

# **FINPRO Submission to the 2025 Statutory Review of the Local Government Rate Cap Mechanism**

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## **Executive Summary**

### **About FinPro**

Local Government Finance Professionals (FinPro) is the peak body servicing local government finance professionals in Victoria. As an incorporated association, FinPro serves as the peak body for local government finance professionals in Victoria, with over 1,000 members representing all Victorian councils, five regional library corporations, and more than 20 other organisations.

FinPro aims to collaborate with the sector and State Government to benefit our communities, and we recognise that Councils play a crucial role and are part of the solutions in ensuring the financial sustainability of the sector.

### **Key Considerations**

The analysis completed by FinPro indicates that, the financial position of the local government sector has deteriorated. The current rate cap system is providing insufficient rate revenue to match the cost of providing community services and infrastructure, as outlined by Essential Services Commission (ESC) in providing advice to the Minister. The impact of rate capping is demonstrated by the impact of the rate peg in NSW, which has led to a large number of NSW councils applying for large special variations to correct the impact of the rate peg and resulting rate shocks across NSW communities.

The suggestion by Local Government Victoria (LGV), ESC, and the Minister that councils can simply apply for a higher rate cap overlooks the significant administrative and political burden this process places on the sector. This effectively shifts the responsibility of correcting insufficient revenue from the Victorian Government onto councils, which is an undue administrative burden, shifting responsibility onto councils.

FinPro acknowledges a rate cap is a reasonable policy approach by the State Government and is not advocating for its removal. However, the indicators used, and the criteria applied to provide advice to the Minister must be reviewed to avoid the system further impacting on local government financial sustainability.

Most councils provide over a hundred services which benefit the community. Community expectations continue to increase regarding delivery of additional community assets such as sporting fields, pavilions and open space. Whilst at the same time needing to maintain these additional assets, which now often have larger footprints due to increased population, need to comply with additional regulations including change rooms for men and women and disability access. While these are all fantastic inclusions there is a cost to deliver these.

Like all levels of government Councils need to review service and determine the capacity to continue to deliver however, local government is at an unfair disadvantage to the other levels of government in continuing to provide valued community services due to the disparity in ability to raise income on par with inflation with how the current rate cap is calculated.

Although reduced rates might appear beneficial to the community, the reality is that this leads to decreased services and facilities and ultimately impacts negatively on the wellbeing of the community as a whole.

## Recommendations

### **1. Develop a Local Government Cost Index (LGCI) to underpin the annual rate cap, reflecting council cost drivers and past shortfalls.**

Develop a dedicated Local Government Cost Index to underpin the annual rate cap calculation. The index should:

- a. Reflect the specific cost drivers of local government.
- b. Incorporate adjustments for the previous year's cap.
- c. Allow differentiated rate caps for different council cohorts
- d. Include additional indexation for rural councils to recognise the higher costs of accessing resources and delivering services in regional areas.

The current CPI-based cap left councils with an 8.6% cumulative funding gap relative to actual inflation between 2020-21 and 2024-25, so an LGCI would better match council cost growth.

### **2. De-politicise the Rate Cap Exemption Process**

Introduce a financial sustainability framework for local government that includes

risk-based assessment criteria, with consideration of different risk thresholds across the different council cohorts. Once agreed thresholds are met, a rate cap exemption application would be automatically triggered, ensuring a transparent, consistent, and objective process. The framework developed in collaboration with the sector should include:

- a. Financial indicators to measure both the current financial position and future sustainability;
- b. Criteria for each financial indicator to enable an assessment of the risk of the performance of each indicator and an assessment of the total risk to long term financial sustainability; and
- c. Different ranges for the criteria that is appropriate for the different council cohorts.

### **3. Simplify Rate Notices through Centralised Collection of the ESVF**

Transfer responsibility for collecting the Emergency Services Volunteer Fund (ESVF) to the State Government. This would streamline rate notices, reduce year-to-year variability, and minimise confusion for ratepayers.

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## **1. Introduction**

This statutory review (required under the Local Government Act) offers an opportunity to address these issues after nearly a decade of rate capping. The current rate cap system is seen as a major contributor to the deteriorating financial sustainability of the sector. Changes are necessary to prevent further decline.

Local governments play a crucial role in community development, supporting residents through various services. However, without a sustainable funding base, they struggle to meet state and national priorities, such as climate action and housing.

The report disputes the assessments by Local Government Victoria (LGV) and the Essential Services Commission (ESC) that describe the financial position of local governments as "sound." It argues that these assessments overlook the critical issue of unrestricted cash, which is a more accurate measure of financial health. The incorrect assessment of sustainability can lead to inappropriate rate cap settings, further harming local government finances.

FinPro suggests that the lack of a risk-based assessment framework and inconsistent use of financial sustainability indicators must be addressed. A new framework should be developed in collaboration with the sector, including financial indicators to measure both current and future sustainability, criteria for assessing risk, and different ranges for different council cohorts.

## **2. Assessment of Local Government Financial Performance post rate cap**

The data utilized for this assessment is substantially the same data used by Local Government Victoria (LGV) and Essential Services Commission (ESC) to make their assessments of the financial position for local government. One major exception is that FinPro has used the VAGO audit data for 2022-23 results.

One of the main factors in the deteriorating financial position of Councils is the variance between the rate cap and CPI. The rate cap has been based on conservative Victorian Department of Treasury and Finance forecasts that have not accurately reflected actual cost increases faced by councils.

The table below notes the gap between the rate cap and actual/forecast CPI across the last five years:

	2020-21	2021-22	2022-23	2023-24	2024-25	Cumulative Impact
<b>Actual Inflation<sup>1</sup></b>	1.40	4.00	7.00	4.90	2.80	20.10
<b>Rate Cap</b>	2.00	1.50	1.75	3.50	2.75	11.50
<b>Variance (Rate Cap less prior)</b>	<b>0.60</b>	<b>(2.50)</b>	<b>(5.25)</b>	<b>(1.40)</b>	<b>(0.05)</b>	<b>8.60</b>

<sup>1</sup>Actual Inflation based on Melbourne All-Groups CPI

In 2022/23, with a gap of 5.25% compared to inflation, the cost of construction rose to more than 10%, insurance premiums increased by 16%, and Workcover premiums almost doubled. Looking ahead, the rate cap for the 2024/25 financial year is set at 2.75% and 3.00% in 2025-26. Cumulatively, there is a gap on inflation of 8.60% between 2020-21 to 2024-25.

The disparity between the rate cap and CPI, combined with the absence of mechanisms to address cost increases surpassing income, has significant implications for councils' ability to adequately fund their operations. Merely suggesting that councils apply for rate cap variations fails to acknowledge the challenges posed by the burdensome and politicised nature of the Victorian application process, which deters councils from pursuing such variations.

In addition to the rising costs faced by councils, many councils experienced a depletion of cash reserves and a sharp decline in own-sourced revenue from fees and charges because of the COVID-19 pandemic and subsequent lockdowns. For instance, in the case of Maroondah, the estimated cumulative impact of the pandemic on fees and charges related to leisure activities alone amounted to \$48.2 million. In response to the dwindling cash reserves, there have been suggestions for the sector to increase its level of debt. This approach raises concerns about the long-term financial sustainability of councils. While taking on debt can provide temporary relief, it is not a sustainable solution in the face of ongoing financial challenges. A dependency on increasing debt levels while constraining own source revenue capability is a recipe for disaster. Debt should be reserved for funding intergenerational assets, not for renewing existing assets, and certainly not for covering operating activities.

Legislative changes, cost shifting and evolving reporting obligations can add complexity to financial management for councils. These changes often require councils to allocate additional resources to comply with new regulations or take on new responsibilities without adequate funding, further impacting financial sustainability.

### **3. Overview of Revenue Streams**

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

Most Councils receive approximately 80% of their revenue from rates and charges and recurrent operating grants (mostly due to the horizontal fiscal equalisation applied to the allocation of Financial Assistance Grants within Victoria, resulting in councils with less capacity to generate revenue through rates receiving more funding through Financial Assistance Grants).

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

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

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

### **4. Operating Results/Cash balances**

In the 2023-24 Council Budgets Summary report, LGV states that councils should aim for small operating surpluses over multiple years to remain financially sustainable.

Continued operating deficits reduce council financial resources, leading to an unsustainable financial position. For 2023-24, 71 of 79 Victorian councils are budgeting for an accounting operating surplus, while 8 are budgeting for a deficit.

FinPro agrees that deficits reduce financial resources but argues that the adjusted underlying result, not the accounting operating result, is a more accurate indicator of financial health. FinPro's analysis shows a clear trend of deterioration in the adjusted underlying result for local government, leading to reduced financial resources.

The LGV assessment of 2023-24 operating results is inconsistent with VAGO's assessment, which indicates that the sector's adjusted underlying result deteriorated to 0.15% in 2022-23, compared to 1.41% in 2021-22. VAGO noted that the adjusted underlying result before the pandemic was greater than 4%.

The ESC also highlighted that the increase in local government service costs has exceeded the rate cap set by the Minister, leading to a deterioration in cash reserves. This indicates that the current rate cap system is impacting the financial position of the local government sector. The ESC stated that the gap between the rate cap and inflation, rising construction costs, and expected wage increases could present major cost pressures on councils.

LGV's reference to the "*accounting operating surplus*" in the 2023-24 budgets is inconsistent with its own analysis in the 2022-23 budgets, which reported both the operating surplus and the adjusted underlying result.

In the 2022-23 budgets, while only 7 out of 79 councils planned for an accounting operating deficit, 55 planned for an adjusted underlying deficit.

Across these examples, the adjusted underlying result is a better measure of financial health/position as it:

- excludes revenue from developer contributions and non-recurrent capital grants.
- reflects the ability to generate a surplus from normal business operations.

### ***Cash and Investments***

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

*Collectively, Victorian councils are budgeting to hold cash and investments worth \$5.99 billion as at 30 June 2024 (increased from \$5.28 billion as at 30 June 2023). The*

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

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

## **5. Unrestricted Cash Position**

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

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

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

considered as a proportion of unrestricted cash it increases to an estimated 23.2% of the \$3.34 billion of unrestricted cash held across all Councils.

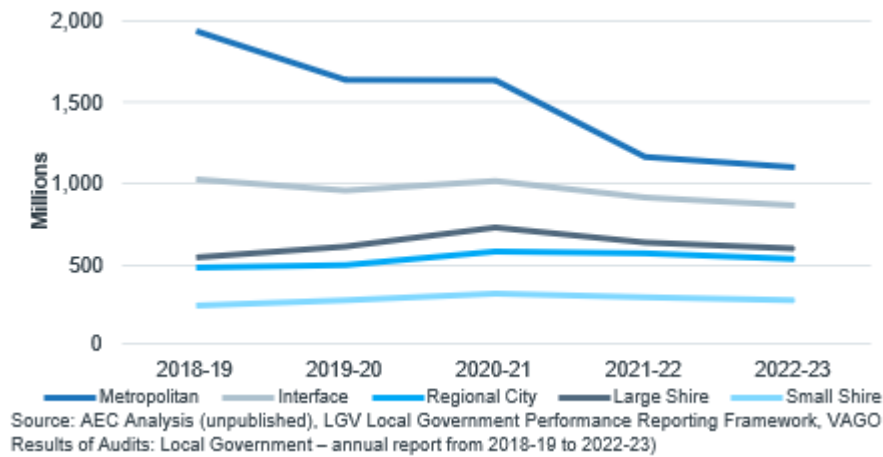
The increase in cash due to the prepayment of grant funding would most likely materially improve the large shire and small shire councils more than the other council cohorts. Unless this cash is held in a reserve, it is important to note that the unrestricted cash position is likely to deteriorate in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

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

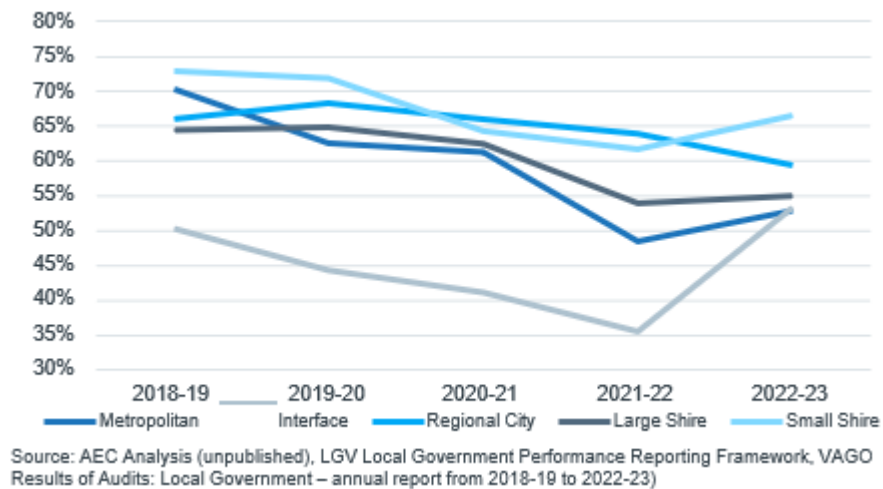
Figures 1 and 2 illustrate the calculated total unrestricted cash and other financial assets held by all Victorian councils between 2018-19 and 2021-22. The calculation of the unrestricted cash and other financial assets has been performed using the unrestricted cash ratio, cash and other financial asset balances and includes corrections where necessary (FinPro analysed each council's reported position and adjusted in accordance with financial statement notes).

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

**Figure 1 Total Unrestricted Cash and Other Financial Assets**



**Figure 2 Proportion of Cash and Other Financial Assets Unrestricted**



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

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

## **6. VAGO Assessment of Local Government Financial Performance**

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

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

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

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

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

### **Misinterpreting Financial Health: The Difference Between a Balance Sheet and a Cash Flow Statement.**

What VAGO consistently fails to reflect accurately on behalf of the sector is that Local Government balance sheets will almost always appear healthy, largely due to the high valuations of assets such as roads, land, buildings, and infrastructure. For example, a council may hold just \$1 million in cash but report \$800 million in assets—most of which cannot be sold or monetised. From a balance sheet perspective this appears ‘healthy,’ as the large asset valuations overshadow liabilities and mask potential cash flow challenges. Also, whilst Council’s can hold large amounts of cash, in most cases,

this cash represents developer contributions and grants that are specifically tied to the delivery of future infrastructure.

Regarding operating surpluses, VAGO states that:

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

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

....

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

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

**Table 2.3. Councils' Adjusted Underlying Result**

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

Source – VAGO (2023)

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

note, the prepayment of financial assistance grants avoided a much higher number of councils reporting a deficit.

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

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

## **7. Adjusted Underlying Result**

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

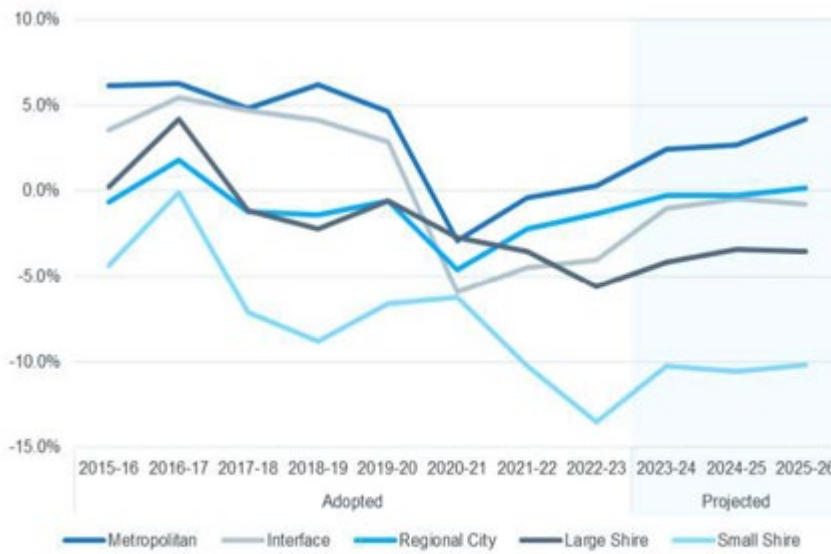
Therefore, FinPro agrees with the LGV comment in the 2022-23 report that the adjusted underlying result is a more appropriate measure of the operating result of normal business. Furthermore, FinPro agrees with the LGV comment that a small adjusted underlying surplus is required for a council to be sustainable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

Figure 3 highlights the adjusted underlying result ratio for the different council cohorts. The ratio is a calculation of the adjusted underlying operating surplus (or deficit) as a percentage of adjusted underlying revenue. This measure is audited and reported in the Local Government Performance Reporting Framework.

The COVID pandemic significantly impacted reported adjusted underlying results, particularly in 2020-21. However, prior to the COVID council budgets had already indicated a deterioration in the adjusted underlying result. Furthermore, most councils adopted a budget for an adjusted underlying deficit in 2022-23. The forward projections indicate an improvement in the projected forward three financial year budgets. However, as LGV outlined in their assessment, most councils are forecasting an

increase in expenditure to match projected rate caps, which is unlikely to occur in actuality based on historical outcomes.

**Figure 3 Adjusted Underlying Result Ratio**

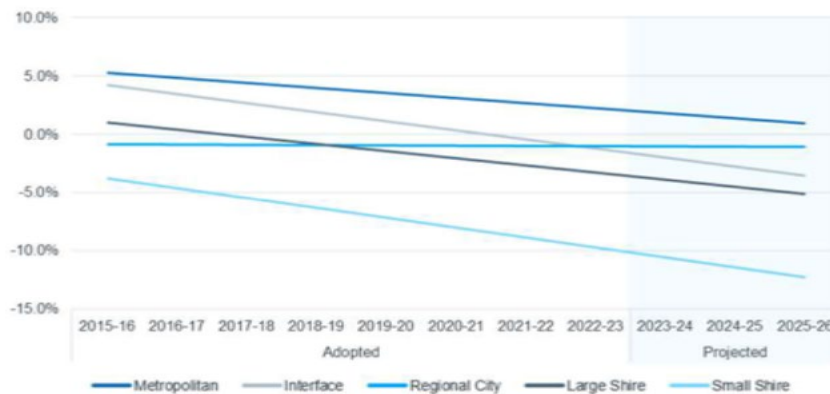


Source: AEC Analysis (unpublished), LGV Budget Summary Report data (various years)  
 Notes: The Australian Government has provided a prepayment of financial assistance grants over recent financial years. Given the analysis presented here is budgeted not actual, it is unlikely that councils planned to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

Figure 4 provides the trendline in the adjusted underlying result ratio over the same period. All Council cohorts except for regional city councils show a declining trend in the ratio in the budgets adopted from 2015-16 to 2022-23 and projections through to 2025-26.

**Figure 4 Adjusted Underlying Result Ratio Trendlines**

**Figure 2.2. Adjusted Underlying Result Ratio Trendlines**



A deteriorating adjusted underlying result is not sustainable, as noted by LGV, and is likely to result in continued deterioration of cash reserves (as indicated by ESC).

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

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

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

## **8. Capital**

Local councils are responsible for maintaining and renewing infrastructure and assets while navigating changing community service expectations. They face increasing costs related to climate change mitigation, environmental impacts, and extreme weather events. These costs include implementing sustainability initiatives, upgrading infrastructure to withstand climate risks, and complying with environmental regulations. These financial pressures create uncertainty about councils' ability to maintain existing infrastructure and introduce new infrastructure demanded by the community.

While councils may pursue digital transformation to improve efficiency and service delivery, the economic returns are often minimal. Balancing innovation with financial sustainability is challenging, as digital transformation requires significant upfront costs without immediate benefits.

The Victorian Budget 2024-25 highlights the financial sustainability challenges faced by councils, noting a 22 percent increase in infrastructure costs since 2021, while rates are capped at just 2.75 percent.

The 2023-24 Council Budgets Summary report by LGV states that Victorian councils plan to spend \$4.15 billion on capital works in 2023-24, unchanged from 2022-23. However, the Victorian Auditor General identified a significant underspend on capital works of 28.9 percent for 2021-22, equating to \$1.24 billion. LGV notes that aggregate numbers mask variability at the individual council level, making consolidated analysis inappropriate.

Two key considerations for funding capital works are:

1. Investment in renewing existing assets in line with asset management plans.
2. Investment in upgrading and creating new assets to meet growing demand.

Both are crucial, but their significance varies across councils. The capacity to renew assets is fundamental for long-term financial sustainability. Under the current RCM, councils are not renewing assets sustainably. The underspend in capital works includes asset renewals, which is a concern for all councils. However, without this underspend, the cash position of local government would have deteriorated further. While not ideal, the underspend defers short-term financial deterioration but likely worsens the long-term financial position.

For many councils, especially small shires and regional/rural councils, investing in new and upgraded assets relies on grant funding. Delays and uncertainties in grant funding often occur, impacting project timelines.

FinPro acknowledges that councils need to improve capital works delivery but notes several factors affecting project delivery, including:

- High competition and accessibility for contractors.
- Increased contractor costs (particularly between project initiation and delivery).
- Timing and application processes for State and Federal Grants.

## **9. Cost Shifting**

Local governments are often the service provider of 'last resort' in communities where higher levels of government and the private sector have not provided adequate services,

or where there is a failure from other parties to provide essential services within the community. This includes services or other costs transferred to local government from other levels of government without the necessary funding (or powers to raise general revenue) to fund the services or costs incurred.

In many cases, the social objective to provide such services is not discretionary and the responsibility to provide services has been forced upon local government through cost shifting from other levels of government. Cost shifting describes increases to intra-government charges or removal of access to income.

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.

In the last four years, Councils across Victoria have also witnessed Workcover premiums double. In some cases, these costs equate to millions of dollars. The increase has not been due to higher incidents, but increases to industry rates that help fund the Workcover Authority's special dividend to the State Government. This is entirely unsustainable.

Another example of cost shifting includes recent "desktop" exercises conducted by the State Electoral Commission to establish ward boundaries for the 2024 local government elections that cost councils up to 50% more than the last election, on top of the costs of running the elections increasing by a similar factor. At the same time, the state has introduced new taxes and increased its landfill levy, all of which are seriously undermining the financial sustainability of Local Government Authorities.

A further example impacting most Councils is the shift in funding for Libraries, the agreement with the State Government is that the funding split should be 50/50. Most councils are now contributing significantly more, often covering around 80% of the total cost. In recent years, the State Government has either frozen indexation or increased its

already reduced contribution by only 1%, a rate that falls well short of even the rate cap. While these services are highly valued by the community, councils' ability to continue providing them may require offsets from other services or a reduction in library services.

Individual councils also provided submissions to the State Parliamentary Inquiry in 2024 detailing cost shifting estimated including:

- City of Great Geelong – estimated annual cost shift of \$20.8 million
- Moonee Valley City Council – estimated annual cost shift of \$10.2 million
- City of Casey – estimated annual cost shift of \$14.8 million.

## 10. Assessment of 2022-23 Budgets by LGV

The health of the Local Government sector is being misrepresented through inaccurate reporting. One example is in this section.

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

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

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

*An adjusted underlying result removes the revenue from developer contributions and non-recurrent capital grants in order to measure an entity's ability to generate a surplus in the ordinary course of business.*

....

*An adjusted underlying result is a useful measure of financial performance over time since it excludes items that may fluctuate significantly or not be consistently received. Individually, 7 out of 79 councils are budgeting for an accounting operating deficit whilst 55 out of 79 councils are reporting an adjusted underlying deficit.*

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

LGV notes that the total planned capital expenditure of \$4.15 billion in 2022-23 represented a 0.6% decrease on the prior year but that over the 4-year budget

projections, the collective capital spend of \$14.23 billion was up on the previous estimate.

In this report LGV states that:

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

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

## **11. Essential Services Commission Assessment of Local Government Financial Performance**

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

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

The ESC concluded that:

*While council cash reserves are declining, the sector maintains low levels of debt and stable borrowing levels.*

*Council costs increased at a slower rate than inflation during 2022-23 but 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 future wage increases have the potential to raise council costs in the future.*

*Major driving factors of the overall increase in CPI are not key council cost components.*

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

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

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

ESC also stated that:

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

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

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

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

The suggestion by ESC that the use of borrowings is a responsible option for councils to address declining cash reserves is inappropriate for the majority of councils. Only councils with an adjusted underlying surplus and a growing revenue base are likely to be in a financial position to use borrowings to fund assets. Most councils are not in this position and rely on grant funding to invest in assets. As ESC noted, the cost base of councils has increased at higher rate than rate revenue and cash reserves are declining,

on top of which increased borrowings will increase the deterioration in the sustainability of the council (without an adequate increase in revenue).

## **12. Risk Assessment of the Sustainability of Local Government**

The assessment of the medium to long term financial sustainability of local government provided by FinPro above contrasts with the assessment previously by LGV. Local government in Victoria is not in a “sound position” as indicated by LGV.

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

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

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

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

## **13. Rate Cap Adjustments**

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

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

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

The application of the rate cap system in its current form is resulting in a deterioration in the financial position and long-term sustainability of local government, yet the system has not made adjustment for this.

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

Rather, it is likely to result in councils deferring a decision until much larger adjustments are required, as evidenced by the impact of the rate peg in NSW. As outlined later in this report, the requirement for NSW councils to seek rectification through an application for a “special variation” has resulted in NSW councils deferring such decisions and later seeking much higher increases in the rates, resulting in larger rate shocks to the community. In NSW, 17 councils applied for special rate variations in 2023-24 as a direct result of the rate peg limits, with some seeking increases exceeding 40%.

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#### **14. Appropriateness of the RCM in the policy context**

The intent of the RCM, to provide ratepayer protection against escalating costs is understandable. However, the mechanism is not well aligned to the cost structures of local government. CPI, which underpins the cap, reflects household consumption patterns rather than the cost drivers faced by councils (labour, construction, utilities).

As a result, the mechanism does not appropriately balance ratepayer affordability with council sustainability. As outlined in the previous sections of this report, over time, it has eroding councils’ capacity to maintain existing service levels, particularly in fast-growing or high-needs communities.

What is often not well understood by ratepayers is that the rate cap applies only to the general rates component and, where applicable, the municipal charge. Most residential properties are also subject to a mandatory waste charge, which is appropriately excluded from the cap and set on a net cost recovery basis by councils.

Since the introduction of the rate cap, waste costs have risen significantly, driven in part by substantial increases in the State Government landfill levy—at times by more than

20% in a single year. This levy remains uncapped and is announced annually. In addition, State Government requirements such as standardised bin lid colours, the introduction of food and organics bins, and the rollout of glass bins have all added to costs. These increases are passed directly to ratepayers and result in changes to their overall rates notice.

### **Essential Services Volunteer Fund (ESVF)**

The Victorian State Parliament recently adopted the Emergency Services and Volunteers Fund (ESVF) Act, which took effect on 1 July 2025. The Fire Services Property Amendment (Emergency Services and Volunteers Fund) Act 2025, and requires Councils to collect the ESVF levy on behalf of the state.

The ESVF levy has been subject to significant increases, in some cases over 100% based on the previous Fire Services Levy, and yet appears on rates notices where Council rates are subject to the rate cap.

This has caused significant confusion for ratepayers, leading to anger and frustration, and furthermore increasing psychosocial harm to Council staff who deal with the initial complaints. Despite Councils investing significant effort into rates notice redesign and community engagement, the industry is still dealing with the significant backlash from the levy's introduction. Finpro considers that this levy should be collected via the State Revenue Office.

While this review focuses on the rate cap, it is difficult to separate it from other issues. When ratepayers receive their rates notice, many do not understand the differences between the various components. The fact that two of these components can increase outside the cap creates confusion.

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## **15. Effectiveness of the Rate Cap Mechanism (RCM) in delivering the policy direction**

The RCM has been effective in limiting the growth in average rates across the state, meeting the government's objective of containing costs for ratepayers. However, this has come at the expense of councils' financial sustainability as highlighted in previous sections.

- Sector data shows declining operating surpluses and tightening liquidity.

- Renewal gaps in community infrastructure are widening, particularly in smaller rural councils.
- Councils are increasingly reliant on external grants, borrowings, and non-rate revenue to maintain service levels.

In this sense, while the RCM achieves cost containment in general rates, it is not effective in sustaining local government's ability to deliver on community expectations.

Community **expectations are increasing**. Councils are expected to maintain and expand services, meet higher standards of community engagement, and invest in climate resilience and infrastructure renewal. This creates a widening gap between what can be funded under the rate cap and what communities seek.

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## 16. Are there any improvements which could be considered to the legislation underpinning the rate cap mechanism?

**Entities and roles** – The ESC's role has been clear, but the process can be resource-intensive and politically unappealing.

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

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

**Inside vs outside the mechanism** – the only item recommended for inclusion within the cap is the amount the State Government can increase the landfill levy by annually.

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## 17. What impact has the RCM had on budget-setting, revenue and pricing, and expenditure decisions at councils?

Since the introduction of the RCM, councils have:

- **Reduced or rationalised services** – some councils have scaled back discretionary programs (e.g., community grants, events, some recreation programs).
- **Pursued efficiency savings** – shared services, operational efficiencies, procurement aggregation, and digital transformation initiatives have helped mitigate costs. For some Councils these are exhausted and for others there is still ongoing programs.
- **Capital expenditure** – capital renewal programs have in some cases been deferred or decreased, increasing long-term asset risks. For growth Councils with DCP's with the escalation of total project costs, some of these Councils may be moving towards cash deficits, requiring material borrowings and associated costs to fund these plans into the future.
- **Raised non-rate revenue** – fees and charges for services where Councils have capacity to set pricing such as for various business permits, leisure facilities have increased faster than rates and are more aligned with CPI increases. As the cost of providing these services has increased above the rate cap and these pricing structures reflect this coupled with Councils seeking other revenue opportunities to improve financial sustainability. As noted, these make up a small percentage of overall council revenue streams and are unable to bridge the gap between rate cap and CPI.
- **Adjusted balance sheet policies** – some councils have drawn down reserves or increased borrowings to maintain capital programs.

### Borrowings

FinPro acknowledges that borrowings may be a good funding source for long life assets, particularly assets that are provided to growing communities (and in turn growing local government revenue). However, a minority of councils are in a position with current low borrowings, an adjusted underlying surplus and with growth that enables the council to take on additional borrowings without impacting the long term sustainability of the council. Borrowings are not a sustainable solution for councils that have underlying

deficits and with little or no growth as they will only work to further deteriorate financial sustainability.

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

### **Example 1: Debt (borrowings)**

Councils will generally seek to borrow to fund intergenerational capital works projects. If a council is at a point of needing to borrow to service general operating activities for consecutive years, the council would not be considered financially sustainable.

A key difference between local government and Federal and State government when it comes to borrowings is local government's main income stream (rates) is set by another level of government.

The Victorian government also has many other controls over local government that can materially impact council operations including legislating how much rates can be collected, legislating additional activities councils must perform and cost shifting.

Current interest rates through Treasury Corporation Victoria (TCV) for a 10-year principal and interest loan are approximately 4.7%. The rate cap for 2024-25 is 3.00%. To take out borrowings at these rates also requires other efficiencies to be able to service the debt.

This operating environment places councils at much higher risk of not being able to service debt without material impacts to either services or asset renewal.

## Example 2: Borrowings Small Shires

Small rural councils do not have the financial capacity to take on significant borrowings while remaining sustainable. For example, if a council were to borrow \$5 million over 10 years at 4.7% interest, total interest repayments alone would be \$1.295 million. On top of principal repayments, this represents a substantial additional outlay each year.

Small shires do not have the financial reserves or generate the revenue needed to absorb these costs without cutting back on essential services. Many rural councils operate with budgeted year-end cash balances of only \$0.8 million to \$10 million. In this context, committing to a \$5 million loan is not only high-risk but effectively unfeasible, the required repayments would consume a disproportionate share of available funds, leaving little room to respond to unexpected cost pressures, emergencies, or community needs.

Borrowing at this scale would therefore force difficult trade-offs: either reducing service delivery, deferring critical asset renewal, or increasing reliance on external funding. This undermines the principle of long-term financial sustainability and risks shifting an unsustainable burden onto future ratepayers.

In short, while borrowing can be an effective tool for some councils, for small rural shires the limited revenue base, low cash reserves, and already constrained budgets mean that material borrowings are simply not a viable or responsible option.

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## 18. How has the RCM impacted on the development and implementation of longer-term financial planning and projections?

A benefit of the RCM under the current system is that it has encouraged long-term financial planning and prioritisation of capital works. Whilst also promoting cost control and efficiency in service delivery.

However, the RCM has also constrained councils' ability to prepare realistic long-term financial strategies.

- **Four-year budgets** must now assume capped revenue growth, often requiring difficult service prioritisation.

- **10-year financial plans** show structural deficits in many councils if current trends persist, particularly in rural/regional areas.
- **10-year asset plans** increasingly highlight renewal gaps, with councils unable to fund full lifecycle costs under capped revenue.

This creates intergenerational equity risks, as today’s communities may underfund infrastructure renewal, leaving future ratepayers with a greater burden.

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## **19. Higher rate cap process – clarity and understanding**

While the ESC has provided guidance, the process is viewed by councils as complex, burdensome, and reputationally risky. Councils are reluctant to be seen as “overburdening ratepayers,” even when the financial case is sound. The detailed evidentiary requirements (including extensive community engagement) create barriers for councils with limited resources.

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## **20. Councils considering but not applying for higher caps**

Are you aware of councils that have ever considered applying to the ESC for a higher rate cap, but decided against submitting an application? What went into this consideration? Why didn’t they act on this?

Yes, some councils have considered applying but decided against it. Key reasons include:

- **Political and reputational risk** – fear of being seen as “ignoring” ratepayers or not living within means.
  - **Process burden** – the cost and time required to prepare an application can outweigh the potential revenue gain.
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## **21. Timing between Minister’s cap determination and ESC applications**

Is the time between the Minister’s determination of the Annual Rate Cap and when applications to the ESC close sufficient to consider and lodge an application? Why or why not?

The current timeframe between the Minister’s announcement of the annual rate cap and the ESC application deadline is too short for councils to undertake the necessary work. Preparing a higher cap application requires robust financial modelling, alignment with strategic priorities, and genuine community engagement—all of which take time to do responsibly. The compressed schedule strains internal resources, risks producing a less considered case, and exposes councils to reputational risk if the process appears rushed or lacking transparency.

Any timing changes, such as an earlier announcement of the rate cap, should not be considered in isolation. They should be accompanied by a review of the rate cap calculation (as outlined in this submission) to ensure it reflects past outcomes and appropriately adjusts the cap for the following year.

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## **22. Timing between ESC decisions and council budget adoption**

Is the time between when the ESC may decide on an application and when Council budgets must be adopted sufficient? Why or why not?

The ESC’s determinations are often provided close to the statutory budget adoption deadlines (30 June). This places pressure on councils to adjust draft budgets late in the process and limits community engagement on final budget settings. This compressed timeline places pressure on governance processes and can compromise the quality of budget deliberations. Extending or bringing forward ESC timelines would improve alignment.

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## **23. Conclusion**

In conclusion, the financial sustainability of local governments is at a critical juncture. The current rate cap system, combined with increasing costs and the pressures of climate change, is straining the ability of councils to maintain and renew infrastructure, deliver essential services, and meet community expectations. The assessments by Local Government Victoria (LGV) and the Essential Services Commission (ESC) have overlooked key indicators of financial health, such as the adjusted underlying result and unrestricted cash, leading to an inaccurate portrayal of the sector's financial position.

To ensure the long-term viability of local governments, it is imperative to adopt a risk-based assessment framework that accurately reflects the financial realities faced by councils. This framework should be developed in collaboration with the sector and include measures for both current and future sustainability. Additionally, addressing the issue of cost shifting and ensuring adequate funding for local governments is crucial.

Without these changes, the financial sustainability of Victorian local governments will continue to deteriorate, impacting the delivery of vital services and the achievement of shared state and national priorities. It is time for a comprehensive review and reform of the rate cap system to safeguard the future of local government and the communities they serve.