importance of each function across cohorts, with the top five functions across the state compared in the figures on the following pages.

4.4 Impact of Cost Shifting on Core Services

As raised later in this report, cost shifting is having an impact on the capacity of local government to remain financially sustainable and to continue to provide the levels of service desired by the community. This is particularly the case with the restrictions of rate capping, providing local government with no capacity to fund the services shifted onto local government.

Figure 4.1. Percentage of Expenditure by Functional Category Across Local Government – 2021-22 (cohort breakdowns shown for comparison)



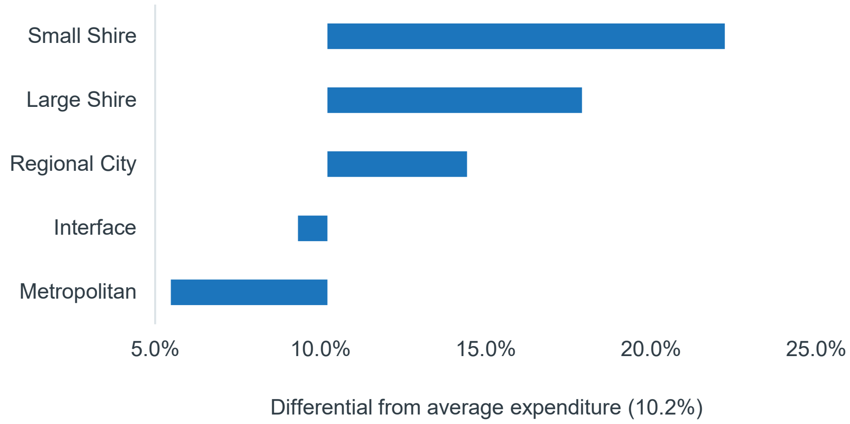
Source: Victorian LGGC – Questionnaire 2021-22 response from councils

Table 4.2. Top Ten Functions Provided by Expenditure, 2021-22

State-Wide		
Local Roads & Bridges Works	10.22%	$1,051,043,982
Residential General Waste	7.23%	$743,365,114
General Administration	6.70%	$689,047,134
Parks & Reserves	6.00%	$616,967,569
Sports Grounds & Facilities	5.49%	$564,865,855
General Operations	5.04%	$518,732,730
Community Development & Planning	4.40%	$452,259,779
Financial & Fiscal Affairs	4.05%	$416,811,064
Community Care Services	3.54%	$363,929,484
Business Undertakings (Property)	3.18%	$326,781,056
Metropolitan		
General Administration	6.86%	$315,474,840
Business Undertakings (Property)	6.72%	$308,824,072
Parks & Reserves	6.56%	$301,633,245
Residential General Waste	6.36%	$292,056,790
Local Roads & Bridges Works	5.47%	$251,558,813
Community Development & Planning	5.46%	$251,030,443
Sports Grounds & Facilities	5.35%	$246,033,889
General Operations	5.02%	$230,467,321
Financial & Fiscal Affairs	4.15%	$190,644,684
Community Care Services	3.92%	$180,243,705
Interface		
Local Roads & Bridges Works	9.32%	$209,038,702
Residential General Waste	8.18%	$183,474,449
Parks & Reserves	7.60%	$170,404,739
Sports Grounds & Facilities	5.69%	$127,479,010
General Administration	5.51%	$123,584,961
General Operations	4.57%	$102,382,131
Community Development & Planning	4.03%	$90,416,368
Financial & Fiscal Affairs	4.03%	$90,347,072
Residential Recycled Waste	3.88%	$87,018,139
Drainage	3.46%	$77,670,021
Regional City		
Local Roads & Bridges Works	14.44%	$217,775,615
General Administration	8.92%	$134,568,500
Residential General Waste	7.72%	$116,383,705
Sports Grounds & Facilities	6.75%	$101,824,399
General Operations	4.85%	$73,113,185
Parks & Reserves	4.41%	$66,557,089
Community Care Services	3.75%	$56,538,089
Families & Children	2.93%	$44,250,870
Community Development & Planning	2.92%	$43,961,637
Financial & Fiscal Affairs	2.82%	$42,497,219
Large Shire		
Local Roads & Bridges Works	17.91%	$244,938,264
Residential General Waste	8.31%	$113,572,714
General Administration	6.38%	$87,270,384
General Operations	5.64%	$77,150,389
Sports Grounds & Facilities	4.73%	$64,712,133
Parks & Reserves	4.15%	$56,806,459
Financial & Fiscal Affairs	4.15%	$56,751,764
Local Roads & Bridges Administration	3.86%	$52,764,029
Community Development & Planning	3.65%	$49,844,489
Community Care Services	2.39%	$32,654,679
Small Shire		
Local Roads & Bridges Works	22.24%	$127,732,588
Residential General Waste	6.59%	$37,877,455
Financial & Fiscal Affairs	6.37%	$36,570,325
General Operations	6.20%	$35,619,704
General Administration	4.90%	$28,148,450
Sports Grounds & Facilities	4.32%	$24,816,424
Local Roads & Bridges Administration	4.05%	$23,262,242
Parks & Reserves	3.75%	$21,566,037
Council Operations	3.59%	$20,614,954
Community Care Services	3.39%	$19,492,845

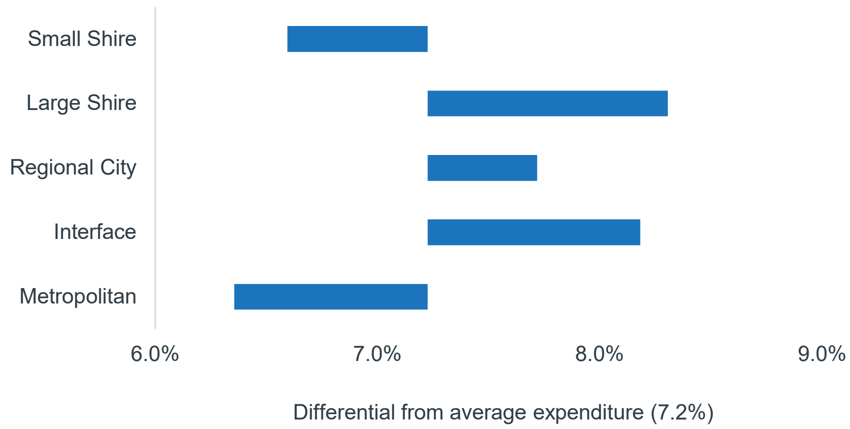
Source: Victorian LGGC Data Collection 2021-22

Figure 4.2. Local Road & Bridge Works Differential from Average Expenditure, 2021-22



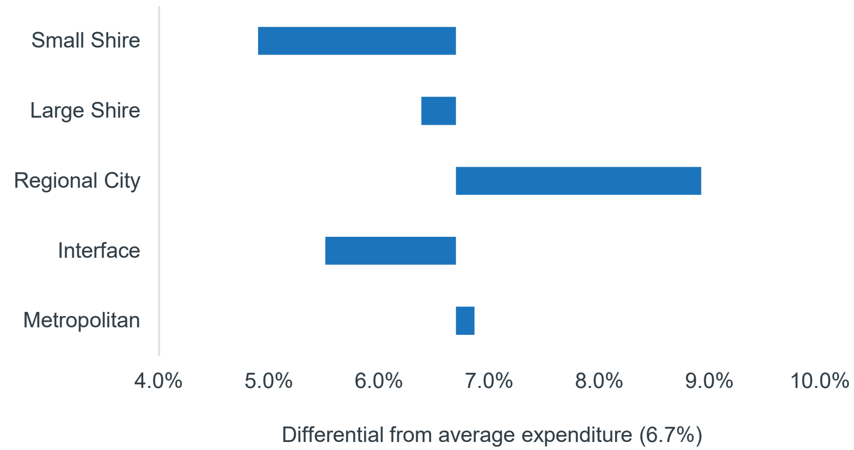
Source: Victorian LGGC Data Collection 2021-22

Figure 4.3. Residential General Waste Differential from Average Expenditure, 2021-22



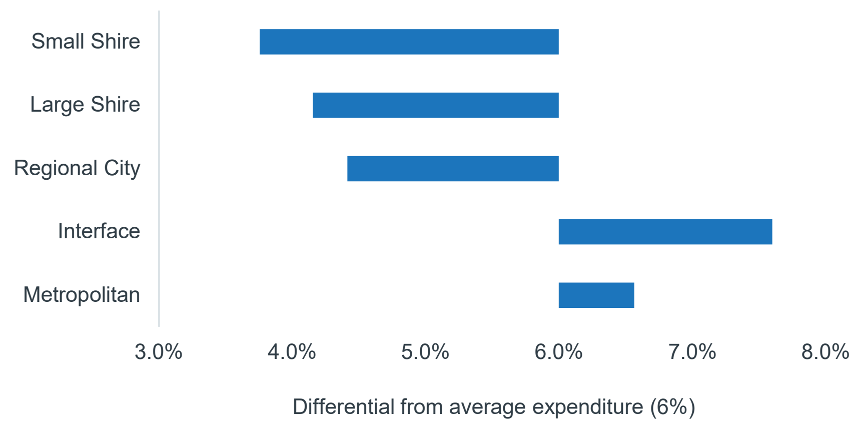
Source: Victorian LGGC Data Collection 2021-22

Figure 4.4. General Administration Differential from Average Expenditure, 2021-22



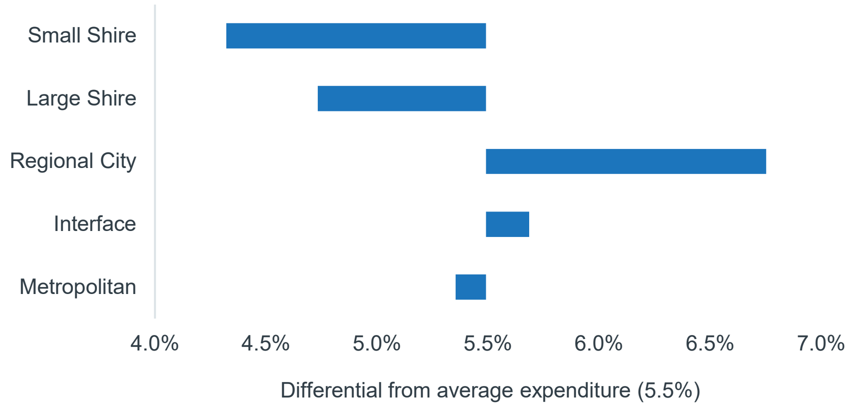
Source: Victorian LGGC Data Collection 2021-22

Figure 4.5. Parks & Reserves Differential from Average Expenditure, 2021-22



Source: Victorian LGGC Data Collection 2021-22

Figure 4.6. Sports Grounds & Facilities Differential from Average Expenditure – 2021-22



Source: Victorian LGGC

5. Cost Shifting

5.1 Defining Cost Shifting

Local government is responsible for a wide range of economic, social, environmental and infrastructure services, usually provided to maintain or improve the liveability (or social capital) for their communities. The increase in the range of services necessarily provided by local government is broadly accepted as impacting upon the financial sustainability of the local government sector.

A further challenge impacting the sustainability of the local government sector is the impact of state legislation amendments and cost to local government to comply with the legislation.

A concern that ALGA has advocated with the Commonwealth Government is the significant impact that cost-shifting has had and is having on the financial sustainability of local government, which is threatening councils' ability to continue to provide essential services that enable the liveability of local communities.

Local governments are often the service provider of 'last resort' in communities where higher levels of government and the private sector have not provided adequate services, or where there is a failure from other parties to provide essential services within the community. This includes services or other costs transferred to local government from other levels of government without the necessary funding (or powers to raise general revenue) to fund the services or costs incurred.

In many cases, the social objective to provide such services is not discretionary and the responsibility to provide services has been forced upon local government through cost shifting from other levels of government.

The House of Representatives Committee Inquiry into Local Government and Cost Shifting in 2003 acknowledged that cost shifting has long been recognised as a significant contributor impacting the sustainability of local government. However, establishing a widely agreed definition for cost shifting has been difficult.

The Committee's Inquiry in 2003 provided five major areas of cost shifting:

1. The withdrawal or reduction of financial support once a program is established, therefore leaving local government with the choice of continuing a program or suffering the political odium of cancelling the service;
2. The transfer of assets without appropriate funding support;
3. The requirement to provide concessions and rebates without compensation payments;
4. Increased regulatory and compliance requirements; and
5. Failure to provide for indexation of fees and charges for services prescribed under state legislation or regulation.

Examples of cost shifting raised by local government have in the past been considered by other levels of government as "cost sharing" arrangements, such as in the instance where other levels of government fund the establishment of infrastructure or a service with the intention that the local government would take responsibility for ongoing operations and maintenance.

The term "cost sharing" is also often used by other levels of government to counter the claims of cost shifting, implying that the council has the ability to make decisions regarding discretionary services and to fund in part or in full through generating rate revenue to subsidise (or fund in full) the service. However, the discretion of the council to decide not to provide a service (whether a community service obligation or created by cost shifting) will often either impact on the liveability of the community or the capacity of the community to pay for the service.

Following a period of focus during 2000 to 2013, including an Australian House of Representatives Inquiry in 2003 and a tripartite intergovernmental agreement in 2006, there has been little to no research completed on the impact of cost shifting on local government in Victoria.

In a submission to the Australian House of Representatives Inquiry in 2003, MAV estimated the cost shift in Victoria to be $40 million per year for the recurrent funding of three major specific purpose programs: Home and Community Care (HACC) services, libraries and Maternal and Child Health, with a further $20 million estimated to be the cost shift on a range of other specific programs.

Individual councils also provided their own submission to the Parliamentary Inquiry including:

- City of Great Geelong – estimated annual cost shift of $20.8 million

- Moonee Valley City Council – estimated annual cost shift of $10.2 million
- City of Casey – estimated annual cost shift of $14.8 million.

Examples of cost shifting to Victorian councils highlighted in literature include:

- Libraries
- School crossing supervision
- Maternal and child health
- Early years infrastructure
- Building services
- Urban planning
- State infrastructure projects
- Environmental protection.

5.2 Intergovernmental Agreement (2006)

The national Inter-Governmental Agreement Establishing Principles Guiding Inter-Governmental Relations on Local Government Matters (IGA) was signed by the federal Minister for Local Government, State and Territory Ministers for Local Government and the President of the ALGA on behalf of all state and territory local Government associations in April 2006.

The Parties agreed in principle that where local government is asked or required other levels of government to provide a service or function to the people of Australia, any consequential financial impact is to be considered within the context of the capacity of local government.

5.3 2014 Victorian State-Local Government Agreement

In response to the IGA, a Victorian State-Local Government Agreement (VSLGA) was established to build collaborative working relationships between state and local government. The VSLGA was most recently revised and agreed to by the parties in 2014: https://www.localgovernment.vic.gov.au/our-partnerships/victorian-state-local-government-agreement

It is clear that the Agreement has not been fully implemented and is not currently being followed by the Victorian Government, in all circumstances.

The agreement was intended to apply to arrangements where the State:

- Intends for local government to administer or enforce new or revised primary legislation or regulation, or function as an agent and deliver services on its behalf
- Is, or intends to, partner with local government to deliver programs
- Is, or intends to, fund local government to deliver a program
- May be affected by the relationship between the Commonwealth Government and local government

It was agreed that the implementation would result in the following outcome (amongst a longer list):

- Where the Victorian Government intends for local government to administer or enforce new primary legislation, or new or revised regulation, the relevant lead department shall, subject to exceptional circumstances, consult with local government in accordance with the Victorian Guide to Regulation. In doing so, the relevant department shall consider the impacts of the regulation on local governments, including any cost and resource impacts on local governments of administering the regulation.
- The Victorian Government commits to consultation other than in exceptional circumstances with local government on any material change to funding agreements that impact on local government. It recognises the importance of the resources available to, and the capability of local government, to effectively administer and enforce state regulation.
- The introduction and application of a new Cabinet process to assess local government impacts of policy, as appropriate, to ensure consistent consideration and appropriate processes for consultation with local government on issues that may impact on local government.
- Continue to streamline state regulatory and reporting requirements on local government.

The Victorian Government agreed to monitor the implementation of the agreement and to evaluate its performance on a regular basis, including:

- Annually maintain and review a register of working committees and plans required to be developed by councils for each Portfolio.
- The Minister for Local Government will seek six-monthly written feedback from MAV, Victorian Local Governance Association and Local Government Professionals Inc. regarding successes and failures of parties to work in accordance with the agreement.
- The Minister for Local Government to meet individually with MAV, Victorian Local Governance Association and Local Government Professionals Inc on a quarterly basis regarding successes and failures of parties to work in accordance with the agreement.
- The Minister for Local Government writing annually to Cabinet colleagues reminding them of their obligation to adhere to the VSLGA.

6. Recommendations

Recommendations

The following recommendations are made for the sector to work collaboratively with the State Government to implement:

6 That LGV engages with the sector and establishes a risk-based assessment framework for financial sustainability of local government, including criteria set for different council cohorts, to assist both the state government, Councillors and local governments officers to take action to manage risks to sustainability.

7 That ESC be required to calculate and have regard in advice provided to the Minister to a local government cost index for the Victorian local government when considering advice to the minister on setting the rate cap each year.

8 That ESC be required to consider adjustments to correct historically set rate caps that were insufficient to meet the indexation of local government costs.

9 That LGV engages with the sector and establishes a more detailed report on assets, similar to the required schedule Report on Infrastructure Assets for NSW councils, to ensure transparency in reporting of assets and the capacity of councils to fund the necessary maintenance and capital investments.

10 That the Minister Local Government, LGV and local government peak bodies reengage with a model like the Victorian State-Local Government Agreement established in 2014, which seeks to enable consultation, co-design, and a fair balance of cost apportioning to achieve the best outcomes across policy domains. Recent engagement has not adhered to the responsibilities or intent of the agreement, and in some cases had significant costs shifted to local government.

The following recommendations and specific notifications for the Committee to consider:

11 That the Committee notes the FinPro analysis of the financial position of local government which is in contrast to other assessments outlined in this report that local government is in a sound financial position.

12 That the Committee notes the analysis provided by FinPro that a majority of councils have a deteriorating underlying adjusted deficit, deteriorating unrestricted cash and investing insufficient cash to asset renewals, resulting in an increased risk to financial sustainability of the local government sector.

13 That the Committee notes the combination of a deteriorating financial position and cost shifting is impacting on the capacity of local government sector to deliver core services That the Committee notes that the vertical fiscal imbalance that exists results in the local government sector being vulnerable to policy settings of other levels of government, including the allocation of grant funding, which is exacerbated in Victoria by the further restriction placed on local government by the Victorian Government through the rate capping system.

14 That the Committee notes there is a significant difference in the rate cap calculated for Victorian councils compared to NSW councils for 2024/25. The rate peg set for NSW councils will be 4.5%, while the rate cap set for Victorian councils will be 2.75%. Applied across the total rate revenue base for Victorian councils, the difference equates to over $138 million in lost rate revenue for local government in Victoria. FinPro requests the Committee to recommend to the Minister for Local Government to seek the development of a Local Government Cost Index, for use in the annual rate cap calculation.

15 That the Committee notes the administrative and in particular the political challenges faced by councils seeking a higher rate cap under the Fair Go Rate System and the likely outcome that Victorian communities will experience significant rate shocks in future years when significant rate increases will be required.

16 That the Committee notes that, unlike the Commonwealth and Victorian governments, the revenue base of local government does not grow in line with economic growth, due to the impact of rate capping and the Financial Assistance Grant funding model – due to rates and operating grants contributing 80% of revenue in the local government sector. This means while the Commonwealth and Victorian Governments can respond to demands for higher living standards as the economy grows (e.g., additional funding for better health services and better education), the local government sector is significantly constrained to meet the demand of the community for higher living standards.

17 That the Committee notes that, between 2011/12 and 2021/22, Commonwealth Government taxation revenue (excluding GST) increased by 65% (or 31% in the five years to 2021/22) and Victorian Government taxation revenue increased by 98% (or 34% in the five years to 2021/22) yet Victorian local government taxation revenue (municipal rates) only increased by 54% (or 16% in the five years to 2021/22).

18 That the Committee notes that as a percentage of total Commonwealth Government taxation revenue (excluding GST), the amount of Financial Assistance Grants made available to local government decreased from 0.76% to 0.57% from 2011/12 to 2021/22.

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Appendix A: Cohort of Victorian Local Councils

Metropolitan – 22 Councils
Populations: 93,482 to 209,568
Area: 20-130 km^2

Banyule City Council
Bayside City Council
Boroondara City Council
Brimbank City Council
Darebin City Council
Frankston City Council
Len Eira City Council
Greater Dandenong City Council
Hobsons Bay City Council
Kingston City Council
Knox City Council
Manningham City Council
Maribyrnong City Council
Maroondah City Council
Melbourne City Council
Monash City Council
Moonee Valley City Council
Moreland City Council
Port Phillip City Council
Stonnington City Council
Whitehorse City Council
Yarra City Council

Interface – 9 Councils
Populations: 65,099 to 353,962
Area: 409-2,468 km^2

Cardinia Shire Council
Casey City Council
Hume City Council
Melton City Council
Mornington Peninsula Shire Council
Nillumbik Shire Council
Whittlesea City Council
Wyndham City Council
Yarra Ranges Shire Council

Regional City – 10 Councils
Population: 19,920 to 258,938
Area: 121-22,082 km^2

Ballarat City Council
Greater Bendigo City Council
Greater Geelong City Council
Greater Shepparton City Council
Horsham Rural City Council
Latrobe City Council
Mildura Rural City Council
Wangaratta Rural City Council
Warrnambool City Council
Wodonga City Council

Large Shire – 19 Councils
Populations: 16,017 to 53,394
Area: 866-20,940 km^2

Bass Coast Shire Council
Baw Baw Shire Council
Campaspe Shire Council
Colac-Otway Shire Council
Corangamite Shire Council
East Gippsland Shire Council
Glenelg Shire Council
Golden Plains Shire Council
Macedon Ranges Shire Council
Mitchell Shire Council
Moira Shire Council
Moorabool Shire Council
Mount Alexander Shire Council
Moyne Shire Council
South Gippsland Shire Council
Southern Grampians Shire Council
Surf Coast Shire Council
Swan Hill Rural City Council
Wellington Shire Council

Small Shire – 19 Councils
Populations: 2,939 to 16,699
Area: 2,939-16,699 km^2

Alpine Shire Council
Ararat Shire Council
Benalla Shire Council
Buloke Shire Council
Central Goldfields Shire Council
Gannawarra Shire Council
Hepburn Shire Council
Hindmarsh Shire Council
Indigo Shire Council
Loddon Shire Council
Mansfield Shire Council
Murrindindi Shire Council
Northern Grampians Shire Council
Pyrenees Shire Council
Borough of Queenscliffe
Srathbogie Shire Council
Towong Shire Council
West Wimmera Shire Council
Yarriambiack Shire Council

Appendix B: 2023-24 Victorian Financial Assistance Grants Allocation

Council	General Purpose	Local Roads	Total
Alpine Shire	3,480,429	1,399,982	4,880,411
Ararat Rural City Council	4,717,720	3,035,760	7,753,480
Ballarat City Council	14,856,223	3,250,675	18,106,898
Banyule City Council	3,307,668	1,223,652	4,531,320
Bass Coast Shire Council	6,926,155	1,882,423	8,808,578
Baw Baw Shire Council	8,877,956	3,722,978	12,600,934
Bayside City Council	2,655,433	662,580	3,318,013
Benalla Rural City Council	3,566,141	1,893,545	5,459,686
Borough of Queenscliffe	394,281	75,932	470,213
Brimbank City Council	13,981,995	2,246,573	16,228,568
Buloke Shire Council	5,046,644	3,228,011	8,274,655
Campaspe Shire Council	9,966,644	5,198,752	15,165,396
Cardinia Shire Council	12,228,022	3,430,786	15,658,808
Casey City Council	24,436,118	3,677,566	28,113,684
Central Goldfields Shire Council	3,686,653	1,635,514	5,322,167
City of Boroondara	4,407,531	1,190,348	5,597,879
City of Darebin	3,916,972	1,147,421	5,064,393
City of Glen Eira	3,939,794	836,606	4,776,400
City of Greater Dandenong	11,471,172	2,032,186	13,503,358
City of Greater Geelong	23,310,977	4,691,104	28,002,081
City of Knox	7,502,153	1,495,782	8,997,935
City of Maribyrnong	2,484,507	769,819	3,254,326
City of Port Phillip	2,705,462	548,139	3,253,601
City of Whittlesea	15,817,454	3,095,251	18,912,705
Colac Otway Shire	5,398,439	3,397,012	8,795,451
Corangamite Shire Council	5,505,824	4,501,517	10,007,341
East Gippsland Shire Council	14,409,300	6,068,027	20,477,327
Frankston City Council	8,976,552	1,430,559	10,407,111
Gannawarra Shire Council	4,539,463	2,573,841	7,113,304
Glenelg Shire Council	6,487,312	4,451,046	10,938,358
Golden Plains Shire Council	4,880,577	2,755,674	7,636,251

Council	General Purpose	Local Roads	Total
Greater Bendigo City Council	17,653,038	4,550,281	22,203,319
Greater Shepparton City Council	12,958,865	4,059,786	17,018,651
Hepburn Shire Council	4,337,074	1,998,805	6,335,879
Hindmarsh Shire Council	3,535,855	1,878,452	5,414,307
Hobsons Bay City Council	2,387,374	956,496	3,343,870
Horsham Rural City Council	5,111,202	2,835,648	7,946,850
Hume City Council	18,106,350	3,558,683	21,665,033
Indigo Shire Council	4,098,709	2,181,799	6,280,508
Kingston City Council	4,158,168	1,358,043	5,516,211
Latrobe City Council	12,844,141	3,330,706	16,174,847
Loddon Shire Council	6,512,198	4,713,190	11,225,388
Macedon Ranges Shire Council	6,945,179	2,839,783	9,784,962
Manningham City Council	3,282,792	1,093,396	4,376,188
Mansfield Shire Council	2,861,722	1,197,154	4,058,876
Maroondah City Council	4,598,439	1,008,154	5,606,593
Melbourne City Council	4,161,185	931,861	5,093,046
Melton City Council	21,178,896	3,324,014	24,502,910
Mildura Rural City Council	14,124,247	5,382,852	19,507,099
Mitchell Shire Council	8,295,450	2,626,213	10,921,663
Moira Shire Council	9,043,517	5,012,463	14,055,980
Monash City Council	5,060,426	1,583,517	6,643,943
Moonee Valley City Council	3,200,275	909,846	4,110,121
Moorabool Shire Council	6,228,891	2,549,160	8,778,051
Merri-bek City Council	4,542,859	1,201,202	5,744,061
Mornington Peninsula Shire Council	4,404,167	3,216,195	7,620,362
Mount Alexander Shire Council	4,295,318	2,306,067	6,601,385
Murrindindi Shire Council	3,862,710	2,122,109	5,984,819
Nillumbik Shire Council	2,178,001	1,497,243	3,675,244
Northern Grampians Shire Council	6,010,283	3,734,442	9,744,725
Pyrenees Shire Council	4,224,225	2,746,365	6,970,590
Shire of Moyne	5,559,460	5,355,081	10,914,541

Council	General Purpose	Local Roads	Total
Shire of Strathbogie	4,146,824	2,843,375	6,990,199
Shire of Towong	3,830,687	2,308,688	6,139,375
South Gippsland Shire Council	7,808,987	4,804,815	12,613,802
Southern Grampians Shire Council	5,546,148	3,963,721	9,509,869
Stonnington City Council	2,769,483	581,072	3,350,555
Surf Coast Shire	3,616,215	2,116,696	5,732,911
Swan Hill Rural City Council	6,037,715	2,941,089	8,978,804
Wangaratta Rural City Council	6,269,134	3,120,211	9,389,345
Warrnambool City Council	4,579,805	851,025	5,430,830
Wellington Shire Council	11,647,764	6,224,808	17,872,572
West Wimmera Shire Council	4,401,863	3,003,067	7,404,930
Whitehorse City Council	4,479,272	1,377,755	5,857,027
Wodonga City Council	6,141,272	1,056,455	7,197,727
Wyndham City Council	22,228,882	3,484,611	25,713,493
Yarra City Council	2,400,334	518,066	2,918,400
Yarra Ranges Shire Council	13,370,622	4,245,419	17,616,041
Yarriambiack Shire Council	4,292,434	2,676,562	6,968,996
Totals	**573,210,028**	**205,725,502**	**778,935,530**

Source: Department of Infrastructure, Transport, Regional Development, Communications and the Arts

Appendix C: Literature Review

KPMG (2017) – Rural and Regional Councils Sustainability Reform Program – Stage 1 Project Report

Local Government Victoria (LGV) engaged KPMG to explore the current and emerging barriers to financial and organisational sustainability experienced by rural and regional councils, to understand the impact of the identified barriers, and to develop a suite of reform options to address sustainability barriers and support the long-term financial sustainability of rural and regional councils.

The barriers and challenges identified by KPMG as limiting the ability of rural and regional councils to be sustainable over the long term were:

- Financial pressures and constraints – limited capacity to increase own source revenue, limited community capacity to pay increased rates, fees or charges, increasing expectations of service delivery, and increased cost bases.
- Relatively higher infrastructure and service delivery costs – regional and rural councils face relatively higher unit costs in maintaining assets and the delivery of some services, with large council areas, large road networks and dispersed populations.
- Capability constraints and operational capacity issues – regional and rural councils face challenges in attracting and retaining skilled, professional and knowledgeable staff.

KMPG noted that the functions of Local Government have broadened over time, with an increasing role for Local Government in the delivery of social functions – such as the management of health and community safety – as well as a regulatory role in areas of development and planning, public health and environmental management. The drivers were found to be increased community expectations, increased complexity or standard of service delivery, devolution of responsibilities for select functions, and filling gaps in service provision as the “provider of last resort” left by other levels of government. Regional and rural councils spent a greater proportion of budgets on core services, leaving less for other functions.

Core services were defined as the seven services that all councils performed (measured by reported expenditure) and included community welfare services (youth/welfare administration), community health, libraries, community development and planning, parks maintenance, residential waste management and local road and bridge works. Other services that were not considered core, but most councils reported expenditure against, included sports and recreation facilities, building control/inspections, street lighting, community care, environmental protection, drainage services, education (preschools and adult learning) and traffic control.

KPMG identified that the growth in expenditure was outpacing the growth in available revenue for some key functions delivered by regional and rural councils including maternal and child health, public libraries, Home and Community Care (HACC), emergency services and school crossing supervisors. It should be noted that this assessment was completed prior to the introduction of rate capping in Victoria and therefore the impact is likely to have increased due to limitations on ability of local government to increase revenue. In terms of capital expenditure, KPMG noted that smaller councils focused on asset renewals, with comparatively less expenditure on new asset spending.

Following the report, the Victorian Government committed $20 million in 2018-19 to the Rural Councils Transformation Program with the following aims to improve financial sustainability:

- Achieving economies of scale through regional service delivery or collaborative procurement
- Promoting more efficient and improved service delivery through collaboration and innovation
- Facilitating benefits for rural and regional communities, prioritising rural communities
- Demonstrating potential efficiencies to be gained through regional service delivery.

The $20 million in funding was released in two rounds – June 2019 and May 2022 – noting COVID and competing internal priorities impacted delivery of the first round.

In September 2022, LGV initiated the development of the RCTP2 IT Implementation Strategy for Shared Services. In November 2023, the Rural and Regional IT Strategic Implementation Framework for Shared Services was released by LGV.

Inquiry into the Sustainability and Operational Challenges of Victoria's Rural and Regional Councils (2018) – Parliament of Victoria

The Environment, Natural Resources and Regional Development Committee tabled the inquiry report in 2018, which identified the challenges specific to regional councils and potential changes that should be explored.

The first initiative was the development of a new funding model to improve the fairness and equity of rates, reporting on the financial and social impact of rates on the community and reducing a council's dependence on rates by increasing the Financial Assistance Grant and other State grants for rural councils.

The second initiative was to review the responsibilities of councils to determine what services and infrastructure are currently managed and which level of government would be best suited to manage them and the development of a clear set of core responsibilities and minimum service levels for core responsibilities. The continuation and expansion of the efforts to facilitate councils finding efficiencies and establishing shared services was also recommended.

The Committee recommended that councils needed to:

- Better manage community expectations
- Continue to communicate the level of subsidy provided by councils for services
- Communicate to the community what is core and what is discretionary expenditure.

Essential Services Commission (2023) – The Outcomes of Rate Capping

Essential Services Commission (ESC) is required to report every two years on the outcomes of the rate capping system. The objective is to promote the purposes of the rate capping framework – to promote the long-term interests of ratepayers and the community in relation to sustainable outcomes in the delivery of services and critical infrastructure and to ensure councils have the financial capacity to perform their duties and functions.

ESC concludes that the financial health of Local Government in Victoria remains sound, noting that as a whole, Local Governments had a positive operating position and the ability to meet short-term and long-term liabilities. ESC also noted that results for individual councils varied, with some having stronger performances than others.

In the six years of rate capping, ESC reported that annual real growth in revenue from rates on a per property basis was negative – 0.4% per year on average in inflation-adjusted terms or a decrease of $7 per year.

ESC noted that in 2021-22, growth in revenue from capped rates per property decreased by 2% (reflecting the difference between the rate cap (based on forecast) and actual inflation), with the decline expected to continue for 2022-23 due to the 1.75% rate cap being significantly below actual inflation for the financial year.

ESC noted that rate debtors (overdue rates) for each council group have grown over the six years of rate capping.

On average, total revenue has grown by 2% per year on average, compared to 3.2% annual growth in the three years prior to introduction of rate capping – noting the decline in 2019-20 was impacted by the COVID pandemic. Total revenue per person for Local Government continued to grow, but at a slower rate over the six years of rate capping. Revenue per person grew by 0.6% per year since rate capping compared to 1.1% pr year in the three years before rate capping.

Expenditure per person increased for all council groups since rate capping, with the groups experiencing lower population growth (i.e., metropolitan and small shire councils) having higher expenditure per person growth. All council groups experienced growth in operating expenditure per person while most councils also increased capital expenditure per person. ESC noted, however, that growth in expenditure outcomes varied significantly between individual councils within each council group.

Increased capital spending was found to have increased the asset renewal ratio, which remained above 100% each year since 2017-18.

ESC reported that the average adjusted underlying result as a total over the six years of rate capping was 4%. Most councils reported a positive but declining operating result up to 2019-20, when all groups except the metropolitan group reported a negative result due to the COVID pandemic. Metropolitan and interface councils on average reported better results than others. ESC observed that councils in urban and developing communities had more favourable ratios of revenue to expenditure.

Although the ESC concluded that local government was in a financial position to meet short term and long term liabilities, the ESC noted that the average adjusted underlying results indicated that one third of councils (or 27 of 79 councils) may not have had enough revenue to continue funding the services they provide. The 27 councils highlighted by ESC included 1 metropolitan, 2 interface, 5 regional city, 9 large shires and 10 small shire councils. ESC noted that councils with a negative average adjusted underlying result can apply to ESC for a higher cap if the Minister's cap is deemed insufficient.

Table C.1. Summary of Rate Caps and Compliance (report extract)

Year	Minister's cap	Number of councils with an approved higher cap	Number of compliant councils
2016-17	2.50%	6 (ranging from 3.05% to 6.34%)	79
2017-18	2.00%	4 (ranging from 3.50% to 5.55%)	76
2018-19	2.25%	4 (ranging from 2.57% to 5.55%)	75
2019-20	2.50%	4 (ranging from 3.50% to 13.94%)	79
2020-21	2.00%	3 (ranging from 3.50% to 5.55%)	76
2021-22	1.50%	No applications received	79
2022-23	1.75%	No applications received	79

Source: Essential Services Commission – The Outcomes of Rate Capping

Essential Services Commission – Advice on Rate Cap for 2024-25

ESC's advice for 2024-25 recommended the average rate cap be set to equal the 2023-24 Budget Update forecast of the consumer price index (CPI) for 2024-25 from the Department of Treasury and Finance (DTF), with no adjustment to be applied. ESC outlined that the recommendation was based on its consideration of the financial sustainability of the sector, changes in council costs, expectations of future wage rises and recent economic forecasts. The ESC expected that the CPI forecast announced in the 2023–24 Budget Update from DTF would be similar to the RBA's update of 10 November, which was 3.4 per cent - DTF published forecast for 2024-25 was 2.75%.

In terms of the financial sustainability of the sector, ESC observed that:

- While council cash reserves are declining, the sector maintains low levels of debt and stable borrowing levels.
- Council costs increased at a slower rate than inflation during 2022-23, but at a higher rate than the current rate cap of 3.5%.
- Construction costs continued to rise but at a slower pace than last year.
- Expected wage increases have the potential to raise council costs in the future.
- Major driving factors of the overall increase in CPI are not key council cost components.

ESC noted that in recent years councils have been using cash reserves to sustain service levels, due to the impact of low average rate increases relative to actual inflation and other revenue reductions due to the COVID pandemic. Furthermore, while the working capital positions of most councils are still in the appropriate range, the downward trend may not be sustainable in the longer term.

In terms of borrowings, the ESC suggested that borrowing to fund the construction of "long-lived" assets can be a viable option for councils facing reduced cash reserves.

In considering the increase in costs, ESC noted that due to the rate capping framework being forward-looking, differences between the rate cap and actual inflation should be expected, however, the differences for 2021-22 and 2022-23 were larger than in previous years, with the Melbourne CPI at 4% in 2021-22 and 7% in 2022-23 versus the 1.5% and 1.75% rate caps for the respective financial years.

ESC noted that the fuel, electricity and rent components of the CPI were some of the largest drivers of the overall increases but these components are not considered core inputs for council operations. Referencing Local Government cost indices in New South Wales, South Australia and Tasmania, and updated with price inputs relevant to Victorica setting, ESC concluded that council costs increased by around 3.9-4.3% from September 2022 to September 2023, while Melbourne headline inflation was 4.9%. That being stated, ESC noted that the rate caps approved by the Minister for 2021-22 and 2022-23 were lower than the increases in council costs and ESC projected the trend of rate cap being below actual increased costs to continue to hold for the 2023-24 financial year given quarterly inflation reporting as at end of September 2023.

ESC noted that as cost indices consider various components of the CPI and the producer price index (PPI) – in addition to wage price index (WPI) – the inclusion of PPI in the cost indices accounts for changes in construction costs – which comprise around 25% of total council expenses in 2023-24. It was also noted that the Victorian Auditor-General's Office (VAGO) reported a significant underspend trend for actual capital expenditure compared to budget. ESC noted that some council stakeholders have reported these challenges may stem from pressures relating to the gap between the CPI and the rate cap, the inflationary environment and the rising cost of delivering services and materials.

Employee costs were found to account for around 40% of total council expenses in 2023-24, with the WPI in Victoria rose by 2.8% from September 2022 to September 2023. It was also noted that the average council enterprise agreement rate increase for 2023-24 was 3.5%. However, public sector wage forecasts were expected to rise. The Fair Work Commission's minimum wage decision, which applies to contractors performing work for councils, increased the minimum wage by 5.75% in 2023.

In summary, the Commission states that:

> *In our view, the gap between the rate cap and inflation, rising construction costs, and the expectation of future wage increases have the potential to present major cost pressures on councils going forward.*

Alternative Sources of Income for Local Government – Rural Councils Victoria – SGS Economics and Planning

In 2022, Rural Councils Victoria engaged SGS Economics and Planning Pty Ltd to report on the funding challenges faced by rural councils in meeting the needs of their communities and remain financially viable. The report identified that rural councils rely heavily on Australian and State Government grants as there is little access to substantial or helpful levels of own source income. The report highlighted that while some opportunities for raising additional revenue exist, these are relatively limited, require levels of resourcing beyond the capacity of many rural Local Governments, and will not resolve broader structural funding challenges.

Final Report: Local Government Rate Capping Mechanism Review – Grosvenor Public Sector Advisory

In 2021, the Victorian Government engaged Grosvenor Performance Group (GPG) to conduct an independent review on the rate cap mechanism, administration and process. The feedback received from the GPG research showed that since the rate cap was introduced, councils had positively pursued alternate revenue streams, cost sharing and cost saving measures. Adversely, there had been changes in expenditure with increasing trade-offs that resulted in greater operational expenditure spend at the expense of capital expenditure spend. This may have negative long-term impacts on the delivery of services and infrastructure and has been raised as a concern by councils. It was also reported that the quality of services were also potentially negatively affected.

GPG also found that small councils and regional councils had a greater dependency on grants. They used the VAGO data to assess whether the rate cap mechanism had led to financial distress of the councils. The positive net operating results and levels of indebtedness indicated that there was no financial distress being faced by these councils. GPG recommended the continued monitoring the sector due to potential concerns of negative long-term impacts of rate caps on the financial sustainability of councils, particularly the continued trade-off between capital and operating expenditure

Local Government Victoria – 2023-24 Council Budgets Summary

LGV provides a review and analysis of all council budgets to understand the planned financial performance and position of the Local Government sector, including the forward projections. For the 2023-24 budgets, LGV concluded that overall council finances remain sound, highlighting the following:

- Large majority of councils budgeting to produce an operating surplus (71 of 79)
- Most councils have substantial cash and investments
- Council debt levels remain low.

LGV also noted that 70 of 79 councils adopted the 3.5% rate cap for 2023-24, eight councils adopted a rate rise less than 3.5% and one council adopted no rate increase. For comparative purposes, the 2022-23 rate cap was 1.75% and 75 of 79 councils adopted the 1.75% rate cap. It was also noted that since 2019-20 there has been no application to ESC for a higher cap. Of note, there have been 17 higher cap applications made since 2016-17 and 13 of the applications have been approved in full or in part.

An assessment made by LGV is that Local Government financial planning remains unsophisticated due to an observation that councils are using the rate cap as the basis for revenue forecasting, rather than an actual determined revenue requirement. LGV comment that councils' budgets are highly predictable due to the large, fixed asset base with known future costs of maintenance and depreciation.

Regarding waste charges, the LGV notes that all 79 councils have a separate levy for kerbside waste collection, enabling a cost recovery approach and enabling Council to address the increase in costs for waste services that LGV acknowledge has increased above the rate of inflation. However, LGV make an observation that there is an emerging trend of levying public waste charges on properties for services unrelated to kerbside waste and concluding that such charges are being used to fund general public services such as street cleaning, graffiti removal, drain cleaning, public bins and environmental education. LGV note that while this practice is technically permissible, it is inappropriate and being used to circumvent the State Government's rate cap.

With respect to cash and investments, LGV notes that the budget cash and investment position reflects the accumulation of rates and charges, user fees and bank interest. LGV also refer to cash being "slightly offset" by the decision to bring forward payment of 100% of the 2023-24 Financial Assistance Grants into the 2022-23 financial year – LGV notes that the impact of the decision was to bring forward $235 million. The prior year (2021-22), 75% of the Financial Assistance Grants was brought forward.

In total, councils are budgeting to hold borrowings of $1.7 billion as 30 June 2024, which includes 38 councils who plan to use new borrowings in 2023-24. LGV comment that the overall level of debt is very low, noting that Councils have balance sheets dominated by fixed assets, and that in comparison to the Australian or State Governments, councils in Victoria remain conservatively geared.

It is worth noting that in the Analysis of the 2022-23 Adopted Budgets published by LGV, the report noted that VAGO introduced the notion of an adjusted underlying operating result as part of their overall assessment of a council's financial sustainability. The adjusted underlying operating result removes the revenue from developers. contributions and non-recurrent capital grants in order to measure an entity's ability to generate a surplus in the ordinary course of business. LGV noted that the favourable results in the form of accounting operating surpluses were in sharp contrast to considering the adjusted underlying operating deficits. LGV noted that all 5 cohorts of councils in Victoria were cumulatively planning to deliver an adjusted underlying operating deficit for 2022-23.

The analysis by LGV on the 2023-24 council budgets does not comment or report the underlying operating result for councils.

Victorian Auditor-General's Office: Results of 2021-22 Audits: Local Government

The financial analysis published by VAGO concluded that the financial performance of Victorian councils only improved in 2021-22 because of an increase in government funding (Financial Assistance Grants) and would have deteriorated without the increase.

VAGO noted that council balance sheets remain relatively strong, and councils remain financially liquid with increased cash and financial assets – although this was noted to be due to additional government grant funding and delays in delivering capital works programs. An analysis of budgeted versus actual capital expenditure for 2017-18 to 2021-22 resulted in an observation by VAGA that there is a trend of underspending in capital expenditure which existed prior to the COVID pandemic.

However, councils face challenges that include:

- The rate cap, which constrains the ability of councils to increase rate revenue.
- Variability in government funding.
- Rising cost of material and services, which needs to be actively managed.

In commenting on the adjusted underlying result indicator, VAGO noted the impact of the COVID pandemic and that the underlying result had not recovered to pre-pandemic levels. (It is also worth noting that there was a deteriorating trend in the adjusted underlying result prior to the pandemic.)

In terms of the replacement and renewal gap indicator, VAGO concluded that over the previous five financial years (2017-18 to 2021-22), the average ratio across all councils remained above 1 indicating councils had spent more on asset replacement and renewal than depreciation expense.

House of Representatives Committee Inquiry into Local Government and Cost Shifting – 2003

In 2002, the House of Representative Economics, Finance and Public Administration Committee examined a diverse range of matters relevant to the issue of Local Government and cost shifting including Local Government funding, its roles and responsibilities in society, capacity building and regional approaches to service delivery and cooperation. The main objective of the Inquiry was to address the problem of cost shifting onto Local Government and in doing so ensure that this sphere of government is appropriately financed to serve the community more effectively and efficiently.

The Committee concluded that cost shifting is ultimately a symptom of dysfunctional governance and funding arrangements. The major areas of cost shifting reported were:

- Withdrawal or reduction of financial support once a program is established, leaving Local Government with the choice of continuing a program or suffering the political odium of cancelling the service
- Transfer of assets without appropriate funding support
- Requirement to provide concessions and rebates without compensation
- Increased regulatory and compliance requirements
- Failure to provide for indexation of fees and charges for services prescribed under State legislation or regulation.

The Committee concluded the majority of cost shifting was from State to Local Government but there was also evidence of cost shifting by the Australian Government. The Committee acknowledged the impact on Local Government from expanding service provision due to cost shifting and other market failures, recommending that an agreement across the three levels of government be reached on principles to reduce cost shifting and to ensure responsibilities administered by Local Government are adequately funded.

The Australian Local Government Association (ALGA) estimated cost shifting could be between $500 million and $1.1 billion per annum.

The Committee highlighted the impact of non-rateable land and recommended that, in line with the Tasmanian Partnership Agreement, Australian and State Governments pay rates to Local Government.

Australian Government Response to the Committee Report – 2003

With respect to recommendations made in the above inquiry report, the Australian Government provided a number of responses:

- The development of a tripartite inter-governmental agreement on Local Government relations was supported and it would pursue its development.

- Where Local Government has a direct role in delivering a program and participates in negotiations, the share of payments that are to be provided to the Local Government need to be identified.
- No support for the recommendation that, in line with the Tasmanian Partnership Agreement, Australian and State Governments pay rates to Local Government, due to the inclusion of Local Government in reciprocal taxation (including Local Government paying taxes such as land and payroll taxes) would be administratively and legally complex. Local Government financial assistance grants were indicated to effectively compensate Local Government for its lack of rate revenue from Australian Government land.
- No support for the development of Local Government impact statements to identify impact on Local Government from legislation by other levels of government.
- Under the inter-governmental agreement, the problem of cost shifting will be recognised as a problem, have revenue allocated to Local Government if responsibilities are devolved and to have state restrictions on Local Government revenue raising addressed.

Inter-Governmental Agreement Establishing Principles Guiding Inter-Governmental Relations on Local Government Matters – 2006

The national Inter-Governmental Agreement Establishing Principles Guiding Inter-Governmental Relations on Local Government Matters (IGA) was signed by the federal Minister for Local Government, State and Territory ministers for Local Government and the President of the ALGA on behalf of all State and Territory Local Government associations in April 2006.

The Parties agreed in principle that where Local Government is asked or required other levels of government to provide a service or function to the people of Australia, any consequential financial impact is to be considered within the context of the capacity of Local Government.

Impact of Cost Shifting on Local Government in NSW – 2018

Local Government New South Wales (LGNSW) conducted a Cost Shifting Survey every two years over a ten-year period, with the latest report being published in 2018. The purpose of the report is to highlight the consequences of cost-shifting from the Australian and State Governments to Local Government. The last published report (2018) highlighted the following:

- Cost shifting was acknowledged as one of the most significant problems faced by NSW councils and, combined with rate capping, undermines the financial sustainability of Local Government in NSW.
- Cost shifting onto NSW councils in the 2015/16 financial year was estimated at $820 million, with the cumulative cost shifting burden estimated at $6.2 billion over the ten years the survey had been undertaken.
- The annual cost shifting burden has more than doubled in a decade.
- The annual cost shifting burden exceeds the estimated annual infrastructure renewal gap across all councils.
- Cost shifting is considered to be increasingly impeding on the ability of councils to deliver and maintain essential infrastructure for communities.
- The most significant examples of cost shifting included the waste levy, mandatory contributions to fund emergency services agencies, shortfalls in funding to operate libraries, failure to fully reimburse for mandatory pensioner rate rebates and the costs incurred to meet regulatory burdens associated with companion animals, noxious weeds, flood controls and other activities.

South Australian Productivity Commission – Inquiry Into Local Government Costs And Efficiency – 2019

The Commission was asked by the South Australian Government to consider and report on Local Government costs and efficiency, including identifying the drivers of the cost of Local Government operations and to assess their impacts.

The Commission heard that expenditure growth was influenced by a number of factors not fully within council control: mandated requirements by the Australian and State Governments (both unfunded and partially funded), population growth and density, and the size and location of councils.

While services mandated by the State Government are relatively small in number, they accounted for 46% of sector operating expenditure in 2017-18. Mandated services consistently accounted for a higher proportion of operating expenditure for rural councils, at close to 60% (compared to 40% for urban councils), reflecting the relative importance of the transport function, mainly roads.

Cost-shifting, regulatory compliance and the expansion of mandated responsibilities under State legislation were identified by councils as cost drivers over which they have limited control. On the basis of available evidence, the Commission concluded that these factors have contributed to council cost pressures. However, the Commission was unable to quantify the impact on council costs and concluded based on available evidence the impact has been relatively small in recent years.

Councils highlighted the burden of complying with State Government legislation had grown, adding to their costs. However, data limitations prevented quantification by the Commission.

Cost Shifting Impact on Local Government: Submission to Committee on Regional Development and Decentralisation

In 2017, the City of Greater Bendigo provided a submission to the Federal Government inquiry into Regional Development and Decentralisation detailing the impact that cost shifting has on the City's finances. The submission outlined that if this trend is to continue, it will impact the delivery of other core services to the community.

Examples reported of council functions where cost shifting had occurred included:

- Libraries – funding began in 1975 as 50:50 funding contributions with the State Government but has deteriorated, with the State Government now only contributing 17% funding at an estimated cost shift of $994,201 in 2015/16
- School crossing supervision – funding began in 1975 as a 50:50 funding contribution with the State Government, with the State Government now only contributing 20% funding at an estimated cost shift of $307,517 in 2015/16.
- State emergency services (SES) – the SES is the legislated overarching emergency authority for the State and should not be relying on funding from Local Government, at an estimated cost shift of $35,302 in 2015/16
- Statutory planning – prior to 2010, Local Government was not required to pay the costs of appointing an Independent Panel to provide recommendations on Planning Scheme Amendments. In addition, planning permit application fees have been held fixed at the same rate by the State Government since 2009, grants for heritage advisory services have been halted, and 50% funding support is no longer received from the State Government for heritage studies. The estimated cost shift was $2,081,213 in 2015/16.
- Maternal and child health – the council cost to provide the service was estimated at $700,000 under a 50:50 contribution, but funding contribution from the State Government for the service has not kept pace with actual costs associated with delivering the service.
- Streetrader – administration of the State Government's Streetrader database at an estimated cost of $21,804 in 2015/16.

The submission notes that collaboration to align Federal, State and Local Government direction and priorities is required. This collaboration to align the priorities of regional cities for Australia will do more than just help to reduce the impacts of cost shifting.

LGAQ Cost Shifting Report

In 2022, the Local Government Association of Queensland engaged AEC Group to develop a survey to quantify the level of community service obligations provided by council in Queensland and to identify and quantify cost shifting.

A community service obligation was defined as an obligation government imposes on a business entity to do something that is not in the commercial interest of the business entity to do.

AEC received survey responses from 58 of 77 Councils – a response rate of 75%. Councils completed the survey to the best of their ability, with support from AEC Group – including facilitated interviews where necessary. In 2001/02 LGAQ estimated the impact of cost shifting to be $47 million to Local Government in Queensland. The recent survey estimated $360 million in cost shifting impacting Local Government – or an increase of 378% (after factoring in indexation) since 2022).

Examples of cost shifting reported by councils included:

- Environmental health services - $42.8 million
- Disaster management – $18.4 million
- Regulatory compliance – $7.5 million
- State road responsibilities - $14.0 million
- Housing services - $6.7 million
- Biosecurity services - $19.7 million

- Health services - $3.3 million
- Airport and aerodromes - $4.3 million
- Crime and public safety - $3.0 million
- State exemption on council rates - $9.5 million
- Ministerial Infrastructure Designations (State Government controlled development) - $5.0 million, although this is substantially underestimated.
- Payroll tax applied to council services - $14.3 million
- Library services - $25.7 million
- Tourism services - $3.0 million
- Maintenance of the stock route network – 3.0 million

To show the magnitude of the impact on councils, AEC presented the total estimated cost of cost shifting as a proportion of the councils general rate revenue. Given that increased responsibilities on Local Government without additional funding can only be funded through increased own source revenue, reporting cost shifting as a proportion of rate revenue reflects the direct impact on the councils financial sustainability.

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