

TOO TOUGH A NUT TO CRACK: DETERMINING FISCAL SUSTAINABILITY IN AUSTRALIAN LOCAL GOVERNMENT¹

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ABSTRACT: The problem of determining the financial sustainability of local councils in Australia has attracted the attention of five recent official inquiries into local government. This paper considers the work of these public inquiries in South Australia, New South Wales, Queensland, Western Australia and the nation-wide assessment by PriceWaterHouseCoopers on the financial sustainability of local authorities. It is argued that despite reliance on a common method, not only has no generally agreed approach been achieved, but that the inherent difficulties in designing a satisfactory method of measuring sustainability make any consensus in future most unlikely.

1. INTRODUCTION

Over the past few years, Australian local government policy makers have become increasingly concerned with the question of the 'financial sustainability' of individual local councils. Quite apart from forming the central theme of numerous local government conferences across Australia, this concern has also manifested itself in several recent public inquiries into local government systems. For instance, the South Australian Financial Sustainability Review Board's (FSRB) (2005b) *Rising to the Challenge* attempted to define the concept of financial sustainability and then assess South Australian councils against this measure. Similarly, the Independent Inquiry into the Financial Sustainability of NSW Local Government's (LGI) (2006) produced a comprehensive Final Report entitled *Are Councils Sustainable* that also sought to determine financial sustainability in NSW local government. Moreover, both the now defunct

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Queensland Local Government Association (LGAQ) (2006) *Size, Shape and Sustainability* (SSS) project and the recently completed Western Australian Local Government Association (WALGA) (2006) *Systemic Sustainability Study: In Your Hands - Shaping the Future of Local Government in Western Australia* Inquiry have grappled with financial sustainability in their respective local government systems.

In addition, the *Local Government National Report, 2004-05*, prepared by the Local Government Section of the Department of Transport and Regional Services (DOTARS) (2006, p. 61), highlighted the significance now placed long-run financial sustainability by state government policy makers by considering the notion of a 'structural gap' induced by 'the unbalanced growth of revenues and expenditures' that results in fiscal distress in local government. A commissioned report by the commercial company PriceWaterhouseCoopers (PWC) (2006), entitled *National Financial Sustainability Study of Local Government*, considered the problem of financial sustainability across all Australian local government. Finally, the academic literature has also explored the problem of financial sustainability of Australian local government from an empirical perspective (see Murray and Dollery, 2005; 2006; Walker and Jones, 2006; and Dollery, 2006).

A fundamental problem faced by all these attempts at tackling financial sustainability in local government resides in providing a precise definition for the concept and determining how to measure financial sustainability from available data. Although unanimity exists that large numbers of local authorities in Australia suffer from acute financial distress, no consensus has yet been reached on how best to define and measure the concept. This lack of agreement has far-reaching policy ramifications. If no widely accepted meaning can be attached to the term financial sustainability, then firm policy conclusions on the optimal method of alleviating the problem obviously remain allusive.

The modest and limited aim of this paper is to review these five inquiries into the problem of financial sustainability in order to demonstrate an ongoing lack of consensus on how to define and measure financial sustainability in Australian local government, despite the fact that four out of the five inquiries relied heavily on the methodology developed by the private consulting firm Access Economics. In an ideal world of complete and comparable data on the different Australian local government systems, a more ambitious effort would have sought to apply the different available measures of sustainability to local councils in different states in order to determine variations in their assessment of financial sustainability. But data deficiencies mean that this is not possible.

If we are correct in arguing that no agreed and satisfactory measures of local government financial sustainability exist in Australia, then this has important implications for policy making. For instance, if the same council would be adjudged differently by the different measures of financial sustainability in different states, then this indicates how arbitrary the definition of financial sustainability has become in spatial context. If measurement is capriciously subjective, then it follows that regional policy intervention will also be arbitrary.

The paper itself is divided into seven main parts. Section 2 provides a

synoptic discussion of the generic problems associated with local government performance measurement and Key Performance Indicators (KPIs). Section 3 considers the work of the South Australian FSRB (2005b). Section 4 focuses on the NSW LGI's (2006) *Final Report*. Section 5 examines the criteria advanced in the now redundant Queensland (2006) *Size, Shape and Sustainability* manual. Section 6 considers the WALGA (2006) *Systemic Sustainability Study*. Section 7 discusses the deliberations of the PWC (2006) *National Financial Sustainability Study of Local Government* report. The paper ends with some brief evaluative comments in section 8.

2. LOCAL GOVERNMENT PERFORMANCE MANAGEMENT AND KEY PERFORMANCE INDICATORS

In the Australian local government milieu, all state and territory governments have enacted Local Government Acts that grant local councils enabling powers and prescribe the nature of their activities. These Acts also provide state Departments of Local Government with oversight powers over the conduct of local authorities. Under this legislative matrix, state governments must also periodically assess the financial soundness of councils within their local government systems and take action when fiscal and other circumstances demand intervention.

Financial oversight by state government agencies of local councils is a thorny question since it inevitably involves developing methods of appraising the financial performance of municipalities. The conceptual and measurement difficulties revolving around the creation and implementation of satisfactory performance measurement cannot be overstated. In the first place, despite a voluminous literature on the question, summarized by Honadle et al. (2004) in their *Fiscal Health for Local Governments*, there is no agreed definition of what constitutes 'financial sustainability' over the long term in local government. Indeed, Honadle et al. (2004, p. 18) observe that there is not even 'consensus about the terminology surrounding fiscal health'! Definitions abound. In the United States, writers use a bewildering array of terms, including 'fiscal health' (Berry, 1994), 'financial condition' (Lin and Raman, 1998), 'fiscal strain' (Clark and Appleton, 1989), 'fiscal stress' (Pagano and Moore, 1985), 'fiscal capacity' (Johnson and Roswick, 1991), and 'fiscal crisis' (Campbell, 1991). By contrast, in Australia the term 'financial sustainability' has recently become fashionable and acquired widespread usage, even though it still lacks any satisfactory meaning.

It is easy to appreciate how conceptual difficulties of this kind could arise and persist in the financial assessment of local government. For instance, should financial soundness refer to short-term or long-run time periods and how long should time horizons be? Similarly, should the financial circumstances of a given council be judged exclusively in the light of financial magnitudes, such as operating expenditure, operating revenue, indebtedness, and the like, or should the yardstick reside in standards of service provision and community expectations? On analogous grounds, should financial performance be gauged in its own terms or relative to operational effectiveness? What weight should be

accorded to governance efficacy relative to external factors beyond the control of councils?

Secondly, aside from these fundamental disputes surrounding the definition of financially troubled municipal entities, further intractable problems arise in measuring financial performance. The first attempt at systematically evaluating the fiscal standing of local government was undertaken by the American Advisory Commission on Intergovernmental Relations (ACIR) in 1973 which devised six early 'warning signs' of 'local financial emergencies' in the form of financial indicators. This set in train a rapidly growing literature on the development of indicators for local government in the United States (see, for instance, Kloha et al., 2005) that culminated in the construction of comparative indicators, typically in the guise of financial ratios, as perhaps best exemplified by Brown (1993; 1996).

Parallel developments have occurred in Australian local government. Woodbury et al. (2003, p. 78) have provided a systematic analysis of Australian local government performance measurement systems. They observed that in Australia 'a key strategy in improving local government performance over the past decade has been the development of performance measures for use in the benchmarking of services' in order 'to measure performance and assess the efficiencies of councils'. Woodbury et al. (2003, p. 79) have summarized these developments as follows:

A number of Australian states and territories have required councils to provide information on key service areas. Although this has varied somewhat between the states, more detailed and better-defined data continues to be collected each year. It was not until 1995 that national performance indicators were first proposed at the Local Government Ministers' Conference and since then the National Office of Local Government has facilitated a voluntary process of developing and adopting standard performance measures and indicators with the states, peak industry bodies and technical committees. No efficiency measures for councils services are currently compared Australia wide since indicators and definitions vary from state to state.

As a result, 'each state now either releases comparative performance data for local government on an annual basis or is in the process of doing so'. In effect, the methodologies developed in the South Australian FSRB's (2005b) *Rising to the Challenge*, the NSW LGI's (2006) *Are Councils Sustainable*, the now redundant Queensland (2006) *Size, Shape and Sustainability* manual, the WALGA (2006) *Systemic Sustainability Study*, and the PWC (2006) *National Financial Sustainability Study of Local Government* report all seek to find the allusive satisfactory comparative measures of local government financial performance.

The aim of constructing comparative indicators that can be applied to a whole local government system is certainly laudable. Policy makers seek some kind of 'objective' measurement tool that will enable them to compare the performance of individual councils and make recommendations that are unbiased. In the Australian context, this approach has been described by Woodbury et al. (2003,

p. 78) as follows:

[P]erformance has been exclusively assessed by either comparing performance indicators against data for similar councils, primarily the 'average council' figure for that state, or by comparing current performance with earlier indicators for a given council. Little effort has been directed at explaining why there are differences between councils, determining what constitutes 'best practice' levels of efficiency, or how state governments can best apply direct pressure to force inefficient councils to improve performance (through linking grant funding to economic performance).

However, as Woodbury et al. (2003) suggest, efforts at compiling and applying indexes of comparative indicators are fraught with difficulties.

Kloha et al. (2005, pp. 316-17) have identified some of the problems inherent in all system-wide sets of local government comparative financial indicators. Firstly, almost all indexes of comparative indicator indexes contain 'too many variables' that limit the 'ability to assess which are the most important or to combine them into a more useable and easily understood composite'. Secondly, the 'exclusion of key variables' consequent upon 'focusing almost exclusively on balance sheet data seems to hinder an indicator's ability to give early warning of distress'. An additional problem resides in 'ambiguous expectations' since 'some indicators include variables that may have differing interpretations'. A 'failure to allow for diverse preferences' typically derives from the application of average financial ratio values to every local council in strident deviance of preference differences on the part of residents of different local authorities. In the fifth place, an emphasis on the 'relative rather than absolute' values of indicators serves to punish councils whose absolute values are satisfactory but nevertheless fall at the bottom end of a given scale. An inability 'to focus on one locality' is a further problem that plagues systems of comparative indicators since 'ratios for all local governments must be computed before the relative fiscal health of a single government can be determined' with onerous cost implications. Finally, acquiring accurate data is always a costly problem.

These specific problems inherent in almost all sets of local government financial performance indicators are amplified when we consider wider conceptual anomalies. For instance, in *The Financial Analysis of Governments*, Berne and Schramm (1986, p. 93) stress that 'the judgment factor will never be replaced entirely by cookbook formulae' offered by the apparent 'objectivity' of quantitative financial ratios in comparative local government performance indicators. Similarly, in direct reference to Australian performance indicators, Worthington and Dollery (2000) pointedly emphasised the significance of 'nondiscretionary variables' in performance indicators that cannot be altered by the behaviour of a given council. Nondiscretionary variables include items such as pensioner rate rebates, non-rateable properties in a local government area, the proportion of non-English speaking and Aboriginal people, and a host of other economic and social factors that cannot be influenced by a council.

In the Australian local government milieu, these complexities are magnified when the methodologies developed by the different state and territory Local Government Grants Commissions to determine the allocation of Financial

Assistance Grants to local councils is considered. Although the minutiae of the actual formulae employed differ between the different jurisdictions, a set of common principles are embodied in the General Purpose (Equalisation) Grant formulae which are derived from the National Principles of the Local Government (Financial Assistance) Act 1995. These principles are aimed at equalizing the revenue and expenditure capacities of local councils with different characteristics in order that they are capable of delivering a reasonable level of services (Mathews and Jay, 1972) and do not incorporate either the policies or practices of actual councils. In other words, no measure or index of efficiency is contained in the formulae; grants are designed purely on equity grounds. It follows that an analysis of the grants accruing to different councils cannot reveal anything useful about the behaviour of the local councils in question. A comparison of councils receiving substantial grants with those ranked as 'financially unsustainable' in the five inquiries could not be expected to divulge any meaningful association.²

3. SOUTH AUSTRALIAN FINANCIAL SUSTAINABILITY REVIEW BOARD

The South Australian FSRB was set up as an independent body by the South Australian Local Government Association on the 14th February 2005. Its chief task was to assess 'the financial position and prospects of councils in South Australia' by considering three central questions. Firstly, does local council expenditure on service provision and local infrastructure meet with current and future revenues flows? Secondly, what is the optimal manner of remedying a potential 'mismatch' between expenditure and revenue. Finally, should grants from higher tiers of government be directed reducing any such financial mismatch?

The Inquiry itself published three documents: A discussion paper entitled *Local Government in South Australia: Assessing Financial Sustainability* in March 2005; an Interim Report (2005a) published on 30th May 2005; and a Final Report *Rising to the Challenge: Towards Financially Sustainable Local Government in South Australia* (2005b) released on 17th August 2005.

A central question tackled by the FRSB considered the problem of defining 'financial sustainability' as a method of assessing the long-term solvency of South Australian councils. The FRSB (2005b, p. 7) argued that although 'the term "financial sustainability" has a well-understood meaning among Commonwealth and state governments, involving a local council being able to manage likely developments and unexpected financial shocks in future periods with having at some stage to introduce significant and economically or socially destabilizing revenue or expenditure adjustments', no comparable agreement existed on the meaning and content of 'financial sustainability' Australian local government.

After due consideration, the FRSB (2005b, p. 10) proposed the following definition of financial sustainability in local government:

² We are grateful to an anonymous referee for this suggestion.

A council's long-term financial performance and position is sustainable where: (i) continuation of the council's present spending and funding policies; (ii) likely developments in the council's revenue-raising capacity and the demand for and costs of its services and infrastructure; and (iii) normal financial risks and financial shocks, altogether are unlikely to necessitate substantial increases in council rates (or, alternatively, disruptive service cuts).

In order to determine whether or not a given local authority met with this definition, the FRSB (2005b, p. 15) advanced a quadrilateral set of key financial indicators 'for assessing a council's financial sustainability'. These indicators were: (a) net financial liabilities as the 'key indicator of the council's indebtedness to other sectors of the economy'; (b) operating surplus or deficit as the 'key indicator of the intergenerational equity of the funding of the council's operations'; (c) net outlays on the renewal or replacement of existing assets as the 'key indicator of the intergenerational equity of the funding of the council's infrastructure renewal or replacement activities'; and (d) net borrowing or lending as the 'key indicator of the impact of the council's annual transactions – both operating and capital – upon the council's indebtedness to other sectors of the economy'.

On the basis of these considerations, the FSRB (2005b, pp. 19-20) drew its to its major conclusion (in the form of Recommendation 2.3(1)) in which it determined a 'statement of principles' governing 'key financial sustainability indicators' founded on the following six ingredients:

- A local council is financially sustainable financial if 'its net financial liabilities are at levels at which the associated interest payments (less interest income) can be met comfortably from a council's annual income (i.e. by current ratepayers) without the prospects of rates increases which ratepayers would find unacceptable (or disruptive service cuts)';
- The net financial liabilities of a specified local authority 'can be too low where they are (a) associated with current ratepayers being asked to bear an inequitable proportion of the cost of future service potential or (b) below levels that include more than enough room to absorb unexpected financial risks or financial shocks';
- Annual operating financial performance of a local council is sustainable 'if operating deficits will be avoided over the medium- to long-term, because such deficits inevitably involve services consumed by current ratepayers being paid for either (a) by borrowing and so by future ratepayers or (b) by deferring funding responsibility for the renewal or replacement of existing assets onto future ratepayers';
- A local authority's operating surplus can be too high 'where it (a) is associated with current ratepayers being asked to bear an inequitable proportion of the cost of the council's future service potential or (b) is above a level that includes more than enough room to absorb unexpected financial risks or financial shocks';
- The annual capital financial performance of a municipality is sustainable 'if capital expenditure on the renewal or replacement of existing assets on average

approximates the level of the council's annual depreciation expense, because any shortfall of such capital expenditure against annual depreciation expense would involve future ratepayers being left with an excessive burden when it comes to replacing or renewing the council's non-financial assets'; and

- Finally, net borrowing of a local council can be too low 'where, over the planning period, it results in the council's net financial liabilities as a ratio of non-financial assets falling well below the targeted ratio'.

These principles formed the benchmarks that the FSRB employed to assess South Australian councils.

4. INDEPENDENT INQUIRY INTO THE FINANCIAL SUSTAINABILITY OF NSW LOCAL GOVERNMENT

The Local Government and Shires Associations of NSW (LGSA) commissioned an Independent Inquiry into the Financial Sustainability of Local Government in NSW (LGI) composed of an independent panel consisting of three persons highly experienced public policy making under the leadership of Professor Percy Allan. The aims of the Inquiry were fourfold: To determine the current financial position and performance of NSW local government sector; to gauge the adequacy of existing NSW local government physical infrastructure and service delivery; to assess the financial capacity of local government to meet its statutory obligations, expected functions and likely future challenges; and to identify possible financial, administrative, governance and intergovernmental reforms that could address any problems. To this end, the Inquiry published three public documents: *A Background and Issues Paper* presented in October 2005; *A Findings and Options Report* released in February 2006; and a *Final Report* published in early May 2006.

It is thus evident that the LGI represented a much broader investigation than the South Australian FSRB Inquiry since it roamed far beyond the narrow question of financial sustainability of the latter investigation. However, the Independent Inquiry itself explicitly acknowledged that the thorny issue of financial sustainability lay 'at the heart of this Inquiry' (LGI, 2006, p. 267). In the present context, we will focus exclusively on the deliberations of the Inquiry with respect to financial sustainability.

In Chapter 11, the Inquiry set out the 'key financial aggregates necessary for the analysis of a council's financial position and performance' (LGI, 2006, p. 267). These are reproduced in Table 1.

After discussing the 'realities' of financial reporting by NSW councils, and bemoaning inadequacies in financial information, the Inquiry contended that 'each council's financial reports should be accompanied by disclosure of relevant key financial performance indicators (financial KPIs)' (LGI, 2006, p. 271). The financial KPIs employed must provide information on the following financial dimensions of a council's operations (LGI, 2006, p. 272):

- 'A council's *financial position*, which involves the state of its balance sheet, and so the relative level -and composition -of its assets and liabilities'; and
- 'A council's annual *financial performance*, which involves the state of its annual operating statement, and especially the size of relevant annual surpluses

or deficits’.

These financial KPIs should bear ‘a strong predictive relationship with the degree to which a council’s finances are likely to be sustainable in the long term, being based upon generally-accepted key analytical balances’. The ‘principal choices’ of KPIs identified by the Inquiry are reproduced in Table 2 (LGI, 2006, p. 272).

Table 1. Key Financial Aggregates

Income items	Expense items	Capital flows	Asset items	Liabilities items
Rates revenue	Operating costs (employee expenses, superannuation, other non-employee expenses, current grant expenses, subsidy expenses and capital grant expenses)	Capital expenditure, distinguishing between capital expenditure on: (i) The renewal or rehabilitation of existing assets; and (ii) New or enhanced assets	Cash and investment securities – externally restricted	Interest bearing liabilities
Fees and charges			Cash and investment securities – other	Other liabilities (provisions, other)
Grant from other governments for non-capital purposes		Grants from other governments for capital purposes	Other financial assets (receivables, investments accounted for using equity method, other)	Memo item: infrastructure renewal backlog
Other operating revenues	Borrowing costs	Other grants and contributions provided for capital purposes		
Interest	Loss from the disposal of assets	Assets donations		
Gain from the disposal of assets	Loss from interests in joint ventures/ associates	Revenue from disposals of non-financial assets	Non-financial assets (property, plant and equipments, inventories)	
Gain from interests in joint ventures/ associates	Depreciation			
Gain on revaluation of non-financial assets				

Source: LGI (2006, p. 267, Table 11.1).

Drawing on these financial KPIs, the Inquiry prescribed ‘benchmark values’ based on the ‘average’ NSW council, with upper and lower ‘safe’ limits. The Report noted that ‘these values should be adjusted on account of each council’s individual circumstances’ (LGI, 2006, p. 273), such as whether the local council in question is ‘developed’ or ‘developing’ or whether it is ‘growing’ or

‘declining’.

Table 2. Key Analytical Balances

Analytical balances	Definition	Denominator for comparative ratio
Net debt	Interest-bearing financial liabilities less holdings of cash and securities other than externally restricted cash and securities	Total operating revenue
Net financial liabilities	Total liabilities less financial assets net of holdings of externally restricted cash and securities	Non-financial assets plus holdings of externally restricted cash and securities
Net interest expense	Annual interest expense less interest earnings on holdings of cash and securities other than externally restricted cash and securities	Total operating revenue
Operating surplus/ (deficit)	Operating revenue before capital amounts less operating expenses less depreciation expense less net interest expense	Own-source revenue
Net borrowing/(lending)	Capital expenditure less capital revenues less depreciation expense less operating surplus/(deficit)	Annual capital expenditure on new or enhanced assets
Annual renewals deficiency	Annual depreciation expense less annual capital expenditure on existing assets	Annual capital expenditure on renewal or rehabilitation of existing assets
Renewals backlog	Cumulative past annual renewals deficiencies	Non-financial assets

Source: LGI (2006, p. 272, Table 11.2).

These ‘indicative benchmark values’ are reproduced in Table 3. With respect to this table, the LGI (2006, p. 274) stressed that ‘if used, each of these ratios should be adhered to, not just some of them’.

In section 11.4 of the Final Report, the LGI (2006, p. 276) addressed the conditions that must be met should a council wish to be classified as ‘currently healthy’ in financial terms: A given council should be ‘a modest net debtor’ with borrowings or debt making up only ‘a minority of the total capital invested in the council’s infrastructure and other assets’ and at the same time ‘the associated expense burden should not be a substantial proportion of the council’s annual operating revenues’.

This represents a minimum requirement. In addition, ‘for a council’s financial performance to be assessed as “currently healthy” and to ‘involve a margin of comfort to cope with the usual assortment of financial risks and financial shocks’ the council must meet three further criteria. In the first place, the council in question should ‘generally be running an operating surplus rather

than an operating deficit'. Secondly, the local authority should not exhibit a 'significant infrastructure renewal backlog' and its capital expenditure over the financial year on infrastructure renewal and replacement should 'on average over time be about the same level as the council's depreciation expenses'. Finally, 'annual net borrowing should not be putting any pressure on the council's targeted net financial liabilities ratio'.

Table 3. Indicative Benchmarks for Council Financial KPIs

Financial Key Performance Indicators	Average Council Data	Proposed Council Target	Proposed Upper Limit	Proposed Lower Limit
Net debt as % of total revenue	10.5%	100%	150%	50%
Net financial liabilities as % of total capital employed	2.2%	10%	15%	5%
Net interest expense as % of total revenue	0.6%	15%	20%	7%
For general government activities: Operating surplus as % of own-source revenue	-4.5%	5%	10%	0%
For commercial activities only: EBIT as % of non-financial assets	0.9%	5%	7%	3%
Net borrowing as % of capital expenditure on new or enhanced assets	1.3%	50%	60%	30%
Annual renewals deficiency as % of renewals capital expenditure	40.2%	0%	10%	-10%
Infrastructure backlog (\$M) as % of total infrastructure assets (estimated at fair value)	8.1%	0%	1%	0%

Source: LGI (2006, p. 273, Table 11.3)

Chapter 11 of the Final Report (LGI, 2006, p. 283) conceded that the concept of financial sustainability is a 'controversial issue'. It concluded that 'a council's finances should be considered sustainable in the long term only if its financial capacity is sufficient – for the foreseeable future – to allow the council to meet its expected financial adjustments over time without having to introduce substantial or disruptive revenue (and expenditure) adjustments'.

Bearing in mind the earlier discussion on the conclusions of the South Australian FSRB Final Report regarding financial sustainability, the similarities between it and the LGI in this respect are startling. The high degree of commonality between the two conclusions can perhaps best be explained by the fact that both have their origins in the work of Access Economics (2006a). It should thus not be interpreted as indicative of any emerging consensus on the meaning and content of financial sustainability in the Australian municipal context.

5. THE QUEENSLAND SIZE, SHAPE AND SUSTAINABILITY APPROACH

In 2004, the Local Government Association of Queensland (LGAQ) resolved to consider the pressures confronting councils in Queensland and to explore the need for local government reform to ensure the long-run viability of local councils. As a consequence of this decision, a Discussion Paper entitled *Size, Shape and Sustainability of Queensland Local Government* was released on 3rd March 2005 and a Special Conference of the LGAQ held in Brisbane in early June 2005, which formulated a Communique approving a 'comprehensive reform blueprint'. A 'ten point Action Plan' followed from the Communique that was subsequently endorsed by both the LGAQ Executive and the Queensland Minister for Local Government and Planning. The Action Plan provided for a local government reform program embodying the *Size, Shape and Sustainability* (SSS) Review Framework, sustainability indicators, 'options for change', 'Independent Review Facilitators' (IRF), and funding arrangements for state government support. The reform program itself was outlined in the *Size, Shape and Sustainability: Guidelines Kit* (LGAQ, 2006).

The Guidelines Kit (LGAQ, 2006, p. 6, Chapter 1) noted that, as part of the overall reform program, local councils must 'assess their current and future sustainability against a number of key indicators'. It argued that 'the use of indicators for SSS will assist councils determine how their councils are performing'. In particular, the SSS indicators may 'help identify where there might be present or future vulnerabilities, opportunities, and strengths'. These latter three terms are defined in some detail: 'Vulnerabilities' consist of 'risks or weaknesses within specific areas of council operations'; 'opportunities' focus on 'areas within council operations that could be improved'; and 'strengths' consider excellence in council operations and areas where a given council could 'provide assistance/benefit to other councils'.

The *Guidelines Kit* (LGAQ, 2006, p. 4, Chapter 3) set out five criteria that indicators should fulfill: 'Relevant' and 'limited' in number; 'capable of relating to other indicators'; 'easy to understand' 'reliable' in the sense of providing trustworthy information; and based on 'accessible information'. It should immediately be noted that while the *Guidelines Kit* (LGAQ, 2006, p. 8) concedes that 'some indicators are qualitative in nature and will [thus] be scored based on judgment and local knowledge', and thereby does at least recognize some of the generic problems associated with performance indicators outlined earlier in this paper, it nonetheless neglects to mention the problem of discretionary and non-discretionary variables.

Each of the indicators must be scored on a 1 to 5 cardinal scale, with high scores indicating satisfactory outcomes. Prescribed IRF persons will 'oversee' the application of individual council data to the indicators. However, the Guidelines Kit does not explain the process whereby IRF personnel are selected and appointed. This raises obvious and unfortunate difficulties with the independence of the IRF process.

Four categories of indicators are prescribed in the now defunct Guidelines Kit

and set out in detail in Chapter 3. They are briefly listed and commented on below.

5.1 Category #1: Financial and Resource Base

1. Financial forecasts
2. Revenue base
3. Rating capacity
4. Asset sustainability
5. Levels of service
6. Human resourcing
7. Cross border use of council services

These seven indicator groups derive from the Queensland Treasury Corporation's (QTC) 'Financial Sustainability Review' and were to form part of the overall *Size, Shape and Sustainability* exercise. Two indicator groups contain more than a single indicator. For example, 'revenue base' includes three specific indicators dealing population growth, age dependency, and population size respectively. An aggregate score for revenue base is obtained by averaging the score for each of these specific indicators. This is unfortunate since population growth, population age structure and population base all have quite different effects on council service, expenditure and revenue patterns.

A second unusual feature of these financial and resource base indicators resides in the fact that whereas some of them require subjective judgment, other indicators simply report ratios taken from 'objective' data. This means that the scores obtained for different indicator groups are not directly comparable since they are based on completely different assessment criteria.

Thirdly, in contrast to both the South Australian FSRB's (2005b) *Rising to the Challenge* and the NSW LGI's (2006) *Are Councils Sustainable*, the resultant scores represent absolute and not relative perceptions of financial sustainability since the data are not expressed in comparative terms.

Fourthly, insufficient justification is provided for the selection and range of the indicator groups. For example, unlike the NSW LGI's (2006) *Are Councils Sustainable*, no distinction is drawn between a council's financial position (i.e. the state of its balance sheet and the level and composition of its assets and its liabilities) and the annual financial performance of a council (i.e. the state of its annual operating statement and the magnitude of relevant annual surpluses or deficits). This has serious implications for the usefulness of the data that is gathered through the exercise.

In the fifth place, the indicator groupings under 'financial and resource base' confuse inputs into council operations with the outputs from council activities. For example, 'asset sustainability' clearly deals with council assets employed to produce serve outcomes whereas 'service levels' obviously represents a final output. Since the analysis of production functions is premised on the distinction between inputs and outputs, economists always separate these two categories for fear of comparing apples with oranges!

Finally, some indicators are approached in a puzzling manner. For instance,

the adequacy of 'levels of service' should be gauged on the basis of council 'monitoring and reporting', 'future' needs, and 'community expectations' and adjudged by reference to 'customer complaints', 'community surveys', 'various legislative requirements', like Total Management Plans (TMPs), and Strategic Management Plans. The suggested data sets immediately bias scoring towards large councils that do not have the type of intimate interaction with small communities so characteristic of small councils and thus must use these indirect measurement and planning systems. Similarly, the existence of these instruments rather than their efficacy can boost council scores. These and other problems mean that the scores that eventuate would not have properly reflected community satisfaction with service provision.

5.2 Category #2: Community of Interest

1. Service centre and community linkages
2. Community engagement

These two indicator groups follow the same pattern as the 'financial and resource base' exercise since the indicator group 'service centre and community linkages' contain more than one indicator by combining the scores for 'service centre linkages' and 'community linkages'. For the same reasons, this is unfortunate because the two indicators seek to measure different phenomena and an aggregate score is obtained by averaging the score for each of these specific indicators.

A second problem once again resides in the fact that no rationale is provided for the apparently arbitrary choice of indicators. 'Community of interest' is a complex and multi-faceted phenomenon that is very difficult to measure in any meaningful way. For instance, numerous councils combine urban, semi-urban and rural populations with divergent and often competing needs for local services. This aspect has been ignored. Similarly, no mention is made of the important psychological construct of 'sense of place' that is critical in the 'well-being' of small communities. This is typically critical in cases where small settled communities have coexisted alongside much larger councils for long periods of time. A much better way of tackling the question of community of interest is to formally survey public opinion with a statistically reliable sample. A survey of this kind can also gather valuable information on many other aspects of council performance, not least satisfaction with service provision.

5.3 Category #3: Planning

1. Service coordination and efficiency
2. Growth management

Unlike the indicator groups under 'financial and resource base' and 'community of interest', the two planning category indicators do not combine different aspects of local government under a single averaged score and thus is not open to the same objections. However, both deal with the phenomenon of inter-jurisdictional externalities between adjacent local government areas. For example, 'service coordination and efficiency' is centrally concerned with the

question of the duplication and coordination of local government infrastructure across council boundaries. The now abandoned *Guidelines Kit* (2006, p. 18, Chapter 3) explicitly acknowledges that 'where difficulties exist in coordinating infrastructure services across council areas and/or regions, then structural reforms options may be needed', without indicating what kind of options may be appropriate. In this sense, the 'service coordination and efficiency' indicator duplicates to a significant degree the earlier 'cross border use of council services' under the 'financial and resource base' indicator groupings. The difference between the two apparently rests on an artificial distinction between local infrastructure and the services flowing from local government infrastructure. It is thus by no means obvious why these two indicators are not grouped together.

5.4 Category #4: Standards of Governance

1. Decision making and management
2. Accountability

Unfortunately, in common with the indicator categories 'financial and resource base' and 'community of interest', the two 'standards of governance' indicators both combine different aspects of local government under a single averaged score and can thus be attacked on the same grounds. For instance, while there is no denying that 'corporate planning', 'risk management', and 'delegations' are all important dimensions of organisational functioning, experience suggests that harmonious relationships between councillors is one the most critical predictive factors for explaining the smooth running of local authorities. This aspect was entirely ignored by the *Guidelines Kit*.

'Accountability' also comprises two separate aspects of 'performance management' and 'internal audit process' it thereby lays itself open to criticism since it averages scores again. It can also be attacked on grounds that both these dimensions of accountability deal with 'internal' processes rather than 'external' public perceptions of accountability required by democratic entities.

This brief assessment of the indicator groupings contained in the *Size, Shape and Sustainability* exercise thus suggest that there would be considerable room for improvement. At the very least, there would be an urgent need for the Local Government Association of Queensland to explain the rationale for its selection of indicators and for indicators combining more than one conceptually different aspect of local government to be separated.

On a more positive note, a saving grace of the *Size, Shape and Sustainability* indicator exercise resides in its flexibility. The *Guidelines Kit* (2006, p. 6, Chapter 3) specifically notes that 'if the Review Group of Councils believe there are other indicators that are applicable to their circumstances (for example, environmental management and economic development), then it is entirely appropriate at the discretion of the Review Group to add to the sustainability indicator list'. This allows councils to take action to limit the weaknesses inherent in the indicator groupings. Given the unilateral abandonment of the *Size, Shape and Sustainability* program by the Queensland government on 17 April 2007, these considerations must remain purely hypothetical.

6. WESTERN AUSTRALIA SYSTEMATIC SUSTAINABILITY STUDY

In January 2006, the Western Australian Local Government Association (WALGA) commissioned a wide-ranging review of local government in that state. This process culminated in December 2006 with the Final Report of the WA *Systematic Sustainability Study* (WASSS) group entitled *In Your Hands: Shaping the Future of Local Government in Western Australia*. Although this document deliberately considered the entire gamut of local government activity in WA, it nevertheless devoted significant attention to the question of financial sustainability. Indeed, two of nine chapters examined this issue.

The assessment of financial sustainability in WA in the Final Report is based largely on the Access Economics (2006b) *Local Government Finances in Western Australia* commissioned by WASSS; a feature in common with the South Australian, NSW and PWC reports. It is thus not surprising that the definition of financial sustainability shares a great deal with these other three reports. The Access Economics (2006b, p. 55) report defines financial sustainability as follows: 'A council's finances are sustainable in the long term only if its financial capacity is sufficient – for the foreseeable future – to allow a council to meet its expected financial requirements over time without having to introduce substantial or disruptive revenue (and expenditure) adjustments'.

In essence, this method of defining financial sustainability inextricably implies comparing long-run fund-raising ability with long-term expenditure needs. In this context, 'financial capacity' refers to the operating and capital finance that can be raised using existing 'revenue-raising and financing policies' as well as 'any additional funding were the council to increase its revenue-raising efforts to levels commensurate with those displayed with higher-effort councils'. By contrast, 'financial requirements' has two components: capital and operating expenditure sufficient to meet statutory requirements and 'expected spending pressures' (both of which imply asset maintenance and renewal); and a 'margin of comfort' adequate to meet any 'future financial shocks'.

The application of this method of defining local government financial sustainability requires an analysis of individual council accounts. It is made operational by examining a council's 'underlying operational deficit' as a proportion of its 'own-source' revenue. According to Access Economics (2006b, p. 56), 'persistent operating deficits' thus imply a council's revenue-raising efforts are 'too low' whereas 'excessive operating surpluses' mean that a municipality's revenue-raising efforts are 'too high'. A 'benchmark' deficit of 10 per cent of the operating debt ratio was arbitrarily set; councils with a ratio in excess of 10 percent were assessed as 'financially unsustainable'.

However, Access Economics (2006b, pp.56-7) presents four caveats against the blanket application of the underlying operational deficit criterion of 10 percent of the operating debt ratio. In the first place, it contends that councils failing to meet this cut-off mark may not necessarily be unsustainable 'on the grounds that a 10 percent deficit could be eliminated if necessary by "manageable" increases in rates and other charges' since this deficit could be eliminated by a one percentage point increase in rates and charges over the 'no-

policy change' option in ten years. Secondly, current operating deficits do not take into account the 'spending pressures that will arise as councils address their infrastructure backlogs'. Instead, operating debt ratios should be adjusted on the understanding that deferred infrastructure maintenance and renewal has effectively subsidized current consumption by councils. Nominal interest rates on the accumulated backlog should thus be notionally charged to account for this historic subsidy. Thirdly, current operating deficits do not 'allow for the additional financial capacity available to those councils with below-par revenue-raising efforts'. In other words, councils that have 'under-charged' with rates and charges require adjustment to their operating deficits to the extent of this imputed under-charging. Finally, 'another candidate for the adjustment of currently-observed operating deficits when assessing the financial sustainability of councils would be the impact of likely expenditure trends on a no-policy change basis on account of population shifts and ageing along with environmental imposts'. This latter category is sometimes termed 'non-discretionary' variables in the literature since it refers to costs over which councils have no control!

On the basis of these considerations, Access Economics (2006b, Table 5.1, p. 57; Chart 5.1, p. 58) constructed a summary table and chart depicting all WA local councils, adjusted to reflect the caveats outlined above, according to their financial sustainability. This information was subsequently employed in the WASSS (2006, Table 5.1, p. 33) report in the form of a table of financial sustainability by type of council. This is reproduced as Table 4.

Table 4. Financial Sustainability Assessment: By Types of Councils

Type of council	Councils whose long-term finances are assessed as unsustainable:			
	Number	% of total	% of type	% of State population
Metropolitan	3	4%	10%	5%
Regional, with large towns	19	23%	70%	11%
Regional, without large towns	61	73%	71%	5%
Above-average growth	13	16%	45%	8%
Declining population	53	64%	75%	9%
Largest 25%	11	13%	31%	12%
Smallest 25%	24	29%	69%	1%
All WA councils	83	100%	58%	21%

Source: WASS (2006), Table 5.1, p. 33.

It is evident from Table 5.1 that 83 (out of 142) WA local councils or 58 percent - serving around 21 percent of the population - are classified as unsustainable according to the Access Economics (2006b) methodology.

Access Economics (2006b, p. 58) compared this outcome with its earlier calculations for the South Australian and NSW inquiries based on broadly the same technique: 'In NSW, 25 percent of that state's councils were assessed as financially unsustainable, with such councils serving 17 per cent of the state's population' whereas 'in SA, 50 percent of that state's councils were assessed as financially unsustainable, with such councils serving 50 percent of the state's population'.

7. THE PRICEWATERHOUSECOOPERS REPORT

The PriceWaterhouseCoopers (PWC) (2006) *National Financial Sustainability Study of Local Government report* was commissioned by the Australian Local Government Association to determine 'key financial issues' affecting financial sustainability and develop recommendations for improving sustainability. The report was made public in November 2006 amidst a fanfare of media attention. In contrast to the earlier state-based inquiries, the PWC (2006) report took a nation-wide perspective on the problem of financial sustainability.

The PWC (2006, pp. 6-7) report stressed the difficulties involved in assessing the 'financial viability' of local councils across Australia. Three main problems prevented the use of a common sustainability index: 'Mixed approaches to measuring and recording financial data' and 'inconsistencies between states'; 'infrequent' asset valuations and differences in assumed asset lives; and 'incomplete' financial and asset management records, especially in smaller councils. These difficulties forced the authors of the PWC report to adopt two techniques in their assessment of financial. Firstly, the PWC applied financial ratio analysis to a sample of 100 local councils appropriately weighted by state and stratified in proportion to the number of councils in each of the DOTARS seven categories. In the second place, PWC 'extrapolated' from the Access Economics and Municipal Association of Victoria (MAV) (2005) approaches using the KPIs in the (FSRB, 2005b), LGI (2006) and WALGA (2006) state inquiries and the MAV 'viability index'.

The PWC (2006, p. 95) defined 'financial sustainability' as follows: 'The financial sustainability of a council is determined by its ability to manage expected financial requirements and financial risks and shocks over the long term without the use of disruptive revenue or expenditure measures'. This involves two elements. In the first place, councils should maintain 'healthy finances', given current expenditure and revenue policies and foreseeable future developments. Secondly, councils must ensure infrastructure expenditure 'matches' asset planning.

This definition is made operational through the application of five financial KPIs:

- 'Operating surplus' representing 'total operating revenue less total operating expenses'. If an operating deficit exceeds 10 percent of total revenue,

then places at financial risk. In its sample of 100 Australian local councils, 16 percent of all councils could be classified as unsustainable.

- ‘Interest coverage’ measuring a council’s ability to pay interest on its debt and calculated as the ratio of ‘Earnings Before Interest and Tax’ (EBIT) to ‘borrowing costs’. A ratio value below 3 indicates unsustainability. Almost 36 percent of the PWC sample failed on this KPI.

- The ‘sustainability ratio’ or the ratio of capital expenditure to depreciation which measures changes in the asset base of councils. If the ratio exceeds unity, then the asset base is increasing. In the sample, the median ratio was 1.8, with only 8 percent of councils falling below 1. However, the PWC (2006, p. 97) report does stress that the sustainability ratio must be ‘interpreted with care’ due to infrequent and inconsistent asset valuation procedures.

- The ‘current ratio’ or the ratio of current assets to current liabilities. This is intended to measure a council’s capacity to meet its short-term debt obligations; a sustainable council must have a current ratio at least equal to unity. 21 percent of the sample fell below this level.

- ‘Rates coverage’ or total rates revenue as a proportion of total costs. An arbitrary ‘benchmark’ of 40 percent was taken to indicate ‘adequate self-funding and 48 percent of all councils exceeded this figure. However, a significant majority of rural councils fell short.

In its evaluation of these findings, the PWC (2006, p. 114) report was at pains to stress that ‘these results must be assessed with a caveat on their accuracy’ due to data deficiencies. Nonetheless, the PWC (2006) felt able to draw three main conclusions from its work on the sample of 100 local councils, spelt out in terms of the seven DOTARS categories:

- Most ‘large’ metropolitan councils are ‘generally viable’, with some ‘stretched’ owing to ‘service expansion’, and ‘internal reform’ is necessary.

- ‘Urban Fringe’ councils have ‘mixed’ sustainability, ‘internal reform’ is needed, and ‘only some’ councils need ‘additional’ funding.

- ‘Rural Remote’ and ‘Rural Agricultural’ exhibited ‘pronounced’ sustainability problems, required ‘internal reforms’, and most should receive ‘extra funding’ for the ‘renewal of existing community infrastructure’.

The second approach adopted in the PWC report involved extrapolation using the KPIs in the (FSRB, 2005b), LGI (2006) and WALGA (2006) state inquiries and the MAV ‘viability index’ to all Australian local councils in order to ascertain infrastructure sustainability. While we have already considered the (FSRB, 2005b) and LGI (2006) KPIs, the MAV ‘viability index’ comprises three elements: ‘Cumulative long-term debt’ relative to annual rate income; ‘cumulative underlying operating surplus/debt’; and ‘rate effort, rates affordability and population growth’.

The outcome of this exercise has been summarized by the PWC (2006, p. 111) report as follows:

- 20 to 40 percent of all councils ‘could be unsustainable’.
- In monetary terms, NSW unsurprisingly has the largest ‘financial viability issues’.

- The average annual per council ‘underspend’ on ‘existing infrastructure

renewals' seems 'likely' to lie between \$1.3million and \$1.7 million.

- In order to remedy the annual infrastructure shortfall plus the accumulated infrastructure backlog, the 'average' council would need to spend an additional \$2.6 million to \$3.3 million per year.

In its summary of the findings from both its evaluation exercises, the PWC (2006, p. 117) report concluded that (1) around 40 percent of all Australian local councils 'are currently not sustainable' and (2) a 'significant proportion' of all councils – 'say 10 percent to 30 percent' – face 'sizeable sustainability challenges'.

8. CONCLUSION

A notable feature of our review of the five inquiries into local government financial sustainability is that four of the five reports relied heavily on the work of Access Economics. The approach adopted by Access Economics sought to define financial sustainability in terms of accounting measures by identifying inevitably arbitrary financial ratios to delineate between sustainable and unsustainable councils. The fact that the four Access Economics-dependent inquiries still reached somewhat different conclusions serves to underline how easily even basic ratios can be modified through the politicized process of public inquiries. It is also striking that the now defunct *Size, Shape and Sustainability* (LGAQ, 2006) inquiry generated a much broader view of sustainability without Access Economics input.

Three further unfortunate features of excessive reliance on a single commercial consulting firm seem evident. Firstly, a purported strength of a federal system of government is the competition for ideas it introduces between different state and local government jurisdictions. However, in the present case this has largely been nullified by the use of Access Economics in four of the inquiries. Secondly, the comparatively uncritical acceptance of the 'accounting' approach advanced by Access Economics has allowed 'ideology' to masquerade as objective 'analysis' in some instances. For example, if we employ operating deficits in which financial capacity plays a key role – as in the WA report – then obviously this will identify small rural councils as unsustainable due to their unavoidably low rate base, itself an artifact of non-discretionary factors, like demographic trends. Indeed, it is precisely because of this problem that state local government grants commissions were established long ago by a wiser previous generation of Australians. Thirdly, Access Economics has ignored the growing academic literature on the problem of Australian local government unsustainability that focuses on the predictive capacity of KPIs (see Murray and Dollery, 2005; 2006; Walker and Jones, 2006; and Dollery, 2006).

These questions aside, what general lessons can be drawn from this analysis of Australian attempts at defining and placing operational meaning on financial sustainability in local government? At least four major inferences emerge from these attempts to measure the sustainability of local councils in Australia.

In the first place, experience abroad strongly suggests that it is not possible to define sustainability with any degree of precision. Since the concept cannot be given precise meaning, it cannot be captured adequately through performance

indicators. This means that other techniques are needed to augment the current prescribed indicators in the different Australian state systems, particularly public opinion surveys aimed at soliciting the views of the relevant communities. Put differently, a local council may be sustainable if the community is reasonably content with its performance!

Secondly, serious data inconsistencies and deficiencies mean that performance indices, financial ratios, and the like, are only at best broadly indicative of the actual financial situation facing individual councils. This claim is borne out by all the state-based inquiries we have considered as well as the Australia-wide PWC (2006) report. Moreover, as the PWC report reliance on a sample of 100 councils has amply demonstrated, differences in data collection and regulation between the different Australian local government jurisdictions means that no coherent national 'holy grail' set of financial KPIs can be constructed with any confidence. The old computer adage 'garbage in, garbage out' perhaps best describes the difficulties data problems present to the calculation of satisfactory indicators of financial sustainability.

These considerations are supported by the results of analogous exercises carried out in the private sector by well-known groups like Standard and Poor's, Moody's Investor Service and Fitch that provide financial risk assessments of private sector firms and the ability of these enterprises to meet their financial obligations. For example, Standard and Poor's develops credit ratings of debt and equity issuers in Australian capital markets that range from AAA (the highest investment grade and least default risk) to C (the lowest investment grade and highest default risk). Standard and Poor's use a range of financial KPI in arriving at these rankings but always augment ratio analysis of this kind with 'subjective' information obtained from interviews with senior managers precisely because exclusive reliance on financial KPIs has proved unreliable in the past (see, for instance, Gup, et al. 2007). This is instructive in the local government milieu because private sector financial reporting embodies much better measures of performance by including performance criteria, like earnings per share, etc., not available in a public sector context, but this financial data must still be augmented by 'subjective' opinion.³

Thirdly, immense diversity between local councils in any given local government jurisdiction precludes the use of a 'one-size-fits-all' method of assessing municipalities. Not only are the expectations and needs of residents of metropolitan, regional, rural and remote councils quite different, but the problems faced by these different categories of councils are also varied. A given and fixed set of indicators cannot hope to cope with these subtleties.

Fourthly, where indicators are to be employed, effort and resources should be invested ex ante to determine the predictive capacity of the proposed set of indicators. In other words, to what extent do a particular set of indicators actually predict good, bad, or indifferent council performance? This is an

³ We are indebted to an anonymous referee for drawing our attention to potential analogies between financial sustainability assessment in Australian local government and risk assessment in the private sector.

empirical issue that can only be settled by resorting to available data along the lines of the statistical exercise undertaken by Murray and Dollery (2005). Needless to add, this evaluative type of 'pretest' or 'trial program' should be used before embarking on expensive system-wide performance measurement programs.

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