DISCUSSION PAPER

Purpose – To inform a submission by FinPro to the Legislative Council Economy and Infrastructure Committee Inquiry into Local Government Funding and Services

Prepared By AEC Group

FEBRUARY 2024

Executive Summary

Background

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

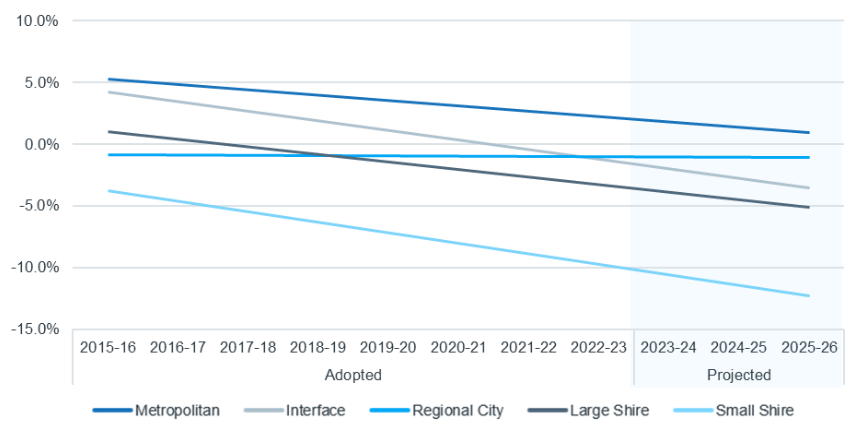
That this House requires the Economy and Infrastructure Committee to inquire into, consider and report, by 30 June 2024, on local government funding and service delivery in Victoria, including but not limited to —

- *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.*

Discussion Issues

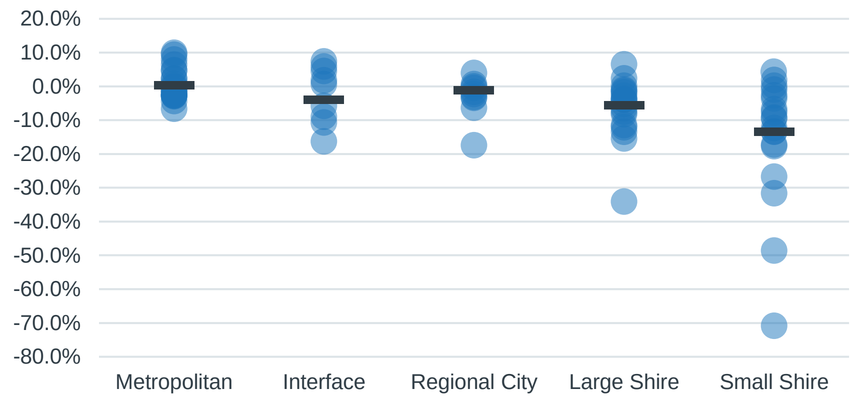
- While the literature outlines concerns with the financial sustainability of local government, particularly rural and regional councils, recent published reports from Local Government Victoria (LGV) and Essential Services Commission (ESC) indicates that local government is in a sound financial position, with sufficient cash to address short term and long term liabilities.
- The Minister (The Hon, Melissa Horne MP), in a letter responding to FinPro dated 12th February 2024, has expressed view that continued generalist advocacy and claims by the local government sector of widespread financial unsustainability are difficult to reconcile with facts – that being, from recently completed annual reporting it is evident that local government is in good financial shape, with low debt and record levels of cash. The minister does acknowledge that some councils, primarily rural shires, face some challenges. The Minister suggests that 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.
- Analysis completed by AEC indicates a deteriorating adjusted underlying result and a deteriorating unrestricted cash position for local government in Victoria.

Adjusted Underlying Result Ratio Trendlines



Source: AEC Analysis (unpublished), LGV Budget Summary Report data (various years)

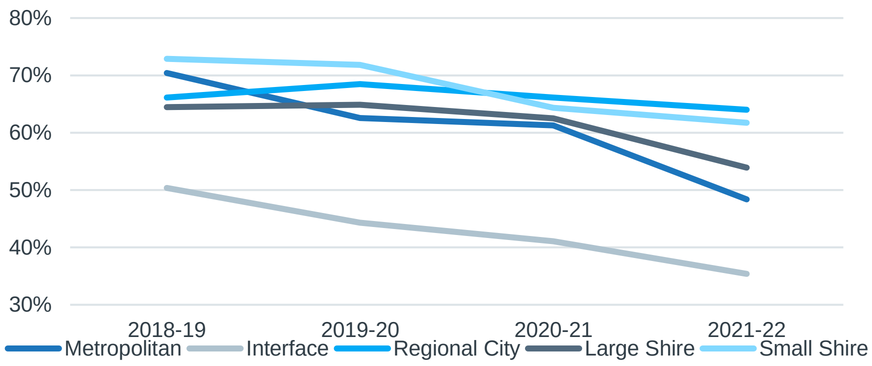
Adjusted Underlying Operating Result Ratio – 2022-23 Budget



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

- LGV refers to the payment in advance of Financial Assistance Grants 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 in payment in advance (or 3.9% of $5.99 billion) is additional payment brought forward in 2022-23. The total Financial Assistance Grants payments received in advance for Victorian councils as at 30 June 2023 is $746 million (or 12.5% of $5.99 billion) which is not a small percentage and if considered as a proportion of the unrestricted cash - estimated to be 23.2% of the estimated $3.34 billion unrestricted cash across all Councils.
- Despite the $746 million in payments received in advance from the Financial Assistance Grants, the unrestricted cash position across all council groups has deteriorated since 2016-17.

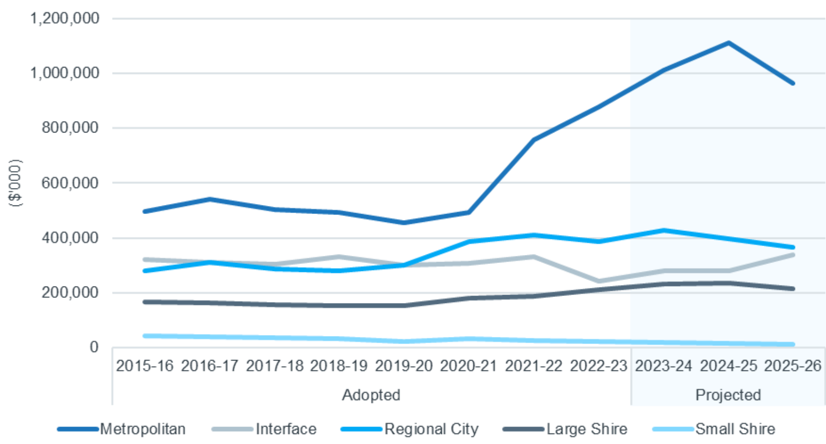
Proportion of Cash and Other Financial Assets Unrestricted



Source: AEC Analysis (unpublished), LGV Local Government Performance Reporting Framework, VAGO Results of Audits: Local Government – annual report from 2018-19 to 2021-22)

- ESC advice on the rate cap for 2024-25 noted that while council cash reserves are declining, they maintain a low level of debt and stable borrowing levels. ESC suggests 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 has referred to the low level of debt as an indicator that local government is in a strong financial position. When further analysed it is evident that the local government sector is using borrowings responsibly and in an affordable manner. To use borrowings to replace operating revenue is not responsible nor is it sustainable. Analysis of historical and projected borrowings (see below) highlights that total borrowings have increased for councils that are in a financial position to use borrowings (particularly metropolitan, large shire, 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.

Total Budgeted Borrowings



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

- Core services for local government is difficult to define. How the Committee intends to measure adequate delivery is unknown.
- The rate cap since 2016-17 has been based on recommendation of ESC, with reference to the Cost Price Index (CPI) forecast for Melbourne as produced by Department of Treasury and Finance. The rate cap has been significantly less than CPI and Wage Price Index since 2021-22.
- There is limited literature on recent cost shifting in Victoria, with most initiatives driven by individual councils. No report has been produced reporting on cost shifting in Victoria since the House of Representatives Committee Inquiry in 2003. LGNSW produces a report on cost shifting every second year.

Discussion Questions for Further Exploration

1 Given the significant investment of resources (both LGV and Councils) into the Rural and Regional Councils Sustainability Reform Program, including the initial $20 million funding and current Implementation Strategy for Shared Services, what benefits have been realised to the financial sustainability of your local government? What, if any, barriers or constraints have there been in realising the intended benefits?

2 What aspects of financial sustainability are not adequately assessed or considered by ESC in their conclusion that the financial health of local government in Victoria remains sound despite the introduction of rate capping in 2016-17?

3 What are the reasons why no applications for a Higher Cap have been submitted since 2020-21, as this is used by some as support to conclusions that local government is in a sound financial position?

4 ESC has concluded the asset renewal ratio reported for local government has been above 100% since 2017-18. Noting that the ratio includes upgrades which may be a significant contribution, is there other analysis FinPro could undertake on assets and capital works spend since 2016-17 that may indicate under the rate cap that investment in renewals is not adequate to sustain assets over the medium to longer term?

5 What, if any, aspects of the ESC consideration and conclusion do you not agree with in making the recommendation on the rate cap for 2024-25?

6 Should there be a formalised and reported Victorian Local Government Cost Index, given ESC is relying on reference to cost indices in other jurisdictions?

7 Given the recent implementation of the Minister's Good Practice Guidelines for Local Government Service Rates and Charges takes effect from 1st March 2024, should further analysis be completed on the impact the Guidelines may have upon local government revenue?

8 Is the LGV view substantially correct that overall councils' financials remain sound due to large majority of councils budgeting for an operating surplus (not adjusted operating surplus), most of substantial cash investments and debt remains low? If not, what aspects of councils' financial performance is not being considered and how can the sector best provide that information?

9 Given that the State Government of Victoria were party to the Inter-Governmental Agreement, what, if any, services or functions have been required to be performed by local government, or asked to perform without due consideration of the consequential financial impact on the capacity of local government?

10 New South Wales is the only jurisdiction where local government has continued to report on cost shifting from the State and Australian Governments since the intergovernmental agreement in 2006. Should the sector be advocating for a similar report to be produced in Victoria? If yes, how often and who is best positioned and resourced to collect the data and prepare the report?

11 Is there any other approach that has been used to identify core services of local government that you may be aware of and that may assist the Committee in defining what are core services for local government and whether councils are adequately delivering the core services? Further analysis of the LGPRF data in the response may assist the Committee in assessing the adequacy of service delivery.

12 What other aspects or impacts of the adjusted underlying operating result should the sector emphasise in the submission?

13 What information or other analysis could the sector do to overcome the inconsistency and accuracy of the reported unrestricted cash position? Should the sector express an opinion on the appropriateness of the current unrestricted ratio as an indicator of financial sustainability? What changes need to be made to improve the indicator and associated analysis/conclusions?

14 What are the potential risks and consequences associated with excessive borrowing by Local Governments, and how can an appropriate level of borrowing be determined to ensure financial sustainability??

15 Are there any other concerns that should be raised by the sector in relation to the historical setting of the rate cap? Given the rate cap for 2024-25 has been set at 2.75% in line with DTF forecast, is there further research or analysis that should be done on this decision and to be included in FinPro's submission?

16 Should the sector be advocating for a review of the rate cap methodology to include the following learnings from the NSW review:

- Differentiated base cost change rather than the current reliance upon forward projections of CPI Melbourne – for example, differentiated by metropolitan, regional and rural council cost bases?
- Including consideration of a (to be developed) Victorian Local Government Cost Index?
- Application of a Population growth factor?

17 Is there any other change to the current Victorian methodology for setting the rate cap that the sector should be highlighting in its submission?

18 Acknowledging that a redistribution of Financial Assistance Grants is a zero-sum game, are there any changes to Financial Assistance Grants that the sector should highlight in the submission?

19 Noting that a later questions in this Discussion Report address the cost shifting of State grant funded programs, is there other considerations of the impact of State grant funded operations that should be considered or quantified?

20 Are there any other major grant programs, operational or capital, that should be included? Are there any changes to the administration or distribution of the grants listed that the sector should be highlighting in the submission?

21 Are there any issues with statutory fees or charges that FinPro should be highlighting in the submission?

22 Should developer contributions be highlighted in the response? If so, what issues with developer contributions should be included? What changes should

FinPro advocate for with respect to establishing and administering developer contributions?

23 Are there any charges, fines, fees or other revenue that the State Government receives that are more appropriate to be the responsibility of local government to collect?

24 Are there current competitive and tied grant programs that the sector should advocate to be rolled into general purpose payments (possibly rolled into Financial Assistance Grants program so that it is protected under legislation)?

25 Other than continuing the current advocacy through MAV and ALGA, is there any other initiative that the sector should be supporting to achieve an increase in the allocation of Commonwealth funding to the Financial Assistance Grants?

26 Would the following definition of cost shifting be appropriate for collecting estimated cost shifting from Victorian councils and reporting to the Committee Inquiry?

- Devolution of functions from State or Commonwealth governments without adequate funding
- Raising the bar through legislative changes increasing the complexity, reporting or standards of Local government services, including required assessments and implementing State Government initiatives, without adequate funding
- Withdrawal of funding or services by the Australian or State Governments leaving Local Government with little choice as the provider of last resort.

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1. Introduction

1.1 Background

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> - *Any other related matters.*

1.2 Purpose of Discussion Paper

Acknowledging the importance of the Committee Inquiry, the FinPro Executive initiated the preparation of this Discussion Paper to:

- Inform members of the inquiry
- To provide a shared understanding of the key issues to be considered by the Committee Inquiry
- To identify information gaps and raise discussion questions for the consideration of members
- To inform the development of a survey to all members to obtain views, opinions and address gaps in information
- To inform the development of the FinPro submission to the Committee Inquiry.
- To provide the discussion paper and insight to other Peak bodies to assist in the development of their own submissions, or to work in partnership with FinPro on a final submission to the Committee.

1.3 Approach to Developing the Submission to Committee Inquiry

FinPro has initiated a four stage approach to developing a Submission to the Committee Inquiry. Given the Committee has not released a request for submission and is likely to do so with a short time to respond given it must report to the House by 30 June 2024, the following staged approach is considered most appropriate to ensure FinPro is in a position, with background information obtained and following consultation with members and stakeholders, to prepare a response that best represents the interest of our members and stakeholders. It is also acknowledged that the stages may need to change after the Committee releases the invitation for submissions.

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

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

Stage Three – Survey and information requests to obtain required information

Stage Four – Preparation of the FinPro submission.

Stage One - Develop a Discussion Paper to raise awareness of the Inquiry, highlight key considerations and recruit interest from members and stakeholders to contribute.	**Stage Two** – Using the Discussion Paper, consult with members and stakeholders to increase participation, confirm key issues and identify further information required.	**Stage Three** – Prepare survey addressing discussion questions from Stage One and facilitate the completion of the survey from all Councils.	**Stage Four** – Complete analysis of data and prepare the 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. Literature Review

2.1 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.

Discussion Question 1

Given the significant investment of resources (both LGV and Councils) into the Rural and Regional Councils Sustainability Reform Program, including the initial $20 million funding and current Implementation Strategy for Shared Services, what benefits have been realised to the financial sustainability of your local government? What, if any, barriers or constraints have there been in realising the intended benefits?

2.2 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.

2.3 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 2.1. 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

Discussion Question 2

What aspects of financial sustainability are not adequately assessed or considered by ESC in their conclusion that the financial health of local government in Victoria remains sound despite the introduction of rate capping in 2016-17?

Discussion Question 3

What are the reasons why no applications for a Higher Cap have been submitted since 2020-21, as this is used by some as support to conclusions that local government is in a sound financial position?

Discussion Question 4

ESC has concluded the asset renewal ratio reported for local government has been above 100% since 2017-18. Noting that the ratio includes upgrades which may be a significant contribution, is there other analysis FinPro could undertake on assets and capital works spend since 2016-17 that may indicate under the rate cap that investment in renewals is not adequate to sustain assets over the medium to longer term?

2.4 Essential Services Commission advice on the 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 utilising 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.*

Discussion Question 5

What, if any, aspects of the ESC consideration and conclusion do you not agree with in making the recommendation on the rate cap for 2024-25?

Discussion Question 6

Should there be a formalised and reported Victorian Local Government Cost Index, given ESC is relying on reference to cost indices in other jurisdictions?

2.5 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.

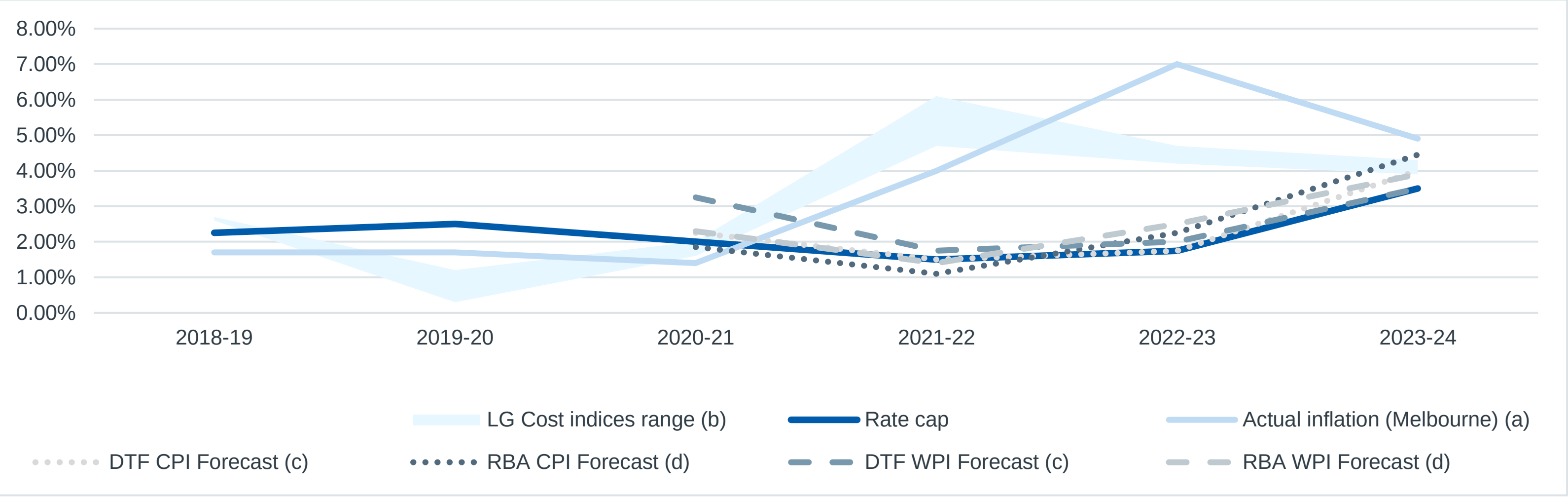
Table 2.2. Rate Cap, CPI, Cost Indices and Forecasts (%) (report extract)

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 inline 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 2.1. Rate Cap, CPI, Cost Indices and Forecasts



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2.6 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

2.7 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.

Discussion Question 7

Given the recent implementation of the Minister's Good Practice Guidelines for Local Government Service Rates and Charges takes effect from 1st March 2024, should further analysis be completed on the impact the Guidelines may have upon local government revenue?

Discussion Question 8

Is the LGV view substantially correct that overall councils' financials remain sound due to large majority of councils budgeting for an operating surplus (not adjusted operating surplus), most of substantial cash investments and debt remains low? If not, what aspects of councils' financial performance is not being considered and how can the sector best provide that information?

2.8 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.

2.9 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.

2.10 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.

2.11 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.

Discussion Question 9

Given that the State Government of Victoria were party to the Inter-Governmental Agreement, what, if any, services or functions have been required to be performed by local government, or asked to perform without due consideration of the consequential financial impact on the capacity of local government?

2.12 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.

Discussion Question 10

Given New South Wales is the only jurisdiction where local government has continued to report on cost shifting from the State and Australian Governments since the intergovernmental agreement in 2006, should FinPro be advocating for a similar report to be produced in Victoria? If yes, how often and who is best positioned and resourced to collect the data and prepare the report (e.g., FinPro, MAV)?

2.13 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.

AEC Observation – The lack of evidence of the material impact on Local Government of both cost shifting and the cost of compliance with State Government legislation significantly impacted on the ability of the Commission to make findings on the materiality of the impact on financial sustainability of Local Government. Enhanced regular reporting of cost shifting and compliance with legislation in Victoria would significantly improve ability to increase awareness and advocate for the impact on Local Government and may prevent or dissuade further imposition on Victorian councils.

2.14 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.

AEC Observation – In recent time a number of Victorian Councils (including Glen Eira City Council and Mornington Peninsula Shire) have published Council reports detailing the impact of cost shifting.

2.15 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.

3. Core Services of Local Government in Victoria

3.1 Core Service Delivery

Per the Terms of Reference, the Committee Inquiry intends to assess whether councils are adequately delivering on their core service delivery objectives. This raises questions regarding how the Committee will define what is a core service of Local Government and how the adequacy of the delivery of the service will be measured? The discussion below outlines what the Local Government Act 2020 (the Act) defines as a Local Government responsibility and, using Local Government Grants Commission (LGGC) data, provides an analysis of the data to identify the services where expenditure is occurring for the different council groups.

3.2 Local Government Act 2020

While the Act and regulations define 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 has 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 a council, 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 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 Act. 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 Act.

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, including road management, land use planning, planning permits, development contributions, making and enforcing local laws, building control, public health services, domestic animal control and environmental protection. Other services typically provided by Local Government include maternal and child health, immunisations, home assistance and respite care, homecare needs, public and street lighting, libraries and events.

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. Councils also have extensive roles as regulators, with examples provided below.

Table 3.1. 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

Discussion Question 11

Is there any other approach that has been used to identify core services of local government that you may be aware of and that may assist the Committee in defining what are core services for local government and whether councils are adequately delivering the core services? Further analysis of the LGPRF data in the response may assist the Committee in assessing the adequacy of service delivery.

3.3 Local Government Grants Commission Data on Expenditure by Function – 2021-22

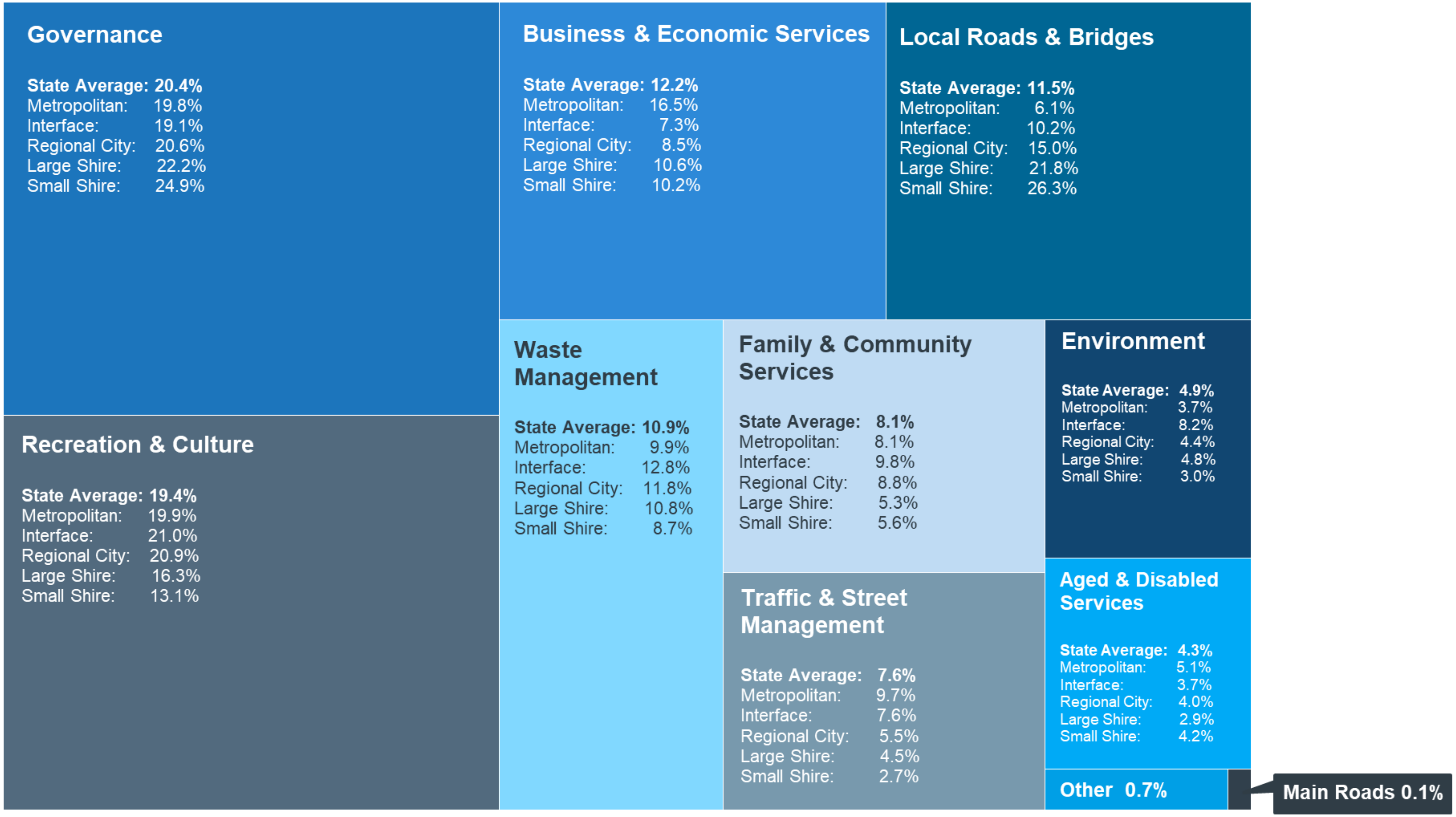
To define a service that may be considered by the Committee Inquiry as a core service, AEC analysed the LGGC on Expenditure by Service (2021-22) with the results provided on the following pages. LGGC defines services by 60 individual functions categorised into ten functional categories. (Refer to the Victorian LGGC Questionnaire Manual for definitions of the functional categories and functions.) Figure 3.1 outlines the relative importance of the ten functional categories.

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. Table 3.2 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.

Figure 3.1. Percentage of Expenditure by Functional Category Across Local Government – 2021-22 (cohort breakdowns shown for comparison)



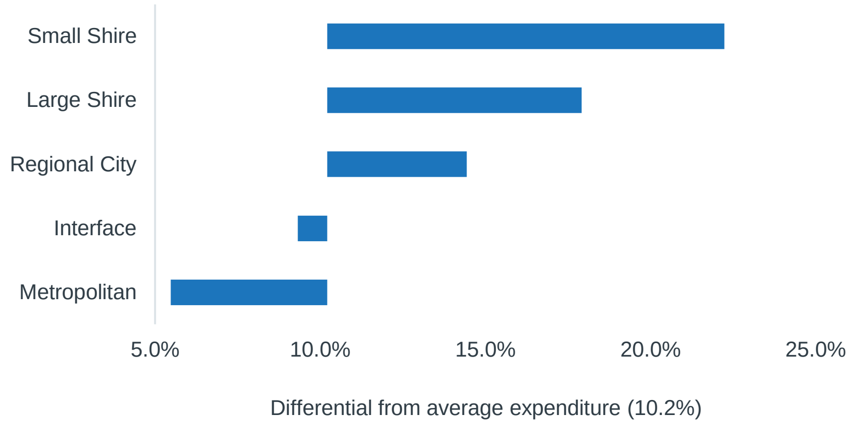
Source: Victorian LGGC – Questionnaire 2021-22 response from councils

Table 3.2. 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

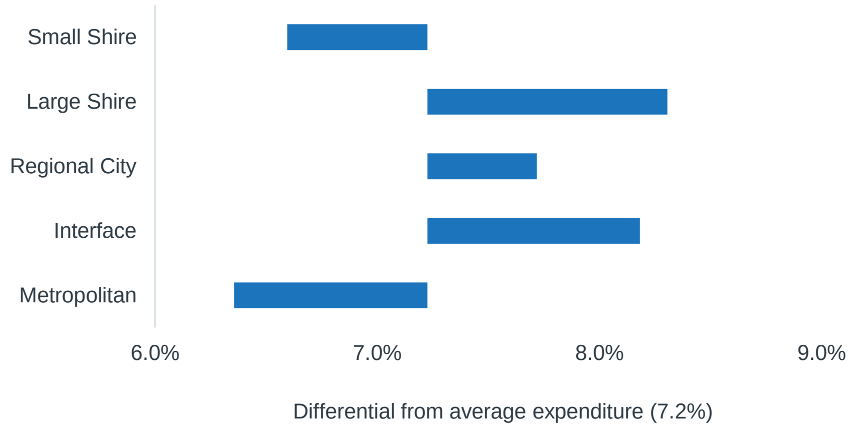
Source: Victorian LGGC Data Collection 2021-22

Figure 3.2. Local Road & Bridge Works Differential from Average Expenditure – 2021-22



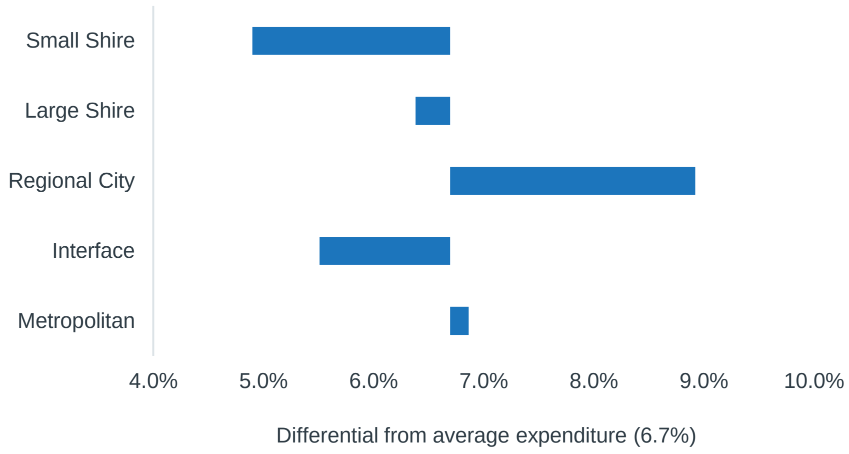
Source: Victorian LGGC Data Collection 2021-22

Figure 3.3. Residential General Waste Differential from Average Expenditure – 2021-22



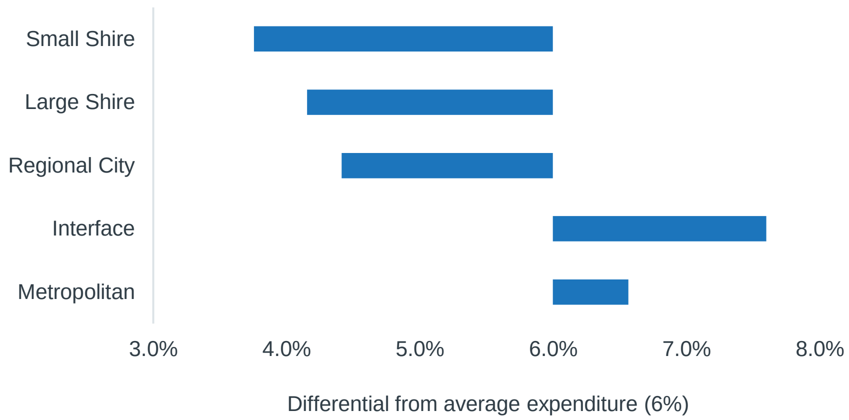
Source: Victorian LGGC Data Collection 2021-22

Figure 3.4. General Administration Differential from Average Expenditure – 2021-22



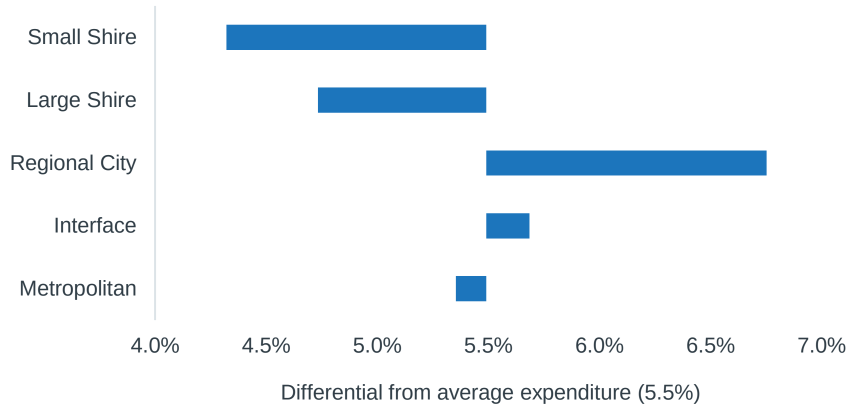
Source: Victorian LGGC Data Collection 2021-22

Figure 3.5. Parks & Reserves Differential from Average Expenditure – 2021-22



Source: Victorian LGGC Data Collection 2021-22

Figure 3.6. Sports Grounds & Facilities Differential from Average Expenditure – 2021-22



Source: Victorian LGGC Data Collection 2021-22

4. Analysis of Adopted Budgets – 2015-16 to 2025-26

As noted earlier in the Literature Review, the financial position of local government is considered by LGV and ESC to be sound, based predominantly on assessment of Council operating result (or adjusted underlying result), availability of cash and low level of borrowings.

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)*

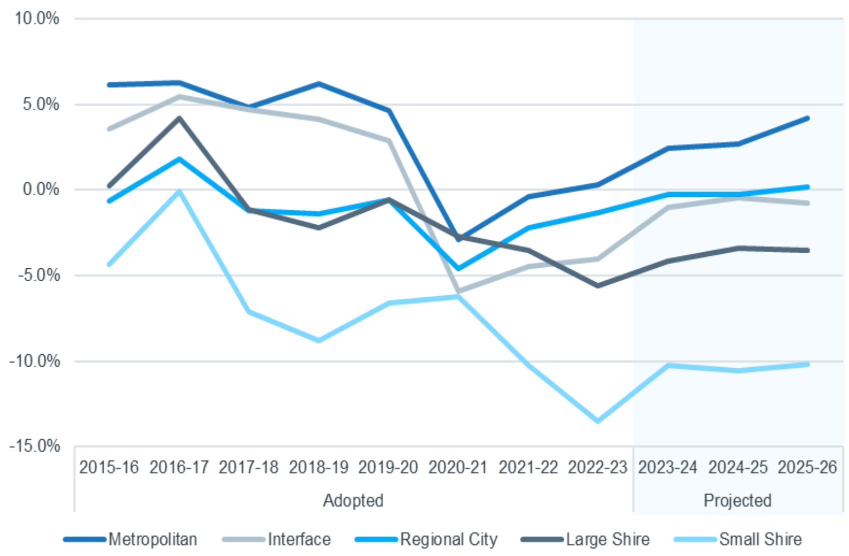
The following section explores the financial position of local government further and raise issues that may require further analysis and discussion to respond to the assessment and conclusions of the Minister, LGV and ESC.

4.1 Adjusted Underlying Result

This operating position performance ratio is a calculation of the adjusted underlying operating surplus (or deficit) as a percentage of adjusted underlying revenue. It is audited and reported in the Local Government Performance Reporting Framework. Adjusted underlying operating surplus excludes capital grants and other adjustments not generated in the ordinary course of business.

Figure 4.1 highlights that the COVID pandemic significantly impacted results, particularly in 2020-21. Most councils have adopted a budget for a negative result in 2022-23 but have indicated an improvement in the projected forward three financial years.

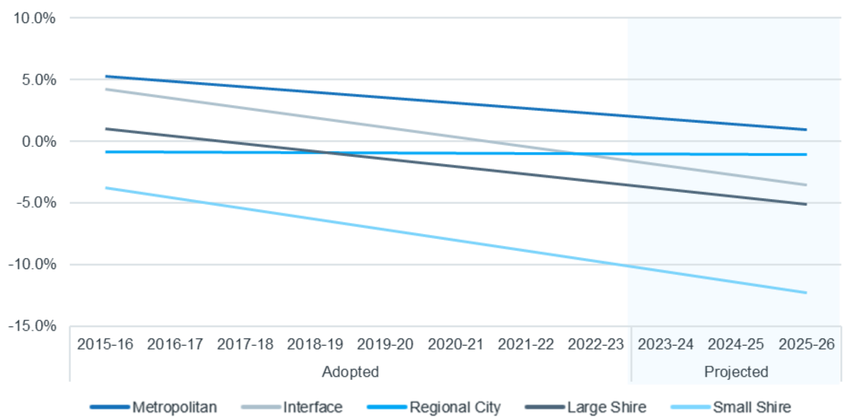
Figure 4.1. Adjusted Underlying Result Ratio



Source: AEC Analysis (unpublished), LGV Budget Summary Report data (various years)
Notes: It should be noted that 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.

More importantly, Figure 4.2 provides the trendline over the same period. All Council groups except for regional city councils show a declining trend in the adjusted underlying operating result in the budgets adopted from 2015-16 to 2022-23 and projections through to 2025-26.

Figure 4.2. Adjusted Underlying Result Ratio Trendlines



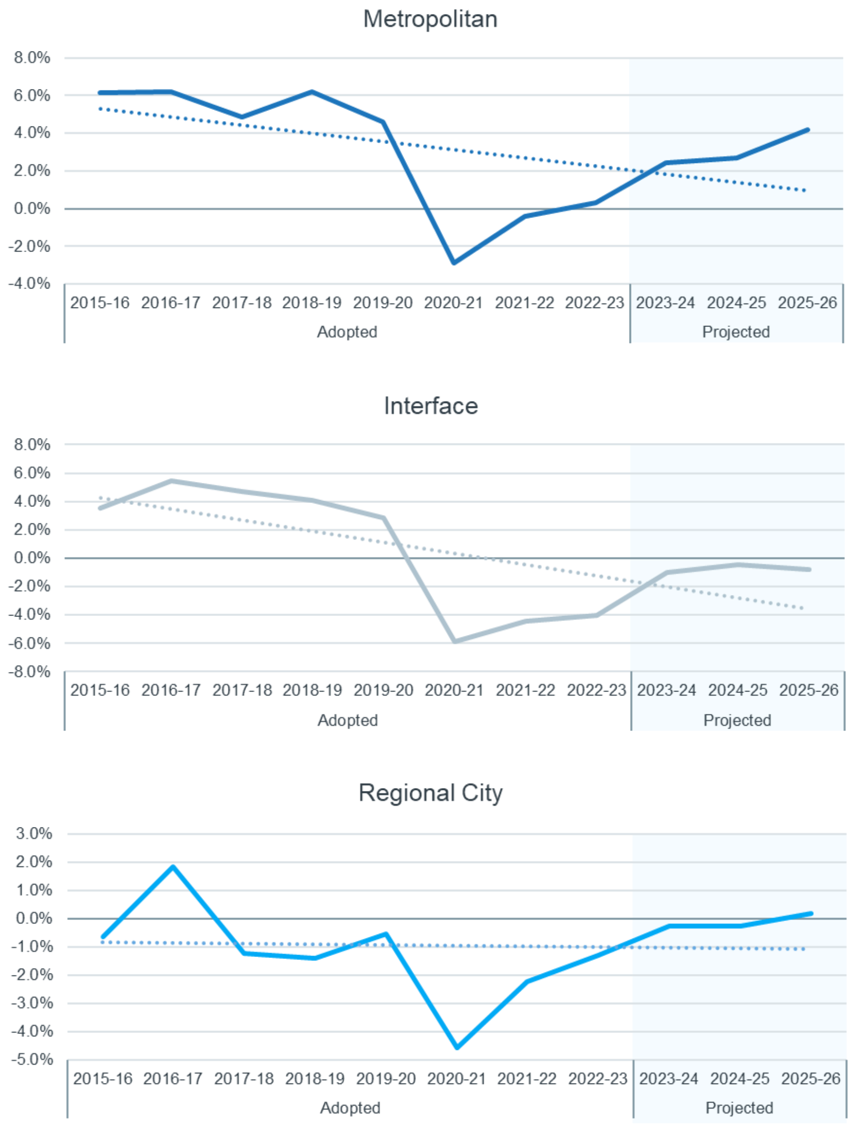
Source: AEC Analysis (unpublished), LGV Budget Summary Report data (various years)

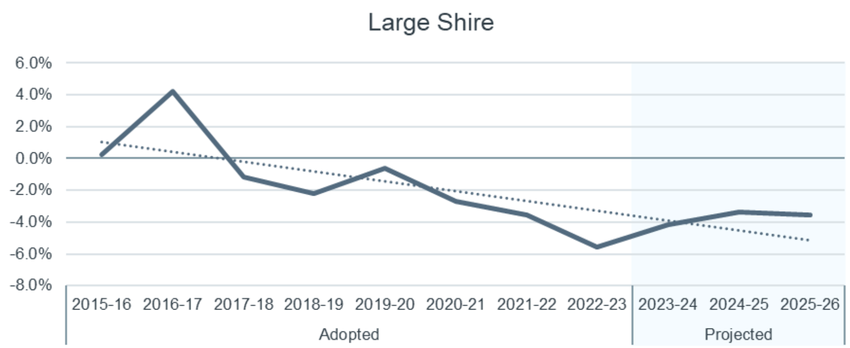
A deteriorating adjusted underlying result, particularly if producing a negative result, is unsustainable for the medium to long term. From the literature review, the key stakeholders (being LGV, VAGO and ESC) consistently raise concerns with a deteriorating adjusted underlying result yet continue to conclude that Local Government is in a sound financial position (mostly due to liquidity, cash holdings and low borrowings).

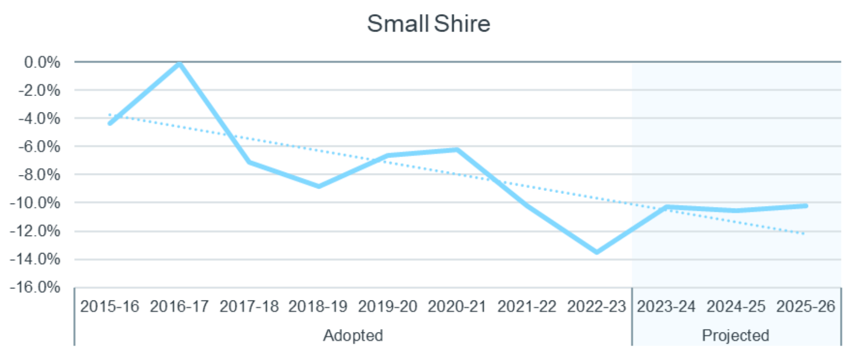
Over the long term, councils cannot be expected to produce operating deficits without a deterioration in infrastructure. Furthermore, investing less than required to maintain assets on a consistent basis will ultimately lead to higher costs to renew and bring assets to a satisfactory condition, leading to a further deterioration in the financial sustainability. This is not being appropriately considered by LGV, VAGO 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 sustainability of Local Government.

Figure 4.3. Adjusted Underlying Result Ratios by Council Cohort



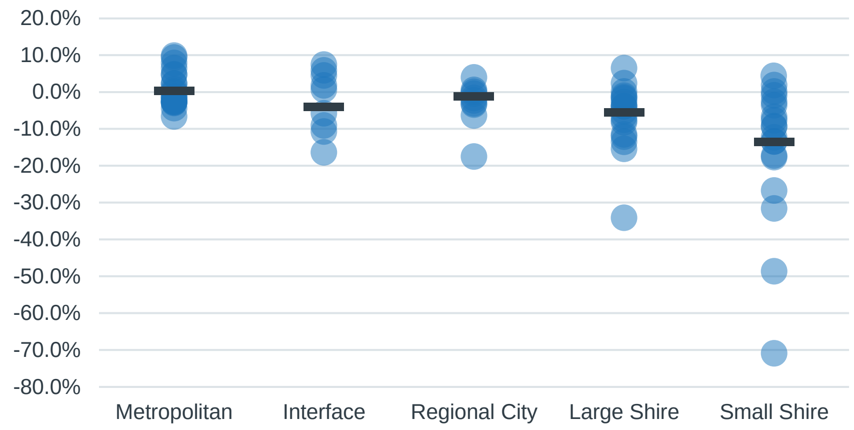




Source: AEC Analysis (unpublished), LGV Budget Summary Report data (various years)

The spread of the adjusted underlying result ratio also varies within each cohort, with the following graph illustrating the ratio spread for the 2022-23 budget.

Figure 4.4. Adjusted Underlying Operating Result Ratio – 2022-23 Budget



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

> **Discussion Question 12**
>
> What other aspects or impacts of the adjusted underlying operating result should the sector emphasise in the submission?

4.2 Unrestricted Cash

A key indicator of whether a council is sustainable is not 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. Incomplete or delayed capital works is a matter that VAGO and ESC have also raised in recent assessments of the financial position and increased cash holdings of councils.

The cash holdings of councils across Victoria have historically improved as a consequence of the bring forward payments of the Financial Assistance Grants from the Australian 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 and if considered as a proportion of the unrestricted cash is estimated to be 23.2% of estimated $3.34 billion unrestricted cash across all Councils.

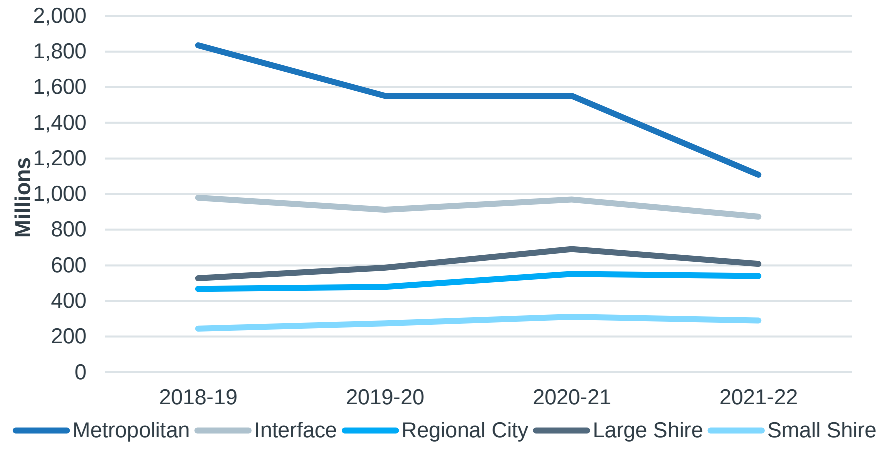
The increase in cash due to the prepayment of grant funding would most likely materially improve the large shire and small shire councils more than other councils. Unless this cash is held in a reserve, it is important to note that the unrestricted cash position is likely to deteriorate in future when 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) AEC analysed the unrestricted cash ratio reported through the Victorian Local Government Performance Reporting Framework. The analysis found that this ratio is not calculated and reported consistently according to the formula across the different councils and from one year to the next for the same council. Furthermore, due to maturity timing of investments, significant cash held in investments may not be being included in the calculation of the ratio, leading to a significantly deteriorated unrestricted cash position and large variability in the reported position from year to year.

Given LGV and VAGO place a high emphasis on the use of this ratio to measure financial sustainability, this inconsistency is of great concern and interpretation of the results can be misleading. The importance of the correct calculation of unrestricted cash and other financial assets is critical due to the restriction on revenue generation that councils are facing combined with the ever growing demand for services.

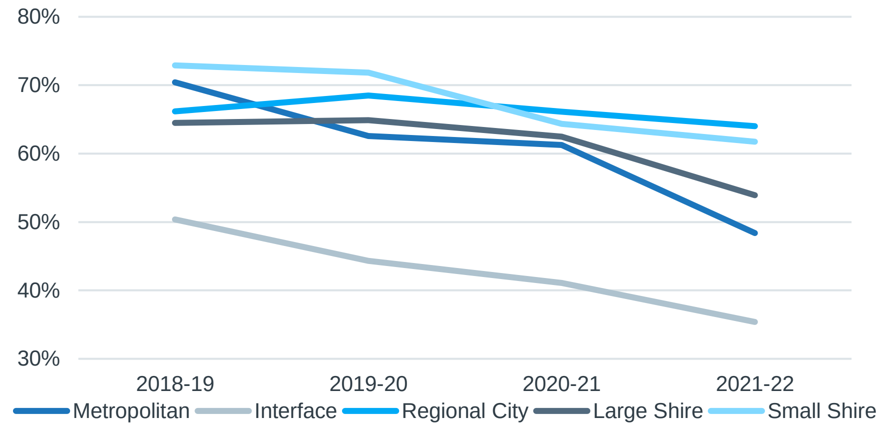
The graphs below illustrate the calculated total unrestricted cash and other financial assets held by all Victorian councils between 2018-19 and 2021-22. The calculation of the unrestricted cash and other financial assets has been performed using the unrestricted cash ratio, cash and other financial asset balances and includes corrections for inconsistent application of the formula. The graphs show that, whilst the unrestricted cash and other financial assets is increasing across some cohorts, as a percentage of total cash and other financial assets there is a deteriorating trend.

Figure 4.5. 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 2021-22)

Figure 4.6. 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 2021-22)

The use of the unrestricted cash ratio to conclude whether a council is in a sound position is highly questionable given the lack of consistency in interpreting the instructions and that the current ratio excludes other financial assets.

Discussion Question 13

What information or other analysis could the sector do to overcome the inconsistency and accuracy of the reported unrestricted cash position? Should the sector express an opinion on the appropriateness of the current unrestricted ratio as an indicator of financial sustainability? What changes need to be made to improve the indicator and associated analysis/conclusions?

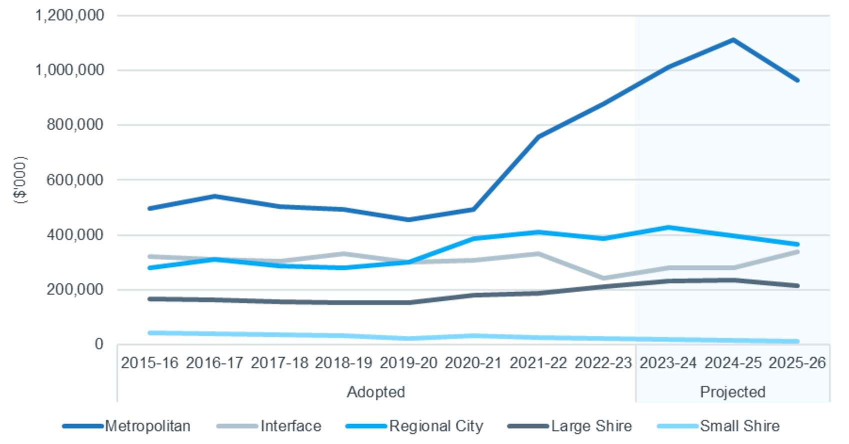
4.3 Borrowings

ESC advice on the rate cap for 2024-25 noted that while council cash reserves are declining, they maintain a low level of debt and stable borrowing levels. ESC suggests 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 has referred to the low level of debt as an indicator that local government is in a strong financial position.

When further analysed it is evident that the local government sector is using borrowings responsibly and in an affordable manner. To use borrowings to replace operating revenue is not responsible nor is it sustainable. Analysis of historical and projected borrowings (see below) highlights that total borrowings have increased for councils that are in a financial position to use borrowings (particularly metropolitan, large shire, 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 the total borrowings are increasing.

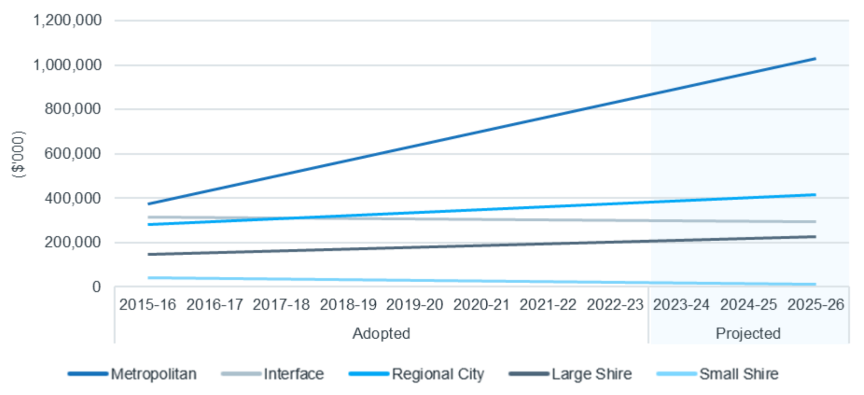
Increasing the use of borrowings by local government with declining unrestricted cash is fundamentally not sustainable. Additional revenue is necessary to pay for the increased borrowings. This is a position that the State government is in and not a position that local government should be planning to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

Figure 4.7. Total Budgeted Borrowings



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

Figure 4.8. Total Budgeted Borrowings Trendline



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

Discussion Question 14

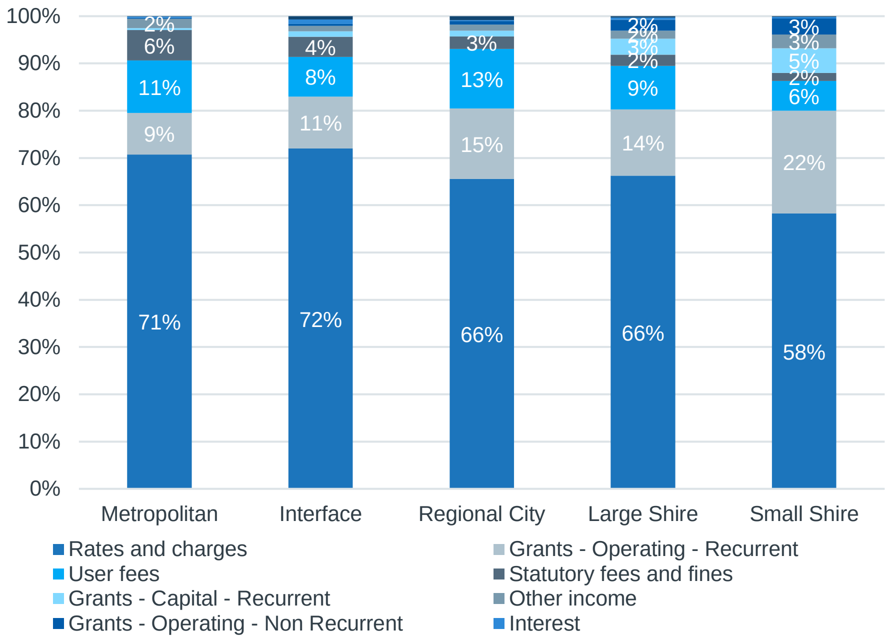
What are the potential risks and consequences associated with excessive borrowing by Local Governments, and how can an appropriate level of borrowing be determined to ensure financial sustainability?

5. Revenue Structure of Local Government in Victoria

5.1 Budgeted Revenue in 2022-23

The main source of revenue for Victorian councils is rates and charges, accounting for 69% the total adjusted underlying revenue, followed by recurrent operating grants (11%), user fees (10%) and statutory fees and fines (5%). Figure 5.1 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 effect of the Financial Assistance Grants).

Figure 5.1. 2022-23 Budget - Revenue Categories as a % of Adjusted Underlying Revenue



5.2 Source: AEC Analysis (unpublished), LGV 2022-23 Budget Summary Report dataRates and Charges

Rates and charges is the key revenue source for the majority of Victorian councils, and the ability of Local Government to determine required rates and charges revenue is therefore fundamental to self-determined financial sustainability. Restrictions placed by the State Government on the ability of Local Government to generate rate revenue must be carefully considered, scrutinised and reviewed, with the impact of any controls on Local Government sustainability appropriately analysed and independently and transparently reported.

5.2.1 Victorian Rate Cap

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 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 consumer price index over the rating year to which the cap relates, plus or minus any adjustment. ESC 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 the recommendation should include the financial sustainability of the sector, changes in council costs, expectations of future wage rises and recent economic forecasts.

In a 2022 published report (The Sustainability Gap – The Financial Health of Victorian Councils) MAV and FinPro jointly raised the following concerns with the Victorian Rate Cap:

- 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. While often criticised, this reflects retaining key services in-house rather than outsourcing, something strongly supported by communities. Neither wages nor civil construction costs are accurately reflected by CPI.
- The current methodology results in a rate cap which doesn't accurately reflect council expenses and the longer this continues, the greater the problem becomes as erosion of the rate base is 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 won't 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.

Discussion Question 15

Are there any other concerns that should be raised by the sector in relation to the historical setting of the rate cap?

Given the rate cap for 2024/25 has been set at 2.75% in line with DTF forecast, is there further research or analysis that should be done on this decision and to be included in FinPro's submission?

5.2.2 New South Wales Rate Peg Methodology

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 Final Report into a review of the rate peg methodology. Submissions from councils in NSW identified the following concerns with the past 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 does not 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 IPART review resulted in changes to the methodology in NSW for setting the rate peg. The new methodology applied by IPART for calculating the 2024-25 rate peg has 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 (instead of one that includes all councils) to better account for the diversity of the base costs, with the groups being metropolitan, regional and rural councils.

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 now be measured by the Local Government State Award increases and superannuation guarantee increases. Asset costs are 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). All other operating costs are 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.

Discussion Question 16

Should the sector be advocating for a review of the rate cap methodology to include the following learnings from the NSW review:

- Differentiated base cost change rather than the current reliance upon forward projections of CPI Melbourne – for example, differentiated by metropolitan, regional and rural council cost bases?
- Including consideration of a (to be developed) Victorian Local Government Cost Index?
- Application of a population growth factor?

Discussion Question 17

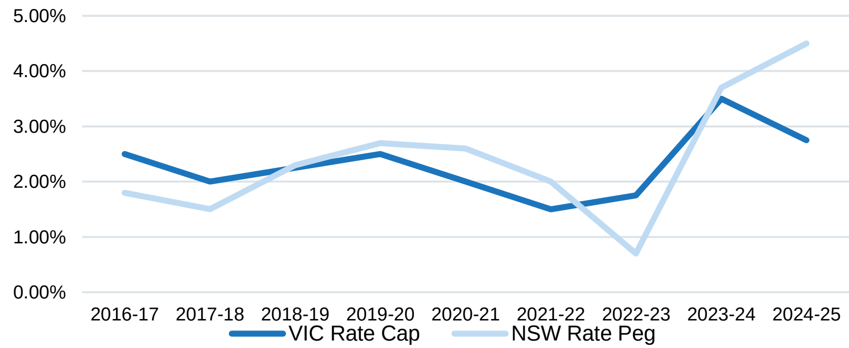
- Is there any other change to the current Victorian methodology for setting the rate cap that the sector should be highlighting in its submission?

5.2.3 Comparison of 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, the difference equates to over $138 million.

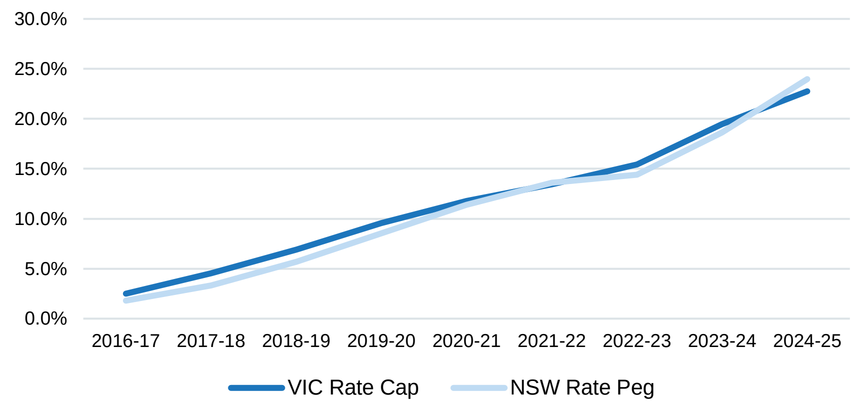
If the 2024-25 new methodology applied in New South Wales is indicative of future differences in outcomes, it could be expected that the restrictions in Victoria will result in significantly less increases in the rate revenue for Local Government.

Figure 5.2. Annual Rate Cap / Peg Increases for Victoria and New South Wales



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

Figure 5.3. Cumulative Rate Cap / Peg Increases for Victoria and New South Wales



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

5.3 Operating Grants

The degree of reliance on operating grants differs significantly across council cohorts, ranging from 9% of total revenue for metropolitan councils to 22% for small shire councils.

5.3.1 Commonwealth Funded Programs

The largest source of operating grants is from the Commonwealth through the Financial Assistance Grants. The Australian Government provides funding to Local Government under the Financial Assistance Grants program. This grant is provided under the Local Government (Financial Assistance) Act 1995. The Financial Assistance Grant program consists of two components:

- A general purpose grant component which is distributed between States and Territories according to population.
- A local road grant component which is 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 Australian 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 lost revenue for councils.

The funding model, based on CPI and population growth, legislated in 1995 (although the distribution by population was established before the 1995 legislation), 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 increased responsibilities, with significant economic growth and community demand for better services, and while the State and Federal Government revenue base 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 5.1 illustrates the allocation of the Victorian Financial Assistance Grants as a percentage of total grants allocated to the State for each Local Government cohort.

Table 5.1. 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 Australian Government for the allocation of the general purpose grants based on an assessment of the councils’ 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.

5.3.2 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, the largest for Victorian councils assist funding the aged services and maternal and child health services provided through local government. Other funding considered recurrent is provided for family and children services, school crossing supervisors and youth services. It should be noted later in this Discussion Paper, many of the recurrent grant programs are also considered by councils to be a cause of cost shifting, with reduced contributions provided by State government for the ongoing provision of the services.

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.

Discussion Question 18

Acknowledging that a redistribution of Financial Assistance Grants is a zero-sum game, are there any changes to Financial Assistance Grants that the sector should highlight in the submission?

Discussion Question 19

Noting that a later questions in this Discussion Report address the cost shifting of State grant funded programs, is there other considerations of the impact of State grant funded operations that should be considered or quantified?

5.4 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 Local Government 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 Australian Government). The availability of capital grants to Local Government is vulnerable to changes in government, government priorities and the financial position of the State and/or Australian Governments.

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

5.4.1 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 Australian 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 Australian 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).

5.4.2 State Grant Programs

The State 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 the competitive nature, there is little certainty to local government in State Government 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 the councils will be more limited in capacity to provide a co-contribution and therefore unable to apply for the grants that they have historically depended upon.

It is also common for local government to invest significantly in the application, often requiring 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.

Discussion Question 20

Are there any other major grant programs, operational or capital, which should be included? Are there any changes to the administration or distribution of the grants listed that the sector should be highlighting in the submission?

5.5 User Fees

While 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 the different groups of councils with regional city councils receiving 13% and small shire councils only receiving 6%. In essence, the different councils across Victoria have different capacities to generate revenue from services provided.

5.6 Statutory Fees and Fines

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 equalisation.

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).

Discussion Question 21

Are there any issues with statutory fees or charges that FinPro should be highlighting in the submission?

Discussion Question 22

Should developer contributions be highlighted in the response? If so, what issues with developer contributions should be included? What changes should FinPro advocate for with respect to establishing and administering developer contributions?

6. Vertical and Horizontal Fiscal Imbalance

6.1 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 but limited revenue capacity and the Australian Government's capacity to raise much more revenue than it requires for its own expenditure needs.

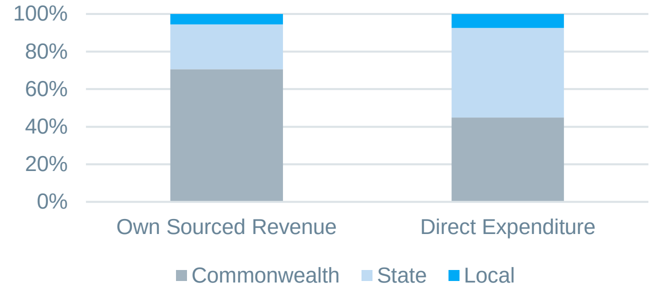
In 2021-22, the Australian Government accounted for around 71% of own-source revenue raised by all levels of government but was responsible for only 45% of government own-purpose spending. State Governments accounted for around 24% of own-source revenue, while Local Government accounted for just 6%. 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 Australian Government and States have access to around 125 other taxes (of these, 99 are levied by the Australian 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 Australian Government. It is important that adequate funding is provided by the Australian Government to ensure that councils are allocated a fair share of broad tax revenue for the provision of important local services and infrastructure.[1]

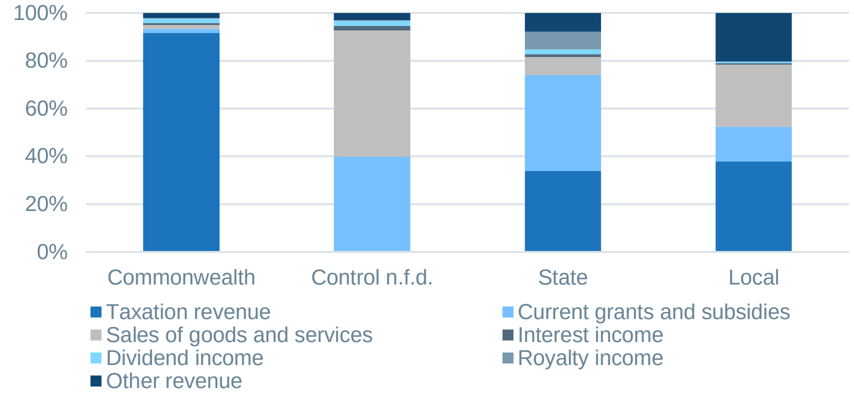
The mismatch of spending responsibilities and revenue-raising capacities between the Australian Government and State Governments produces a need for large financial transfers between levels of government. In 2021-22, the Australian Government's grants to State Governments totalled $133 billion (equating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

Figure 6.1. Own-sourced Revenue and Spending by Level of Government – 2021-22



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

Figure 6.2. 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

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

Table 6.1. All Levels of Government, Operating Statement – General Government – 2021-22

	Commonwealth $m	Control (NFD) $m	State $m	Local $m	All Levels of Government $m
Revenue					
Taxation revenue	550,635	0	112,528	20,840	683,025
Current grants and subsidies	10,558	13,651	133,347	7,973	0
Sales of goods and services	9,194	17,985	24,886	14,291	60,366
Interest income	4,885	645	3,831	365	9,639
Dividend income	11,722	735	6,694	404	19,555
Royalty income	1,559	117	24,766	0	26,440
Other revenue	12,283	1,020	25,922	11,142	32,326
Total revenue	**600,837**	**34,154**	**331,974**	**55,014**	**831,352**
Expenses					
Depreciation	8,678	2,276	16,359	9,320	36,632
Superannuation expenses	12,217	2,411	14,608	1,445	30,681
Other employee expenses	30,660	15,911	132,827	14,333	193,731
Social benefits to households in goods and services	120,339	0	12,004	0	132,343
Other non-employee expenses	58,055	12,164	87,352	17,127	167,743
Total gross operating expenses	*229,949*	*32,762*	*263,149*	*42,225*	*561,130*
Interest on defined benefit superannuation	8,974	0	2,528	0	11,502
Interest expenses n.e.c.	18,893	274	8,718	483	28,281
Other property expenses	0	0	4	0	4
Grant expenses to State Governments	133,322	7	0	18	0
Grant expenses to universities	11,545	0	546	1	0
Grant expenses to Local Governments	0	0	7,972	0	0
Grant expenses n.e.c.	4,436	0	10,466	0	4,436
Subsidy expenses to public corporations	984	0	9,845	2	10,831
Other subsidy expenses	18,368	0	20,226	3	38,595
Other current transfers	174,570	51	22,658	531	197,422
Capital transfer expenses	22,025	8	9,020	299	13,702
Total expenses	**623,067**	**33,102**	**355,130**	**43,563**	**865,903**

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

Gaps between revenue raising and expenditure responsibilities can lead to shared responsibilities between levels of government for funding and/or service delivery in particular functions.

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

6.2 Effect of Vertical Fiscal Imbalance on Local Government

The Council for the Australian Federation (CAF), in a submission to the Commonwealth's Henry Tax Review (Australia's Future Tax System), outlined the following concerns with the effect of VFI on State and Local Governments:

- Weakens government accountability to the public by breaking the nexus between a government's decisions on the level of service provision and the revenue raised to fund it. For every dollar spent by State Governments, 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 Australian 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 VF, best demonstrated by the 2014-15 Federal budget when the Australian 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 worth of Local Government services and infrastructure 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. It is argued that while the Australian Government taxation revenue increases 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. Therefore, 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 Australian 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 Australian and State Government responsibilities onto already resource-constrained councils.
- Thoroughly review the adequacy of the base and indexation methodology of Financial Assistance Grants.

Discussion Question 22

Should the response include further analysis on the annual increases to the State revenue streams, including comparing the annual increases to State fees, fines, charges to the Minister's approved rate peg increase for local government?

6.3 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. When the Commonwealth transfers funds to States and Territories, it does not give each State or Territory a fixed amount or an amount proportional to the State's population relative to other States. Rather, it uses a formula to disburse funds to States on a needs-basis and its 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 in the State or Territory is able to function at a standard not lower than the average standard of other councils in that State or Territory. 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 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.

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.

Discussion Question 23

Are there any charges, fines, fees or other revenue that the State Government receives that are more appropriate to be the responsibility of local government to collect?

Discussion Question 24

Are there current competitive and tied grant programs that the sector should advocate to be rolled into general purpose payments (possibly rolled into Financial Assistance Grants program so that it is protected under legislation)?

Discussion Question 25

Other than continuing the current advocacy through MAV and ALGA, is there any other initiative that the sector should be supporting to achieve an increase in the allocation of Commonwealth funding to the Financial Assistance Grants?

7. Impact of Cost Shifting on Local Government in Victoria

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 Australian 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 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 State and Australian Governments without the necessary funding (or powers to general revenue) to fund the service.

In many cases the social objective to provide such services is not discretionary – the responsibility to provide services has been forced upon Local Government through cost shifting from the State and Australian Governments.

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 to the sustainability of Local Government. However, establishing a widely agreed definition for cost shifting has been difficult.

The Committee's Inquiry in 2003 provided a definition that may be useful in further collection and defining cost shifting. The definition was based on the following identification of causes for increased responsibilities for Local Government services:

1. Devolution of functions from State or Australian Governments
2. "Raising the bar" through legislative changes increasing complexity or standards
3. Cost shifting due to withdrawal of funding or services by the Australian or State Governments
4. Increased community expectations
5. Policy choice when the council chooses to expand services.

The Committee considered that where adequate funding is not provided, (1), (2) and (3) above could be considered cost shifting, while (4) and (5) are a matter of Local Government choice and not a cost shift.

Examples of cost shifting raised by Local Government has 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 the ongoing operations and maintenance.

The term "cost sharing" is also often used by State or Commonwealth interests 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.

Since 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 to be $20.8 million
- Moonee Valley City Council – estimated annual cost shift to be $10.2 million
- City of Casey – estimated annual cost shift to be $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.

Discussion Question 26

Would the following definition of cost shifting be appropriate for collecting estimated cost shifting from Victorian councils and reporting to the Committee Inquiry?

- Devolution of functions from State or Commonwealth governments without adequate funding
- Raising the bar through legislative changes increasing the complexity or standards of Local government services, without adequate funding
- Withdrawal of funding or services by the Australian or State Governments leaving Local Government with little choice as the provider of last resort.

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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

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