

Municipal Association of Victoria

Trends in Local Government Finance 2006-07: Summary

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Introduction

The Municipal Association of Victoria (MAV) has assessed the financial strength of Victorian councils over a number of years. The purpose of the analysis is to identify those councils facing financial risks, and assess whether through internal reform, they can improve their financial performance.

The MAV believes that long-term debt – composed of infrastructure backlogs or borrowings – best reflects the financial risk for councils.

Local government financial strength is difficult to measure accurately because councils spend a large portion of their budgets on capital. Councils own and manage large infrastructure portfolios which represent their biggest financial risk and are a substantial source of expenditure. As the key challenge facing councils is to manage and rebuild this infrastructure, financial analysis is needed to measure the effectiveness of municipalities in completing this task.

The Step Asset Management Program, run by the MAV, also provides data on infrastructure backlogs from an engineering perspective. This alternative dataset has merit when combined with the financial analysis to understand how councils are performing in their stewardship of assets.

Where a council shows high risks, without the ability to overcome these debts or source funding from other levels of government, there are concerns that local infrastructure such as roads, bridges and community buildings will deteriorate over time.

A similar risk is evident around possible financial stress in repaying long-term borrowings. Issues with debt are generally of lesser concern. Analysis indicates that a majority of risk for Victorian councils' financial strength generally relates to their infrastructure renewal.

In interpreting this paper, it is important to note that while local government infrastructure generates vital economic and social benefits and its deterioration will negatively affect communities, being at risk will not result in bankrupt organisations. The issues of failing to fund infrastructure requirements or long-term debt are intergenerational equity consideration.

Being identified as financially 'at risk' in the MAV's analysis does not mean a council is at risk of bankruptcy or becoming broke. No council in Victoria is at risk of becoming broke in either the short or long-term.

Councils' financial performance has been improving in the long term, with a reduced number experiencing operating deficits and capital expenditure increasing significantly.

As the data used by the MAV is collected over the last 10 years, the current state of councils' finances may be influenced by previous or recent financial challenges. Other MAV research suggests the existence of several factors makes councils more susceptible to financial risks:

- small populations
- large geographic area
- significant infrastructure portfolios.

This year, the MAV has improved its methodology for assessing financial strength by supplementing the 10 year MAV Viability Index (1997-98 to 2006-07), with a five year analysis, and examined the renewal performance of councils over three years.

The renewal measure will improve the analysis by ensuring a council's capital program is considered only for its ability to meet its long-term infrastructure replacement obligations. The five-year analysis provides information about the more recent performance of councils facing financial risks.

While borrowings and under-funding of infrastructure indicate the long-term risks to a council's financial strength, the MAV also seeks to assess whether a council has the capacity to improve its position through:

- reducing cash holdings
- increasing rates
- improving efficiency.

In addition, the MAV examines whether population growth or decline is likely to influence the tax base of a council in the future and therefore its long-term financial strength.

The current performance of the Australian economy is characterised by slowing growth with increasing unemployment and reduced corporate and business profit. This may have consequences for councils in implementing strategies to improve their financial strength through increased revenue and capital expenditure.

The current economic conditions also raise important questions about the role of local government in stimulating their economies. With the Commonwealth providing significant funding to local government through the Regional and Local Community Infrastructure program, local stimulus is likely to continue in 2008-09 and into the 2009-10 financial year.

The economic conditions and the stimulus provided will clearly be key drivers for councils from a finance perspective for 2009-10 and can provide opportunities for improvement to capital expenditure. Among the risks from these drivers are reduced revenues and higher demand for services. Councils may also experience longer term challenges to infrastructure from the effects of climate change.

Importantly, these challenges may mean that the immediate priorities of councils may change as they give consideration to rating affordability, local stimulus and employment.

Summary of Financial Strength

In 2007 the MAV Viability Index and related analysis of councils' financial strength identified 20 councils deemed financially at risk, with 13 rated at high or very high risk. As discussed above, the MAV reviewed and updated its methodology to more accurately identify the 'at risk' councils.

As a result, there are 22 councils identified at risk in the 2008 analysis, with 12 rated at high or very high. The overall performance of Victorian councils remains stable and appears to be slowly improving as councils build their understanding of the circumstances that contribute to financial strength and make appropriate policy and financing changes.

Of the 22 councils identified as being at risk of not meeting their debt and infrastructure obligations into the future:

- 10 are considered above average risk
- eight are a high risk
- four are a very high risk.

While the absolute number of councils which have been identified as being at risk has increased, the number of at 'high' or 'very high' risk has reduced from 13 to 12.

The MAV believes those councils at 'above average risk' have the capacity to improve their financial strength over time, while those considered a 'high risk' or 'very high risk' require external funding support.

Measuring Victorian Councils' Financial Strength

Table 1 provides an overview of the key data for the 22 councils identified as 'at risk'. A council is considered at risk if its combined (accumulated) capital underspend and long-term debt exceeds 100 per cent of its rate revenue over the period 1997-98 to 2006-07 or 50 per cent of its revenue between 2001-02 to 2006-07. This rating is known as the MAV Viability Index. A high Viability Index suggests the council has capital underspend and/or long-term borrowing issues. A low or negative index suggests capital expenditure has exceeded depreciation over the life of the survey.

A further Viability Index score has been included for 2006-07 based on the cumulative renewal expenditure. As this dataset is developed over multiple years, this will be increasingly viewed as the preferred index score. However, at this point, the data are unable to distinguish whether high long-term debt reflects short term lack of capital renewal or more persistent risks. This will become apparent as the index develops over several years.

The existence of persistent underlying operating deficits also indicate concerns about a council's ongoing financial strength, as it shows an inability to redirect revenue to debt reduction or increased capital renewal.

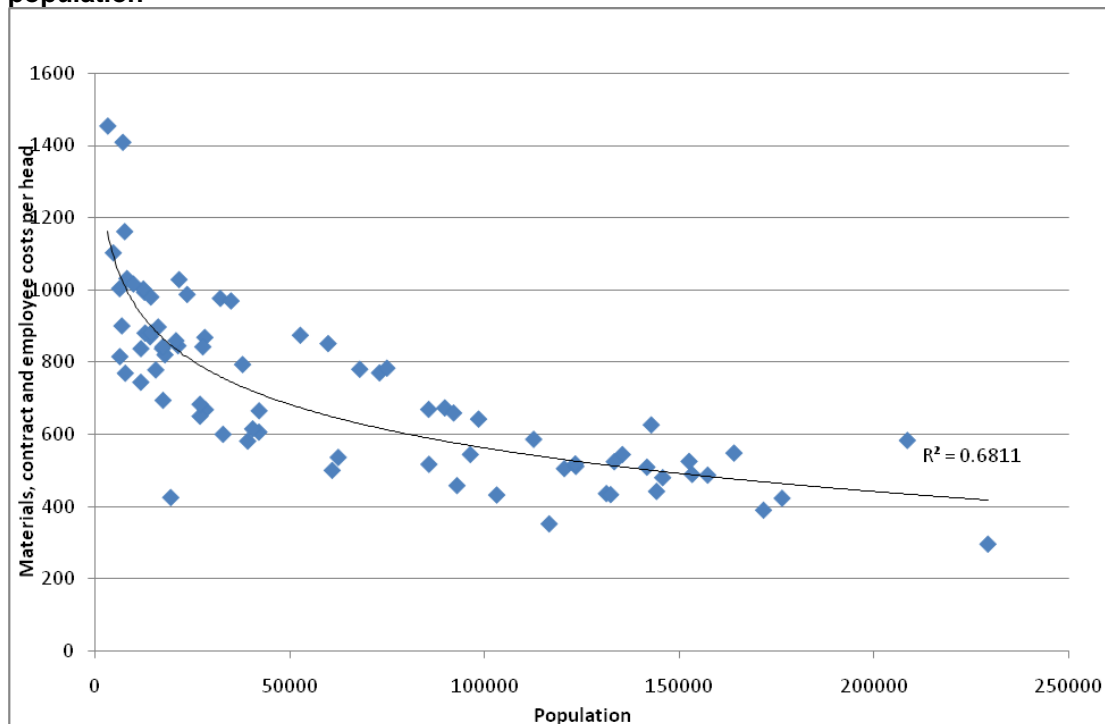
The rating of councils into their respective risk category depends on several important factors. The MAV's approach examines the ability of councils to improve their position through increased tax effort and greater internal efficiencies.

Of particular concern for the MAV is that many councils with ongoing poor viability index scores over both five and 10 years also exhibit high rate effort relative to similar councils, state averages, and local incomes. These councils have only limited capacity to increase their financial strength through rate increases.

Similarly, many 'at risk' councils also demonstrate low costs, with employee, contract and material costs per head of population below cohort and state averages.

Analysis indicates that population is an important driver of council costs, as demonstrated in Figure 1. This graph shows that of all the variables that could influence cost – the number, range and quality of services offered by councils, for example – population is the most important in determining the per capita cost.

Figure 1: Employee, contracts and material costs per head of population by council population



Those councils demonstrating costs below the average levels given their population, face the inability to redirect internal efficiencies towards a reduction in debt levels or an increase in capital spending to improve their viability index rating.

Another salient issue is whether a council currently has high cash holdings¹ which could be redirected to increase capital spend or reduce debt levels and therefore improve their rating. While not explicitly shown in Table 1, reducing cash holdings where excessive, may materially improve the position of eight of the 22 councils.

While all 22 councils exhibiting poor viability index scores are outlined in Table 1, there is significant diversity in their ability to improve their financial strength by either increasing rates, reducing excessive cash holdings, or potentially increasing efficiency.

Those councils deemed to be at 'very high risk' and 'high risk' exhibit poor viability index scores along with high rates relative to local incomes, relatively low costs per head of population, and a limited ability to utilise excessive cash holdings to improve their financial position.

Those councils unable to improve their financial strength through these internal reforms face the ongoing challenge of deteriorating infrastructure and/or high debt. The MAV has concerns about councils facing these challenges and believes the very high risk and high risk municipalities urgently require external funding assistance.

¹ More technically, working capital ratios (current assets to current liabilities) exceeding 200 per cent, which suggests excessive current asset holdings relative to current liabilities.

Table 1: Attributes of 22 Victorian 'at risk' councils

Council	Ten Year VI	Five Year VI	5 Year Underlying +Surplus/-Deficit %	Average Rates Per Assessment 2006-07	Average Real Rate Increases Per Assessment 2001-02 to 2006-07	Average Rates Per Head 2006-07	Average Real Rate Increases per head 2001-02 to 2006-07	Average Employee and Contract Costs Per Head 2006-07	Wage & Salaries as a % of Residential Rates 2005-06	Average Annual Population Change 5 yrs	Overall Assessment
Large Shire	2.69	0.32	-0.8%	\$ 1,200	4.2%	\$650	3.2%	\$850	1.5%	negative	Very High
Small Shire	1.92	-0.06	-1.4%	\$ 1,150	8.3%	\$ 1,000	5.9%	\$1,400	2.2%	negative	Very High
Small Shire	1.62	0.02	0.6%	\$950	8.1%	\$800	9.3%	\$ 750	1.3%	negative	Very High
Small Shire	1.38	0.33	-6.3%	\$ 950	14.7%	\$650	16.7%	\$900	7.4%	low	Very High
Large Shire	1.59	0.49	0.4%	\$ 850	-1.4%	\$650	4.7%	\$650	3.0%	moderate	High
Large Shire	1.5	0.15	-0.8%	\$ 1,000	-1.3%	\$550	-0.9%	\$650	1.8%	moderate	High
Small Shire	1.5	0.49	-0.7%	\$ 1,250	13.7%	\$850	12.9%	\$1,000	3.1%	moderate	High
Regional City	1.45	-0.24	-1.5%	\$ 1,050	9.1%	\$600	8.9%	\$450	2.9%	moderate	High
Small Shire	1.39	0.84	-3.2%	\$ 950	13.4%	\$550	13.9%	\$800	3.2%	moderate	High
Small Shire	1.32	-0.01	-3.5%	\$ 1,200	10.0%	\$700	11.5%	\$850	2.4%	minimal	High
Large Shire	1.25	0.11	-7.5%	\$ 1,050	7.7%	\$700	11.8%	\$850	1.5%	low	High
Small Shire	1.1	0.37	-0.2%	\$ 1,050	10.2%	\$603	12.7%	\$750	2.2%	negative	High
Inner Metro	1.35	0.35	-4.1%	\$ 1,050	11.1%	\$500	13.4%	\$500	2.4%	moderate	Above Average
Regional City	0.88	0.38	-2.2%	\$ 1,150	9.5%	\$550	13.6%	\$700	2.8%	moderate	Above Average
Small Shire	0.88	0.2	-1.4%	\$ 950	10.3%	\$700	12.9%	\$1,000	2.4%	negative	Above Average
Inner Metro	0.79	0.02	-2.6%	\$ 1,000	7.6%	\$450	14.2%	\$450	1.5%	low	Above Average
Outer Metro	0.78	0.53	-2.1%	\$ 850	9.5%	\$550	12.0%	\$650	2.3%	moderate	Above Average
Regional City	0.68	0.48	-2.8%	\$ 1,360	9.6%	\$700	9.0%	\$1,000	0.9%	moderate	Above Average
Large Shire	0.67	0.36	-8.6%	\$ 1,150	10.9%	\$600	18.8%	\$650	1.2%	high	Above Average
Outer Metro	0.66	0.38	3.6%	\$ 1,150	-2.5%	\$500	6.2%	\$500	2.4%	very high	Above Average
Small Shire	0.64	0.49	-4.9%	\$ 1,250	10.0%	\$700	18.0%	\$850	2.2%	low	Above Average
Outer Metro	0.6	0.06	0.3%	\$ 1,050	5.1%	\$400	6.4%	\$500	1.7%	high	Above Average
Statewide Average	-0.12	0.05	3.8%	\$ 1,100	5.9%	\$600	8.3%	\$600	1.9%	average	

Identifying 'at risk' councils

The MAV does not produce a table identifying any councils or their assessed financial strength. Councils are only identified by number in the MAV's analysis. Each council is provided with a copy of the MAV's financial strength report, along with their corresponding number. Therefore, each council only knows its own identity, not the identity of any other municipalities.

The MAV has chosen this approach due to the sensitivity of the information being analysed and to ensure the key purpose of the analysis is maintained. That is, to strengthen the knowledge and capacity of municipalities and their elected representatives to make budgetary decisions that address each council's particular financial risks over time.

Policy Response

The MAV believes that targeted support to those councils with the greatest demonstrated need represents an appropriate policy response. Targeted assistance to improve the standard of local infrastructure is essential for Victorian communities.

Given the current economic climate has led to policy responses encouraging the allocation of funding from the Commonwealth for local infrastructure projects, the results for councils in future years will be of interest. Funding under these approaches has totalled \$800 million in two tranches of funding across Australia.

It is likely that this funding will improve the financial position of Victorian councils.

The MAV has formed the view that financial assistance from the Commonwealth Government should support the 12 Victorian councils exhibiting 'very high' and 'high risk' characteristics.

The MAV also seeks a commitment from the State Government to work cooperatively with councils to focus capacity and capability building efforts towards asset management, financial management and community planning skills in these councils.

An important element of any financial assistance package from another level of government is the requirement that councils implement adequate asset management, financial management and community planning reforms.

Councils' long-term strategies should identify the appropriate community service and infrastructure needs and align them to their revenue raising capacity and infrastructure renewal and maintenance needs. This would ensure future ability to manage financial and asset management challenges without the need for ongoing external funding assistance once infrastructure backlogs have been overcome.