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**Catalysing the renewal of local
infrastructure in regional communities:
The case for Local Infrastructure Australia**

November, 2012

Table of Contents

Table of Contents	2
Acknowledgements.....	2
Executive Summary	3
Report Overview.....	3
Introduction	6
Understanding the Local Infrastructure Policy Challenge	8
Magnitude of the problem	8
Policy solutions	11
Facilitation of private sector financing is essential	12
The Economics of Municipal Infrastructure Finance Authorities	14
Definitions and an overview of precedents	14
Pooling of projects	15
Credit enhancement approaches	16
Significant benefits for small councils	17
Associated benefits - access to advice	18
Examples of Finance Authorities	19
Local Government Finance Authority of South Australia	19
New Zealand Local Government Funding Agency	20
Municipal Finance Authority of British Columbia	21
Local Infrastructure Australia	24
A uniquely Australian approach to an international challenge	24
Exclusive focus on local infrastructure maintenance and renewal.....	25
Adapting to the Australian federal structure	25
Advice and assistance to local government.....	26
Improved information on local infrastructure	26
Initial endowment and establishment costs	27
Governance and operation	27
Conclusion	29
APPENDIX A: Ernst and Young Report key findings and recommendations	30
References	34

Acknowledgements

This report was prepared for the Regional Australia Institute by Professor Brian Dollery on behalf of New England Education and Research Proprietary Limited.

The Regional Australia Institute was established with the support of the Australian Government.

Executive Summary

A new national organisation dedicated to catalysing renewal in local infrastructure represents the most promising public policy for tackling the local government infrastructure shortfall.

To effectively address the policy problem, this organisation must fulfill three main functions:

- *Provide Australian local government with access to private sector capital for infrastructure renewal in the most efficacious and cost-effective manner possible.*
- *Provide local authorities lacking adequate capacity with advice and assistance to overcome the local infrastructure shortfall and engage in effective infrastructure planning, investment and management.*
- *Provide policy makers with adequate and accurate information on the distribution and magnitude of the local infrastructure backlog, as well as policy advice on the best methods of addressing the backlog consistent with national and state infrastructure priorities.*

International experience suggests that the establishment of this organisation will be both low cost and low risk. The initiative can also be 'budget neutral' if delivered from existing Australian Government funding allocated to regional infrastructure.

Report Overview

It is universally agreed that Australia faces a massive infrastructure maintenance and investment backlog, which includes a shortfall in local government infrastructure estimated by PricewaterhouseCoopers at between \$12 billion and \$15.3 billion.

Various policy solutions have been proposed to tackle the local government infrastructure backlog. These range from 'internal' municipal reform to reduce operational costs, increase 'own-source' revenue and improve local asset management, to 'external' policy options, such as increased grants from state and federal agencies, as well as greater local government borrowing.

A new national organisation dedicated to catalysing renewal in local infrastructure represents the most promising public policy for tackling the local government infrastructure shortfall. An organisation of this kind has precedents in numerous other countries, including the Nordic bloc, Japan, many American states and Canadian provinces, and New Zealand.

The impetus for a new organisation has been boosted by the publication of a report by Ernst and Young in June 2012 entitled *Strong Foundations for Sustainable Local Infrastructure: Connecting Communities, Projects, Finance and Funds*, and commissioned by the Commonwealth Government.

Ernst and Young recommend that the Australian Government investigate the establishment of a 'national financing authority for local government' which 'would have a mandate to invest directly in local government programs by providing competitive and low-risk finance, and to facilitate inward investment'. The finance authority would be

empowered to 'bundle approved council borrowings into a limited number of bond issues, which could be underwritten by the Australian Government'.

The chief contribution of the Ernst and Young report lies in its emphasis on the need to ensure that large institutional investors, like the Australian superannuation industry, are offered attractive debt instruments by the local government sector. This is best achieved by bonds issued by a national organisation which are underwritten by the Commonwealth.

Against this background, this report provides a detailed examination of the case for this organisation and proposes an approach which encompasses this recommendation while also providing for the organisation to take a wider role in catalysing change and investment in local infrastructure.

This report sets out detail on the design and operation of such an organisation as well as the economic foundations on which local infrastructure authorities with finance responsibilities are based and the best methods of embodying these principles in a practical real-world finance authority tailored to meet Australian circumstances.

Our analysis concludes that Australian local government infrastructure renewal is plagued by three main problems:

- insufficient investment in local infrastructure;
- a chronic lack of adequate infrastructure finance, planning and management expertise in most local authorities; and
- poor information on the nature of the local infrastructure backlog which impedes effective policy making.

A national organisation focused on local infrastructure renewal must therefore fulfill three main functions:

- Provide Australian local government with access to private sector capital for infrastructure renewal in the most efficacious and cost-effective manner possible.
- Provide local authorities lacking adequate capacity with advice and assistance to overcome the local infrastructure shortfall and engage in effective infrastructure planning, investment and management.
- Provide policy makers with adequate and accurate information on the distribution and magnitude of the local infrastructure backlog, as well as policy advice on the best methods of addressing the backlog consistent with national and state infrastructure priorities.

This report suggests that a new organisation called Local Infrastructure Australia be established as a Commonwealth statutory authority to fulfill this role.

In its financing operations, Local Infrastructure Australia would:

- Invite local councils which had secured state borrowing permission to apply for finance for defined types of infrastructure. This finance would be secured by debt obligations made out by individual councils in accordance with state regulations and protected by state government guarantees.
- Pool all debt sold in regular issues, harnessing operational scale economies and pooling any perceived risk.
- Present institutional investors and councils with investment instruments best suited to their needs, as outlined in the Ernst and Young report, with the sequence and maturity of bond issues tailored to attract large institutional investors, such as the Australian superannuation industry.

- Operate under a Commonwealth guarantee of all debt issued to generate credit ratings comparable to standard Commonwealth debt issues and thereby minimise interest costs.

Supporting this financing role, Local Infrastructure Australia would also catalyse widespread management change and new investment in local infrastructure by:

- offering extensive advice on infrastructure finance and management to individual local authorities on a cost-recovery, 'fee-for-service' basis;
- collecting accurate comparable information on local infrastructure across all Australian local government systems; and
- providing informed policy advice to key infrastructure policy making bodies at federal and state level.

International experience suggests that the establishment of Local Infrastructure Australia is both low cost and low risk. Our review of international experience and current arrangements confirms that:

- one-off establishment costs of Local Infrastructure Australia will be minimal and potentially 'budget neutral' for both federal and state governments if existing Commonwealth allocations to local government infrastructure are used to fund the set-up process;
- Local Infrastructure Australia will not require ongoing investment by the Commonwealth as future running costs will be able to be covered by transaction fees for financing and advisory services; and
- a Commonwealth guarantee to pooled instruments can be extended with negligible or no risk based on the international experience of zero defaults in similar pooled arrangements and existing state government guarantee arrangements for individual council debts.

Introduction

Mounting public unease exists over the parlous state of Australian infrastructure maintenance and investment. For example, in its *Infrastructure Finance Reform Issues Paper*, the Infrastructure Working Group observed that ‘there is widespread and ongoing concern that Australia’s rate of investment in its physical infrastructure is not keeping pace with demand’, which has resulted in a ‘large and growing infrastructure deficit’, estimated at between ‘\$450 billion and \$770 billion over the next decade’.¹

The problem is especially acute in Australian local government, particularly in regional, rural and remote local councils.² While the exact magnitude of the local government infrastructure shortfall is uncertain, in its 2006 *National Financial Sustainability Study of Local Government*, PricewaterhouseCoopers has calculated the backlog at between \$12 billion and \$15.3 billion.

Local government plays an immediate and vital role in the lives of almost all Australians. Adequate infrastructure maintenance and investment is thus crucial to the wellbeing of all local communities across the continent. Given the importance of the ‘tyranny of distance’, local infrastructure is an especially critical factor in determining the prosperity of regional Australia. The existing local infrastructure shortfall has thus served to seriously inhibit economic development outside the capital cities.

In the broad sense, local government infrastructure is defined as the physical assets which enable local communities to enjoy access to economic and social facilities and services. It embraces a host of specific kinds of physical infrastructure, including council and library buildings, storm-water control, sewerage collection and treatment facilities, street lighting, landscaping, sidewalks, public space improvements, transport infrastructure, and most notably local roads. In those Australian states where local government still provides urban water services, such as non-metropolitan NSW, water production, treatment, storage and distribution systems also represent local infrastructure. Finally, local infrastructure covers the maintenance, renewal and refinancing of existing debt for eligible projects.

Given the vital importance of local government infrastructure for the economic and social wellbeing of local communities, urgent steps are required to address the local infrastructure renewal backlog. A host of national and state local government inquiries has considered the problem and made various recommendations, ranging from improved asset management to much higher intergovernmental transfers from state and federal government.

Some remedial public policy initiatives have been initiated, such as the Commonwealth Roads to Recovery (R2R) Program and the NSW Government recent Local Government Infrastructure Renewal Scheme. However, it is universally acknowledged that the size of the infrastructure backlog and its relative concentration in predominantly non-metropolitan local authorities render it essential that further remedial action be taken.

In June 2012, Ernst and Young published a report entitled *Strong Foundations for Sustainable Local Infrastructure: Connecting Communities, Projects, Finance and Funds*. In this report, Ernst and Young recommended that the Commonwealth investigate the establishment of a ‘national financing authority for local government’ which ‘would have a mandate to invest directly in local government programs by providing competitive and low-risk finance,

¹ Infrastructure Working Group (IFWG, 2011, p.5)

² Dollery and Mounter (2010)

and to facilitate inward investment'³. The proposed municipal finance authority would be empowered to 'bundle approved council borrowings into a limited number of bond issues, which could be underwritten by the Australian Government'.

This report examines this recommendation and the associated policy challenges, offering a more detailed model for a new national organisation to catalyse renewal in local infrastructure.

The report has six main sections:

- Section 2 provides a synoptic account of the dimensions of the local infrastructure backlog, as well the various policy remedies which have been proposed, in order to place the Ernst and Young report in context.
- Section 3 outlines the national municipal infrastructure finance authority recommendation advanced in the Ernst and Young report and its associated stakeholder consultation.
- Section 4 sets out the economic foundations on which local and national municipal infrastructure authorities are based and generic methods of embodying these principles.
- Section 5 briefly describes the operation of existing authorities in South Australia, British Columbia and New Zealand.
- Section 6 examines how the design of an Australian finance authority can best be achieved.
- The report ends with some brief concluding remarks on the public policy implications in section 7.

³ Ernst and Young (2012, p. 3)

Understanding the Local Infrastructure Policy Challenge

Magnitude of the problem

Australian local government presently comprises 556 individual entities responsible for the provision and maintenance of local infrastructure, together with a comparatively narrow range of other functions by international standards.

The past few decades have seen the financial capacity of many of these municipalities deteriorate, especially in regional, rural and remote areas. In general, local government has responded by reducing local infrastructure investment and maintenance in order to sustain current service provision. The net result has been a substantial and growing local infrastructure shortfall in all Australian state and territory local government systems. This trend has been extensively documented in a number of state-based and national public inquiries, including the PricewaterhouseCoopers 2006 *National Financial Sustainability Study of Local Government*⁴.

There is an absence of comprehensive nationwide data on local government infrastructure maintenance and renewal. PWC provides the best estimates of the scale of the backlog, which are summarised in Table 1.

Table 1: Australian Local Infrastructure Backlog Estimates

Type of Estimate	Infrastructure Renewal Backlog (\$m)	Expenditure Shortfall on Existing Infrastructure Renewal (\$m pa)	Estimated Infrastructure Funding Gap pa (\$m pa)	Estimated Infrastructure Funding Gap per Council (\$m pa)
Total NSW/WA/SA/VIC	\$9,156	\$711	\$1,362	\$3.1
'Low-case' national estimate	\$12,012	\$922	\$1,826	\$2.6
'Mid-case' national estimate	\$14,533	\$1,129	\$2,163	\$3.1
'High-case' national estimate	\$15,305	\$1,190	\$2,281	\$3.3

Source: Dollery and Mounter (2010).

⁴ See, for example, the South Australian Financial Sustainability Review Board (FSRB) (2005) *Rising to the Challenge Report*, the NSW Independent Inquiry into Local Government (LGI) ('Allan Report') (2006) *Are Councils Sustainable*, the Local Government Association of Queensland (LGAQ) (2006) *Size, Shape and Sustainability Inquiry*, the Western Australian Local Government Association (WALGA) (2006) *Systemic Sustainability Study*, the Local Government Association of Tasmania (LGAT) (2007) *Review of the Financial Sustainability of Local Government in Tasmania*, and NSW Independent Pricing and Regulatory Tribunal (IPART) (2009) *Review of the Revenue Framework for Local Government*. At the national level, see the Commonwealth Grants Commission (CGC) (2001) *Review of the Operation of Local Government (Financial Assistance) Act 1995*, the House of Representatives Standing Committee on Economics, Finance and Public Administration ('Hawker Report') (2004) *Rates and Taxes*, the PricewaterhouseCoopers (PWC) (2006) *National Financial Sustainability Study of Local Government* and the Productivity Commission's (PC) (2008) *Assessing Local Government Revenue Raising Capacity*.

Table 1 indicates a national local government infrastructure backlog, ranging from \$12 billion at the lower end to a \$15.3 billion upper estimate, with an annual expenditure shortfall falling between \$0.9 billion to \$1.2 billion. This suggests that between \$1.8 billion and \$2.3 billion per annum would be needed to alleviate the current deficit in infrastructure maintenance and investment outlays. These estimates are equivalent to between \$2.6 million and \$3.3 million per council per annum. PWC (2006) also calculated the financial impost on local residents of addressing the infrastructure burden. Table 2 shows that the burden on residents amounts to an additional \$2.6 million per council, which represents around \$87 to \$109 per resident per annum.⁵

Table 2: PWC Australian Local Infrastructure Backlog Estimates Per Capita

Type of Estimate	Infrastructure Renewal Backlog	Expenditure Shortfall on Existing Infrastructure Renewal pa	Estimated Infrastructure Funding pa
'Low-case' national estimate	\$571	\$44	\$87
'Mid-case' national estimate	\$692	\$54	\$103
'High-case' national estimate	\$728	\$57	\$109

Source: Adapted from Dollery and Mounter (2010)

Apart from its sheer magnitude, a further critical dimension of the local infrastructure backlog resides in the size and spatial distribution of Australian local government. Table 3 provides data on the size of local councils by population in 2007.

TABLE 3: Population of Local Government Areas in 2007*

Council Population	Rural Areas	Urban Areas	Total
Up to 10,000	373+	16	389
10,001-30,000	69	67	136
30,001-70,000		82	82
70,001-120,000		42	42
120,001-200,000		40	40
More than 200,000		6	6
Total	442	253	695

* Data pre-dates amalgamations in Queensland and Northern Territory.

+ Includes 30 small Indigenous councils in Queensland officially classified as 'urban'.

Source: Aulich, et al. (2011)

⁵ A caveat must be added to the information contained in both Table 1 and Table 2 since it represents inexact estimates of the magnitude of the current Australian local infrastructure shortfall due to unavoidable data deficiencies and data inconsistencies. Furthermore, the same caution must also be exercised with respect to the estimates developed in the FSRB Report (2005), the Allan Report (2006), LGAQ Report (2006), WALGA Report (2006), and the LGAT (2007) (see Dollery and Mounter, 2010).

Table 3 indicates that a majority of Australian local authorities are small, as measured by population size. In 2007, 389 local municipalities (56 per cent) possessed populations below 10,000 people and 46 councils (6.6 per cent) possessed populations greater than 120,000 residents.

This has significant ramifications for policy remediation. Typically, small local government entities do not have adequate financial and asset management expertise. This means that they frequently do not possess satisfactory information on the state of their local infrastructure, they have difficulties in preparing long-term local infrastructure strategies, and they often do not have adequate infrastructure depreciation policies. In addition, lack of financial expertise inhibits their ability to borrow using sophisticated financial instruments. As a consequence, for these local authorities, advice and assistance in infrastructure remediation represents an important part of any successful policy intervention.

Policy solutions

In principle, only three generic policy options exist for tackling the local infrastructure shortfall:

- Much higher property taxes, fees and charges, developer charges, and other 'own-source' methods of revenue raising, as well as better infrastructure management on the part of local government itself.
- Substantially increased intergovernmental transfers from Commonwealth and state governments in the form of grants and *ad hoc* payments, along the lines of the Commonwealth Roads to Recovery (R2R) Program and the NSW Government's recent Local Government Infrastructure Renewal Scheme, or substantial tax-sharing arrangements, as exemplified in the Commonwealth GST payment scheme to the states and territories.
- Much greater reliance on the use of private financial capital through borrowing.

Much of the debate over the most promising approaches to meeting the local infrastructure backlog has taken place within this framework.

For instance, a 2005 South Australian inquiry recommended improved governance and financial management practice, particularly in asset administration. Other policy options emanating from public inquiries into local government have included increased grants from state and federal agencies, the imposition of higher rates and charges by local councils, increased local government borrowing, as well as the transfer of responsibility for the provision of some services between the different tiers of government⁶.

PWC advocated a dual approach to the problem. In the first place, public policy should concentrate on 'internal' municipal reform focused on reducing operational costs, increasing 'own-source' revenue, prioritising local service provision, and improving local asset management and local financial expertise. Secondly, PWC recommended increased fiscal transfers from higher tiers of government, notably the establishment of a Local Community Infrastructure Renewals Fund (LCIRF) financed by the Commonwealth.

To a limited degree, this second recommendation has been adopted by the Commonwealth. For example, in November 2008, it undertook to provide \$300 million to local government through its new Regional and Local Community Infrastructure Program. These funds were delivered in two stages by June 2009: the first instalment allocated \$250 million amongst all Australian councils and the second tranche comprised \$50 million for investment in larger-scale projects⁷. These transfers augmented the earlier and ongoing Commonwealth Roads to Recovery Program (R2R), which had transferred billions of dollars directly to local government, bypassing state and territory governments. It is widely agreed that, without the R2R Program, the local infrastructure crisis would have been much more severe.

In addition, PWC argued for a new method of calculating Financial Assistance Grants (FAGS) with the aim of increasing local government funding, extending both the lifetime and the magnitude of the R2R program, and state government incentives to assist local councils in improving asset management and practice. In the event, the Commonwealth Government injected an extra \$2.2 billion in FAGS and R2R funding into the local government sector. However, as we have seen, given the enormity of the infrastructure shortfall, these funds represent a proverbial 'drop in the ocean'.

⁶ See FSRB (2006), LGI (2006), WALGA (2006) and LGAT (2007).

⁷ Australian Council of Local Government (ACLG, 2008).

In addition to the various recommendations flowing from the state and national inquiries into local government, several other suggested policy strategies have been advanced. For instance, it has been argued that Public Private Partnerships (PPP) should be accorded a greater role in local infrastructure provision⁸. The Association of Superannuation Funds of Australia has observed that ‘investment in infrastructure can play an important role in boosting national productivity’, with significant potential for ‘network effects’, so that ‘investment in infrastructure can have a system-wide benefit by, for instance, improving the efficiency of the whole road system’⁹. In its *Infrastructure Finance Reform Issues Paper*, the IFWG considered several borrowing instruments which could be used *inter alia* to provide funds for local government infrastructure, including superannuation funds, infrastructure bonds, such as ‘revenue bonds’, ‘covered bonds’ and an ‘infrastructure bond market’, infrastructure funds, government equity through public sector debt, and government underwriting of the financial performance of infrastructure projects¹⁰.

While most of these proposals have at least some merit, many of them are not grounded in the practical realities of contemporary local government finance. Indeed, the sheer size of the Australian local infrastructure backlog necessarily implies that – under the current assignment of expenditure and taxation powers in Australian fiscal federalism – the vast bulk of the local government sector simply does not possess the financial capacity to provide the level of funding required to meet the shortfall.

Facilitation of private sector financing is essential

Raising funds to pay for local infrastructure upfront is not an optimal approach given the nature of capital expenditure. Capital expenditure differs from operating expenditure in two main ways. In the first place, capital expenditure is typically lumpy, with few consistent trends, and therefore borrowing is the most rational approach to its finance. Secondly, the financing of capital expenditure differs from operating expenditure: it is financed by means of developer charges, special assessments, reserves and borrowing, whereas operating expenditure normally relies on ‘own-source’ revenue and grant income.

Given the current parlous Australian and state government budgetary circumstances, virtually no feasible prospect exists of substantial increases in grants or other types of transfer payments. Similarly, in light of the findings of the Productivity Commission’s 2008 *Assessing Local Government Revenue Raising Capacity Report*, it is unrealistic in the extreme to assume that the majority of local government entities possess either the financial capacity or political will to impose the kind of draconian increases in rates or other charges required to raise the enormous volume of funds required¹¹.

It follows that borrowing represents the only practicable solution short of a wholesale revision of current fiscal arrangements in Australian federalism. The challenge is to reduce barriers for access to judicious borrowing sources, minimise associated costs and ensure local council management is prepared to make the most of its resources in servicing borrowings over time.

⁸ Beresford-Wylie, Watts and Thurairaja (2006)

⁹ Association of Superannuation Funds of Australia (2011, p.3)

¹⁰ IFWG (2011, p.5)

¹¹ Dollery and Grant (2011).

An embryonic academic literature has investigated several promising avenues through which local government could efficaciously borrow private sector funds. For example, it has been suggested that an Australian municipal bond market should be established, along similar lines to the American municipal bond market¹². In an analogous vein, some scholars have presented the case for a federal infrastructure fund for local government infrastructure funding¹³. Other commentators have considered and rejected the feasibility of municipal banking in Australia which would mirror widespread practice in many European local government systems¹⁴. Finally, a national municipal infrastructure finance authority has been advocated to pool individual council risk in aggregated infrastructure bonds issues guaranteed by the Australian Government¹⁵.

In late November 2011, the Commonwealth Department of Regional Australia, Local Government, Arts and Sport (DRALGAS) engaged Ernst and Young to 'review the prioritisation and financing of local infrastructure'.

The publication of the Ernst and Young *Strong Foundations for Sustainable Local Infrastructure: Connecting Communities, Projects, Finance and Funds* Report in June 2012 has stimulated further interest in a national municipal infrastructure finance authority as the best method of funding infrastructure through borrowing for local government.

The report explored the barriers and opportunities for the establishment of a national financing authority for local government. In summary, it argued that such an organisation ought to be established and recommended that the government further investigate the matter¹⁶.

The key reasons provided by the report in favour of the establishment of a local infrastructure authority included:

- It would provide all Australian councils access to lower-cost debt finance by means of: (a) the aggregation of risk and supply across many councils; (b) access to Commonwealth cost of capital; and (c) the 'pass-through' of administrative efficiencies.
- It would provide financial and legal assistance and expertise to those councils with limited 'in-house' capacity.
- It would provide finance to qualifying regional bodies which have responsibility for community infrastructure.
- It would encourage 'rigour and discipline' in financial planning by ensuring that the provision of finance is conditional upon evidence of long-term forecasts and evidence of a capacity to service and repay debt (although the authority would not involve itself directly in council budgetary and planning processes).
- It would provide and facilitate due diligence and prudential oversight for the local government sector (such as the identification of concessional tax arrangements in infrastructure finance).
- It would satisfy the need to find intergenerational equity by apportioning the expense across those generations that are likely to benefit from the investment.

¹² Byrnes, Dollery, Crase and Simmons (2008)

¹³ Dollery, Byrnes and Crase (2007a)

¹⁴ Dollery, Grant and Kortt (2012)

¹⁵ Dollery, Grant and Kortt (2011; 2012)

¹⁶ Ernst and Young (2012, pp.37/38)

The Economics of Municipal Infrastructure Finance Authorities

As we have seen, some Australian economists have argued for the establishment of an Australian municipal bond market to assist local government infrastructure borrowing¹⁷. Their argument was partly based on the enormous and diversified American municipal bond market (or ‘muni market’).

In the United States, the muni market has given local authorities direct access to infrastructure finance, as well as to private credit ratings and insurance institutions. The vitality of the American municipal bond market can largely be attributed to the fact that municipal bonds are actively traded. This offers even short and medium-term investors the possibility of purchasing long-term bonds in the knowledge that they can be readily traded in the secondary market¹⁸. While an American-style municipal bond market would have undoubted advantages for large Australian local authorities which possess the financial capacity to take advantage of its benefits, the majority of small local councils would effectively be excluded from such a market.

Despite the efficiency of the American market, unlike their larger counterparts, small American municipalities cannot easily participate because of the high fixed costs involved. These costs include disclosure documentation, bond insurance and the cost of securing credit ratings. In order to surmount this problem, numerous American state governments have established chartered bond banks (i.e. state municipal finance authorities) to take advantage of scale economies in bond issuance. Many American states have also conferred ‘credit enhancement’ measures on these bond banks, including state guarantees against default¹⁹. Given the size distribution of Australian local government entities, an Australian municipal bond market would also limit participation by a majority of councils, and thus a finance authority to pool projects and instrument establishment costs represents a superior policy option.

Definitions and an overview of precedents

National and state-based local government finance authorities presently exist in a number of countries, including the Nordic bloc, Japan, numerous American states and Canadian provinces, New Zealand and South Australia. However, these institutions display a high degree of heterogeneity, reflecting on the different circumstances prevailing in different countries.

While no single definition adequately describes all of these institutions, the American Council of Infrastructure Financing Authorities (CIFA) has offered the following generic definition: a finance authority is ‘an entity that sells its own securities and re-lends bond proceeds to local governmental entities’.

¹⁷ Byrnes, Dollery, Crase and Simmons (2008)

¹⁸ Hillhouse (1975)

¹⁹ American Council of Infrastructure Financing Authorities (CIFA) (1997)

This definition obviously covers a wide range of institutions, which can include private for-profit firms, non-profit organisations, and public institutions ‘which only issue debt for a single purpose’²⁰. However, the CIFA has also advanced a more precise description of a finance authority as ‘a state-sponsored entity that makes local infrastructure projects feasible by providing access to the municipal bond market and by providing direct and indirect financial subsidies to localities primarily through debt issuance’. It has observed that ‘in distinguishing between these two definitions, the concept of state sponsorship and assistance is important in distinguishing those borrowing entities that enjoy an element of state “legitimacy” and support, as opposed to those entities that are purely free-standing and unassisted’. The main objective of most municipal finance authorities is to provide local government with low-cost infrastructure financing through debt issuance, typically with some form of government support.

Most American state finance authorities are founded under state government legislation. Whereas most other finance authorities are independent entities, with autonomous governing boards and a dedicated administrative structure incorporating financial expertise, some banks are located within the state administrative bureaucracy.

In the American market, most finance authorities are financially independent in the sense that they are not reliant on state governments to provide ongoing operating funds, thereby representing a ‘one-off’ cost to host state governments rather than an ongoing financial burden. Finance authorities depend instead on a variety of sources of income to fund their operations. The most common method is to use fees and charges levied on borrowing municipalities, including lump-sum fees at the close of an issue, an annual fee based on outstanding loans, and mark-up interest rates.

While significant variation exists in the operational approach of finance authorities, a common pattern is applicable to most municipal finance corporations²¹. As a general rule, finance programs offered to local government can be classified into three main types:

- Long-term bond pools, including the refunding of existing debt.
- Cash flow financing to align income and expenditure flows over the financial year.
- Equipment lease financing to purchase expensive facilities and machinery.

Each of these financing options services a specific need in local government, especially smaller municipalities with limited financial reserves and a constrained ability to borrow. For example, long-term bonds provide finance for infrastructural assets with extended lives, whereas cash flow financing requirements can be met with short-term loans.

Pooling of projects

Given that inadequate local infrastructure funding is the major problem in Australian local government, and local infrastructure largely has lengthy life expectancies, any institutional solution would have to concentrate on long-term bonds.

²⁰ CIFA (1997, p.2)

²¹ See, for instance, CIFA (1997), Gilbert and Pike (1995), Kidwell and Rogoski (1983); Martell and Guess (2006), Peng and Brucato (2003), Robbins and Kim (2003), Solano (2005) and Yusuf and Lui (2008).

Two main approaches to long-term infrastructure are typically followed by finance authorities, often simultaneously by the same institution:

- Pooling together the smaller issues of multiple local governments into a single large bond sale.
- Issuing bonds on behalf of a single, typically large, local authority.

Given the comparatively small size of most Australian local authorities, in practice an Australian national finance authority would have to deal mostly with long-term bond pooling. The mechanics of a long-term bond pooling are relatively straightforward. In general, a finance authority issues bonds under its legal indenture and uses the revenue to make loans to numerous small municipalities, which have applied for finance through the finance authority.

As lenders to local authorities, finance authorities typically apply credit tests which borrowing councils must satisfy in order to qualify for loans. These commonly take the form of a general obligation by local borrowers and/or various forms of minimum requirements for debt service coverage. These credit requirements obviously have significant implications for a finance authority's credit rating.

Several advantages flow from this approach. Firstly, bond purchasers are secured by loan repayments from the pool of local government borrowers as opposed to a single municipality.

With respect to the cost of funds, bond pooling means that investors would require lower interest rates than they would otherwise request if they were buying a single obligation from a single local authority, especially small and little known local authorities. Bond pooling can also yield operational scale economies since it spreads the fixed costs of issuance – like rating fees and legal fees – over a larger number of lenders and borrowers. Scale economies in purchasing also derive from negotiating lower fees for bond insurance, advertising, etc., than would be the case for more limited single issues.

Furthermore, if the finance authority is underpinned by a central or state government guarantee, then borrowers receive further security through this 'credit enhancement'.

Credit enhancement approaches

National and state governments offer credit enhancement or financial support of various kinds to bond banks which serve to reduce the costs associated with borrowing²². In essence, this decreases interest rates on bond bank debt since state credit ratings are typically higher than those of most local authorities for the same debt instruments.

The most common type of credit enhancement provided to American bond banks takes the form of state government moral obligation pledges to secure debt service reserve (DSR) funds. Finance authority debt issues are often accompanied by a DSR fund which is equivalent to the maximum annual debt service that can be drawn on in case of default on debt service payments. Should a default occur, then the bond bank can request state financial intervention to restore the DSR fund to its required level. Nonetheless investors still face the risk that state

²² Gilbert and Pike (1995).

legislatures will refuse to augment a DSR fund. However, credit rating agencies typically acknowledge state moral obligation pledges with ratings one category lower than a state's general obligation rating.

In fewer cases, state governments pledge their full credit support to a pooled issue sold by a finance authority. Finally, in numerous American states, finance authorities enjoy the statutory power to intercept state payments to local authorities, such as grants, if these municipalities default on their obligations to the finance authority. 'Intercepts' of this kind can have a significant impact on credit ratings in those local government jurisdictions where local authorities receive a substantial proportion of their revenues from state governments. In some American states, bond banks benefit from more than one of these types of credit enhancement.

Furthermore, finance authorities frequently structure tailored repayment schedules for small councils by offering monthly (rather than semi-annual) payment deadlines. This is a key attribute in the Australian model for a national finance authority proposed in section 5 of this report.

Significant benefits for small councils

Although finance authorities have created substantial benefits for the local government sector, especially smaller local government entities, various disadvantages have also been noted in the literature²³.

For instance, borrowing terms can be inflexible because they have been designed to meet national and state statutory obligations on the finance authority. Similarly, local authorities which possess both the requisite skills and credit ratings demanded by the market can secure lower total interest costs than a finance authority by simply issuing their own debt since they do not have to implicitly cross-subsidise smaller councils with weaker creditworthiness²⁴.

As a result, finance authorities typically offer more to smaller councils with limited capacity and weaker ratings than to their larger, better-endowed counterparts. In the Australian local government milieu, small local authorities suffer disproportionately from infrastructure backlogs.

Robbins and Kim have summarised the advantages of bond banks for different sized municipalities as follows²⁵:

“Smaller local authorities may receive lower prices (and bear higher interest rates) for their bonds than their larger counterparts because of the small amount of the issue, high per bond marketing costs, smaller secondary markets, limited information for bond dealers and buyers, difficulty in affording quality legal and financial advisers, or because their issues are unrated. Larger governments are also more frequent issuers, and experience itself has been demonstrated to reduce certain borrowing costs. Larger governments may also possess resident expertise and debt management capacity that smaller governments lack. Finally, larger governments may benefit from relationships established with market actors over the course of many issues.”

²³ See, for instance, CIFA (1997).

²⁴ Robbins and Kim (2003).

²⁵ Robbins and Kim (2003, pp.92/93)

Associated benefits - access to advice

As well as benefits that are derived from the easier access to finance at a lower cost through finance authorities, there are a range of secondary benefits that can be built into a model to suit the particular challenges faced by local authorities.

A key opportunity is the access to advice that comes with utilisation of a finance authority. Skilled staff in a finance authority, with expertise in financial markets, can provide invaluable financial advice to small local authorities which wish to borrow funds. In practice, finance authorities also typically simplify complex debt issuance processes, often requiring participating municipalities to complete only a few straightforward forms.

Local authorities in general, and especially smaller local councils and shires with limited managerial and specialist financial capacity – which comprise the majority of the Australian local government sector – can obtain substantial benefits from the advisory roles undertaken by a finance authority.

Leveraging this opportunity is essential in considering the design of an Australian finance authority given the recognised issues in the standards and sophistication of management of infrastructure by many local councils in Australia and the impact this has on the ability for the sector to overcome the infrastructure backlog.

Examples of Finance Authorities

Local Government Finance Authority of South Australia

The Local Government Finance Authority of South Australia (LGFA) was established in December 1983 by the Local Government Finance Authority Act 1983. The LGFA is a statutory corporation of the SA Government and all SA local councils are members. The Authority is overseen by a seven-member Board of Trustees: two members are elected; two are appointed at an annual general meeting of all members of the Authority, two members are appointed by the SA Government, with the Secretary of the SA Local Government Association comprising the seventh member of the board.

The functions of the LGFA are as follows:

- To develop and implement borrowing and investment programs for the benefit of councils and prescribed local government bodies.
- To engage in such other financial activities as are determined by the Minister, after consultation with the Local Government Association (LGA), to be in the interests of local government.

The Act holds that after specifying several types of activity, such as the capacity to borrow overseas, the LGFA may exercise 'any other powers that are necessary or expedient for the performance of its functions'. Under Part 3(3) of the Act, the LGFA can act as a financial advisor to individual local governments. The only caveat to the exercising of all these types of authority is that it must do so 'with the approval of the Treasurer'.

The LGFA was funded by an initial sum of \$10 million from the SA Government. Under Section 22, it must operate 'with a view to avoiding a loss' and 'any surplus of funds remaining may be retained or invested by the Authority', distributed to councils and Prescribed Local Government Bodies (PLGB), or 'be applied for the benefit' of any council or PLGB. Section 24 specifies the LGFA operates under SA Government guarantee.

In essence, the LGFA operates as an exclusive bank to SA local government as well as PLGB. It offers several types of secure investments: call deposits, short-term deposits (ranging from 30 to 180 days), and long-term deposits (from 1 to 5 years). The LGFA offers two broad types of loans: fixed rate and floating rate. At the end of 2010/11, total loans outstanding were \$564.6 million, comprised of \$416.9 million in fixed rate loans and \$147.7 million in variable rate loans²⁶. All borrowings are free of any fees and lenders may receive an annual bonus dependent on LGFA performance²⁷.

The LGFA offers funds to member councils and PLGB on flexible terms. Moreover, the range of projects for which funds are lent is broad. For instance, in its 2011 Annual Report, the LGFA noted that the City of Marion borrowed \$3.5 million from the LGFA which formed a contribution to the \$120 million South Australian Aquatic and Leisure Centre (SAALC) and Health Care Centre (GP Plus). Even small loans are entertained. For example, the District Council of Streaky Bay financed the construction of a new home for its CEO with a \$215,000 loan from the LGFA. The LGFA is a comparatively small financial institution. For example, its operating surplus for 2010/11 was under

²⁶ Local Government Finance Authority of South Australia (LGFA, 2011, p.5)

²⁷ LGFA (2012)

\$4 million. However, it must be stressed that profitability is not the main aim of the LGFA. Indeed, its primary role is to provide funds to its member bodies, which are the sole owners of equity in the Authority. The non-profit nature of the Authority is further reinforced insofar as it distributes surpluses to its member contributing councils and it has not incurred any bad debts since the commencement of operations in 1984²⁸. While the operations of the LGSA are straightforward, it nonetheless represents a potential model for a municipal infrastructure fund – in the form of a bank – which might be replicated at a national level.

New Zealand Local Government Funding Agency

In December 2011, the New Zealand Local Government Funding Agency Ltd (NZLGFA) came into being under the Local Government Borrowing Act 2011. In common with South Australia's LGFA, the NZLGFA is owned by 18 Local Authority Councils and the NZ Government as a 'Council Controlled Organisation (CCO) operating under the Local Government Act 2002'²⁹. However, under Section 16 of the Act there is no Crown guarantee for debts of the funding agency³⁰.

The NZLGFA was specifically designed to operate as a national New Zealand bond bank by borrowing on a large scale and then re-lending to approved local councils seeking funding for any purpose, not limited exclusively to infrastructure funding. Moreover, the NZLGFA is jointly owned by local and central government in proportion to capital contributions, with the national government providing an initial NZ\$5 million investment and securing a 20 per cent shareholding, and local government contributing the remaining NZ\$20 million. No council is obliged to borrow from the LGFA and can use other institutions if it desires. The LGFA has been designed to adopt 'a range of conservative internal policies covering liquidity, pricing, lending, investing and borrowing', with 'its treasury operations, capital raising, lending, liquidity and risk management outsourced to the New Zealand Debt Management Office', which forms part of the New Zealand Treasury³¹. A guarantee has been stipulated for all establishment shareholders, as well as borrowers above \$20 million, in order to ensure the NZLGFA solicits a high credit rating. The guarantee has been spread across all contributors on a *pro rata* basis in proportion to the ratepayer base of participating entities. Since no New Zealand local council has ever defaulted, the prospects of the guarantee being called are minimal.

In its 2011/12 Statement of Intent, the NZLGFA developed a 'business case' for its financial forecasts for the three years to 30 June 2014³². The Agency's 'primary objective' is 'optimising the debt funding terms and conditions' for participating local councils, including loans provided debt at the 'lowest possible interest rates commensurate with the relevant maturity', which 'will be no more than 0.4%' above costs³³. This is reflected in the projected growth of both the Agency's assets over the three-year period and the assets of participating local government authorities over the same period – \$621.5 million to \$1,605.8 million and from \$565.0 million to \$1,459.8 million respectively. In the Statement of Intent NZLGFA also projected that total lending to participating councils would

²⁸ LGFA (2011, p.14)

²⁹ NZLGFA (2011)

³⁰ New Zealand Government (2011, p.6)

³¹ Local Government New Zealand (LGNZ) (2011).

³² NZLGFA (2011/12, p. 3)

³³ NZLGFA (2011/12, p. 3)

increase from 'at least' \$500 million at 30 June 2012 to 'at least' \$1,400 million at 30 June 2014, with 'over 30' local authorities participating³⁴.

With respect to governance, the 2011/12 Statement of Intent specifies that a Board of Directors will 'comprise between four and seven directors with a majority of independent directors', which will be responsible for the 'strategic direction and control' of the NZLGFA's activities³⁵. Furthermore, the board will comply with a General Shareholder Charter. In addition, a Shareholders' Council is also appointed, comprised of nine persons drawn from member councils and one from the NZ Government. The Shareholders' Council undertakes four functions³⁶:

- To review the performance of the NZLGFA and its board.
- To make recommendations on the appointment of directors.
- To make recommendations to the shareholders with respect to policy changes.
- To ensure shareholders are fully informed on NZLGFA decisions.

As at July 2012, the NZLGFA had only been operating for a period of about eight months, with two separate bond issues thus far (for NZ\$265 million and NZ\$300 million respectively) both of which were massively oversubscribed. This bodes very well for the future.

Municipal Finance Authority of British Columbia

The Municipal Finance Authority of British Columbia (MFA BC) constitutes a capital borrowing program for British Columbia's 161 municipalities. It possesses an AAA credit rating. The MFA was established in 1970 under legislation creating regional districts encompassing all municipalities and Crown land in BC. These regional districts provided a tax base upon which a pooled funding agency as borrower could secure funds. The MFA Bill – enacted in April 1970 – guaranteed that all debt created would have the full backing of every local government in the province. Moreover, according to Bryant, a Debt Reserve Fund was established alongside the Authority which is financed by the payment of 1 per cent of all principal borrowed by regional districts³⁷. While initially this fund was created as insurance in the event of defaults by borrowing municipalities, since no defaults have ever occurred, the Debt Reserve Fund has reinforced the MFA BC bond credit rating.

Despite initial political opposition, the Authority has extended borrowing privileges to other public services, including water and sewage services, emergency services and the Greater Vancouver Transit Authority. In addition, MFA BC introduced a Pooled Investment Fund (PIF) financial instrument in 1989 which is used for the capital financing of schools, universities and the requirements of First Nation people³⁸.

With respect to governance, the operations of the MFA BC are directed by two entities. The MFA Authority is comprised of 28 members for each regional district, with an additional 11 members from the demographically larger regional districts, of which Greater Vancouver Regional District (GRVD) is the largest, with 10 elected

³⁴ NZLGFA (2011/02, p. 4)

³⁵ NZLGFA (2011/02, p. 4)

³⁶ NZLGFA (2011/02, p. 5)

³⁷ Bryant (2011, p. 2)

³⁸ MFA BC (2012)

representatives on the Authority³⁹. The executive of the Authority resides in the Board of Trustees, which has 10 members, one from the Capital Regional District (CRD), four from GVRD, and five from other regional districts. The Annual Report 2011 provides a useful synopsis of the current operations of the Authority. Long-term financial needs are met through ‘the placements of bullet debentures in capital markets’, with the bond issues syndicated through six Canadian chartered banks and two other financial institutions.

In 2011, the Authority made three debentures issues⁴⁰:

- A \$225 million 10-year debenture with a return of 4.176% dated June 1, 2021.
- A \$515 million 5-year debenture with a return of 3.029%.
- An additional \$105 million of the June 1, 2011 debenture with a return of 3.175%.

It should be noted that the AAA credit rating of the Authority allowed it to borrow funds at very low interest which, in turn, has enabled it to lend to constituent councils at consistently low rates, regardless of the size of individual local authorities⁴¹. Alongside these bond issuances, several other services are offered. The Pooled Investment Program (PIP) – whereby municipalities can invest surplus funds for short, intermediate and long terms – averaged \$1.8 billion over the reporting period and peaked at \$2.2 billion during the year. The Authority accommodated short-term cash by issuing over \$1.5 billion through the Commercial Paper Program, usually for a term of 35 days, the rates for which were benchmarked against Government of Canada Treasury Bills. In addition, the Debt Reserve Fund sat at an average of \$113 million over the year. The 2011 Annual Report also reiterated that the MFA had never defaulted on any debt obligation and had thus never made a claim on the Debt Reserve Fund. In aggregate, total assets in 2011 under management were in excess of \$7.2 billion, the balance of long-term loans to 28 regional districts and three other entities was \$4.8 billion, and short-term loans and leasing agreements equaled \$175 million. The Authority’s long-term debt at the end of 2011 was \$6.2 billion.⁴²

The overall operations of the MFA BC are broadly comparable to both the SA LGFA and the NZLGFA. However, in common with the NZLGFA, and unlike the South Australian LGFA, it issues bonds on the open market, and thus has access to a far greater quantum of funds. Moreover, in line with the NZLGFA, and unlike the SA LGFA, the MFA BC is not guaranteed by BC Government. However, the security of the Authority, based on the tax capacity of the regional district system, sees it enjoying the highest possible credit rating. As a consequence, it is able to borrow at extremely low rates, offer low yields on deposits, and offer loans to its constituent members at extremely competitive rates.

Besides bond issuances, the MFA BC has developed a range of additional financial instruments, including Pooled Investment Funds and so-called ‘sinking funds’, the former providing a vehicle for local authorities to invest excess funds which are lent to a variety of local entities (such as schools and universities), the latter constituting a mechanism whereby paid-down debt of individual borrowing authorities is reinvested, the proceeds of which are then also set against the authority’s debt.

³⁹ MFA BC (2012b)

⁴⁰ MFA BC (2011, pp.10/12)

⁴¹ MFA BC (2011, p.2)

⁴² MFA BC (2011, p.2/14)

Table 4 provides a synoptic summary of the characteristics of the three examples of finance authorities we have considered:

Table 4: Characteristics of SA LGFA, NZLGFA and MFA BC

Institution	Established	Governance	Method	Government Guaranteed	Debt Default Experience	Approximate Size	Ownership
LGFA	1983	Board of Trustees: from state and local government	Accepts deposits from local government and lends to local government	SA Government	None	Total loans in 2011 about \$565 million	State government
NZLGFA	2011	Board of Directors: majority independent	Issues bonds on capital market to fund lending to local government	NZ Government	None	First two bond issues in 2012 NZ\$265 million and NZ\$300 million	Central and local government
MFA BC	1970	Board of Trustees: drawn from local government	Issues bonds on capital market to fund lending to local government	No guarantee	None	Total loans in 2011 about C\$4.8 billion	Local government

Local Infrastructure Australia

A uniquely Australian approach to an international challenge

Three recurrent themes have predominated throughout this report:

- Australian local government faces a serious local infrastructure backlog, estimated by PWC in 2006 to range between \$12 billion to \$15.3 billion, which will worsen if decisive policy making is lacking.
- Local authorities in Australia are comparatively small and lack adequate capacity in financial expertise and management skills, which must be addressed to effectively overcome the local infrastructure shortfall.
- Policy makers seeking to address the local infrastructure problem confront severe problems arising from inadequate information about the distribution and magnitude of the local infrastructure backlog. This inhibits efficacious policy development and relegates local infrastructure to the sidelines in the debates about national and state infrastructure priorities.

A well-designed Australian finance authority must simultaneously tackle these three problems in an efficient manner to make genuine progress in reducing the infrastructure backlog. This requires an approach that not only delivers increased access to private finance but also provides a substantial high-quality, low-cost advisory service to support improved local council management of infrastructure and better information for policy makers so that local infrastructure is well understood and accounted for in national decision making.

In recognition of this broader role we suggest that the organisation be called Local Infrastructure Australia.

The design of Local Infrastructure Australia should begin by adapting the lessons learnt and approach taken in the formation of the New Zealand LGFA. Both countries face a substantial local infrastructure backlog⁴³ and the local government systems of Australia and New Zealand closely resemble each other in terms of the relatively narrow range of services provided, the political architecture of their respective local authorities, the limited 'own-source' forms of revenue available to local councils, substantial mandated expenditure by higher tiers of government, and prescribed local infrastructure requirements⁴⁴.

However, the New Zealand model requires modification to accommodate the federal structure of local government in Australia, the need to incorporate financial advice and expertise to assist councils lacking financial and infrastructure management capacity, and the requirement to improve existing inadequate information on the local infrastructure backlog. Fortunately, the modifications required to adapt the NZ LGFA to meet Australian circumstances are neither too burdensome nor too complicated. Each of these alterations is considered in turn below.

⁴³ Dollery and Mounter (2010)

⁴⁴ See Marshall (2008) and Reid (2008)

Exclusive focus on local infrastructure maintenance and renewal

Whereas the NZ LGFA allows councils to borrow for any purpose, borrowing facilitated through Local Infrastructure Australia should be specifically limited to local government infrastructure investment, maintenance and improvement.

The justification for this constraint is twofold. Firstly, the rationale for Local Infrastructure Australia centres on ameliorating the local infrastructure crisis rather than simply acting as a general source of funding. It would thus be injudicious to permit scarce funds to be used for other ends. Secondly, the economic and political barriers involved in securing Commonwealth Government support would be harder to surmount if Local Infrastructure Australia was envisaged as providing general funding. Local Infrastructure Australia should therefore focus exclusively on infrastructure finance.

Adapting to the Australian federal structure

In adapting the NZ approach, Local Infrastructure Australia must be designed to respond to inconsistencies between states in relation to local infrastructure issues.

As we have seen in section 2 of this report, the 2006 PWC Inquiry experienced great difficulty in estimating accurately the magnitude of the Australian local government infrastructure backlog in large part because of inter-state inconsistencies.

This stemmed from the fact that different Australian state and territory local government systems employed different reporting standards, collected different data, used different criteria for assessing financial viability, employed different asset planning and management frameworks, as well as applied different financial planning and reporting standards. The net result has been the development of substantial differences between state and territory local government infrastructure systems, which share little in common, except the size of the infrastructure backlog. This heterogeneity complicates the design and operation of Local Infrastructure Australia which will seek to apply consistent prudential standards to borrowers.

However, these complexities have diminished over the recent past due to the efforts of the Australian Local Government and Planning Ministers' Council⁴⁵. In essence, the council has adopted a nationally consistent framework on financial sustainability covering three broad areas:

- criteria for assessing financial sustainability;
- an asset planning and management framework; and
- a financial planning and reporting framework.

In addition, in 2011 the Institute of Public Works Engineering Australia (IPWEA) produced Australian Infrastructure Financial Management Guidelines (AIFMG) to facilitate the adoption of a uniform set of coherent and nationally applicable standards⁴⁶. Although these standards have not yet been implemented by all individual local authorities, a foundation has been laid which could be employed by Local Infrastructure Australia.

⁴⁵ Australian Local Government and Planning Ministers Council (2008)

⁴⁶ IPWEA (2011)

Local government also falls under state jurisdiction. This means that state rather than Commonwealth legislation controls local government, with all the attendant complexities derived from different state and local government oversight mechanisms⁴⁷. In particular, each state imposes its own regulatory authority on local government borrowing and – as a general rule – all council borrowing in all jurisdictions must be approved by respective state Ministers for Local Government or at least their specific borrowing oversight bodies.

However, over the long run this has not proved a significant impediment to council borrowing nor has default been a problem⁴⁸. Thus, from the perspective of fiscally prudent lending by Local Infrastructure Australia, and the credit requirements it might apply to borrowing municipalities, this collage of state regulation need pose no real problem.

Instead, given the absence of loan default in Australian local government history, Local Infrastructure Australia can simply ‘outsource’ the decision on whether or not a specific local authority can borrow to the existing state Minister for Local Government or regulatory body in question. If the council concerned secures requisite state approval, then Local Infrastructure Australia can assess its application on its merits. This will also ensure that existing state government guarantees for council borrowings are preserved within pooled finance arrangements.

Advice and assistance to local government

A key attribute of a successful Local Infrastructure Australia will be its capacity to provide extensive advice to individual local authorities on a cost recovery ‘fee for service’ basis. Local Infrastructure Australia should in particular provide small councils (which possess only negligible financial expertise) with disinterested expert advice on infrastructure finance, infrastructure planning and infrastructure management.

This service would perform a vital function for the large number of small, predominantly rural shires, suffering not only acute financial distress, but also chronic expertise incapacity. In addition to advice on the optimal methods of funding infrastructure, Local Infrastructure Australia could offer assistance in asset management to these councils. In this way, Local Infrastructure Australia would provide small local government entities with both scarce expertise and funding which would otherwise not be available.

Improved information on local infrastructure

A further essential dimension of Local Infrastructure Australia would involve a decisive contribution to available information on the ‘state of play’ in local infrastructure. This role should cover information on a range of relevant issue including investment, maintenance and renewal aspects of the infrastructure situation.

Local Infrastructure Australia should be required under statute to collect accurate comparable information on local infrastructure across all Australian local government systems and to provide this information to key infrastructure policy making bodies, like Infrastructure Australia, the Department of Infrastructure and Transport and the Department of Regional Australia, Local Government, Arts and Sport, as well as their state and territory counterparts.

⁴⁷ Dollery, O’Keefe and Crase (2009)

⁴⁸ Dollery, Crase and Johnson (2006)

In this role, Local Infrastructure Australia could also advise how existing Commonwealth and state government funding for local government could best be allocated amongst needy councils and the relative benefits of investment in local infrastructure compared to major projects and other infrastructure priorities competing for national and state investment.

Initial endowment and establishment costs

Apart from these complications, the structure and operation of Local Infrastructure Australia would be comparatively straightforward.

In terms of the quantum of funds required to establish Local Infrastructure Australia, a rough guide would be to simply 'scale up' the NZ LGFA funding to its Australian magnitude, as well as its extended mandate to deliver advice and improve information. On this reckoning, an initial investment equivalent to the NZ\$25 (approximately A\$20) million accorded the NZ LGFA but set in Australian terms would be required with additional funds to support the establishment of advice and information functions.

If the NZ LGFA model was followed, then *mutatis mutandis* it could be argued that the Commonwealth Government should contribute half of the initial funds, with each state Local Government Association (LGA) combining – in some agreed proportion, such as population size, total rate base, etc. – to contribute the remainder of the initial capital endowment.

However, given the relatively small quantum of funds involved and challenging nature of Commonwealth-state relations, it is suggested that the establishment costs be provided by the Commonwealth from existing budget allocations already allied to local government infrastructure. This would make the establishment of Local Infrastructure Australia 'budget neutral' from the perspectives of both federal and state governments.

Governance and operation

Local Infrastructure Australia would ideally be established under existing Commonwealth legislation for statutory bodies.

An appointed board of independent directors with extensive experience in capital markets, infrastructure financing and local government should constitute the governance structure. An executive director or CEO would manage the organisation, which would comprise a dedicated secretariat possessing specialist financial and advisory skills, as well as employing infrastructure finance experts.

In respect of the financing operations of Local Infrastructure Australia, the following guidelines could apply:

- The Commonwealth would fully guarantee all debt issued by Local Infrastructure Australia which would generate credit ratings comparable to standard Commonwealth debt issues and thereby minimise interest costs.

- All debt sold by Local Infrastructure Australia would be pooled in regular issues, thence harnessing operational scale economies and pooling any perceived risk.
- All bond issues would be designed to bridge the gap between institutional investors and councils by presenting them with investment instruments best suited to their needs, as outlined in the Ernst and Young report⁴⁹, as we saw in section 3. Thus the sequence and maturity of bond issues would be tailored to attract large institutional investors, such as the Australian superannuation industry.
- Local councils which had secured state borrowing permission would be invited to apply for Local Infrastructure Australia funding for defined types of infrastructure, secured by debt obligations made out by individual councils in accordance with state regulations and protected by state government guarantee.

It might be argued that an Australian local infrastructure finance authority would expose Commonwealth and state governments to greater short and longer term risk from council debt default. However, this argument does not stand up to scrutiny for at least three reasons. Firstly, no Australian council has ever permanently failed as a financial entity and there is thus no historical precedent for having misgivings as to default. Secondly, creditworthiness requirements would remain unchanged from the *status quo* and thus risk would not increase. Thirdly, from the perspective of the Commonwealth, state default guarantees offer it absolute protection.

It might be supposed that the establishment of Local Infrastructure Australia would threaten the ‘independence’ of borrowing councils or the states from which those councils originated. Given the long history of state government interference in local government conduct, as well as the testy nature of Commonwealth-state relations, these fears are not imaginary. However, fears of this kind are addressed in the design of Local Infrastructure Australia. In its borrowing procedures, the finance authority would rely entirely on existing state regulations regarding both council creditworthiness and the validity of the proposed project. There is thus no change from the *status quo* in this regard.

⁴⁹ Ernst and Young Report (2012, p.27)

Conclusion

It is essential to the future of Australia and particularly regional Australia that the growing local infrastructure backlog is addressed.

We have seen that unanimous agreement exists that Australian local government has a large and growing infrastructure deficit, far beyond its current capacity to fund, which has been estimated by PWC at between \$12 billion and \$15.3 billion. While some helpful public policy initiatives have been initiated, especially the Commonwealth R2R Program, it is acknowledged that the size of the infrastructure backlog and its concentration in regional, rural and remote areas makes it imperative that further action be taken.

This Report has demonstrated that Local Infrastructure Australia, a national organisation dedicated to catalysing new investment and better management of local infrastructure, represents the most promising public policy instrument available to address the Australian local government infrastructure shortfall.

Given successful overseas experience, the concept of such an organisation is far from a hypothetical construct. Indeed the economic foundations are well understood and operational models finely tuned by long experience.

Judicious borrowing of private capital through Local Infrastructure Australia constitutes the optimal method of funding the capital expenditure necessary for the increased local infrastructure investment required to overcome the backlog. As we saw in section 3, the Ernst and Young report enumerated the manifold advantages of this form of infrastructure finance, including intergenerational equity considerations and the ability to raise the requisite funds in the least costly manner possible.

The Local Infrastructure Australia model proposed in this report would also offer two further urgently required functions. In the first place, Local Infrastructure Australia would provide local authorities with badly needed financial expertise to assist them in infrastructure finance, infrastructure planning and infrastructure management. Secondly, Local Infrastructure Australia would be charged with improving the present inadequate information collection process on local infrastructure in Australia and providing informed advice on local infrastructure priorities to Commonwealth and state government policy makers.

APPENDIX A: Ernst and Young Report key findings and recommendations

Ernst and Young Report key findings and recommendations

Key Findings	Conclusions/Recommendations
<p>1. Overview of Local Government Infrastructure</p> <ul style="list-style-type: none"> ■ While experience varied, Australian councils normally have responsibility for a homogenous stock of assets, including roads, land and buildings. ■ The value of local infrastructure has grown steadily over the past decade. However, most municipalities invested relatively little, with implications for in-house capability and skills. ■ Infrastructure development and maintenance is dominated by local roads. Non-road projects can be substantial, but tend to be 'once-off' rather than regularly procured. This has implications for planning, asset management and procurement. 	<ul style="list-style-type: none"> ■ Capital expenditure by most local governments is relatively low. While a simple average of national expenditure is \$17 million per local government area, this over-estimates expenditure in most areas, because of the existence of a large number of councils with populations considerably below the average.
<p>2. Funding Sources and their Limitations</p> <ul style="list-style-type: none"> ■ Core sources of revenue which all Australian councils can access include rates and taxes, sales of goods and services, and grants. The relative contribution of the different income streams varies considerably between councils. ■ While scope exists for local government to increase its revenue, many constraints exist. ■ In the absence of reform of the funding structure for local government, the sector must make the most of the funds it currently receives. Councils should also explore innovative funding, procurement and financing methods to accelerate new infrastructure investment. 	<ul style="list-style-type: none"> ■ Recommendation 1: Information portal for grants programs.

3. Borrowing for Infrastructure Investment

- Significant scope exists for local government to optimise its borrowing. However, this is constrained by debt aversion and the absence of a structured local government debt instrument suited to institutional investors.
- Centralised financing - where available on a state basis - yields low finance costs and government guarantees. Centralising financing on a national level would enhance these benefits and represent an essential prerequisite for the creation of financial instruments to channel institutional investment into local infrastructure.
- There is thus a role for the Australian Government, working with states and territories, to investigate a national financing authority for local government to bridge the gap between institutional investors and councils.
- The Australian Government can provide assistance in creating sustainable revenue streams which form a direct link between those who benefit from new investments and those who pay for them. Tax Increment Financing - whereby councils leverage future rates revenues to borrow for infrastructure investment - represents one such revenue stream.

■ Recommendation 2: Tax Increment Financing – The Australian Government should work with the states and territories to investigate the legislative changes that would be required to enable councils to introduce Tax Increment Financing.

■ Recommendation 3: National Financing Authority – The Australian Government should work with the states and territories to investigate the feasibility of establishing a national financing authority to aggregate local government borrowing and facilitate the creation of debt products for private investors.

4. Prioritising Local Infrastructure Investments

- The Nationally Consistent Frameworks for local government asset and financial management - and associated programs such as the Local Government Reform Fund – have created momentum for improvement in investment in capability building.
- However, current council capacity varies widely and support is required.
- Role definition is problematic, creating cost pressures for local government and strains on higher tiers of government.
- There is insufficient engagement with local government during the early stages of significant projects or policy initiatives by federal, state and territory departments and agencies, creating additional complexity for local government prioritisation and planning processes.

■ Recommendation 4: Capability building programs – Programs of targeted training and capability building in asset and financial management should be extended.

■ Recommendation 5: Review of asset and financial management practices – Asset and financial management reform initiatives should be supplemented by periodic independent reviews of the implementation of the Nationally Consistent Frameworks.

■ Recommendation 6: Local government impact statements – Federal, state and territory governments should commit to completing local government impact statements as part of the business cases prepared to support new policy proposals and projects, where there is likely to be a direct cost impact upon local government.

■ Recommendation 7: Local government roles and responsibilities – All tiers of government should commit to building on the intent of the Inter-Governmental Agreement 2006 by outlining clear steps to achieving better clarity of the roles and responsibilities of each tier of government. In particular:

- A) State, territory and local governments should cooperatively review the asset registers of local governments to ensure that, for each asset class, the boundaries of responsibility are unambiguous and that an appropriate and transparent process to transfer responsibility between governments is in place.
- B) As part of its community engagement, local government should present its forecast long-term capacity to fund the role it is proposing, with specific reference to the capacity to sustain defined levels of service for existing and proposed assets, services and projects.

5. Creating Value through the Procurement Process

- Despite tentative moves to explore procurement models involving private finance or risk allocation, the sector has not given enough consideration to methods of procurement outside traditional methods.
- Without considering all infrastructure procurement options available, the ability of the local government sector to accelerate new investment will be constrained by limited access to capital.
- Councils should consider achieving procurement efficiencies through alternative delivery models, especially those involving project and financing risk transfer to private sector partners. An information gap exists in this area.
- Lack of engagement by private investors in local government infrastructure projects is accentuated by the absence of projects of sufficient scale. Other barriers include the lack of a clear pipeline, the absence of commercial returns and/or tradeable instruments for investors, and concern surrounding local government's internal capability.
- The Australian Government has a role in generating private finance for specific projects by supporting a trial project with the aim of developing a replicable market and a pipeline of future projects.
- Recommendation 8: National advisory body for local infrastructure procurement – The Australian Government should work with the states and territories to establish a national body to provide skills and oversight of local government infrastructure. Its role would include capability building and the development of policy, guidelines and other assistance.
- Recommendation 9: Major project procurement guidance – Major project procurement guidance should be developed and issued to local government to promote awareness of the spectrum of alternative procurement models for infrastructure delivery.
- Recommendation 10: Trial project for private investment in local infrastructure – The Australian Government should identify an opportunity for a suitable local or regional infrastructure project whereby a market can be 'created' and establish a collaborative group of stakeholders to take the project forward. A 'waste to energy' project may be a good candidate.

6. Regional Capacity and Attraction

- The benefits of regional planning and prioritisation are recognised by all tiers of government, which is reflected in the large number of existing regional alliances and collaborations. These benefits include reduced duplication, better interface management and inter-government coordination.
- Improvements in to the coordination of the existing regional frameworks will help regions achieve their full potential.
- Recommendation 11: Rationalisation of existing regional structures – All tiers of government should work together to rationalise and align the regional structures which currently exist.

- Better alignment of regional structures, including voluntary alliances, could improve participation by member councils. This could result in a smoother application process for regional grants.
- To maximise regional infrastructure planning, all tiers of government should cooperate to align the different regional frameworks which currently exist in parallel. The Australian Government should collaborate with state, territory and local governments to seek the most appropriate way to achieve this goal.

7. Alternative Ownership Structures for Community Assets

- Selected local government assets may be better suited to alternative ownership structures, including corporatisation or privatisation. Not only can this provide additional revenue, but transferring asset management to corporate entities can provide access to new skills, asset and risk management processes, and independent strategic planning.
 - The benefits of regional planning and prioritisation could be far greater if regional structures had the ability to move beyond advocacy and support towards ownership of assets, and the delivery and financing of infrastructure investments.
 - The benefits of regional delivery are likely to be greatest where they relate to network assets, like local roads. The regionalisation of local roads would make it possible to introduce competitive tendering for regional capital and maintenance programs, whereby multiple assets are bundled under a single outsourced contract.
 - Recommendation 12: Review of asset ownership – Local government bodies should review their infrastructure portfolios with a focus on identifying and testing the rationale for continued ownership.
 - Recommendation 13: Regional infrastructure delivery – The Australian Government should work with the states and territories to develop incentives that can be given to councils to create formal regional structures with responsibility for delivering and financing infrastructure investments relating to specific asset classes, with a particular emphasis on local roads.
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Source: Adapted from Ernst and Young (2012).

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