

Port Stephens Council

Debt Capacity Report



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EXECUTIVE SUMMARY

This Debt Capacity Report paints a bleak picture of the financial sustainability challenges facing Port Stephens Council and the concomitant dangers of exposing Council to further debt. Three analyses of Port Stephens Council debt are presented in this Report: the standard debt service ratio, the nett financial liabilities ratio and more sophisticated econometric modelling results.

We show that the debt servicing capacity ratio is flawed in many respects and represents an unsatisfactory metric. The more robust nett financial liabilities ratio calculated over three financial years demonstrates the parlous debt capacity of Port Stephens Council.

Our econometric model embraces a host of factors impinging on financial sustainability and debt capacity covering four financial years for Port Stephens Council and an expanded cohort of peer councils. The model predicts that Port Stephens Council is already perilously close to its debt capacity ceiling.

The Report concludes by offering several recommendations regarding new and existing debt over the current political term of office for elected councillors.

1. INTRODUCTION

Debt is undoubtedly the most misunderstood aspect of local government finance (Dollery, Crase and Johnson, 2006). In the first place, considerable misapprehension relates to the nature of debt; indeed, many think of it as a source of revenue when it is nothing of the kind (Drew, 2020). Debt is simply a way of bringing forward future revenues and this comes at a cost. For instance, establishing the debt facility will cost money, including interest charges. In addition, bringing forward future revenues means that there is a cost of constrained choices for future generations of local taxpayers arising from the fact that some future revenue has already been committed by earlier generations of taxpayers.

Considerable misunderstanding also surrounds how debt might be used to establish intergenerational equity. The central pillar of intergenerational equity is that it is reasonable for future residents to contribute towards the costs of long-lived assets because they will ultimately yield some benefit from these assets. However, it is not essential that debt be employed for this purpose. Moreover, if debt is used for intergenerational equity purposes, then it is imperative that this be done with the utmost of care, as we shall see.

Attitudes to public debt have altered remarkably since the 1960s. Prior to this time it was generally held that to 'spend borrowed funds on ordinary items for public consumption was, quite simply, beyond the pale of acceptable political behaviour' (Buchanan, 1997, p. 119). Testament to this is a local government handbook from the 1940s that holds that overdrafts and other forms of debt must be fully repaid within a single fiscal year (Selby, 1941).

In large part, local politicians of former times practiced strict moral discipline regarding public debt because they recognised the danger that debt could be misused for political capitalisation purposes and thereby distort democracy. In essence, there was an unwritten agreement between politicians that they would not open the debt bottle and hence risk letting the debt genie out.

A second reason why politicians were reluctant to take on public debt was because they applied the same kind of prudence to public finance as what was then commonly employed with respect to personal finance. For example, President Roosevelt famously remarked that 'any family can for a year spend a little more than it earns...but you and I know that a continuation of that habit means the poorhouse' (cited in Borna and Mantriprigada, 1989). Thus, it was an established principle that public debt should be approached in a manner consistent with how a prudent person could be expected to deal with their personal budget.

Indeed, the personal finance metaphor has much to recommend it to contemporary decision-makers. Attitudes to debt have changed over the last half-century and people are often now more willing to take on loans for both items of enduring benefit as well

as consumption purposes. However, when debt is used to finance consumption, such as holidays, people do expect immediate and significant consequences. For instance, we expect to have to make repayments on the loan almost immediately. It is widely understood that this will require sacrifice, such as reduced spending in other areas.

Drew (2021) has employed this personal budget metaphor, as well as natural law concepts, to establish six rules that should be observed for public debt to be considered morally defensible:

1. Debt must be only taken out for capital expenditure and not operational expenditure.
2. The asset financed through debt must have a long and predictable life.
3. The asset must constitute something that future generations are likely to value
4. Debt must be assumed for good moral reasons.
5. Repayments must at least be equal to the rate of consumption of the asset and be quarantined in future budgets.
6. Repayments must involve sacrifice so that a quid pro quo is established.

Even if these rules are observed, a number of problems persist. These problems include: (i) debt capacity must be precisely known; (ii) often there is no access to suitable debt products where the life of the loan is consistent with the expected life of the asset, such as buildings that might be expected to survive a century or more; (iii) all tiers of government are notoriously inaccurate in forecasting the useful lives of public assets (see, for example, Drew and Dollery, 2015).

The present Report focuses squarely on determining the debt capacity of Port Stephens Council, which is essential for it to remain financially sustainable. The Report is divided into three main parts. In section 2, we extend the personal budget metaphor to demonstrate why existing debt ratios are unsuited to the task of establishing debt capacity. In section 3, we conduct sophisticated econometric modelling to establish the capacity of the Port Stephens Council to sustainably service additional debt. We conclude the Report in section 4 with some brief recommendations to guide decision-makers over the current political term of office for elected councillors.

2. DEBT CAPACITY AND DEBT RATIOS

In New South Wales (NSW) local government, as well as other municipal systems, it is common practice for regulatory authorities to stipulate one or more debt ratios that

¹ Political capitalisation is the conversion of hard capital (money) into votes (Drew, 2021).

¹ By definition, operational expenditure comprises items that are expected to be fully consumed within twelve months. It is not morally defensible to obligate future taxpayers to debt for items that are fully consumed well before they are paid for.

¹ Because we are obligating future citizens to pay for the asset, it must be something that they are likely to want. For example, it would not be reasonable to make them pay for some kind of technology that is likely to become rapidly redundant.

¹ Examples of reasons that are not sound include debt bias (i.e. the rational preference of older decision-makers for debt because they are unlikely to be taxpayers long enough to fully pay it off) and fiscal stimulus (a measure best assigned to central governments that have the requisite tax capacity).

¹ That is, repayments should at least equal the annual accrual of depreciation.

must be reported by local governments. The ratios are usually accompanied by an (apparently) arbitrary benchmark and decision-makers are given to believe that achievement of the benchmark confers some sort of assurance regarding financial sustainability.

Unfortunately, the ratios employed are often not fit for purpose and thus present a real risk of misleading both decision-makers and the local communities they serve. Indeed, the ratios have failed to predict past instances of local government financial failure.

The debt service ratio employed in NSW is an especially poor choice of metric. It has been transplanted from the world of corporate finance with little thought given to its consistency with respect to how local government services public debt. The benchmark is entirely arbitrary and has also been grafted from the corporate world where debt bears a nexus to income generation. For instance, a commercial company might invest in factory equipment that produces goods that sell at a price determined by the market. However, for most local government, the price paid by residents is not associated with market forces and it is constrained by political considerations such as rate caps in NSW. Indeed, if the revenue is not set at an appropriate level – such as when a Special Rate Variation is warranted – then the numerator is invalid and the ratio is near to useless.

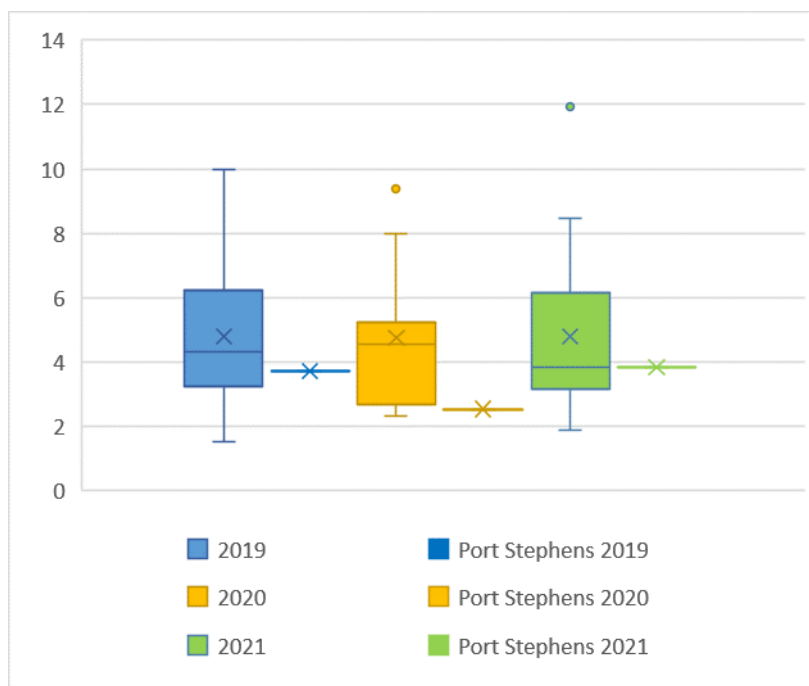
In addition, the debt service ratio is negatively correlated to the making of additional repayments that is both counterintuitive and often counterproductive. Furthermore, the debt service ratio is constrained to just one input and two outputs. Moreover, it is

also exclusively rearward looking and based on just a single year of data (that might be atypical) and thus can only provide shaky guidance at best on what could have occurred over the previous financial year. This is also of little relevance to decision making directed to the future.

In Figure 1, we plot the debt service ratio for Port Stephens Council and its fourteen peer councils (detailed in our earlier reports). As we can see, Port Stephens Council usually performs at a level lower than the typical council in its cohort (but well above the benchmark in most years). However, given our serious concerns regarding the deficiencies in this metric, it would be unwise to place any reliance on Figure 1.

⁷ The absence of a suitable debt vehicle means that a local government may be exposed to rate risk at regular intervals when a new loan needs to be negotiated.

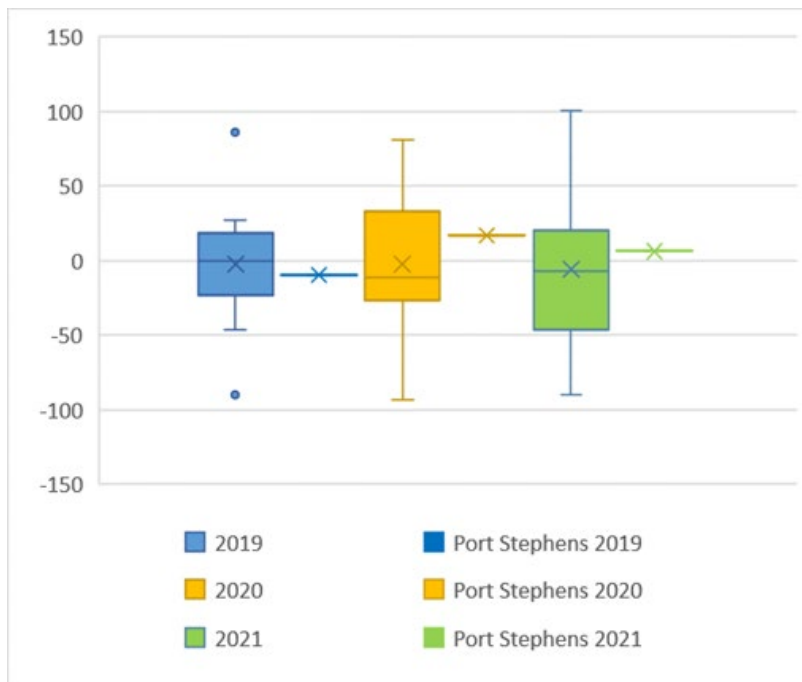
FIGURE 1: DEBT SERVICE RATIO



The nett financial liabilities ratio is a far superior metric. It is widely employed in other local government systems, including in Queensland, South Australia and Western Australia. The nett financial liabilities ratio is better because it includes additional data (total liabilities offset by current assets). However, it is still rearward facing and only reports on a single year of data (that might have been atypical and hence a poor guide to future decision-making).

In Figure 2, we plot Port Stephens Council against its peer group for the last three financial years. For the nett financial liabilities ratio a negative result is the preferred (and typical) outcome. There is thus much reason for concern regarding whether Port Stephens Council has any further capacity for debt (or indeed whether it can comfortably service extant debt) according to its nett financial liabilities ratio.

FIGURE 2: NETT FINANCIAL LIABILITIES



The personal finance metaphor discussed earlier provides a useful guide to the kind of alternative approach that should be adopted to perform a more satisfactory evaluation of debt capacity. If one applies for a loan, two types of information will form the focus of bank deliberations: (i) the number of parties to the loan and (ii) the incomes of the various parties. It follows that similar considerations should also form the focus of a robust empirical investigation of debt capacity. Moreover, to ensure that decision-making is not distorted by data from a single potentially atypical year, it is essential to employ a panel of multi-year data on a broad cohort of local governments.

Accordingly, in section 3 we conduct a random effects econometric analysis of sixty-seven local governments that form the most accommodative relevant category currently in use by regulatory authorities.

3. DEBT CAPACITY MODELLING

Regression analysis is the most sophisticated statistical approach available to understand the debt capacity of a given council (Levine et al., 2013; Ramsay et al., 1988). Specifically, regression analysis allows econometricians to determine the mean response of a dependent variable with respect to changes to multiple independent variables. For the regression that follows, we employed the random effects panel technique (this is the most efficient estimator and it is thus ideal when diagnostic tests allow its use).

The final model specification that we employ in our analysis can be expressed as follows:

$$\mathbf{B}_{it} = \alpha_i + \beta_1 \mathbf{A}_{it} + \beta_2 \mathbf{X}_{it} + \mu_{it} \quad t = 1..4$$

Where **B** is the total explicit borrowings, **A** is the disaggregated assessment data, **X** is a vector of relevant economic and demographic data for particular local government areas at specific times and μ is an idiosyncratic error term. The subscript it refers to the i^{th} council entity and the t^{th} year. Here we included all sixty-seven councils categorised as broadly similar under the current Commonwealth Government classification system. Log transformations were employed to counter skewness when econometric diagnostics tests revealed the need to do so. We also conducted and satisfied all other relevant diagnostic tests. Table 1 provides the definition for each variable as well as summary data.

TABLE 1: DEFINITIONS AND MEANS OF VARIABLES, 2018-2021

Variable	Definition	Similar Councils
Debt		
Borrowings	Total explicit borrowings (\$'000)	40,785.12
Assessments		
Residential (ln)	Number of residential assessments, logged	10.278
Farm	Number of farm assessments, divided by 100	6.729
Business (ln)	Number of business assessments, logged	7.504
Controls		
Median employee income	Median employee income (lagged), divided by 1,000	50.363
Median unincorporated business income	Median unincorporated business income (lagged), divided by 1,000	12.159
Aged (ln)	Proportion of people on an aged pension, logged	2.275
DSP	Proportion of people on a disability support pension	3.286
Newstart (ln)	Proportion of people on a Newstart allowance, logged	0.954
Carer	Proportion of people on a carers' pension	1.198
Single (ln)	Proportion of people on a single parent pension, logged	-0.329
Total Grants (ln)	The total value of grants, logged	15.521

In Table 2, we present the results of our econometric analysis for the main variables of interest. It is important to remember when interpreting coefficients that the *ceteris paribus* claim is implicit; that is, the variables refer to the mean response holding all other factors constant. As anticipated, the numbers of assessments are key determinants of debt capacity and two of the disaggregated assessment variables were statistically significant at the highest level. This confirms our earlier assertion that a failure to account for the number of borrowers party to a loan is a critical oversight in existing ratio methods.

TABLE 2: MULTIPLE REGRESSION RESULTS, 2018-2021 INCLUSIVE.

Cohort	
Number of residential assessments (ln)	43,541.15** (16,092.22)
Number of farm assessments	2,188.51** (631.97)
Number of business assessments (ln)	-9,566.89 (10,764.16)
Income variables	Yes**
Welfare receipts	Yes**
N	275
Coefficient of determination	0.4535

Standard errors in parentheses.

+ p<0.10, * p<0.05, ** p<0.01

Indeed, we can see that holding all other variables constant, a one percent increase to the number of residential assessments is expected to result in an increase of \$435,000 in borrowing capacity. The response predicted by increasing the number of farm assessments is potentially larger, although it must be remembered that the coefficient here has had significant power imputed to it because of the relatively small number of farm assessments typically found in this urban category of local government.

The results from our econometric analysis show that the number of business assessments is negatively associated with debt capacity, *ceteris paribus*. In this regard, it is important to be mindful of several factors. Firstly, the association between business assessments and debt capacity is not statistically significant. Secondly, the relative size of the effect is small: a one percent increase in business

¹ It should be noted that the typical size of the residential cohort is large. Hence, a one percent increase to residential numbers would generally represent a sizable change.

assessments is associated with just a \$96,000 reduction to debt capacity. Thirdly, the *ceteris paribus* assumption is essential to making sense of the *prima facie* contrariwise effect; that is, if we hold all other factors constant but increase the number of business assessments significantly, then it is not surprising that there might be a small negative response, because the ratio of businesses to residential assessments will have increased. This is suggestive of a local government area with tourist characteristics. In our other reports on Port Stephens Council, we have already shown that this has important deleterious effects on financial sustainability.

It should also be noted that a number of the control variables were also highly statistically significant. This effect also confirms the importance of taking cognisance of the incomes of the parties to the loan (as detailed in section 2 of this Report).

The main reason for conducting our econometric estimation was to use the coefficients thus determined from four years of panel data to predict the expected capacity to service the debt of a council exhibiting the relevant characteristics of the Port Stephens local government area. It should be noted that the validity of the prediction is based, in part, on the assumption that no major changes occur with respect to important determinants, such as the relative socio-demographic profile of the area. In our Financial Sustainability Report, we have shown that the relative socio-demographic profile of Port Stephens Council may well deteriorate. Should this change, then the predicted capacity of our model would need to be altered (downwards) accordingly.

As it stands, the model predicts that Port Stephens Council is already close to its debt capacity ceiling. Indeed, if we were to rely entirely on the model, then this would suggest that only \$5.3 million of additional borrowings could be prudently contemplated. However, there are special considerations that arise from the airport business that warrant further exploration.

In section 4, we explore these considerations further and set out our recommendations in relation to debt for Port Stephens Council over the next councillor term of office.

4. CONCLUSION AND RECOMMENDATIONS

Both the nett financial liabilities ratio and the much more sophisticated econometric analysis suggest that Port Stephens Council has very little additional debt capacity. Because the econometric model considers a broader peer group over a longer panel, as well as including all of the important variables associated with capacity to service debt, greater emphasis should be placed on this latter result. *Prima facie* this suggests that only an additional \$5.3 million of debt could be prudently contemplated. However, debt associated with the Newcastle airport partnership could be considered a special case. If we adopted the special case view, then it suggests debt capacity of just over \$20 million.

Given the current COVID-19 situation, future risks (such as increased inflation) and Council's already concerning financial sustainability position, it would be safest to take out no more debt at all, at least until an SRV has been approved. However, we understand that the Port Stephens Council has already adopted resolutions for proposed borrowings of \$10 million (for depot and administration building refurbishment) and \$5 million (for Nelson Bay) respectively. In view of the special

circumstances associated with the airport partnership – and the apparent imperative to progress with these projects – Council may feel that it is reasonable to proceed according to resolutions already adopted. Nevertheless, we urge extreme caution. Moreover, it is essential to secure a SRV in the order of the magnitude proposed in our Capacity to Pay Report as part of the means for servicing the debt, ensuring intergenerational equity, and also combatting fiscal illusion.

We note that tapping into existing reserves – as a means of avoiding further debt – is not a reasonable option for Port Stephens. Reserves are already at dangerously low levels.

Matters regarding debt capacity should be reassessed shortly after January 2025. We note that commercial banks may well lend even larger sums of money to Port Stephens Council irrespective of its problematic situation. However, this would be an example of soft budget constraints in action that have often preceded other financial sustainability crises (Drew and Campbell, 2016; Drew, 2021). We thus strongly advise Port Stephens Council to resist commercial bank accommodation of excessive debt and instead adhere to the recommendations laid out above. We also make note of Council's prudent financial management exemplified by recent action to fix outstanding debts at present historically low rates. This is further evidence of the professionalism of the finance team that has allowed Council to survive given its very challenging conditions. We note further that several additional loans have been identified for conversion to fixed rates. We urge Council management to progress these matters as rapidly as practicable. In addition, it may be prudent to consider whether longer fixed terms – if available – are a better long-term proposition, given empirical evidence that inflation tends to be sticky downwards¹⁰.

In our review of existing debt, we noted that much of the debt finance was associated with projects of a discretionary nature. Funding discretionary projects through debt exacerbates fiscal illusion because the local community receives municipal services that they do not fully pay for (Drew, 2021). Moreover, funding discretionary projects through debt also poses particular risks for intergenerational equity because there can be no certainty that the preferences of existing ratepayers will be the same as the preferences of the future ratepayers asked to service the debt in question. Indeed, in the absence of a SRV – or alternatively cuts to

⁹ However, even after this passage of time – and assuming that the SRV has been approved and risks mitigated – accumulating greater debt would still involve risk because it reinforces extant problematic levels of fiscal illusion amongst the local community, as established in the Financial Sustainability Report.

¹⁰ There is a small risk that a longer term fixed rate might prove regrettable in the outer years (if rates were to drop again). However, the benefit of making servicing costs more predictable over the near-term – when financial sustainability is being challenged – seems worth the small risk. However, Council is still urged to seriously consider the wider evidence about future likely interest rate movements as part of its decision-making process.

discretionary expenditure elsewhere – it is hard to see how a quid pro quo has been achieved.

As we have noted in our other reports on Port Stephens Council, there is already solid evidence of fiscal illusion, which is a sound reason for applying for a SRV. Secondly, it is imperative to address the declining financial position of Council. We thus urge Council to defer further discretionary projects (especially where debt is contemplated) until an SRV application has been approved and some of the imposing outstanding risks have been mitigated.

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