The Sustainability Gap – the financial health of Victorian councils

The Municipal Association of Victoria (MAV) and Local Government Finance Professionals (FinPro) have partnered to develop a dataset which can be used to demonstrate the financial sustainability of Victorian councils and track this going forward.

There are three serious risks to financial sustainability that require immediate action:

- Deteriorating underlying surplus across local government
- A significant asset renewal gap
- The compounding effect of a rate cap which has consistently been set below the cost increases experienced by councils
- A limited and reducing unrestricted cash position of many councils

Our aim is to improve the understanding of council finances both within local government and externally. While there is always room to improve practice within the sector, many of the challenges faced by councils are driven by external factors.

Many levers that have major impacts on council sustainability continue to lie with State and Federal Governments. Despite this, there is a relatively poor understanding of council operations, asset management, and finance within Parliament, departments, and agencies. This represents an opportunity to promote more nuanced consideration of the impacts on councils and their local communities in policy development.

Local Government is at the coalface in managing community services and assets. Working with community at the grass roots level, Councils also need to stand ready to support community recovery and emergency management. As such, it is critical that this sector remains financially resilient to support State and Federal policy objectives

Key indicators

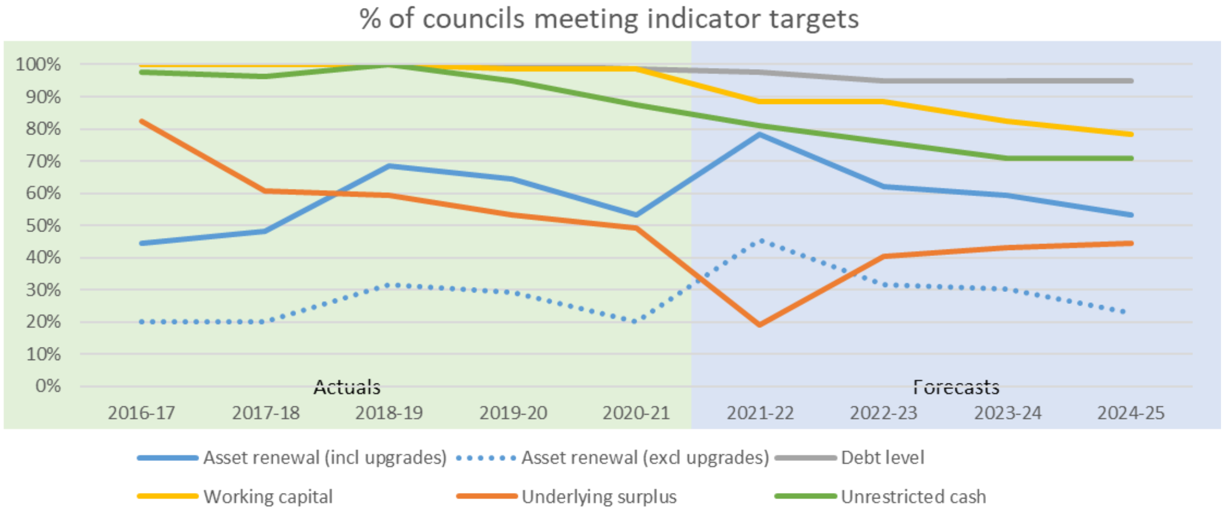
Our key indicators are largely based on existing elements of the Local Government Performance Reporting Framework (LGPRF) financial indicators. In some cases, changes have been made to how these are calculated.

Debt level - the level of debt carried by council in relation to its core revenue	+	Low risk
Unrestricted cash – the level of cash available for use free of obligations in relation to current liabilities, reflecting ability to pay bills on time and fund discretionary priorities	–	Medium risk
Working capital – current assets compared to current liabilities, indicating the short-term financial position of the council	–	Medium risk
Underlying surplus – whether a council is generating sufficient revenue to fund its expenses	✕	High risk
Asset renewal – the ability of council to renew its asset base equal to or faster than depreciation	✕	High risk
Rate cap – the degree to which the rate cap accurately reflects increases in the costs of council operations	✕	High risk

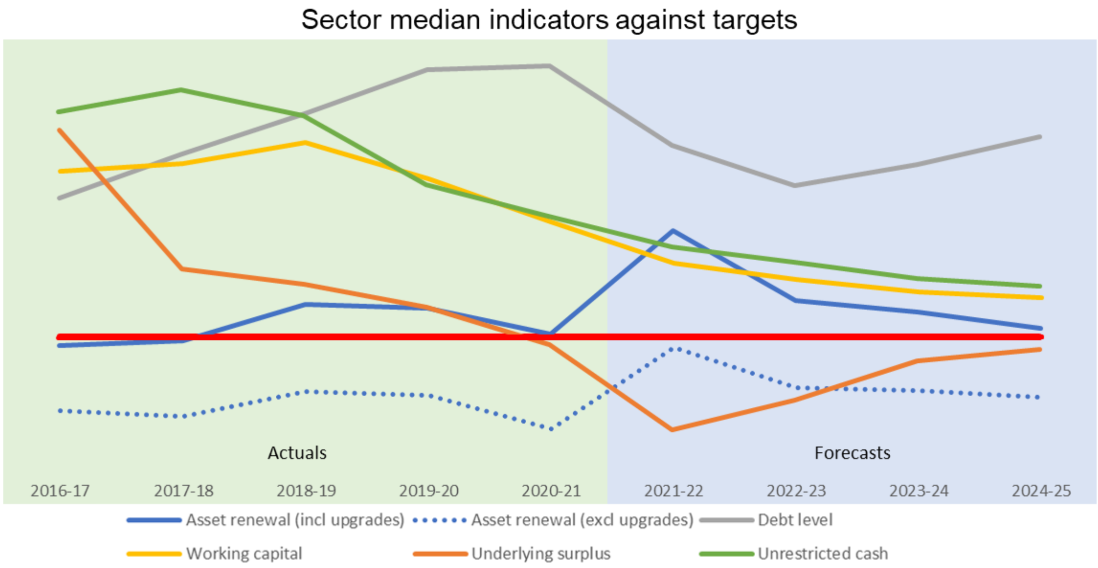
Asset renewal, underlying surplus, and the suitability of the rate cap all need to be addressed in the short term. There is a risk of long-term damage to the financial sustainability of the sector and their delivery of services and infrastructure without appropriate action.

A watching brief should be applied to unrestricted cash and working capital – in particular for rural and regional Councils. In both cases they would likely be improved by addressing the challenge of diminishing underlying positions.

Working capital (current assets / current liabilities) has been on a significant downward trend, with some councils now falling below the target of 120%.



Councils are often perceived as being financially strong based on total cash holdings. It is critical to understand that much of this cash is 'restricted' in nature, linked to statutory or contractual obligations such as developer contributions for the funding of infrastructure. Unrestricted cash has been steadily decreasing. This decline potentially affects the ability of councils to make discretionary investment in local priorities and aspirations. Reduced unrestricted cash also reduces the capacity and ability of Council's to maintain infrastructure and react effectively in the event bushfires, floods, or other emergencies.

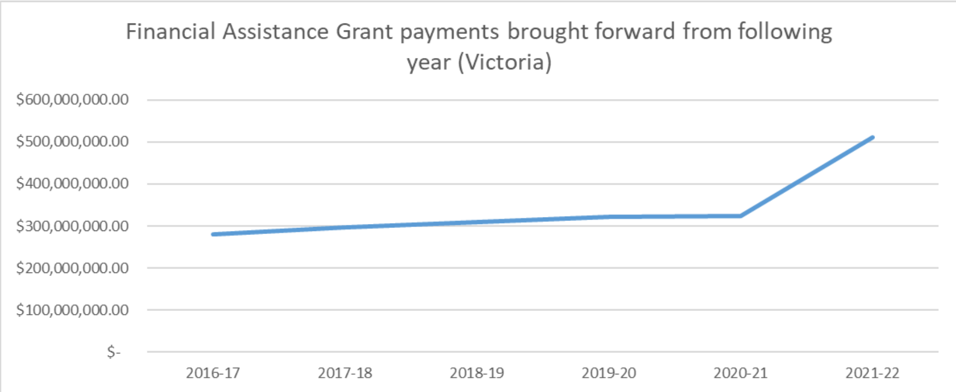


*for this graph, debt level has been inverted to align with other indicators

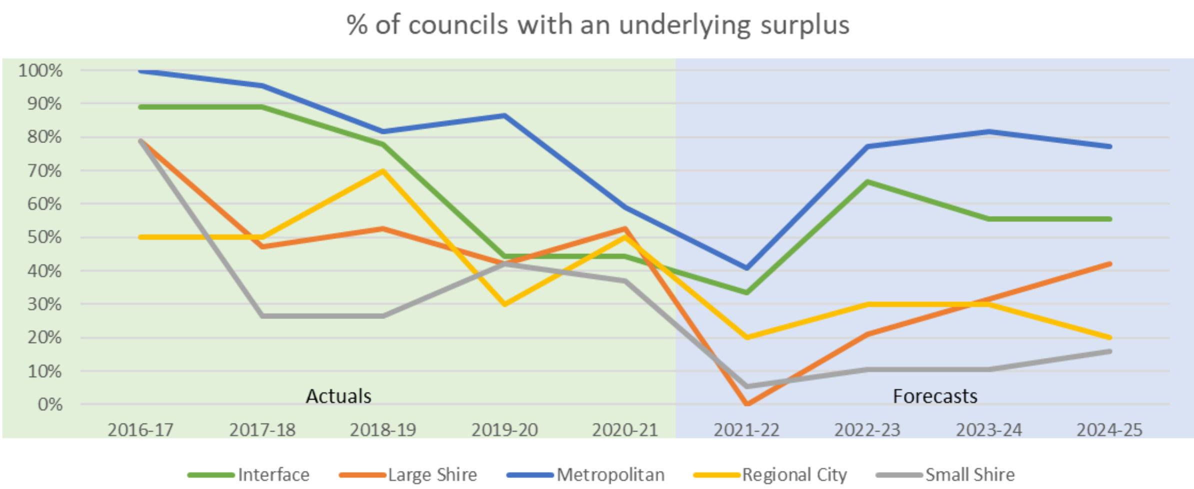
Underlying surplus

The number of councils reporting an underlying surplus has significantly declined from 2016-17 (82% of councils) to 2020-21 (49%). Councils forecast a further drop in 2021-22 with only 19% of them planning for a surplus. LGPRF data indicates this has turned around with 55% of councils reporting they did record a surplus for the year.

While the full picture won't be available until we have access to audited annual report data for the most recent year end, an increase in the amount of Financial Assistance Grant funding brought forward from the following year is a major factor. Traditionally, approximately 50% of Financial Assistance Grant payments have been brought forward into the preceding year, in 2021-22 this was approximately 75% bringing approximately an additional $190m in revenue to Victorian councils. Depending on the Commonwealth Government's ongoing approach, this could see a "rubber band" effect in 2022-23. If the Commonwealth returned bringing forward 50% of grant payments, councils would face an equivalent one-off loss in revenue.

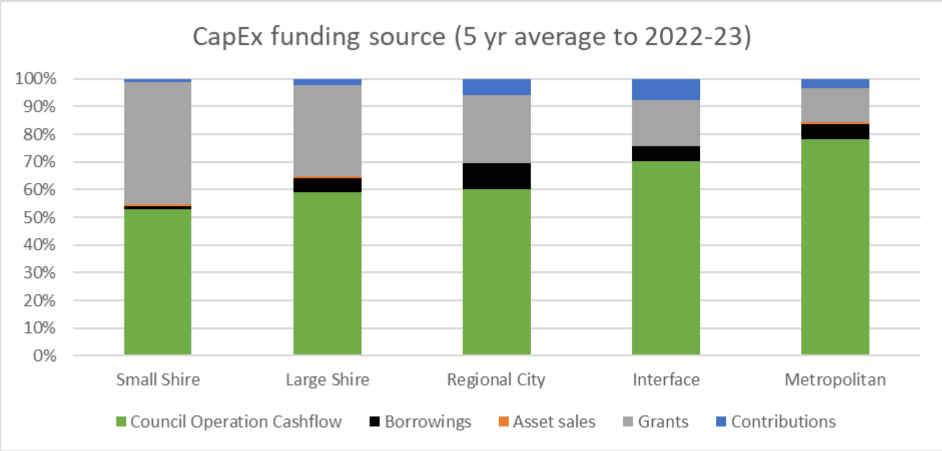


Underlying surplus varies greatly between different council cohorts. Only 16% of small shires forecast a surplus by 2024/25.



For real financial sustainability, all councils in the long-term should not just break-even but operate at an ongoing surplus. Councils running at a deficit will struggle to address year-to-year shocks, resource additional burdens placed upon them by other levels of government (through shifting of responsibilities or changes in regulatory and governing environments), and act on community demands for increased service delivery.

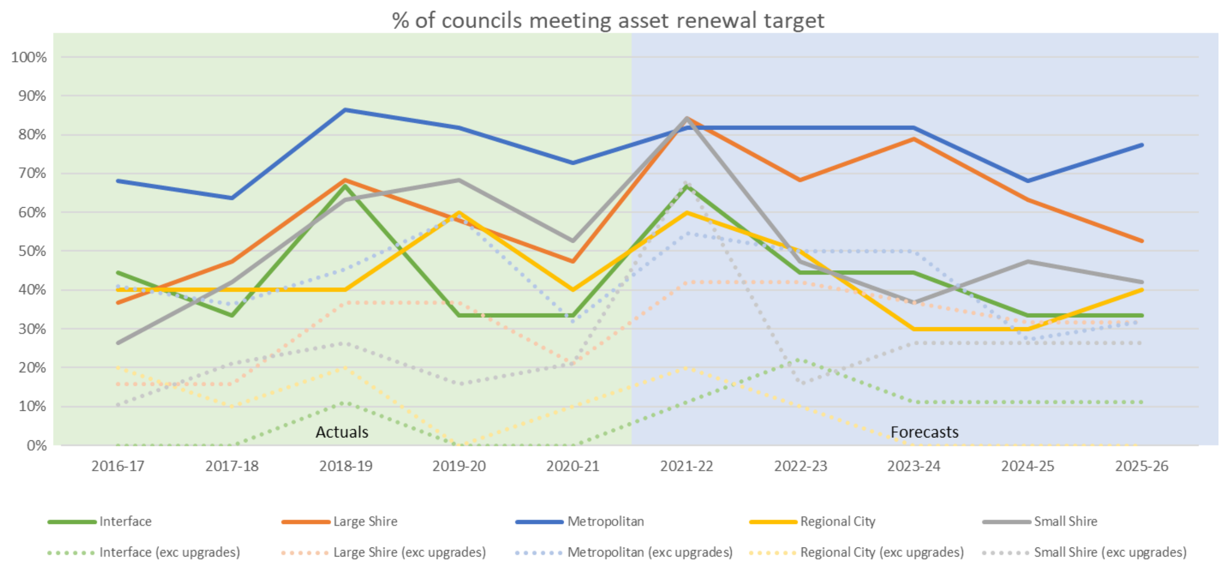
A surplus is also key to councils' ability to deliver infrastructure. Depending on council cohort, between 54% and 84% of capital expenditure is funded through council own-source revenue



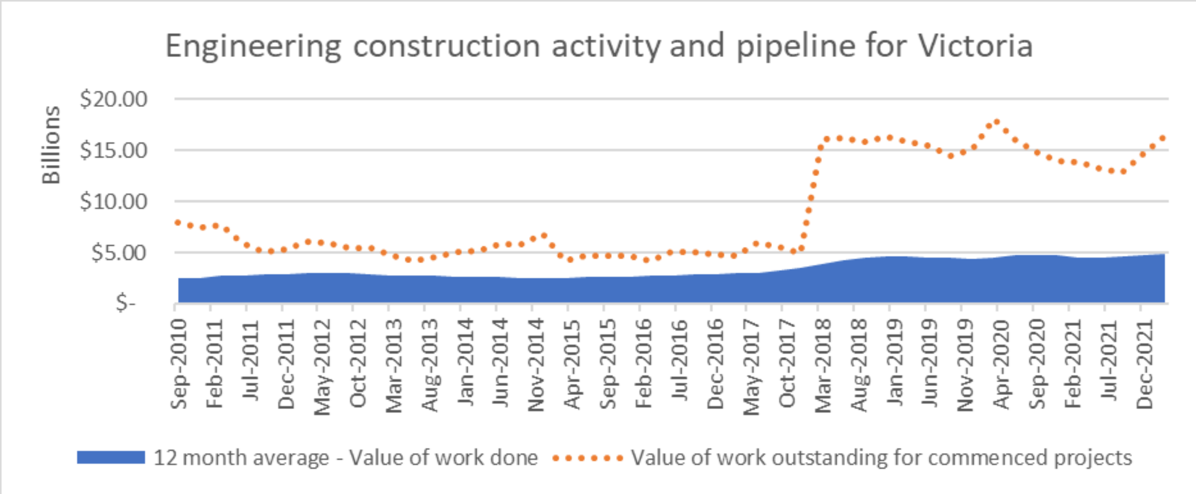
Both the low debt levels across local government and the degree to which borrowings fund capital expenditure are often used to describe local government as having under-geared balance sheets. The sector has welcomed the introduction of Treasury Corporation Victoria (TCV) products. While there is potential to do more with debt, increased borrowings require an operating surplus to fund principal and interest repayments.

Asset renewal

There is a significant asset renewal gap across all cohorts. This gap presents a compounding risk. As assets fall into greater states of disrepair, they will become more expensive to renew further stretching council resources.



Asset renewal challenges are exacerbated by broader infrastructure delivery challenges. These are driven in part by an ambitious infrastructure program at the state level, and this is unlikely to slow down in the foreseeable future.



Rate cap

Since its introduction for 2016/17 budgets, the rate cap has followed the updated inflation forecasts by the Department of Treasury and Finance for the coming financial year.

There are key problems with this. Firstly, these forecasts are an inexact science. Since the introduction of the rate-cap, the November/December forecasts (and thus the rate-cap) have varied from the actual CPI figures by an average of 1.44%. This represents a change in council rate bases in the order of $100 million.

Another problem is that CPI is not a good indicator of the costs faced by council. 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. 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 for interface councils and small rural councils of 11.1% and 9.0% respectively.

The rate cap for the current financial year was set at 1.75%, compared to likely Consumer Price Index increases of 7%.

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. This can lead to a growing permanent gap between lower and higher rating councils.

There is an opportunity, at a minimum, to improve the mechanism.

Next steps

Audited financial statements will be available by the end of the year. This will give us greater understanding of where the sector currently sits.

Updated budgets, financial plans, and asset plans over the coming year will also be the first to reflect the challenges which Local Government faces in meeting community expectation and the difficulties experienced in managing inflation and construction cost increases. This will exacerbate the renewal and rate cap issues covered in this paper.

We will continue to advocate, in partnership with the Australian Local Government Association, for an increase in Financial Assistance Grants to restore them to 1% of Commonwealth tax revenue.

We have started early work on a Local Government Cost Indicator. We intend for this to give a better picture of the costs experienced by local government than CPI which is currently the basis for rate cap advice from the Essential Services Commission.

We have recently completed work on broad infrastructure challenges currently faced by councils, as well as more targeted pieces on early years and transport infrastructure. This will help us target our advocacy on areas that most need funding increases, as well as potential changes to how funding is delivered to help councils make the most out of their capital budgets.