Final Version: 18 March 2011

CONFIDENTIAL

DISCUSSION DRAFT
OF
A REPORT IN PREPARATION FOR THE SOUTH AUSTRALIAN LOCAL GOVERNMENT GRANTS COMMISSION

THE CONSEQUENCES OF GROWTH FOR SALGGC'S GENERAL PURPOSE GRANTS DISTRIBUTION ASSESSMENTS

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March 2011

OVERVIEW

**[Still to be prepared:
See Part IV
Conclusions for
a preliminary indication of what will be a more extensive overview of key issues and arguments]**

I INTRODUCTION

I have termed this Report a Discussion Draft rather than a Draft Report for two reasons.

First, I thought it would be helpful to the Commission if I dispensed with some of the formalities that would be required of a Final Report (such as addressing each of the specific requirements set out in the Terms of Reference) and get more directly to my analysis and conclusions.

Second, I have yet to complete one or two potentially important consultations and to finalise some data analysis. I do not believe that they will change the thrust of my emerging conclusions but they are likely to add some further depth to them.

My principal task, in broad terms, is to assess the (financial) impacts of differences in relative growth rates on local governments in South Australia and to assist SALGGC to determine whether they should be given a special weighting in its General Purpose Financial Assistance Grants assessments and if so how. A secondary task is to review the question of whether depreciation or capital expenditure is the more appropriate variable to include in the Commission's assessments when councils need to fund additional or augmented infrastructure.

In what follows, I examine those two questions in reverse order. I found it helpful to finalising my assessment of the growth issue to complete a rationalisation for using depreciation rather than capital expenditures in the Commission's assessments and believe the Commission might find it helpful, too. So, Part II following addresses the "Depreciation Issue" and Part III addresses the "Growth Issue". Brief concluding remarks are in Part IV.

II THE DEPRECIATION ISSUE

(i) Introduction

In the 2007-2008 GP grants assessment, the Commission changed from using councils' capital expenditures as a cost factor to using depreciation expenses. This followed receipt in December 2006 of a Final Report prepared by Milbur Consulting (on that and other expenditure assessments) and subsequent consultations with councils in early 2007.

It should be said that attempting to track the continuing consequences of the switch from capital expenditure to depreciation expenses alone is not easily achieved. The 2007-2008 assessment changes were a package that included a substantial number of changes to the range and content of the expenditure assessments and, anyway, it would require "back-casting" of capital expenditure data that is not readily available to SALGGC. I have not attempted a tracking exercise because I considered it to be not necessary for current purposes, although I do have some observations to make about the phasing-in of the financial consequences for councils of the package as *a whole*.

In any event, the conclusions of the Milbur Report appear to me to be impeccable. If SALGGC, in its expenditure assessments, is ***solely*** interested in measuring the costs to councils of delivering standard services, it is the cost of capital ***used-up*** in providing services not the cost of ***acquiring*** the assets that subsequently are used-up that is at issue. Given the current objectives of SALGGC's assessments, this is what it should be ***solely*** interested in.

(ii) The Objectives of Fiscal Equalisation

It will be helpful in anchoring the statements in the previous paragraph to briefly review the objectives of horizontal fiscal equalisation (HFE) as currently practiced by SALGGC, by the other States' LGGCs and, for most its life, by the Commonwealth Grants Commission (CGC). It also will be helpful to later addressing the Growth Issue. I set aside for the moment the problems created for LGGCs by the limited quantum of Commonwealth GP grants and the minimum grants requirement, both of which have impacts on some practical aspects of distributing the GP grants.

The standard explanation of HFE is that it aims to ensure that *if all local governments made the same effort to raise revenue and operated at the same level of efficiency, each would have the capacity to provide services at the same standards*.

It is helpful to recognise that what this implies is that local governments would be considered to have the same *fiscal capacity* if they would have the same *net operating income* after providing the same standard of services and making the same effort to raise revenue. Fiscal equalisation aims to give councils the same fiscal capacity—that is, it aims to ensure that they would have the same net operating income if they made the same policy choices about service standards and revenue raising effort. An important thing to note about this, relevant to both depreciation and growth issues, is that the objectives of fiscal equalisation have been taken to concern net operating incomes, not any other measure of local governments' financial

outcomes (such as their net worth or net financial worth). It is their operating statements, not their balance sheets, that are regarded as 'in scope' for GP grant assessments.

If all councils had the same per capita costs of providing services and the same per capita capacity to raise revenue, they would have the same per capita net operating income ***if*** they all provided the same (standard) level of services per capita. In this event, any differences in *actual* net operating income per capita would be the result of policy decisions – about service levels or revenue raising effort.

Washing out the effects of policy differences by comparing those local governments' outcomes to a *standard* level of service provision and a *standard* revenue raising effort would result in them receiving equal per capita shares of GP grants. The "standard" level is typically (and appropriately) determined by the State-wide average of what councils ***actually do***, per capita, in providing services and raising revenue. Any other standard would be arbitrary – someone's judgement about what councils ***should*** do.

In practice, of course, councils differ in revenue-raising capacity and/or service-provision costs. Fiscal equalisation "transfers" – that is different per capita levels of GP grants – aim to ensure that they would have the same (State-wide average) net operating income per capita if they applied the same revenue raising effort per capita and provided the same level of services per capita. In that event, policy differences are still washed-out by using an average of what councils actually do as the standard. But they would receive different per capita GP grants reflecting the "non-policy" differences arising from differences in revenue-raising ***capacity*** and service delivery ***costs***.

The issues created by minimum grants and the inadequacy of the GP pool as matters of Commonwealth policy, which limit SALGGC's ability to actually achieve full fiscal equalisation, and measurement difficulties which result in somewhat arbitrary assessments in Function 50, do not undermine the appropriateness of the objective of "equalising net operating income, per capita". In practice, the Commission's scaling-back procedure results in something more like "relative needs" being reflected in the per capita distribution of grants to non-minimum grant councils. But relative needs are determined by a procedure that begins with assessing needs ***as if*** full equalisation of net operating income per capita was possible.

(iii) Implications for the Depreciation Issue

Given the definition of the objectives of fiscal equalisation as concerning ***net operating income***, there is no question about preferring depreciation over capital expenditures as a measure of the relevant costs of providing services. Capital expenditure (purchasing a new asset) is a *balance sheet item*, (having no initial impact on **net** assets whether funded through borrowing or running down accumulated financial reserves). Its operating budget effect – appropriately recognised under accrual accounting – is to add to operating costs a depreciation expense reflecting the economic (useful) life of the assets acquired to maintain service provision. (It would also add a debt servicing charge or cause a reduction in investment income, to the operating budget but this would be no different whether a capital expenditure or depreciation assessment is used.)

As the Milbur Report in 2006 indicated, however, an important question for SALGGC was the reliability of data available to the Commission on depreciation. The Report's conclusion was that improvements in South Australia's local governments' understanding of asset

management, and provision for depreciation as part of it, had significantly increased in preceding years – sufficiently so that, in effect, including *approximate* estimates of the precisely ***correct*** variable was to be preferred to including *accurate* data on the precisely ***wrong*** variable in SALGGC's assessments.

My consultations with expert authorities at State and local government level have strongly supported the view that data provided by South Australian local governments on depreciation has further improved since the Milbur Report was prepared. The national Ministerial Council of State and Commonwealth Planning and Local Government Ministers has strongly advanced initiatives to assist local governments, nation-wide, to improve their understanding of, and application of, good-practice asset management principles. In South Australia, LGA (SA) has provided strong support for initiatives to assist local governments in these regards. Smaller rural and regional local governments with lesser levels of expertise have been particularly targeted in recent years for support in implementing better practice asset management. There is no question that assessments based on depreciation expenses ***always*** was the most appropriate treatment of capital costs in SALGGC's assessments of the relative costs of service provision. There is also no question that the robustness and reliability of councils' estimates of appropriate depreciation expenses is even greater now than it was when the changeover was implemented in the 2007-2008 grant assessments.

There are, of course, different ways of "measuring" depreciation for financial reporting purposes. The simplest (and apparently currently most common among local governments) is the straight-line approach – that is apportioning depreciation expenses into equal amounts each year of an asset's useful life (e.g., 5 per cent a year of its initial cost for an asset with a 20 year useful life). However, alternative approaches are possible and can be considered legitimate. A standard presumption, based on engineering experience, is that the extent to which an asset is used-up actually increases the closer it gets to the end of its useful life (it deteriorates more rapidly the longer it has been used). It would, therefore, appear appropriate to attribute lower levels of depreciation early in an asset's life than later, while fully writing it off over the same period as would occur with a straight-line approach. I understand that TTG council is considering whether to change to the accelerating depreciation approach.

From a council's perspective, the difference between the straight-line depreciation approach and the accelerating depreciation approach would be that the accelerating approach would result in a council's net operating balance being more favourable than otherwise in earlier years and less favourable than otherwise in later years. From SALGGC's perspective, the consequences would be symmetrical – a council using the accelerating approach would have a lower assessed Raw Expenditure Grant than otherwise initially, offset by a higher Raw Expenditure Grant as the depreciation expense accelerates in later years.

As in all other respects, the results matter not at all to solidly minimum grants councils' shares of GP grants (they would become even more minimum early-on and less minimum later on). For councils that are more marginal minimum grants councils, it might (but unlikely?) shift them out of being minimum grant councils in later years.

For non-minimum grants councils, it is simply a question of *timing* about the size of their Raw and hence PCA grants – a matter of policy choices by them of no concern to SALGGC.

It is equally important to say that, if the Commission was of a mind to modify its methodology in a way that recognised the differential capital expenditure needs of councils facing higher than average growth, the appropriateness of including a depreciation expense in

measuring the recurrent costs of service delivery would not be changed. While also including a relative capital expenditure assessment would ***imply*** a significant change in SALGGC's definition of the objectives of fiscal equalisation, it is inconceivable that such a change would lead to abandoning assessments of the relative *operating* costs (and revenue raising capacities) of councils.

(iv) Continuing Consequences of Adjustment to the 2007-2008 Changes

Although not strictly related to the question of whether depreciation or capital expenditures should be preferred as the capital cost of service provision, nor strictly within the scope of my report, it is not possible to ignore a continuing consequence of decisions by SALGGC about its implementation of the 2007-2008 assessments. Since it was implemented concurrently with changes to other expenditure assessments, it is not possible to attribute all of the subsequent consequences to the change to depreciation alone. However, for the matter raised here, it is likely the change to depreciation was the main element and, anyway, whatever its cause it appears to be an issue that the Commission needs to keep an even more watchful eye on for the near future.

The key matter is the treatment of General Purpose grants to the Onkaparinga, Playford and Salisbury councils. While many councils would have been affected by the 2007-2008 changes and how the Commission dealt with the consequences for them, the Onkaparinga, Playford and Salisbury group's treatment has had the most profound and prolonged consequences for the annual distribution of General Purpose grants. I am aware that the Commission is well aware that the decision in 2007-2008 to insulate the Onkaparinga, Playford and Salisbury group from the consequences of the changes to the expenditure side of methodology changes has had continuing and substantial consequences for grants to them and, as a direct and inevitable consequence, to other non minimum grant councils. My reason for raising them despite them being, strictly speaking, incidental to my principal terms of reference is that they may (arguably should) have a bearing on whether, how and to what extent "growth" should be factored into the Commission's future assessments, to be discussed later in this Report.

The basic fact of the matter is that, despite SALGGC's decisions to impose increasing proportionate cuts to the Onkaparinga, Playford and Salisbury group's Actual Grants over time, they remain substantially above the grants that they would now be receiving if they received only (approximately) their Per Capita Allocated grants as calculated by the Commission's methodology. This would matter less if the extra grants to the Onkaparinga, Playford and Salisbury group were being borne by other relatively "wealthy" councils. The fact of the matter, however, is that the costs are being borne solely by other non minimum grants councils – all of the rural, most of the regional and all of the provincial city councils and two of the Outer Adelaide councils (Alexandrina and Yankalilla) – ***not at all*** by the "wealthiest" councils (the rest of metropolitan Adelaide Councils and a few others – Barossa, Light, Robe, Roxby Downs and Victor Harbor – which are all on minimum grants.

While there are several potential ways of summarising the consequences for other non-minimum grants councils, one way is presented in Table 1, following.

Table 1
The Effects of "Insulating" the O, P&S group

	2007-08			**2010-11**		
	$ Actual (Estimated) Grant LESS "Per Capita Allocated" grant	**$ "Benefit: per capita to residents of the City**	**$ "Cost" per capita to Rest of State Councils not on minimum**	**$ Actual (Estimated) Grant LESS "Per Capita Allocated"**	**$ Benefit per capita to residents of the City**	**$ Cost per capita to Rest of State "non minimum" councils**
Onkaparinga	3,187,775	20.42	9.53	1,887,048	11.76	5.62
Playford	2,801,376	38.74	8.39	1,390,024	17.94	4.14
Salisbury	4,642,971	37.67	13.90	4,468,150	34.36	13.30
O+P+S	10,632,122	30.24	31.82	7,745,222	21.05	23.06

Table 1 indicates that the consequence of the decision in 2007-2008 to completely insulate the Onkaparinga, Playford and Salisbury group from the effects on their actual grants that the methodology would otherwise have had was that, on average, their actual grants were $30.24 per person above their calculated Per Capita Allocated grants. This implied that the other non-minimum grant councils received, on average, grants of $31.82 per person ***less*** than they otherwise would have done. The biggest beneficiary was Playford, closely followed by Salisbury and to a substantially lesser extent Onkaparinga in per capita terms.

Table 1 also indicates that by the time of the 2010-2011 assessments, the average "transfer" from other non-minimum grant councils to the Onkaparinga, Playford and Salisbury group had fallen to about $23 per capita but that almost all of the reduction was explained by falls in the continued transfers to Onkaparinga and Playford: Salisbury's "excess grant" in absolute and per capita terms had barely changed, despite it having had a higher percentage cut in its Actual Grants imposed by the Commission.

Importantly, the reasons for the changes that have occurred have had least to do with the Commission's increasing percentage cuts in the Onkaparinga, Playford and Salisbury group's Actual Grants. As Table 2 following indicates, for Onkaparinga and Playford, their estimated Raw Grants have increased substantially, so the differences between their Actual Grants and their Per Capita Allocated Grants would have fallen substantially even if SALGGC had not cut their Actual Grants. This is because their assessed Revenue "disadvantages" have increased by more than their assessed Expenditure "advantages". In the case of Salisbury, however, its estimated Raw Grant has decreased, causing its Per Capita Allocated Grant to fall further below its Actual Grant. Its Expenditure "advantages "have increased by more than its Revenue "disadvantages". SALGGC's recent 5 per cent cut in Salisbury's Actual Grant only just prevented the gap between Salisbury's Actual and Per Capita Grants being greater in the 2010-2011 assessments than in the 2007-2008 assessments!

Table 2

Changes between 2007-2008 and 2010-2011 for the O,P&S Group			
	Onkaparinga	**Playford**	**Salisbury**
Raw Grant	+18%	+8%	-20%
Per Capita Allocated	+34%	+22%	-9%
Actual Grant	-3.5%	-3.5%	-6%
Actual less Per Capita Allocated	-41%	-53%	-4%
Change in:			
Revenue Disability	+$1,792,299	$1,864,346	+1,530,245
Expenditure Favourably	+$650,176	+1,063,217	+2,918,247
Overall change in disability	+$1,142,123	+801,132	-1,389,002

To put all of this in a slightly different (but revealing) way, in the 2010-2011 assessments, the other non-minimum grant councils received Actual Grants of about 53 per cent of their estimated Raw Grants ***on average***. Playford's Actual Grant was 69 per cent of its Raw Grant, Onkaparinga's was 81 per cent, and Salisbury received an Actual Grant 35 per cent ***more*** than its estimated Raw Grant!

[Note: All data in this section is yet to be rechecked for its precision. However, I am sure that the general conclusions are correct].

What should be done about this? The (small p) politics of the issue is for the Commission to assess. However, in my view, the Commission should pre-warn all members of the Onkaparinga, Playford and Salisbury group that the Commission intends to re-align their Actual Grants with their Per Capita Allocated Grants, under the current methodology, in ***no more than 5 years***, on an "accelerating" basis – i.e., bigger percentage cuts in Actual Grants as time goes on. This may be discomforting to the Commission but, in my view, unavoidable if it wants its current basis for assessing relative needs fully reflected in Actual Grants to all non-minimum-grant councils.

As discussed in Part III, sections (v) and (vi), there may be reasons for the Commission to undertake a more fundamental review of its methodology than is possible or appropriate in this Report – including because it would need wider consultation with the local government sector. This *might* lead to a change to grants to the Onkaparinga, Playford and Salisbury group that *might* be favourable to them—especially Playford, given its likely population growth rate under the 30 Year Plan for Greater Adelaide.

However, in my view, it would be unwise for SALGGC to (implicitly) pre-judge the outcomes of such a review (if undertaken) to given "comfort" to the Onkaparinga, Playford and Salisbury group. The Commission should make clear that any such review would *not* be based on trying to find a way to avoid making cuts to the Onkaparinga, Playford and Salisbury group's grants. It would be fortunate for the group (especially Salisbury) if the outcome was favourable to them but *incidental* to the purpose of any such review.

III THE GROWTH ISSUE

(i) Introduction

The principal element in the ToRs for this Project concerns the financial consequences for local governments of differences in their growth rates, whether a "growth rate" factor should be included in SALGGC's GP grant distribution assessment and, if so, how. An Interim Report completed in 2010 undertook an exploratory investigation of the issues. The current Report is intended to complete analysis in time to be reflected in the Commission's 2011-2012 assessments.

The first thing to be said is that while often articulated as being about population growth, it is not population growth ***per se*** that is, or should be, of principal concern to local governments and SALGGC, once one digs a little below the surface. Other things equal, population growth which only involves more intensive use of existing residential properties (greater household sizes) will not have differential effects on local governments that are not already captured in SALGGC's assessments of relative need. Births, returns to home of older children, moving in of elderly parents or increased house-sharing, for example, might well lead to higher demand for non-property-related services provided by local governments without increasing rates revenue. However, the extra cost of service provision (net of fees and charges) will be reflected in SALGGC assessments of Raw Grants, to the extent that the effects differ from the relevant-State-wide averages. The fact that SALGGC cannot *fully* equalise-away the differential net costs is not peculiar to population growth considerations. The Per Capita Allocated grant assessments reflect their consequences for *relative needs* and that is the most the Commission can do.

The effect of population growth that is the principal source of concern to local governments is where it translates into the need for major new residential developments to accommodate an increase in the ***number*** of households, not their size (for the most part). This primarily involves new broadacre and major infill developments. As councils suggest, seemingly correctly, they face significant net operating and capital costs in the earlier stages of new developments that they do not fully recoup through extra rates revenue until the developments mature. In my consultations during the preparation of this Report, it was suggested that financial modelling (and previous experience) suggested that the "break-even point" might be as long as 20 or even more years.

It is important to be clear about what a "break-even point" means. It is the point at which the Net Present Value of extra revenues generated by the new development, at whatever point they arise, at least equals the Net Present Value of all the extra costs, operating and capital, at whatever point they arise. If, hypothetically, a council borrowed to cover ***both*** any capital expenditures directly attributable to the development as they arise ***and*** any net increase in operating costs directly attributable to the developments as they arise, the break-even point would be the point at which the additional revenues directly attributable to the development, would fully service and pay-off the borrowings.

The fact that there *is* agreed to be a break-even point for major residential developments is a vitally important point. It is independently confirmed in a Report prepared by SGS Consulting for a national organisation representing urban fringe councils and also by independent experts in local government issues in South Australia. Participants in a

Workshop I conducted, organised through SALGGC, in which representatives of about 20[?] councils in South Australia participated did not dispute the proposition but pointed to long time frames. One immediately important point is that the fact that there is a break-even point is independent of whether or not new residential developments occur essentially as a consequence of policy choices by councils themselves or are imposed on them by State government policies.

Before following this line of thought further, however, it might be helpful to the Commission to have available to it a brief statement of known or knowable facts about recent-past and likely future major residential developments in South Australia – especially in the Greater Adelaide region – and the influence of State and local government policies on them.

(ii) Some Facts and Future Possibilities

After a period in the early-to-mid 1990s when South Australia's population growth rate, and dwelling construction rate, declined substantially following the "State bank debacle" and fiscal policy austerity in its wake, South Australia's population growth rate has steadily increased – and done so at historically rapid rates in recent years.

Changes in residential construction rates have broadly tracked population growth rate changes. However, they have done so less in recent than in previous periods. This appears to reflect both that population growth has included a significant increase in birth rates – which do not affect household formation rates and hence dwelling demand for 15+ years – and that students-on-visas have been better enumerated – with different consequences for housing demand. There might yet be some catch-up necessary to meet unsatisfied underlying demand, but it is likely to be modest in proportional terms.

Within this overall pattern of growth, the Outer Adelaide region has exhibited the fastest rates of population ***and*** dwellings growth.

In recent years, the Northern and Southern Adelaide Regions, unsurprisingly, have provided the largest absolute number of (net) new dwellings, with Salisbury providing somewhat more new dwellings than Onkaparinga, Playford or Port Adelaide Enfield.

The average annual supply of (net) new dwellings in recent years has been 8,000 to 9,000. Interestingly, apparently new dwellings provided by minor infill in the metropolitan area (10 or fewer residences per development) has been between 2,500 and 3,000 a year – that is, around one-third of the total net new dwelling supply. Equally significantly, as further discussed later, the 30 Year Plan for Greater Adelaide envisages both the overall average annual growth of new dwelling supply and the contribution of minor infill to be similar to the experience of recent years (albeit with some significant differences between local government areas). That is, on average, the *future* consequences of the 30 Year Plan are not more significant than the consequences or recent past actual growth in aggregate terms, though their distribution by LGA is very likely to be different.

As the Interim Report to SALGGC on the growth issue made abundantly clear, a condition precedent for growth issues to be considered for specific identification and inclusion in SALGGC's assessments is that they ***not*** reflect policy choices of councils themselves. Although this question is to be asked about *prospective* growth pressures, I sought the views of council representatives and independent expert observers of developments in the local

government sector about whether the growth in residential developments in, say, the last 5 years were, or were not, the result of policy choices by councils. The answers I received were mixed. There is no question that State government policies have played a role in where and when new developments have occurred. However, it also seems to be the case that many councils in the Greater Adelaide region became more pro-growth in the past decade – seeing consequent higher revenues and economies of scale in service delivery enabling them to "do more". There are some obvious exceptions, of course, with Mount Barker a stand-out case. And some councils that accept the inevitability of growth see themselves as facing some (acutely) different pressures than others which deserve special consideration, they suggest – especially Victor Harbor facing, for example, growth in the numbers of "income poor, if asset rich" residents who also have service-level expectations based on where they previously lived and also Port Adelaide/Enfield with a high proportion of new immigrant resident from non-traditional areas.

It is also relevant, of course, to ask about the extent to which the costs of differential growth rates would already be being reflected in the Commission's assessments of relative need. This is a question to which I return in the next section.

The principal "hook" on which councils are hanging their current arguments for current and future recognition of the "special needs" of high-growth councils is the consequences for them of the 30 Year Plan for Greater Adelaide. Also, needless to say, they are adamant (to varying degrees) that the growth in residential developments they face under the 30 Year Plan are essentially the result of the State government's population growth strategy, not the result of policy choices of councils.

Since my ultimate conclusion about the Growth Issue is independent of whether or not councils are willing participants in delivering the 30 Year Plan, the question is (to me) purely "academic". However, for the sake of completeness, and because the Commission might come to a different judgement about whether there might be a case for special consideration, it is appropriate/desirable that I offer an "informed judgement" on the issue.
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One view in DPLG appears to be that the Plan's targets, in terms of the size and distribution of new residential developments, was developed in consultation with councils about where development opportunities existed, consistent with the State government's willingness to invest in new infrastructure, including extending transport corridors.

The predominant view of councils, on the other hand, appears to be that they considered themselves to be being consulted about feasibility, not desirability from a council policy perspective. Some were less adamant however, suggesting that their councils recognised the potential advantages of "economies of scale" for faster residential growth.

There is no objective basis on which to provide a definitive assessment of the reality. It is not irrelevant that much of what is planned for the first 5 to 10 years of the Plan involves developments scheduled before the development of the Plan. To that extent, it can be said to be less clear that the first stage is attributable to the Plan. To that extent, it can be said to be less clear that the first stage of the Plan is 'imposed' on councils. However, more recent advice from a senior executive in DPLG puts the "policy choice versus imposition" question into a somewhat different light. It appears that Cabinet, through DPLG, is taking control of all DPAs, including negotiating infrastructure provision with developers. Apparently Playford, Salisbury, Mount Barker and Murray Bridge have, in effect already lost control of

major residential developments in their LGAs and will have to substantially change their 10 year Financial Management Plans to accommodate the new circumstances they face. In light of this, the recommendation below is strengthened.

Applying a "least-regrets" principle, I would recommend that the Commission work on the basis that there is likely to be a material extent to which the 30 Year Plan is being "imposed" on councils, rather than the result of councils' policies and plans. In any event, it seems to me that (though depending on how it was implemented) introducing a special growth factor would/should involve a State-wide average comparator that would wash-out, to some extent, the consequences of different policy choices by councils. This is not implying whether or not a special factor ***should*** be introduced but, rather, suggesting that a specific growth related Function in SALGGC's Raw Grant assessments might not inadvertently unduly compensate pro-growth councils for their resulting extra costs (if any) over time. All high growth councils would benefit, whether they chose higher growth or not.

Turning now to the 30 Year Plan's implications for residential developments, Table 3 provides an overview of what the implications are, within the 7 State Administrative Regions that constitute Greater Adelaide, and what is planned for the first 15 years.

Table 3
Number of (net) New Residences under the 30 Year Plan

Region	**Local Government Areas**		**30 Year Plan**	**1st 15 Years**	**1st 15 of 30 as %**
Eastern Adelaide	Adelaide City Campbelltown Prospect Unley	Burnside Norwood, Payneham and St Peters Walkerville	33,440	16,500	49.3%
Northern Adelaide	Playford Tea Tree Gully Salisbury	Port Adelaide/Enfield [part East of Main North Road (includes Northgate/Northfield)]	67,600	37,500	55.5%
Western Adelaide	Charles Sturt balance Port Adelaide/ Enfield	West Torrens	42,560	20,500	48.2%
Southern Adelaide	Holdfast Bay Mitcham	Marion Onkaparinga	40,500	23,000	57.0%
Barossa	Barossa Council Light	Gawler Mallala	46,400	15,000	32.3%
Adelaide Hills (and Murray Bridge)	Adelaide Hills Council Mount Barker	Murray Bridge	13,000	9,000	69.2%
Fleurieu	Alexandrina Victor Harbor	Yankalilla	14,500	9,500	65.5%
Total Greater Adelaide			**258,000**	**131,000**	**50.8%**

It should be said that it is an open question how credible the projections are – and they have been questioned by a number of people I have consulted, including officials from other government agencies. Moreover, I understand changes have already been made to both the 30 Year Plan and the first 15 year projections, with Southern Adelaide (mainly Onkaparinga) now projected to contribute less to the total (including because, apparently, Onkaparinga council has become more resistant to growth, so council policies seem to matter to some degree).

Although I have been unable to obtain projected new residence numbers by LGA, and will not any time soon, I have obtained *some* relevant to where concerns about growth are likely to be most intense. Specifically, Playford has a target of 40,000 additional dwellings for the 30 Year Plan, beginning soon, out of a Northern Adelaide region total of 67,000 – i.e., approximately 60 per cent of the Northern region total and 26 per cent of the total 30 Year Plan. Salisbury, which has been the highest growth area in the Northern region in recent years as Mawson Lakes has been rolled-out, by comparison has a target of only 17,400 additional dwellings, about 26 per cent of the total in the region and only 7 per cent of the total 30 Year Plan. Importantly, too, Salisbury now has a high level of industrial land which will earn it substantial additional rates income in the near term with (relative to residential land) smaller service costs because businesses arrange and pay for numerous services themselves (e.g., waste disposal) that councils fund for residential properties.

Also relevant to growth pressures is that Onkaparinga will be a lower growth area than it has been in recent years (as the Seaford developments mature?) and proposed developments around Aldinga and Sellicks do not proceed [NB THIS TO BE RECHECKED]. On the other hand, the Mount Barker and Murray Bridge developments are heavily front-end loaded (69 per cent in the first 15 years) as are the Fleurieu developments (65 per cent in the first 15 years).

The Barossa region (Mallala and Light as well as Barossa LGAs) will eventually become the most impacted region – its combined number of residences will increase almost four-fold, though only 32 per cent of this will occur in the next 15 years. Although arguably less pertinent to growth pressure issues of "concern" to SALGGC, after urban fringe developments have been initiated, the State government's attention will turn to new major infill in Inner Adelaide. At this stage, Western Adelaide – especially the Charles Sturt council around Woodville – particularly comes into play, but there are also significant new (?) areas in Port Adelaide Enfield, Marion, Onkaparinga, Unley, Burnside and Adelaide City. Since these are solidly minimum grants councils and unlikely to switch over to non minimum grant even with a substantial growth-factor assessment, the "political" pressures that might arise will be relatively easily deflected towards the State government.

[I intend, for the Final Report, to provide the Commission with some more tabulations that help to more precisely pin down potential changes in Outer and Inner Adelaide that *might* be pressure points for its assessments.]

(iii) Residential Development and the Financial Implications for Local Governments

In Attachment A, for the benefit of the Commission, I have prepared a Sketch-Outline of the principal stages involved in a major new residential development (broadacre or major-infill). For each stage, I identify what would be:

- the major sources of costs to councils solely attributable to the development;
- the major sources of revenues solely attributable to the development;
- the likely net effects on the council's Raw Grants assessment solely attributable to the development.

I have not attempted to put dollar values on costs, revenues and Raw Grants effects. Not only would they likely differ significantly between developments

(and developers) but also would differ if, say, a council had spare capacity in its Planning Department (so the ***net*** effect on its Raw Grant attributable to the development would be less to that extent). In any event, the main points to be drawn from the tabulation can readily be dealt with qualitatively.

The general point to be made is that there appear to be no significant operating costs or operating income to councils that would not be included in SALGGC's Raw Grants calculations as they arise.

Doubtless, different councils would want to emphasise differences associated with, for example, the socio-demographic characteristics of their new residents. For example, older-aged residents on fixed incomes/pensions are typically given some degree of concession on their rates (Victor Harbor would especially emphasise this); younger couples as new residents may impose additional demands on numerous community services, especially children-related services (urban-fringe councils would likely particularly emphasise this); and sea-change/tree change new residents may have expectations of service delivery standards different from existing residents (all/most Outer Adelaide councils would likely emphasise this). These are not entirely related to population growth *per se* but rather to its composition and distribution. Some/most would be reflected either explicitly or implicitly in Raw Grant assessments. **[Peter/Jane: ???]**

The operating costs that would be recognised include those associated with the creation of new physical assets for which councils would be responsible as a result of new residential developments (depreciation expenses, finance charges, on-going maintenances costs etc). It is invariably the case that developers will fund and gift to councils on-site property-related infrastructure (e.g., roads, footpaths, stormwater drains etc), and (generally? Invariably?) reserved land. However, because there is no statutory provision in the Planning Act for "developer contributions" for the funding of on-site community infrastructure (parks; sport and recreation; infrastructure facilities; cultural; child, youth and aged service facilities; etc) whether these are funded by developers and gifted to councils or funded by councils themselves varies across developments (and developers). One way or another new residents probably (predominantly) pay for them – either through higher land costs or higher subsequent rates set by councils. There is apparently also some variability in whether developers contribute to any necessary off-site infrastructure augmentation (e.g., stormwater systems, road capacity, etc).

The central point about this, however, is that, whether assets are gifted by developers, contributed to by capital grants from other governments or involve capital expenditure by councils themselves, the subsequent operating costs which impact on their net operating income are reflected in SALGGC's Raw Grant assessments to their full extent. The fact that (for non-minimum grant councils) their Per Capita Allocated Grants have to be scaled-back from their Raw Grant assessments does not contradict the fact that any changes in their ***relative needs***, during and after a new residential development is in-train, are reflected in their Per Capita Allocated Grants. It is also possible that one or more of the current minimum grant councils could be switched to a non-minimum grant council (other factors unchanged) during the earlier stages of a new development (when additional costs exceed additional revenues). However, the general presumption would have to be that, in the longer-term, a council that is currently minimum grant – if nothing else changed – as a new development matured (additional operating revenues sufficiently overtook additional operating costs) would remain (or become) minimum grant.

As noted earlier, the view of independent experts and local government professionals consulted during this Project is that, over time, new residential projects will more than break-even on a Net Present Value basis. That is, if all deficits on net operating income attributable to the new residential development and all capital expenditures by councils attributable to the development were funded through borrowings, the extra revenues would eventually pay off the attributable borrowings and provide on-going operating surpluses beyond that point. Affected councils would, along the way, have been assisted by increased Raw and hence Per Capita Allocated Grants, if they were, or became, above-minimum grant councils.

The flip-side, of course, is that any increase in Actual Grants to councils attributable to new residential developments would reduce the Actual grants to other councils on above-minimum grants (rural, regional and provincial city councils, for the most part, though the State-wide 30 Year Plan might have differential consequences for some of them, too).

(iv) Should there be a Growth Factor in SALGGC's Methodology?

The broad thrust of my argument is that:

(a) only poor planning would result in a council not (eventually) achieving and going beyond a break-even point (in Net Present Value terms) for a new major residential developments; and

(b) all of the consequences for a councils' ***net*** *operating income* arising from a new residential development would appear to be captured by SALGGC's methodology as the attributable operating costs are incurred and attributable operating income is received.

Equally importantly, those conclusions apply whether a new residential development occurs as a result of pro-growth policy choices of councils or are "imposed" on them by policy decisions of the State government. In the event that they reflected pro-growth policy decisions of councils, SALGGC's methodology washes the effects out ***over time*** by comparing their costs (as they arise) and revenues (as they arise) to State-wide averages. Of course, the extra costs arise early and the extra revenues arise later and it might be argued that this causes an intertemporal inequity to other non-minimum grant councils. This is not different from any other circumstances in which one or more councils make outlays today which only increase their revenues in future **[FOR EXAMPLE?]** although in the case of new residential developments the switch from up-front costs to later period revenues might be substantially longer.

Whether there might be a case for recognising growth as a special factor, notwithstanding that all operating costs and revenues from new residential developments are included in SALGGC's assessments, seems to me to be best answered by reference to the (at least implicit) objectives of fiscal equalisation as currently practiced by the Commission. Given that all effects on net operating income are included, it would appear that the relevant issue is whether councils' expenditures on new infrastructure should receive specific recognition at the time they are incurred.

As explained in Part II, Section (ii) earlier, at least implicitly, the Commission's procedures treat net operating income, after providing the standard level/quality of services and applying the standard level of revenue-raising effort, as the measure of a council's fiscal capacity. ***Given that, it would be inconsistent – arguably incoherent – to include in SALGGC's***

assessments a factor reflecting capital expenditures – and, to do so in addition to the operating costs of funding and of using the assets funded from capital expenditure.

To put the point another way, it would represent a change in the Commission's objectives – its definition of fiscal capacity – to include an infrastructure expenditure factor.

As the 2006 Milbur Consulting Report pointed out, over the long-run, recognising depreciation as the cost of assets used up (consumed), or recognising capital expenditures as the cost of providing the assets that are subsequently to be used up, amount to the same thing if depreciation is appropriately calculated. The preference for using a measure of depreciation rather than capital expenditures in SALGGC's assessments had both a practical and a conceptual basis. The practical basis was that since capital expenditures by any one council are typically lumpy and intermittent, including them in assessments as they occur would create more instability in grants assessments than would recognising a consequent increase in (appropriately calculated) depreciation expenses. The conceptual basis was that it would be more consistent with the Commission's underlying measure of fiscal capacity as related to net operating income (adjusted for relative service delivery costs and revenue raising capacity).

The key point, however, is that it is possible to use one or the other as a measure of capital costs, but to include both would be to double-count capital costs. This applies as much to capital expenditure to facilitate new residential developments as those to refurbish or replace "worn out" assets or to enhance service delivery capacity or standards. Or, to put it the other way round, if a case ***could*** be made for including capital expenditures as well as consequent depreciation expenses for new residential developments, it is not obvious why there would not be an equivalent case for doing so for ***all*** capital expenditures by all local governments, whatever the sources of "need" for them, relative to State-wide average standards of service delivery.

The alternative possibility to be considered is that some of the additional ***operating*** costs faced by councils experiencing significant residential developments might be said to be "out-of-the-ordinary". Councils have particularly mentioned to me the up-front costs of Research and Planning for major new developments. However, it seems to me that to give special enhanced recognition to some operating costs that already are recognised in SALGGC's assessments would also involve "double-counting" them, for no reason that can be obviously justified . (In fact, in relation to application, planning and developments costs to councils, it is not obvious to me that the cost per allotment – i.e., per potential new residence – would be higher for major residential developments (broadacre or major infill) than for minor infill proposals.) In any event, expert advice currently available to me suggest that Research and Planning costs are relatively minor. It is the costs of monitoring the quality of developments in progress that bulk large.

Finally, there is a general issue of ***equity***. Any 'special treatment" given to councils for major residential development expenses would benefit only non-minimum-grant councils (and possibly some councils that currently are minimum-grant but would switch to being non-minimum-grant as an attributable result of the "special treatment"). The bulk of those non-minimum-grant councils that might benefit councils would be fringe or near-fringe metropolitan Adelaide councils (Onkaparinga, Playford and Salisbury, in particular). Some Outer Adelaide Councils (Alexandrina, Mallala and Yankalilla) are also currently non-minimum grant councils among likely affected councils and it is not inconceivable that others in the Outer Adelaide regions could switch over with sufficiently generous "special treatment for high-growth councils.

This has fairly obvious implications. None of the costs of special treatment would be borne by the "wealthiest" of South Australia's council. They would all be borne by the slower growing least wealthy non-minimum-grant councils (rural and regional – and possibly provincial cities, though they might be among higher-growth councils when the 30 Year Plan is extended to other-than-Greater Adelaide regions). The consequence for them of special treatment for high growth councils is that their General Purpose Grants would be even lower than otherwise during the early-phases of new residential developments with no corresponding "special cost recovery" applied to beneficiary councils as developments become net revenue positive. In any event, the intertemporal consequences would be that "loans" from GP grants would be made by low-growth councils to high-growth councils early-on recouped later-on from high-growth councils additional rates revenue-raising capacity, but with no interest payable on the "loan".

In all circumstances, the Commission would unquestionably want to weigh these equity consequences in its decisions. As analysed in Part II of this report, moreover, there is a particularly acute equity problem already embedded in the Onkaparinga, Playford and Salisbury group's Actual Grants. To avoid this becoming an even bigger equity problem, SALGGC would have to be prepared to, in effect, exclude the Onkaparinga, Playford and Salisbury Group from benefiting from any "new residential development" special treatment until (individually) their Actual Grants fell to the level of their Per Capita Allocated Grants as calculated by the Commission's methodology (as amended by any "special treatment" provision).

In my view, given the Commission's current (at least implicit) definition of fiscal capacity, and the means by which it translates this into General Purpose Grants that reflect relative needs, there is no compelling case for giving any form of recognition of "special needs" for high growth councils. Even if the Commission considered that there were reasons, on pragmatic grounds, to give recognition to "special needs", somehow defined, in my view it should isolate members of the Onkaparinga, Playford and Salisbury Group from any potential benefits until their Per Capita Allocated Grants based on any new methodology had risen sufficiently to close the gap between their PCA Grants and their Actual Grants.

There may be reasons for SALGGC to want to review its (implicit) definition of fiscal capacity and the underlying means of achieving a grants distribution that reflects appropriately defined relative needs. However, as discussed in the next two sections, this desirably should be undertaken as a "major review" in close consultation with all councils and independent experts. Differential growth rates between councils may be a pertinent issue, but it is not the only one, and may not be the decisive one.

(v) Recent Decisions by the Commonwealth Grants Commission

As I have previously explained to the Commission, the Commonwealth Grants Commission (CGC), in its major methodology review completed in 2010 and first reflected in its recommended relativities for the distribution of GST revenue between the States in 2010-2011, made a major change to its definition of fiscal capacity.

[THIS SECTION IS YET TO BE REVIEWED BY A SENIOR OFFICIAL IN THE STATE DEPT OF T&F WHO IS EXPERT IN THE CGC'S APPROACH (AND

CRITICAL OF HOW PART OF IT IS BEING IMPLEMENTED). I INTEND TO SHARE WITH HIM ONLY THIS AND THE NEXT SECTION.]

To begin with, I present an overview of what changes the CGC has made, and why, in terms somewhat different from how the CGC explains them. This is because I think it is considerably easier to understand why they have done what they have done in these terms. Also, I suppress a number of complicating factors at this stage. I later explain what the CGC has *actually* said about what it has done, and why, and explain some of the complexities involved in its application of the new approach. ***[I should clearly state at this stage that it is my understanding that most (but not all) States agreed with the thrust of the changes and why they were being proposed. Aspects of the practical implementation of the changes were, however, strongly contested by some States – most substantially and consistently by South Australia.]***

Although the CGC does not express it this way, what it has done, ***in effect***, is to change its definition of the "objective" of fiscal equalisation from one of equalising net incomes (in the sense I explained as Part II, Section (ii) earlier) in each assessment year to one of equalising ***changes in net worth*** in each assessment year. Changes in net worth are the sum of changes in the value of a State's stock of physical assets ("infrastructure") and changes in the value of its net financial assets (net cash, equity, etc *less* debt). So the approach amounts (roughly) to recognising a State's new capital expenditure each year plus/minus any changes in its financial reserves each year (e.g., through new borrowings which decrease them or budget surpluses which increase them).

One way of thinking about "the why" of this approach is that when a State's population increases, its stock of infrastructure assets *per person* is "diluted" and it eventually will have to build the stock up again to provide services to the extra people – i.e., build more hospitals, schools, roads, police stations etc., or at least augment its existing physical infrastructure. The CGC's new approach recognises a State's actual capital expenditures for these purposes as they arise. Likewise for a State's net financial reserves. They are diluted by population increases and to rebuild them, and restore the associated (net) interest income or dividends etc., that are part of its fiscal capacity on a *per person* basis, the State will have to run higher operating surpluses or extract higher dividends from its trading enterprises, for example. Again, the CGC's approach recognises a State's need to increase its effort to rebuild its financial reserves – and have capacity to generate interest and dividend income from them – *per person* as they arise.

Of course, consistent with its approach to differences in recurrent spending and recurrent revenue-raising effort among the States, the CGC uses a policy-neutral approach to comparing differences in what States do to rebuild their per person net worth by comparing individual States to an all-States' average. The effect is that States with faster growing populations (especially, currently, Queensland, but also Western Australia and the Northern Territory) will (*on this account*) receive larger shares of General Purpose Financial Assistance Grants (GST Revenue) than they otherwise would have done and the other States will receive smaller grants (*on this account*).

In practice, the CGC has explained its approach in a different way to this. It says that it has always recognised that States with faster growing populations have higher infrastructure spending needs, but has not said so in so many words. To better reflect this, it has now modified its general depiction of what fiscal equalisation is intended to achieve to include specific reference to infrastructure needs. It now says that:

> *State governments should receive funding from the pool of goods and services tax revenue such that ... each would have the fiscal capacity to provide services* ***and the associated infrastructure*** *at the same standard, if each made the same effort to raise revenue from its own sources and operated at the same level of efficiency.* [Emphasis added]

Including explicit reference to infrastructure needs to achieve the same (all-State standard) level of services in the above statement, is to define States to have ***the same fiscal capacity***:

> *if they have the same change in* ***net financial worth,*** *after providing the same standard of services, providing the same standard of infrastructure to provide the services and making the same revenue raising effort ...*

That is, by taking infrastructure provision into its revised definition of "capacity to provide the same standard of services", the CGC has made equalising net *financial* worth, not net *total* worth its *stated* objective.

In principle, the two ways of interpreting the CGC's new objective are not different. It is just a matter of "where" you recognise the changes in net worth in equalisation assessments. The CGC, in effect, has made changes in the value of stocks of physical assets (capital expenditure) *internal* to its assessment as a cost of providing services at the same standard (as well as recognising depreciation as a cost of maintaining service delivery capacity over time). That leaves changes in net financial worth (net lending or borrowing) as *external* to measuring service delivery costs and revenue raising capacity: it becomes the measure of whether States have the same fiscal capacity after providing the same standard of services and infrastructure and applying the same revenue-raising effort to fund them.

Importantly, relevant to a number of my earlier statements based on the (at least implicit) basis for SALGGC's assessments of relative needs, the CGC has now explicitly introduced annual *balance sheet changes* into its assessments, not just *annual net operating balances* (on an accruals basis).

As I noted earlier, it appears that most (though not all) States agreed that it was appropriate for the CGC to take into account the effects of population growth in diluting States' net worth in its assessments of the appropriate interstate distribution of GST revenue. However, what was hotly contested was how it should be done.

Re Capital Expenditure

With respect to capital expenditure, the faster growing States preferred a *direct* approach to recognising dilution of the quantity of infrastructure per person associated with population growth, and hence increased infrastructure needs to maintain standard service levels. That is, they wanted recognition of new capital expenditure as it actually occurred.

Most of the slower growing States argued for an *indirect* approach. That is, recognising new capital expenditure through an (increased) annual opportunity cost assessment, reflecting that, on an on-going basis, new capital expenditures to meet particular service delivery needs represented lost opportunities to use States' accumulated reserves in some other way (the best alternative way.

Although not strictly correct, what the *indirect* approach amounts to on a financial accounting basis is recognising the interest on borrowings to fund new infrastructure and/or the loss of investment income on reduced financial assets to fund new infrastructure, over time. This would be *additional* to including a depreciation expense in the costs of service delivery as existing and new assets are "used-up". *This appears to be what SALGGC currently does* – i.e., in addition to a depreciation expense, it includes a debt charge in expenses and an investment income item in revenues, which would, other things unchanged, move in opposite directions as new capital expenditure is incurred if funded out of financial reserves or the debt charge would increase by more in absolute terms if the investment was funded solely from new borrowings. If this is broadly correct, the CGC's new approach, if adopted by SALGGC, of recognising capital expenditure as it occurs would amount to giving councils engaging in new capital expenditure an up-front loan from other councils to be paid off over time.

The other thing to be said about the CGC's new approach to recognising capital expenditure as it occurs is that it involves a significant degree of complexity. Since it aims to ensure that each State has the same stock of infrastructure per capita with the same average life that is required to deliver average per capita services, the CGC has to include so-called "infrastructure stock disability factors". Some of these reflect the fact that there may be differences in levels of infrastructure required to meet some service delivery needs: for example, differences in socio-demographic characteristics of States' populations that require higher service delivery expenses may also require higher infrastructure levels. Other disability factors include the fact that there may be differences in unit costs of providing infrastructure with the same average life between States and regions within them (e.g., because of different wages and materials costs or higher rates of asset deterioration). The CGC's assessment approach is, predictably, somewhat arbitrary – and to a degree that cannot be known. In fact, because of uncertainties, it applies a 12.5 per cent discount to its assessments (but did not explain why 12.5 per cent was chosen).

Re Changes in net financial worth

The CGC's approach to reflecting dilution of net financial worth was also contested. Faster growing States argued for an approach of giving the States equal capacity to hold the same per capita stock of *net financial worth* each year, and hence an equal per capita capacity to generate interest and dividend income, by calculating the net lending per capita a State would need for its end of year net financial worth to be equal to the average per capita. Slower growing States argued that the CGC should equalise *net lending* per capita each year (net financial asset accumulation/decumulation each year) meaning that they would have different assessed changes in their stocks of financial worth per capita and hence different abilities to earn revenue from them (interest and dividends) which would need to be assessed differently.

The CGC chose the approach of equalising States' net financial worth per capita through a net lending assessment because, it said, it was the simplest way of recognising the impact of population growth on States' capacities to generate revenue (interest and dividends) from net financial worth. It also said it is a more reliable approach.

Having said that, however, the CGC acknowledged that its approach would not recognise all potential disabilities between States affecting their net financial worth and consequential revenue raising capacity (e.g., differences beyond their control in asset revaluations and differences in borrowing costs). It also acknowledged that concerns had been expressed about

data quality. Recognising these "uncertainties", it applied a 25 per cent discount to this assessment (but didn't explain the basis for choosing 25 per cent).

(vi) Are there implications for SALGGC's Methodology?

I consider it beyond the scope of this Project to undertake a full assessment of whether SALGGC would have reasons to want to adopt changes to its methodology to reflect the CGC's new approach to equalisation. Quite apart from it being beyond the time constraints and the agreed time-budget for this Project, it would be challenging to consider how differences in the methods SALGGC uses to make its assessments and those CGC now uses (including how its *method* of making assessments might affect judgements about whether methodology changes are necessary/desirable). Moreover, SALGGC would unquestionably want a run of its model without and with any methodology changes required to reflect the CGC's new approach as part of its considerations.

That said, I can offer some initial *a priori* observations. I have done some testing of them with officials in the SA Department of Treasury and Finance and have received at least partial agreement.

First-up, it seems to me that my argument for why it would *not* be appropriate for SALGGC to include a "special" population growth factor in its assessments under its current definition of what equalisation is intended to achieve carries over to consideration of whether SALGGC should follow the CGC's new methodology *with respect to capital expenditure assessments*.

Population dilution and capital expenditure

As noted throughout this report, the major impacts of population growth on local governments involve the effects of new major residential developments. Most of the capital expenditure needs are met by developers and gifted to councils, leaving councils with only residual on-site community infrastructure and off-site infrastructure augmentation to cover from their own budgets (possibly partly offset by capital grants). This is, clearly, quite different from the situation facing State governments (save for the capital grants they receive from the Commonwealth) concerning the *extent* to which they must fund new infrastructure needs.

Moreover, new residential developments appear to be more in the nature of revenue-accretive ***self-contained projects***. The revenue streams to cover all recurrent and capital costs are contained within them as new residents take-up residence. Depending on the stage at which councils need to create new community infrastructure and any off-site augmentation, they may already have been part paid-for by new residents. In any event, pre-existing residents of a council area can be protected from the population growth dilution effect on a council's infrastructure by the new residential development being fully funded *internally to the project* by (non credit-foncier) borrowings that capitalise interest and principal repayments until the stream of rates revenue and fees and charges from new residents can cover them and fully repay the debt incurred. (And any new assets created would receive a depreciation expense assessment from SALGGC, though this would be no different from the CGC's methodology.)

Even if a council chose not to fund its capital expenditures on a new development fully internally to new residents, it would receive an increased finance charge on any borrowing not internally funded and/or reduced investment income assessment to the extent it runs down its

financial reserves. And eventually additional rates from new residents would (at least) repay existing residents for any "infrastructure dilution" that occurs earlier in the project.

My bottom-line (at this stage) is that the CGC's "population dilution of economic and social infrastructure" assessment does *not* apply to local governments when population growth is the result of new residential developments since the new residents eventually pay for any dilution they otherwise would cause. There might be some dilution where existing residences are more intensively used (e.g., through birth of children to existing residents) or where minor infill occurs on a significant scale in a council area (the "two-for-one" phenomenon). It is not easy to assess how extensive these effects are likely to be by council area. However, they are likely to be "relatively" minor and, anyway, SALGGC's inclusion of finance charges and investment income in its assessments by function can be argued to be approximations to what the CGC refers to as the "holding cost" approach to accommodating the population dilution effect on older existing infrastructure.

Net financial worth dilution

It (at this stage) seems to me that the above argument also covers the CGC's "net financial worth dilution" argument. A fully internally financed new residential development would not dilute the net financial worth attributable to existing residents and eventually would create at least equivalent levels of net financial worth attributable to new residents.

Again there might be some effects on net financial worth from other sources of population growth, but accommodated by SALGGC's treatment of finance charges and investment income.

Where to from here?

In my view, there is no question that the SALGGC needs to undertake a more in-depth analysis of the implications of the CGC's recent changes in its methodology. Importantly, too, if it appeared that a case could be made for SALGGC to follow the CGC's lead, at least to some extent, it would be highly desirable that consultations occur with councils, informed not only by a discussion paper, but also modelling of what the implications for the distribution of grants might be.

A particular issue that would require detailed attention would be the consequences that arise from insufficiency of GP grants to achieve full fiscal equalisation and the consequences of the minimum grant requirements. As in all other respects, the consequences of adjusting for population growth dilution effects impact only on lower growth non minimum grant councils not at all on lower growth minimum grant councils.

IV CONCLUSIONS

1. Under SALGGC's current methodology which, in effect, equalises net operating balances (positive or negative) of councils, the appropriate treatment of new capital expenditure is to recognise an increased annual depreciation expense over the estimated useful life of the asset. This reflects the extent to which assets are used-up over their life. Decisions by councils about how to fund the expenditure will be reflected in changes in their finance changes and/or investment income as they impact on their operating budgets. There is no basis in the Commission's current methodology for recognising capital expenditure *rather than* depreciation.

2. The financial consequences for councils of population growth that are of most concern to councils involve the impact on them of significant new residential developments. Population increases (such as the result of births) that increase household sizes, not the number of households, (or of minor infill increases in the number of households) involve additional recurrent costs of providing services. However, these are reflected in SALGGC grants assessments. They might also eventually require additional capital expenditures to augment service-delivery infrastructure. These will be reflected in SALGGC's grants assessments through increased depreciation expenses and increased net finance charges and/or reduced investment income assessments.

3. Major new residential developments (broadacre or major infill) will (possibly significantly) negatively affect council's net operating balances (other things unchanged) as they meet the costs of planning, approvals and engineering inspections early-on and throughout the development. These expenses will be reflected in SALGGC's current grants assessments. Capital expenditures for property-related services (roads, footpaths and stormwater drainage, for example), the provision of opens spaces and reserved land for community infrastructure are invariably provided by developers and represent gifted assets to councils. Depreciation and operating expenses associated with them will be reflected in SALGGC's assessments as those expenses arise.

4. Less clear cut is the funding of on-site community infrastructure and offsite augmentation of physical and community infrastructure. Absent a provision in the Planning Act for "developer contributions", South Australia's councils have to negotiate with developers about who will fund what. It appears to be the case that, most often, developers will agree to contribute to such capital expenditure needs to some degree (often, apparently, expressed a share of developer profit margins or sales revenue). Councils may also be able to obtain State or Commonwealth capital grants for community infrastructure provision or renewal (recently Building the Nation grants) or offsite-infrastructure (e.g., special roads grants). The capital cost of non-gifted/capital grant funded assets falls to the councils themselves. These will affect councils' grant assessments in the usual way under the SALGGC's current methodology: that is, there will be an increased annual depreciation expense and an increased (net) financing cost recognised in the assessments by SALGGC.

5. It would appear to be the case that, in the long-run, only poor financial planning would result in councils not being *net* financial beneficiaries from new residential

developments. That is, the Net Present Value of income streams from new developments, whenever they arise, would be unlikely to be more than the Net Present Value of expenditures (recurrent and capital). If so, any *"special* consideration" given to high growth councils would amount to a loan to them in earlier stages of new residential developments which they will repay – *but without interest* – as developments mature and become "net-revenue accretive".

6. This would matter less if the "loans" were funded by relatively low-growth councils with the highest fiscal capacity in South Australia. However, given that only "low-growth" *non minimum-grants councils* would bear the costs and the benefits would most often be received by relatively wealthier non minimum-grants councils, the equity effects of giving high-growth councils "special treatment" is a particularly important matter for SALGGC's consideration.

7. All that said, pertinent to the issue of whether relatively high-growth councils should receive "up-front" recognition of their higher infrastructure and other costs is the fact that the Commonwealth Grants Commission, in 2010, made amendments to its methodology articulated as specifically recognising the extra infrastructure and net financial worth costs of differences in population growth between jurisdictions as they actually arise, not (just) in on-going differences in depreciation expenses and higher debt charges.

8. SALGGC clearly needs to review its methodology for distributing GP grants in light of the changes in the CGC's methodology. However, the CGC should *not* be assumed to be the font of all wisdom on fiscal equalisation issues – aspects of its recent changes have been hotly contested by expert State officials – and it should *not* be assumed that the nature of the CGC's methodology changes necessarily should be adopted by LGGCs. Nonetheless, it would be unwise to assume that the CGC's changes are *entirely* irrelevant to LGGCs' fiscal equalisation assessments. However, a more extensive review of the nature and consequences of the CGC's methodology, and their relevance to SALGGC's assessments than has been possible to date, would be highly desirable. This would involve not only an "in principle" review but also modelling of any changes that appear desirable and also consultation with councils about potential consequences

ATTACHMENT A

A SKETCH-OUTLINE OF THE NATURE OF POTENTIAL FINANCIAL CONSEQUENCES FOR COUNCILS ARISING FROM MAJOR NEW RESIDENTIAL DEVELOPMENTS (BROADACRE OR MAJOR INFILL) AND THEIR IMPLICATIONS FOR SALGGC RAW GRANT ASSESSMENTS

STAGE OF DEVELOPMENT	DIRECTLY ATTRIBUTABLE EXPENSES TO COUNCILS	DIRECTLY ATTRIBUTABLE REVENUES TO COUNCILS	ATTRIBUTABLE EFFECTS ON RAW GRANTS ASSESSMENTS [Other Things Unchanged]
(1) INITIAL • Research and Planning	Staff and consultants, materials, travel etc., (may be using some spare capacity in Planning Departments to some extent?) This is apparently minor.	No recoveries at this stage.	Since there are non-recoverable costs they increase the Raw Grant assessment (Raw Expenditure Grant) but probably to a minor extent.
• Rezoning	Some staff, consultants and related costs for approvals processes? Other? Rezoning may not be necessary in all cases, but when required it can be quite costly (e.g., $50,000 not unusual).	Changes in valuation and rates occur only on change of use (see subdivision section [(2) below]. May be extra revenue at this stage if the rezoned land includes some previously rates–exempt land (e.g., government land) or is designated vacant land (broadacre) ready for development. If farmland is rezoned to residential but the land is still used for farming the VG will generally apply a 'notional' value based on current use rather than highest and best use.	Raw Revenue Grant may decrease on an ongoing basis to the extent that previously exempt land or (broadacre) designated vacant and ready for development is included – otherwise nil. Raw Expenditure Grant will increase "one-off" to the extent of any council costs associated with this stage.

STAGE OF DEVELOPMENT	DIRECTLY ATTRIBUTABLE EXPENSES TO COUNCILS	DIRECTLY ATTRIBUTABLE REVENUES TO COUNCILS	ATTRIBUTABLE EFFECTS ON RAW GRANTS ASSESSMENTS [Other Things Unchanged]
<u>(2) SUB-DIVISION</u> Developer lodges plans for approval and creation of allotments	Costs principally born by developers. Costs to councils for approvals and inspections.	Residential rates apply to all allotments (but not on reserved land) and can be levied in the year following the creation of allotments. This will generate additional rates revenue above the previous broadacre stage. Development application fees apply at this stage but do not cover the costs.	***Net*** reduction in Raw Grant to the extent of valuation increases and rates income increases. Likely to be material/ substantial change on a continuing basis. Some expenditure offsets for any council costs at this stage. Net Raw Grant will increase to the extent of non-recoverable costs, on a "one-off" basis.

STAGE OF DEVELOPMENT	DIRECTLY ATTRIBUTABLE EXPENSES TO COUNCILS	DIRECTLY ATTRIBUTABLE REVENUES TO COUNCILS	ATTRIBUTABLE EFFECTS ON RAW GRANTS ASSESSMENTS [Other Things Unchanged]
(3) DEVELOPMENT IN PROGRESS • On-site property-related infrastructure (e.g., roads, footpaths, stormwater drainage) and reserved land provided by developer.	Gifted Assets, so nil capital expenditure by councils. Costs at this point relate to Council development engineers checking construction to ensure quality standards and completeness before assets are accepted by Council. Apparently *some* developers will take shortcuts leaving Council with sub-standard assets with reduced life. There is no cost recovery for this work. One council apparently spends about $150k pa for this work.	Nil net change in revenue stream until residents move in and higher property values are determined by the VG. [See Stage (4)].	Nil for capital assets gifted because a *balance sheet* change, not an operating statement item. There may be a substantial increase in Raw Expenditure Grant for any additional operating costs related to the assessing quality standards. On-going until the development is complete.
	Subsequent operating expenses (depreciation, maintenance, etc), borne by councils). Depreciation and maintenance start at the point of handover.	Nil net change in revenue stream until residents move in [see Stage (4)].	Raw Expenditure Grant increased by additional operating expenses on a continuing basis on handover.

STAGE OF DEVELOPMENT	DIRECTLY ATTRIBUTABLE EXPENSES TO COUNCILS	DIRECTLY ATTRIBUTABLE REVENUES TO COUNCILS	ATTRIBUTABLE EFFECTS ON RAW GRANTS ASSESSMENTS [Other Things Unchanged]
• On-site community infrastructure (e.g., parks; sport & rec; cultural; and for child youth and aged services).	Uncertain re capital expenditure and timing. Some or all might be Gifted via (voluntary) developer contributions. Unless a major development, developers do not make a contribution to social infrastructure. There is no legal basis to require. However, they must make provision for open space or alternatively pay $7,000 per allotment into an open space fund. Often developers will develop open space as part of the marketing pitch to buyers. For larger developments, Councils can negotiate for social community infrastructure, including joint funding. Sometimes developers will contribute to a trust fund a % of net profit on sales for future community infrastructure. In one example provided, the JV and Council each put 0.5% of land sales into a Trust Fund managed by both parties. Normally developments are more incremental with respect to social/ community infrastructure and as libraries, sporting facilities, or community houses etc are needed, a Council will typically borrow to finance or seek a grant. May be some capital grants some operating costs.	Nil at the time capital expenditure is being incurred.	Nil for ***net*** capital expenditure by councils or for Gifted assets because a *balance sheet* change. Some potential for grant funding for capital costs. Raw Grant increases on a "one-off" basis for operating costs associated with construction.

	Ongoing operating expenses (maintenance, depreciation, finance charges, etc) when completed and operating.	Some fees and charges revenue when operating, though community services are frequently cross-subsidised from rates revenue. Revenue is very minor – services deemed a public benefit and financed from rates. Maybe some operating grant funding but these sources are declining e.g., library subsidies.	Raw Grant increased by ***net*** additional operating costs on an on-going basis, once they begin to arise [probably Stage (4)]. This is irrespective of whether assets are gifted or grant funded. Some offsets are possible through grant funding, but this is less likely nowadays.

STAGE OF DEVELOPMENT	DIRECTLY ATTRIBUTABLE EXPENSES TO COUNCILS	DIRECTLY ATTRIBUTABLE REVENUES TO COUNCILS	ATTRIBUTABLE EFFECTS ON RAW GRANTS ASSESSMENTS [Other Things Unchanged]
• Off-site infrastructure augmentation (e.g., stormwater drainage capacity; additional traffic management infrastructure; others??	Extent and timing of capital expenditure by councils uncertain. Some capital costs may be contributed by developers. May be some capital grants?	Developers are legally required to create open space or contribute to a fund that enables Councils to buy/develop open space elsewhere. Normally developers are required to handle stormwater on site or contribute to a council fund for downstream treatments. This is not a legal obligation but is negotiated prior to development approval. External traffic issues are at Council cost generally – may apply for special local road grants.	Nil with respect to capital expenditure whether Gifted or funded by councils because a *balance sheet* change. Raw Expenditure Grant will increase on a "one-off" basis for any operating costs associated with construction of the assets
	On-going operating expenses (maintenance, depreciation, financing) borne by councils.	Nil.	Raw Grant increased on a continuing basis to the extent of the additional net operating expenses.

STAGE OF DEVELOPMENT	DIRECTLY ATTRIBUTABLE EXPENSES TO COUNCILS	DIRECTLY ATTRIBUTABLE REVENUES TO COUNCILS	ATTRIBUTABLE EFFECTS ON RAW GRANTS ASSESSMENTS [Other Things Unchanged]
(4) DEVELOPMENT MATURES • Residents progressively move in (some items relevant to this probably covered in (3) above).	Continuing operating costs of standard property-related services (garbage collection, street cleaning, verge mowing etc.)	Extra rates income because now charging rates on higher property valuations reflecting the full capital value. Revenue received from building applications which covers a significant part of the costs, including inspections.	Expenditure Raw Grants increases ***AND*** Revenue Raw Grant decrease on a continuing basis. Presumably net effect is to reduce Raw Grant assessment on an on-going basis because rates income eventually exceeds operating costs as more and more residents move in.
	Additional non property-related services operating costs on continuing basis (community services). There is a tipping point at which Council's receive more rate revenue or other income which creates an economy of scale, but then needs an expansion of infrastructure/services.	Some fees and charges income. (Minor)	Most likely net increase in Raw Grant because community services are mostly cross-subsidised from rates and other revenues.

STAGE OF DEVELOPMENT	DIRECTLY ATTRIBUTABLE EXPENSES TO COUNCILS	DIRECTLY ATTRIBUTABLE REVENUES TO COUNCILS	ATTRIBUTABLE EFFECTS ON RAW GRANTS ASSESSMENTS [Other Things Unchanged]
(5) IN PERPITUITY • Operating Activities	On-going standard operating expenses (e.g., staff, materials, depreciation, finance charges) across all standard council services.	On-going standard operating income (rates and fees and charges).	Depends on changes in relative revenue-raising capacity and operating costs. Should involve enhanced fiscal capacity on a net operating income basis.
• Refurbishment and/or Renewal of Infrastructure	Principally capital expenditure. Generally financed internally or from borrowings.	Nil directly. In the case of roads, local road grants can be used to assist in maintenance or renewal.	Nil for capital expenditure because a balance-sheet change Operating costs for staff, materials etc for construction result in a one-off increase in Raw Grants
	Subsequent depreciation, maintenance etc., expenses affect net operating income.	Nil directly.	Proximate effect is to increase Raw Expenditure Grant but, in effect, an "offset" to on-going enhanced revenue raising capacity.