Gearing up for Growth

Report on Local and State Financial Relations

12 August 2024

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KordaMentha

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1 Forward

For decades, Vertical Fiscal Imbalance (VFI) has been a hotly debated topic within the Australian Federation. VFI occurs when the income for each level of government does not match the expenditure on their respective responsibilities. Essentially, one level of government collects more money than it needs, while another level doesn't collect enough to cover its expenses. Typically, discussions on VFI centre on State and Federal financial relations, often overlooking the crucial role of Local Government, which provides essential municipal services shaping our cities' operations.

This report by KordaMentha reviews the current financial landscape in Victoria, particularly focusing on State and local financial relations over the past decade, a period marked by unprecedented events such as the COVID-19 pandemic and increased climatic events. A major part of our analysis centres on capital expenditure and its role in both servicing and growing our cities.

Over the last decade, the Victorian Government has leveraged its balance sheet to dramatically increase its capital spend. Government Infrastructure Investment (GII)[1] expenditure has risen from $7.5 billion in 2014-15 to $23.3 billion in 2024-25 – representing a 210% increase. This increase has largely been funded through increased net debt – with the State's net debt increasing from $21.2 billion in 2013-14 to forecast of $135.9 billion in 2023-24 – representing a 642% increase.

To meet population growth, local governments have also increased their capital expenditure, but the largest funding source has been its own sourced revenue and modest amounts of debt – depending on the individual council. Councils have a good track record of delivery of a solid capital program.

State governments are legally able to spend what they want subject to parliamentary appropriation. On the other hand, local governments regulatory environment restricts their ability. This has presented enormous challenges to the local government sector in being able to deliver high quality services and a capital program to respond to the building of communities.

The financial challenges facing the Victorian Local Government sector are not unknown. On 3 May 2023, the Legislative Council of the Victorian Parliament agreed that the Economy and Infrastructure Committee would consider and deliver a report, by 28 November 2024, on local government funding and service delivery in Victoria. At the same time, the Standing Committee on Regional Development, Infrastructure and Transport of the Australian Government adopted an inquiry into local government sustainability on 21 March 2024.

Both inquires have been introduced in response to a series of challenges, particularly:

- The changing infrastructure and service delivery obligations of local government (i.e. "cost-shifting")
- Vertical and horizontal fiscal imbalances
- The appropriateness off the existing revenue structure

As these challenges grow, they place pressure on the sector in delivering key services and infrastructure for Victorian communities.

With forecast population growth in Melbourne, much more capital expenditure is needed to grow our suburbs. Whilst the Victorian Government has announced it capital spend will need to decline over the budget and forward estimates, local government's will need to increase.

KordaMentha has been engaged by Outer Melbourne Councils to review the current financial relations and make observations for improved outcomes.

1.1 Who is KordaMentha?

We provide innovative solutions, helping organisations grow, protect and recover value.

KordaMentha is an independent and trusted investment and advisory firm, providing specialist cybersecurity, financial crime, forensic, performance improvement, real estate and restructuring services.

We help clients grow and maximise value, protect from financial loss and reputational damage and help recover value in tough times.

[1] The Victorian Government's preferred measure of total capital works expenditure

We have a team of over 500 specialists in nine locations across Asia Pacific. With diverse experience in finance and real estate to law enforcement and C-suite – our team applies a different mindset to our clients' matters.

Since 2002, our experts have been entrusted with some of the region's most complex and sensitive commercial situations. We work together to solve the challenges facing corporations, financiers, lawyers, private investors and government clients. On every occasion, we provide bold and impactful solutions. We deliver growth, certainty and value for all involved. This, combined with our independence, professional expertise and qualifications, enables our people to examine each matter with a unique perspective.

KordaMentha's DNA of restructuring and performance improvement and helping companies (getting in, rolling up our sleeves, with a true 'bias to action') in times of serious stress, mean we are well positioned to work with Government.

Performance Improvement & Restructuring

- Restructuring and turnaround;
- Independent business reviews;
- Receiverships, administrations and liquidations;
- Rapid cost out and control;
- Revenue protection and growth;
- Enterprise & business unit strategy;
- People and organisation redesign;
- Complex commercial and project support; and
- Interim and crisis management.

Real Estate & Major Projects Advisory

- Corporate advisory;
- Asset repositioning and turnaround;
- Development;
- Investment & Transaction management;
- Asset Management and optimisation advisory;
- Project and program management; and
- Project Policy, Governance, Procurement and Delivery advisory.

1.2 This report

This report will draw out some of the challenges listed above and make a number of recommendations for public policy makers to be able to unlock further and turbo charge the ability of councils to be able to build and grow their communities.

KordaMentha believe there is an opportunity for the State and Local Government to enter into a 'compact' which would ensure that Victoria can successfully grow a sustainable population into the future.

The remainder of the report is set out as follows. We will first discuss how local government is funded and the constraints they face. We will then make high-level observations of the financial health of local government, in particular their balance sheets and the use of debt to fund their programs. We will conclude with observations to unlock some of that constraint.

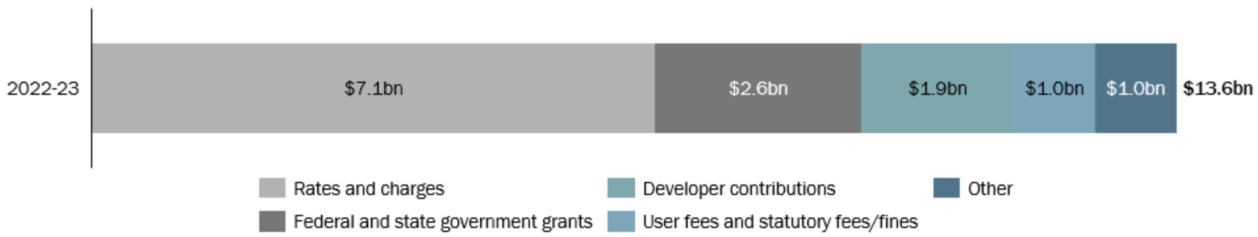
2 Local government financial sustainability

2.1 How are local governments funded?

Local governments broadly generate revenue from four key sources:

1. Rates and charges
2. Federal and state government grants
3. Developer contributions
4. User fees and statutory fees / fines

Figure 1: Breakdown of council's revenue and income by category (2022-23)



Source: Victorian Auditor-General (2024), Results of 2022-23 Audits: Local Government

Victorian local councils have limited discretion over most of their funding sources:

- The main source of revenue / funding for Victorian councils is rates and charges, accounting for 52% of total income in 2022-23. Council rates are property taxes that every household in Victoria must pay. Councils can set the total amount they wish to collect in the next financial year, but this amount is constrained by the rate cap. Rate capping restricts councils' ability to increase property rates beyond a set limit, limiting their revenue-raising capacity. While property values and population growth can affect the distribution of rates among property owners, they do not change the total amount of revenue a council can collect.
- Additionally, a significant portion of their revenue comes from government grants, which are often tied to specific projects or purposes and can be unpredictable. These grants include both general purpose grants and specific purpose grants from the Commonwealth and Victorian governments.
- Another major source of revenue is fees and fines, such as those from planning permits, building inspections, and parking violations. While councils have some control over setting these fees, they are often regulated and cannot be adjusted freely to meet budgetary needs.
- Developer contributions for infrastructure projects also provide revenue, but these are contingent on development activity and are not a consistent source of income. Developer contributions are crucial for supporting capital works in local councils across Victoria, providing essential funding for infrastructure projects. However, these contributions alone are not sufficient to cover all expenses, requiring councils to rely on additional revenue sources to fully fund their capital works.

2.1.1 How does this compare to the Victorian Government

The Victorian Government generates its revenue through a combination of taxation, grants, and other sources. In the 2022-23 financial year, approximately 40% of the total revenue came from state taxes, including land tax, payroll tax, and stamp duties. Grants from the Commonwealth Government contributed around 45% of the revenue, allocated for specific purposes such as healthcare, education, and transportation. The remaining 15% of the revenue was generated from other sources, including fees, fines, and charges for various services like public transport fares and vehicle registration fees, as well as income from investments and asset sales.[2]

Unlike the local government sector, the Victorian Government has a higher level of discretion over particularly their taxation revenue.

[2] Victorian Government (2024), 2024-25 State Budget

2.2 Revenue constraints and growing costs

2.2.1 Introduction of the rate cap

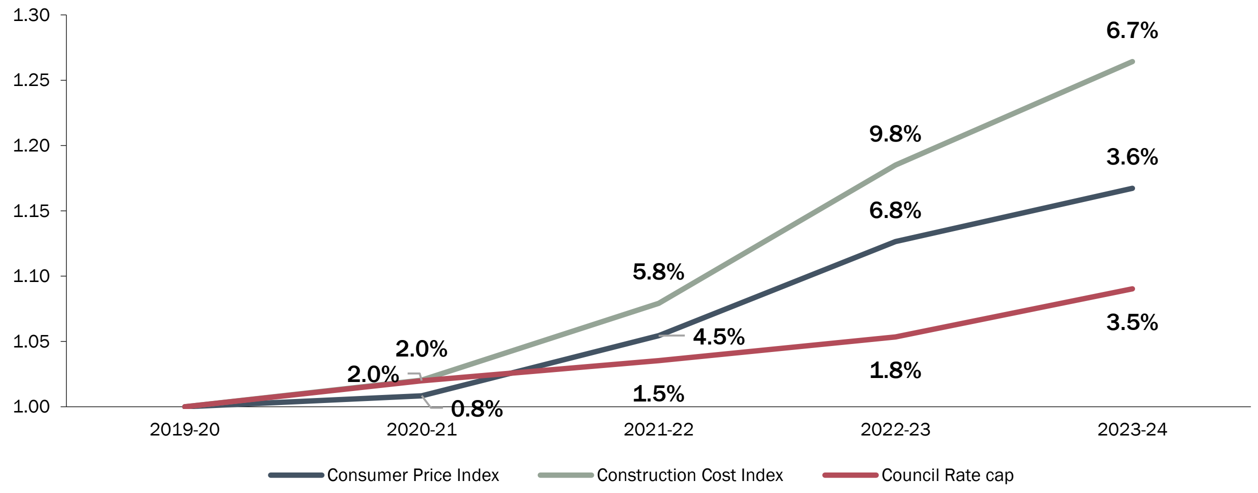
The rate capping policy was introduced in Victoria in 2016 as part of the Fair Go Rates system. This policy was designed to limit the annual increase in council rates, providing a clear framework to guide councils' budgeting while ensuring essential services continue to be delivered. The State imposed a rate cap on Victorian councils, commencing in 2016 and based on forecast movements of the Consumer Price Index (CPI).

The introduction of the rate capping policy in 2016 has had several notable impacts on Victorian local councils. While the policy aimed to protect ratepayers from excessive rate increases, it has also constrained councils' financial flexibility. Many councils have reported challenges in maintaining service levels and infrastructure due to the limited revenue growth.[3] A report by the Essential Services Commission highlighted that, in the initial years of rate capping, some councils struggled to balance their budgets without cutting services or deferring maintenance.[4]

However, council costs are generally affected by growth in construction, material and wage costs, rather than changes in common household goods and services as measured by CPI. The main council costs are staff to deliver human-based services; and staff and materials to construct, maintain and upgrade roads and other assets. A rate cap linked to CPI rather than councils' actual input costs makes it more difficult to provide the same level and mix of services to communities each year.

Using the forward estimate for CPI has been particularly problematic recently, with actual CPI landing significantly higher than expectations in COVID-19 impacted years. Additionally, whilst not the only cost faced by local councils, construction inflation in recent years has risen well above the applied rate caps.

Figure 2: Comparison of various cost indexes against the determined council rate cap



Source: KordaMentha analysis of ABS data
Note: Indexes generated using a starting value of 1.00 in 2019-20, and represent the cumulative impact of percentage changes since that financial year. Label represents percentage change in that financial year

The figure above indicates the cumulative impact of rises in the rate cap falling below these indexes. Between 2019-20 and 2023-24, the rate cap has increased by a total of 9 per cent. Actual CPI and the construction indexes have increased by 17 and 26 percent respectively. Given a total rate collection in 2020-21 of $6.5bn – using these indexes would have meant between $1.0 billion and $2.2 billion additional rate revenue cumulatively between 2020-21 and 2023-24.

MAV has developed a local government cost indicator that better reflects what councils are paying year to year to maintain service standard. Using this cost indicator, they estimate that since the introduction of the rate cap it has reflected just 60 per cent of the cost increases facing councils.[5]

[3] Parliament of Victoria (2016), Second report into rate capping policy
[4] Essential Services Commission (2023), Local council outcomes report 2023
[5] Municipal Association of Victoria (2024), Submission to Inquiry Into Local Government Funding and Services

2.2.2 Federal grants revenue

The Financial Assistance Grants (FAGs) program has been a key source of funding for local councils in Australia since its introduction in 1974-75. The program, governed by the Local Government (Financial Assistance) Act 1995, provides untied grants to local governments, allowing them to allocate funds according to local priorities. The grants consist of two components: a general-purpose component distributed based on population, and an identified local road component distributed according to fixed historical shares.

Financial Assistance Grants from the Commonwealth government are generally indexed in line with both national population growth and the rate of inflation. However, over the past three decades, the value of these grants has declined from around 1% of Commonwealth taxation revenue to approximately 0.55%.[6] This reduction has placed financial pressure on local councils, particularly in rural and remote areas where own-source revenue-raising capacity is limited.

In 2014, the Australian Government announced a freeze on the indexation of FAGs for three years. This decision meant that the grants would not increase in line with inflation, effectively reducing the real value of the funding provided to local councils. The freeze was part of broader budgetary measures aimed at reducing government expenditure. The freeze resulted in councils missing out on close to $1 billion over the four years to June 2018.[7] This loss of funding exacerbated the financial challenges faced by local governments, especially those with limited revenue-raising capacity.

Timing of financial assistance grants

The predictability of FAGs payments is crucial for accurate budget planning. When councils know the timing and amount of their grants, they can plan their budgets more effectively, aligning expenditure with expected revenue. Changes in payment schedules, such as the advance payment of 85% of the 2024-25 FAGs in the 2023-24 financial year, can necessitate adjustments to budget forecasts and financial strategies.

The timing of FAGs payments can also affect financial reporting. Councils need to account for these grants in their financial statements, and changes in payment timing can impact the reported financial position at the end of the financial year. For example, receiving a large portion of the grant in advance can improve the financial position in one year but may require careful management in subsequent years to avoid a perceived drop in revenue.

2.2.3 Growing suburbs fund

The Growing Suburbs Fund (GSF) was introduced by the Victorian Government in 2015. It aims to support the development of critical local infrastructure in Melbourne's fast-growing outer suburbs. The fund has provided a total investment of $440 million over ten years, from 2015-16 to 2024-25.[8]

The primary purpose of the GSF is to address the pressures faced by rapidly expanding communities by fast-tracking high-priority local infrastructure projects. These projects are designed to enhance social and economic participation, meet health and wellbeing needs, and improve the capacity of councils to respond to changing community demands. The fund has supported 360 projects, representing a total infrastructure investment of $1.3 billion and creating over 11,340 jobs.[9]

In the most recent Victorian budget, the Growing Suburbs Fund (GSF) received a reduction in funding. For the 2023-24 financial year, the budget allocated $10 million to the GSF, and for 2024-25, it allocated $5 million. This is a notable decrease compared to the initial allocations when the fund was first introduced in 2015, which provided a total of $440 million over ten years.[10]

[6] FinPro (2024), Submission to Inquiry Into Local Government Funding and Services

[7] Australian Government (2014), Federal Budget 2014-15

[8] Local Government Victoria (2024), Growing Suburbs Fund, accessed at: Growing Suburbs Fund (localgovernment.vic.gov.au)

[9] Local Government Victoria (2024), Growing Suburbs Fund, accessed at: Growing Suburbs Fund (localgovernment.vic.gov.au)

[10] Local Government Victoria (2024), Growing Suburbs Fund, accessed at: Growing Suburbs Fund (localgovernment.vic.gov.au)

2.2.4 Developer contributions in Outer Melbourne Councils

All development creates increased demand on infrastructure like roads, footpaths, stormwater drains, public open spaces and schools to support local communities.

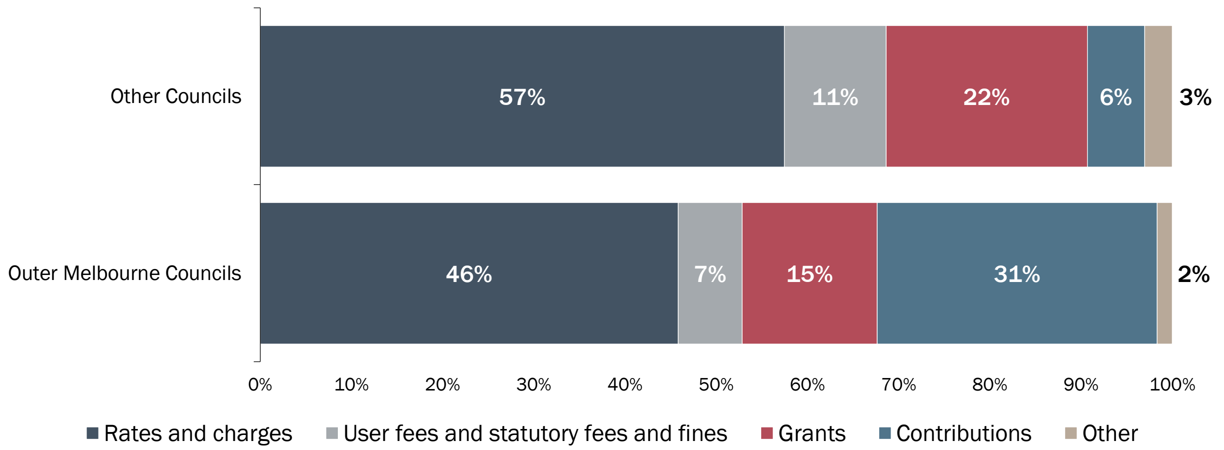
Developers and government share responsibility for providing infrastructure. In Victoria, developers are required to pay contributions to local councils to help fund infrastructure that supports new developments. Developers may contribute to infrastructure by:

- the payment of money
- providing land
- constructing infrastructure on behalf of public authorities (referred to as 'works-in-kind').

These are referred to as 'developer contributions' and are delivered through a planning scheme amendment, a planning permit, or a building permit.

Due to their unique position in housing Victoria's most rapidly growing suburbs, Outer Melbourne Councils have a distinct revenue composition to other Victorian local governments. Notably, average revenue from developer contributions in Outer Melbourne Councils is significantly larger than across other Victorian councils accounting for 31% of their total income in 2022-23.

Figure 3: Breakdown of Outer Melbourne Councils' vs other councils' expenditure



Source: KordaMentha analysis of Essential Services Commission (2023), Local council outcomes report 2023

Total budgeted revenue from contributions for 2022- 23 is $1.0 billion across all Outer Melbourne Councils, making up two-thirds of total developer contributions across the whole state ($1.5 billion). This is made up of $676 million from gifted assets and $321 million in monetary contributions.[11] Despite this, these contributions alone are not sufficient to cover all expenses, requiring councils to rely on additional revenue sources to fully fund their capital works.

This is referred to as asset acceptance and is process by which councils approve and take ownership of public infrastructure built by developers as part of development approvals. These contributed assets can include roads, parks, drainage systems, and street lighting. This level of asset acceptance by Outer Melbourne Councils will represent a significant future obligation for councils to maintain, renew and upgrade.

Local councils already manage $10 worth of assets per every dollar of revenue collected. For the Victorian government this figure is $4, and for the Commonwealth government it is 40 cents.[12]

[11] Victorian Auditor-General (2024), Results of 2022-23 Audits: Local Government

[12] Municipal Association of Victoria (2024), Submission to Inquiry Into Local Government Funding and Services

Figure 4: Value of assets per dollar of revenue held by level of government

Source: Municipal Association of Victoria (2024), Submission to Inquiry Into Local Government Funding and Services

Accordingly, local governments have large-fixed costs to maintain these assets, imposing a major constraint on their budgets.

2.2.5 Cost shifting

Local government is responsible for a wide range of economic, social, environmental and infrastructure services. Where the range of services provided by local government expands, this has an impact on the financial sustainability of the sector. Local governments are often the service provider of ‘last resort’ in communities where higher levels of government and the provide sector have not provided adequate services.

Cost shifting occurs when Commonwealth and state governments transfer program or service responsibilities to local government with insufficient funding or provide grants that don’t keep pace with the actual delivery costs incurred by councils.

There are several concrete examples of cost shifting in Victoria:

- Public Libraries: Historically, public libraries in Victoria were funded equally by the state and local governments. However, over time, the state’s contribution has significantly decreased. Currently, local councils cover about 83% of the operating costs.[13]
- Kindergartens: Local councils have increasingly taken on the responsibility of funding and managing kindergartens, which were traditionally supported by state funding. This shift has placed additional financial burdens on councils.[14]
- Emergency Services Levy: The state government has transferred more of the costs associated with emergency services to local councils. This includes contributions to the Country Fire Authority (CFA) and the State Emergency Service (SES), which were previously funded more heavily by the state.[15]

A recent report by the Mornington Peninsula Shire Council estimated cost shifting over the next five years to total $234 million in operational costs and a further $38.4 million in capital costs.[16]

2.3 The Balance Sheet

Council’s 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.

A better indicator of council’s financial health is the adjusted underlying result. Local Government Victoria in their 2022-23 report suggest that a small adjusted underlying surplus is required for a council to be sustainable over the medium to long term.

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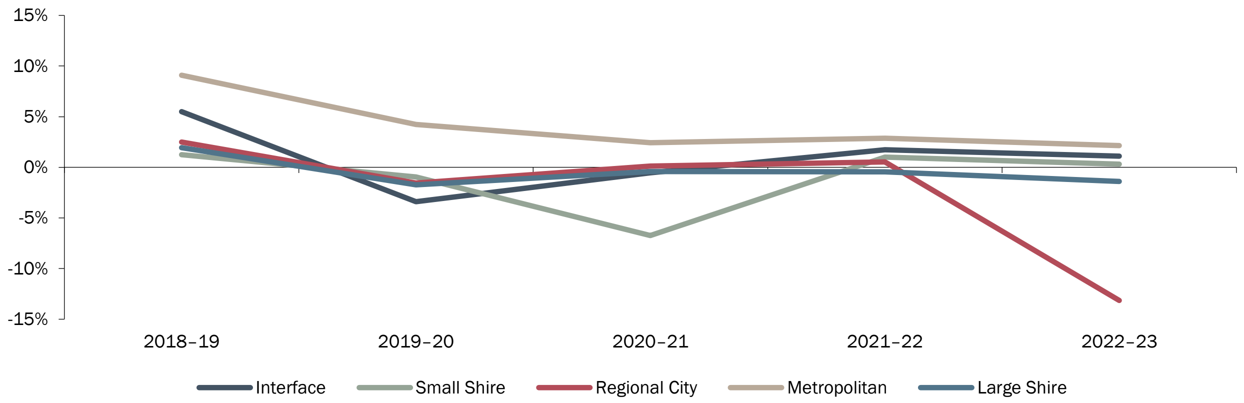
[13] Municipal Association of Victoria, Library funding, accessed at: Library funding | MAV website

[14] FinPro (2024), Submission to Inquiry Into Local Government Funding and Services

[15] FinPro (2024), Submission to Inquiry Into Local Government Funding and Services

[16] Mornington Peninsula Shire (2024), Government Cost Shifting to the Mornington Peninsula Shire

Figure 5: Local council adjusted underlying result by grouping



Source: Department of Government Services (2024), Local Government Performance Reporting

The adjusted underlying result indicates a deteriorating trend across all local council types. This is not sustainable in the long-term and is likely to result in continued deterioration of cash reserves.

Victorian Government Auditor-General audit report

Each financial year, the Victorian Government Auditor-General (VAGO) delivers an audit report on the financial reports and performance statements across the local government sector. As part of the audit process, VAGO also deliver an analysis on the sectors financial health. The 2022-23 audit report delivered the following assessment:

> *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-source 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.*

Source: Victorian Auditor-General (2024), Results of 2022-23 Audits: Local Government

Due to the regulatory requirements that councils face in maintaining their financial conditions, the balance sheet is likely to always represent a similar story. The key for local councils however is service sustainability. As the challenges listed above continue to place pressure on the financial sustainability of local councils, they will be forced to make cuts. This could result in a drop in service quality, reduction in infrastructure expenditure per person and a fall in asset condition.

2.3.1 Councils have a large capital program, especially in growth areas

The management and maintenance of assets owned by the councils is one of the most significant activities undertaken by any council. Outer Melbourne Councils spend approximately 19% of the value of their total revenue collections on capital works, not dissimilar to the 23% of total Victorian Government revenue spend on Government Infrastructure Investment (GII).[17]

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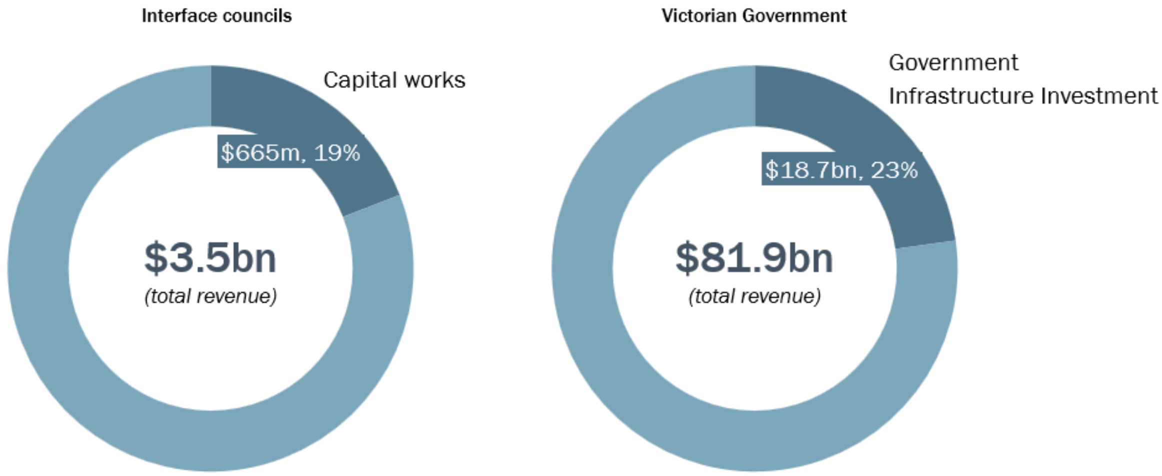
[17] KordaMentha analysis of Victorian Budget submissions and ESC data

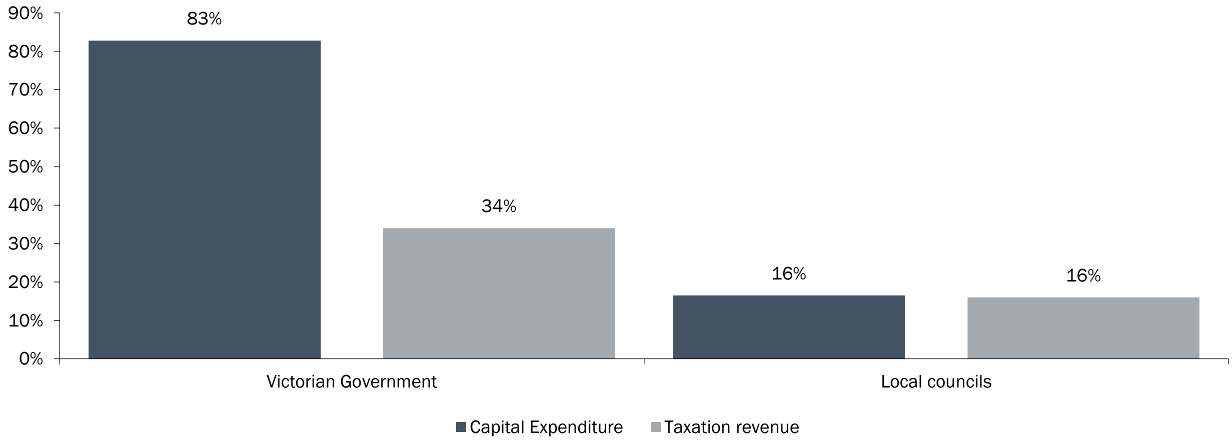
Figure 6: Capital works expenditure as a proportion of total revenue, Victorian Government versus Outer Melbourne Councils (2021-22)



Source: KordaMentha analysis of Victorian Budget submissions and ESC data

Additionally, councils' expenditure on capital works has generally trended with its revenue. As a comparison, state government taxation over the last five years has increased 34 per cent and local government rates have increased 16 per cent.[18] In the same period, local council capital works expenditure has risen by 16% - in line with their increase in taxation revenue. On the other hand, Victorian Government Infrastructure Investment (GII) has increased from $11.6bn in 2017-18 to $21.2bn in 2022-23 – a rise of 83%, significantly higher than growth in taxation revenue.[19]

Figure 7: Growth in capital expenditure and taxation revenue for Victorian Government and Local councils, 2017-18 to 2021-22



Source: KordaMentha analysis of ABS data, Victorian Budget submissions and ESC data

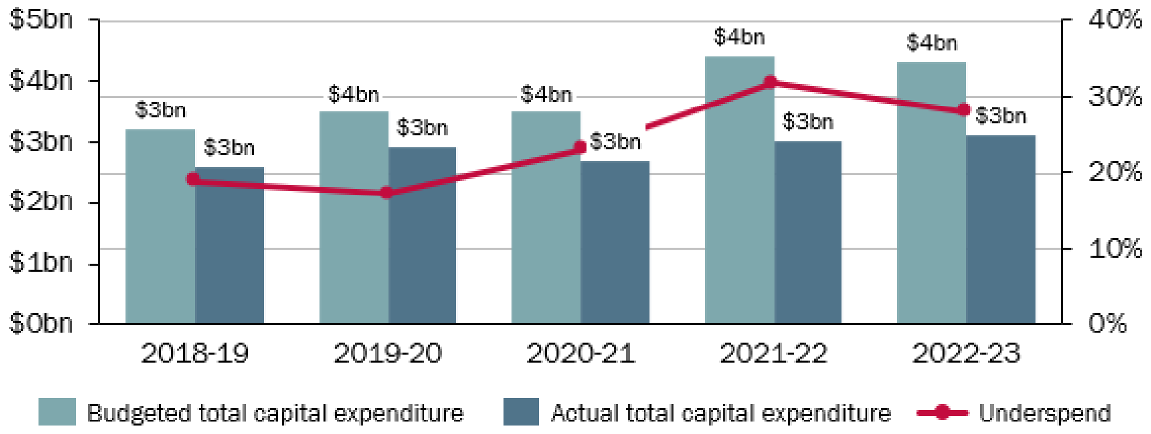
VAGO's audit report indicated that a high level of underspend on councils' capital works programs indicates their long-term financial planning needs more development. Outer Melbourne Councils are called out as the cohort with the largest cash and other financial assets, combined with the biggest capital budget underspend year on year.[20]

[18] FinPro (2024), Submission to Inquiry Into Local Government Funding and Services

[19] KordaMentha analysis of ABS data, Victorian Budget submissions and ESC data

[20] Victorian Auditor-General (2024), Results of 2022-23 Audits: Local Government

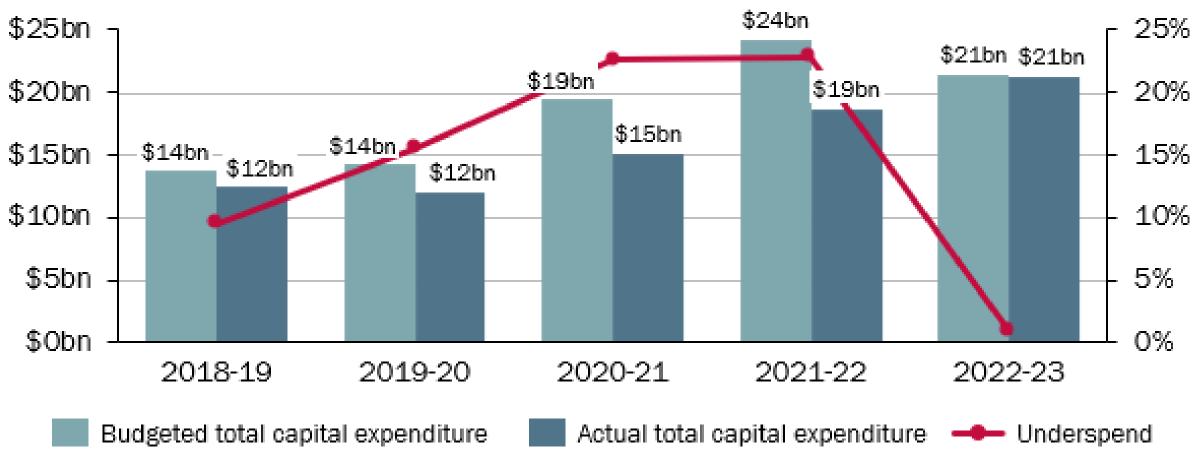
Figure 8: Budgeted versus actual capital expenditure and percentage underspend – Local councils



Source: Victorian Auditor-General (2024), Results of 2022-23 Audits: Local Government

Due to the complexities of delivering a wide capital program, it is often difficult to accurately forecast annual capex. Figure 7 shows the level of 'underspend' on capital program for local government. Comparatively, the Victorian Government has a similar challenge in accurately predicting its spend. [21]

Figure 9: Budgeted versus actual capital expenditure and percentage underspend – Victorian Government

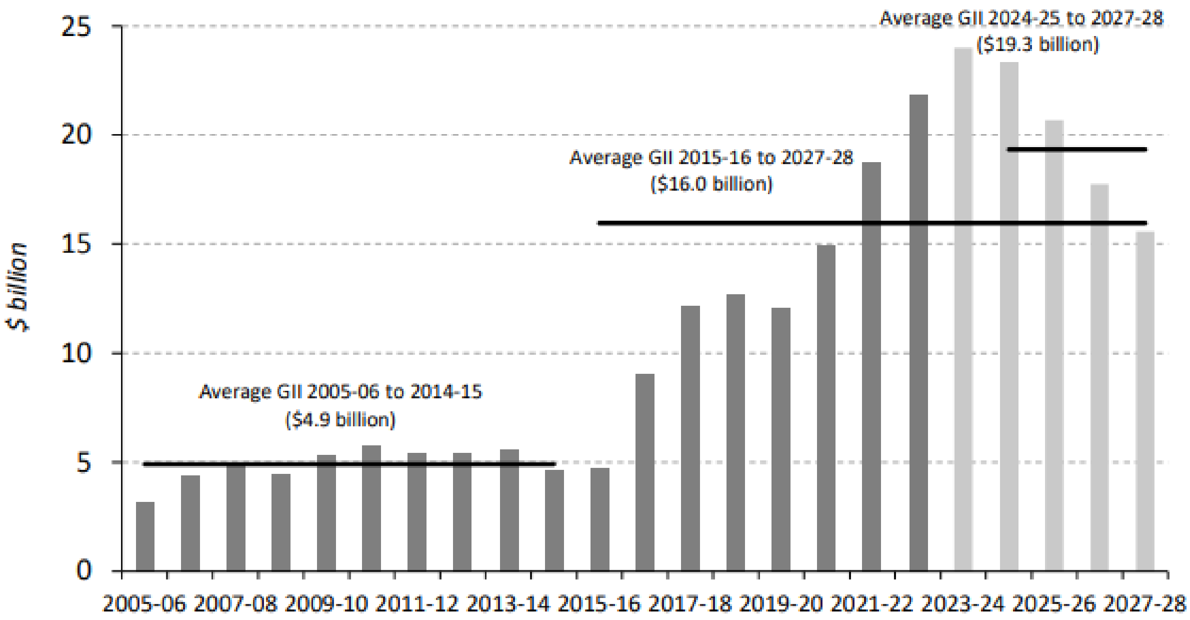


Source: KordaMentha analysis of Victorian Budget submissions

Over the last few budgets, the Victorian Government has leveraged its balance sheet to invest in some of the most ambitious projects across Australia. Moving forward, the 2024-25 Budget indicates a desire to moderate and return Government infrastructure investment back to pre-COVID levels.

[21] This could result in forecast debt for some councils being lower than actual – due to debt being the last source of funds.

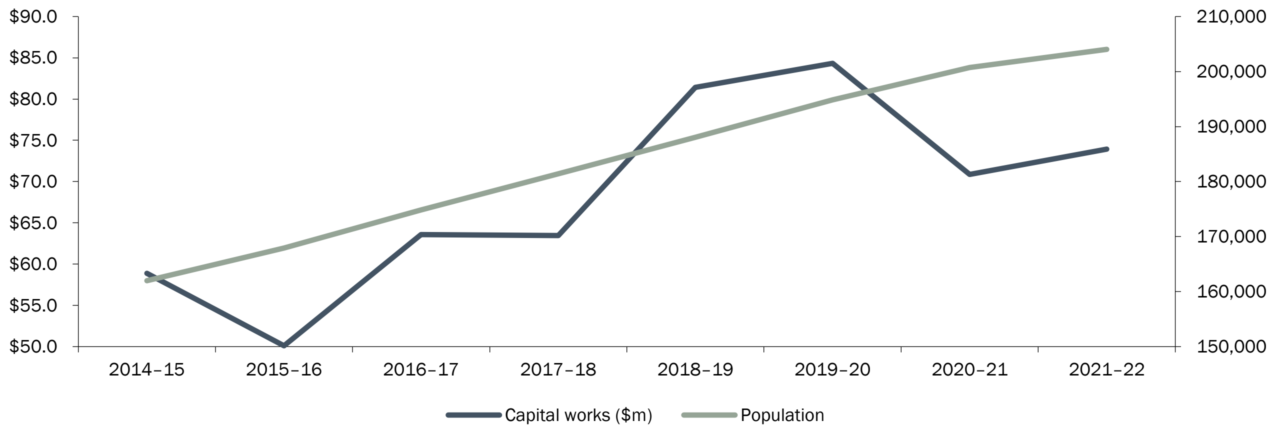
Figure 10: Victorian Government infrastructure investment



Source: Victorian Government (2024), Victorian Budget 2024-25, Budget Paper 2: Strategy and Outlook

Local councils, in their role providing services to their communities, have an ongoing responsibility to ensure and provide adequate infrastructure. Generally, capital works expenditure follows a similar trend as population growth for local councils.

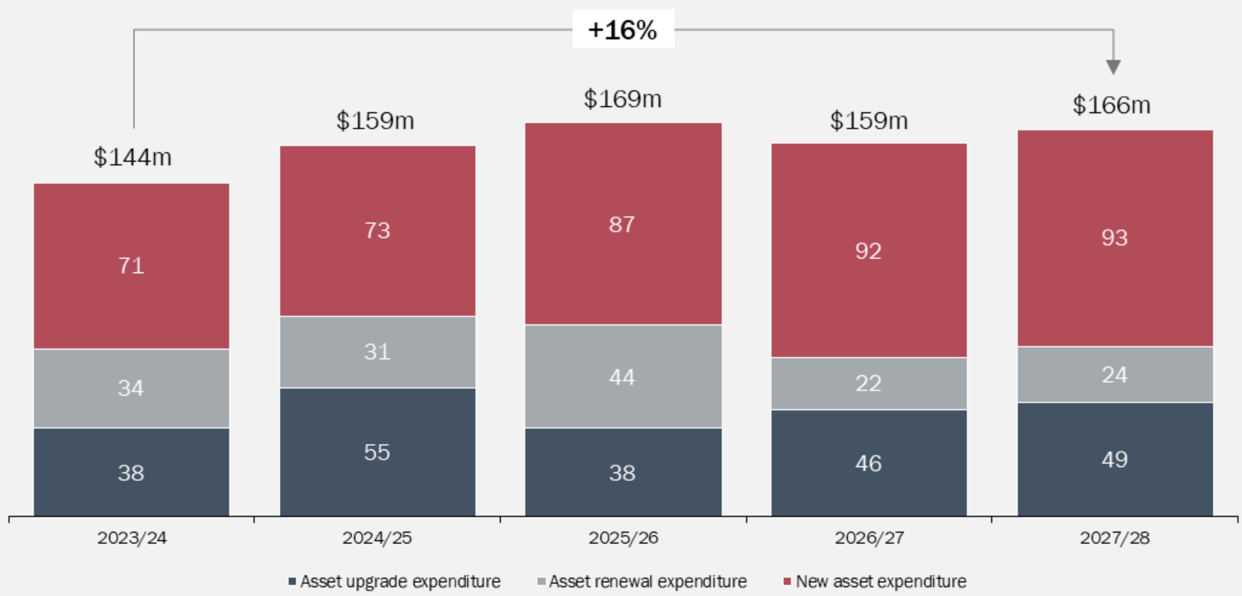
Figure 11: Average population vs expenditure on capital works, Outer Melbourne Councils



Source: Essential Services Commission (2023), Local council outcomes report 2023

The population of the Outer Melbourne Councils are expected to grow from 1.9 million in 2021 to 2.7 million by 2036. An example of the rising obligation for these councils to spend on capital works is shown by the budgeted statement of works for Wyndham City Council.

Figure 12: Statement of capital works, Wyndham City Council (2023/24 – 2027/28) ($m)



Source: Wyndham City Council

Over the four years from 2023/24 to 2027/28, Wyndham City Councils total expenditure is expected to increase by 16%. In the same period, the Victorian Government has budgeted a 35% decrease in GII – from $24.0 million to $25.6 million. As the Victorian Government's infrastructure spending is set to tail off, spending by local councils, particularly in high growth areas is likely to continue to grow.

2.3.2 Local councils use of debt

As part of VAGO's audit report on the financial reports and performance statements across the local government sector, councils are assessed against a number of financial sustainability risks. One of these indicators is their indebtedness ratio, which assesses an entity's ability to pay the principal and interest on its borrowings when they are due from the funds it generates. [22]The measure is calculated as the value of non-current liabilities as a proportion of own-sourced revenue. The risk categories are outlined below.

Table 1 : VAGO Risk Assessment Criteria for Financial Sustainability Indicators

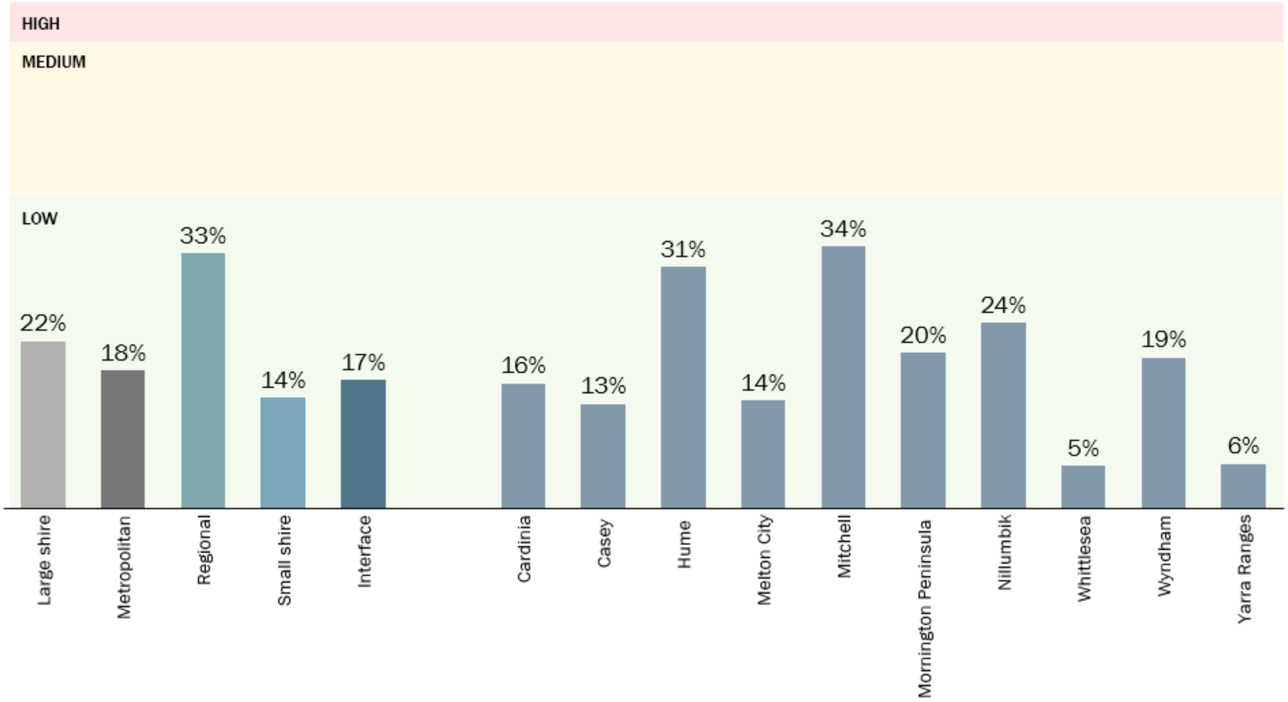
Risk	Indebtedness
HIGH	**More than 60%** Potentially long-term concern over an entity's ability to repay debt levels from own-source revenue
MEDIUM	**40% to 60%** Some concern over the ability to repay debt from own-source revenue
LOW	**40% or less** No concern over the ability to repay debt from own-source revenue

Source: Victorian Auditor-General (2024), Results of 2022-23 Audits: Local Government

[22] In addition to borrowings, the indebtedness ratio calculated by VAGO include other non-current liabilities, including lease liabilities and provisions

Not all, but most councils are carrying reasonable levels of debt, and sit within VAGO's own definition of low risk for the indebtedness indicator.

Figure 13: Council indebtedness ratio, Outer Melbourne Councils and by council group (%), 2022-23



Source: Victorian Auditor-General (2024), Results of 2022-23 Audits: Local Government

In the Essential Services Commission's (ESC) latest assessment of Local Government Financial Performance in their advice to the minister in setting the annual rate cap, they concluded the following:

> *While council cash reserves are declining, the sector maintains low levels of debt and stable borrowing levels. Debt finance can be a key element of a prudent and responsible long-term financial plan. Borrowing money to fund the construction of 'long-lived' assets can be a viable option for councils facing reduced cash reserves. Based on Local Government Victoria's 2023–24 analysis of council budgets, the sector's borrowing levels remained stable.*

Source: Essential Services Commission (2023), Essential Services Commission advice on the rate cap for 2024-25

In reality, the revenue constraints faced by councils as above limit councils' ability to take on and repay additional debt, beyond what they are already carrying. Doing so would place them at higher risk (by VAGO's own criteria) of being able to repay their obligations from own-source revenue alone.

3 The way forward

As Melbourne's population is projected to outgrow Sydney due to factors beyond local government control, the need for substantial investment in new suburbs and infrastructure, especially within the geographical boundaries of the Outer Melbourne Councils, becomes paramount. This growth presents both opportunities and challenges that necessitate a collaborative approach between state and local governments.

The Victorian Government has announced a reduction in capital spending from its peak levels to meet broader fiscal objectives, including stabilising and reducing debt. Despite this, local governments in growth areas will require increased spending to cater to their growing populations. KordaMentha has put forth several recommendations to unlock capital, enabling a robust response to these needs. The synergy between state and local governments can further accelerate capital investment, effectively managing population growth and ensuring sustainable urban development.

As noted in this report, Local Governments in Victoria generally maintain strong balance sheets. By supporting debt through appropriate funding sources, councils can further leverage their financial positions to drive capital investment and development. This strategic financial management is essential to meet the escalating demands of expanding suburbs and improving infrastructure.

3.1 Strategic recommendations

3.1.1 Rate indexation reform

Current indexation rates are inadequate for councils to cope with escalating costs, particularly capital construction costs. Given that a significant portion of council expenditure is capital-related, especially for Outer Melbourne Councils building new suburbs, an adjustment in indexation rates is necessary. Such an adjustment would allow councils to maintain their activities and manage costs effectively. Additionally, providing allowances for councils with larger capital expenditures to genuinely reflect the cost of capital is recommended.

3.1.2 Optimising existing property portfolio

Councils possess substantial land holdings across their municipalities. A strategic review of these holdings presents an opportunity optimise their value and rationalise surplus land holdings. Where appropriate, councils should consider moving up the value chain, partnering with other stakeholders and the private sector (developers, investors and financiers) to unlock value from their portfolios. This comes with exposure to broader risks, but the potential for significantly enhanced returns. This strategic approach to land management can provide additional funding for local projects and initiatives.

3.1.3 Windfall gains tax reform

Currently, land rezoned by councils triggers a State Government windfall gains tax, from which other government institutions are exempt. Reviewing this exemption for local governments and providing rebates against this charge, if reinvested in local capital programs, can align local and state government priorities. This reform would support councils in financing necessary infrastructure projects without the additional financial burden.

3.1.4 Formalise strategic partnerships for large scale capital projects.

Formalising strategic partnerships for large-scale capital projects is crucial. In their *Infrastructure Strategy 2021-2051*, Infrastructure Victoria made the following recommendation:

> **Recommendation 73: Fund libraries and aquatic centres in growth areas**
>
> **In the next five years, increase funding to support local governments to plan and deliver libraries and aquatic recreation centres in Melbourne's seven growth area municipalities**

Source: Infrastructure Victoria (2021), Victoria's infrastructure strategy 2021 - 2051

By aligning with Infrastructure Victoria's recommendations on libraries and aquatic centres funding, councils can engage in more effective collaborations, leveraging expertise and resources to deliver significant infrastructure projects that benefit the broader community.[23]

[23] Infrastructure Victoria (2021), Victoria's infrastructure strategy 2021 - 2051

3.1.5 Other Operating Efficiencies

Several operational efficiencies can be achieved through restructuring initiatives, such as:

- Shared Services: Enhancing service delivery through shared services among councils.
- Co-location of Facilities: Implementing co-location of facilities, exemplified by government hubs, to maximise resource utilisation.
- Joint Procurement Reform: Adopting joint procurement practices, as seen with the ACT Government leveraging federal government contracts, to achieve cost savings.
- Infrastructure Victoria Pipeline: Utilising the Infrastructure Victoria pipeline to streamline and prioritise infrastructure projects.

3.2 Conclusion

Melbourne's anticipated population growth requires a proactive and collaborative approach to infrastructure development and urban planning. By implementing the recommendations outlined in this chapter, local and state governments can ensure that the city's growth is managed sustainably, benefiting all residents and maintaining Melbourne's status as a thriving, liveable city.