

Three of a Kind? The Special Case of Australia's Island Councils

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In common with many other countries, Australian local government policy-makers have focussed heavily on improving financial sustainability and operational efficiency through structural change and other modes of systemic reform. However, this system-wide approach cannot adequately deal with small island councils due to their sui generis characteristics. In an effort to fill this gap in the literature, this article examines the financial sustainability of Australia's three island councils – Flinders, Kangaroo and King – over the period 2008–2013 in order to determine whether alternative organisational arrangements may be better suited to their unique circumstances. In so doing, our study contributes to the literature by providing the first empirical analysis of the financial viability of Australia's island councils while considering the need for an alternative organisation entity in an effort to enhance their long-term financial sustainability.

Keywords: local government, Island councils, financial sustainability, organisational structure.

1. Introduction

In common with local government systems across the world, Australian local government faces a number of daunting problems (Denters & Rose, 2005). The most pressing of these problems resides in ensuring that local authorities of all types secure sufficient funding to sustain their ongoing financial viability. The financial distress confronting local authorities in all Australian local government jurisdictions has been well-documented in a series of state inquiries in New South Wales, Queensland, South Australia, Tasmania and Western Australia, as well as several national enquiries, including the PriceWaterhouseCoopers (PWC) (2006) *National Financing Sustainability Study of Local Government* (for a detailed review of these enquiries see Dollery *et al.*, 2013). Without exception, these enquiries have found that the main burden of the financial difficulties in Australian local government has fallen squarely on local infrastructure investment and maintenance, with local councils now facing a substantial infrastructure backlog, which cannot be overcome by solely relying on "own-source" revenue in the majority of cases.

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Various policies have been proposed to tackle the financial problems facing Australian local government. In the first place, numerous solutions have been proposed to address the local infrastructure crisis. For example, Byrnes *et al.* (2008) has suggested a municipal bonds issue on the Australian equity market. Similarly, Dollery *et al.* (2007) presented the case for a federal infrastructure fund for local councils. In a similar vein, Dollery *et al.* (2012b) and Dollery *et al.* (2013) have called for the formation of a national local government finance authority to pool individual municipal risk in combined infrastructure bonds issues underwritten by the Australian Government. However, with the significant exception of the *Roads to Recovery* program that provided direct Commonwealth funding to councils for local road investment and maintenance (Nagpal *et al.*, 2013), no decisive policy action has been undertaken to address the local government infrastructure problem (Dollery *et al.*, 2013).

Secondly, state and territory governments have taken steps to improve the operational efficiency of local government, particularly comparatively small rural and remote local municipalities. However, policy-makers have relied heavily on structural reform and, more specifically, on the use of forced amalgamation as the central remedial policy tool (Dollery *et al.*, 2012a). With the exception of Western Australia local government policy-makers across Australia have employed forced amalgamation in an effort to improve the efficiency of local municipalities and thereby enhance their financial sustainability (Dollery *et al.*, 2008).

The strong emphasis on compulsory council consolidation underscores the conventional view of Australian local government policy-makers that “bigger is better,” “bigger is cheaper” and “bigger means better service delivery” (Dollery & Crase, 2006; Dollery *et al.*, 2012a). The primary rationale for this position often resides in the view that municipal service delivery is characterised by *inter alia* considerable economies of scale. However, the conceptual literature on local government consolidation is unambiguously sceptical on the efficacy of council mergers, while the empirical literature is at best mixed (Byrnes & Dollery, 2002; Dollery *et al.*, 2012a). For instance, after reviewing municipal mergers in the Canadian municipal milieu, Sanction (2000, p. 83) concluded that “there is no functionally optimal size for municipal government because different municipal activities have quite different optimal areas.” Along similar lines, Allan (2003, p. 80) has contended that in Australia “at the administrative level the efficiency and effectiveness of a local council is not a function of size” and “all the empirical evidence suggests that big is not better when it comes to local government.” In addition, the continued reliance on forced amalgamations by policy-makers has also failed to address the underlying problem of local government financial sustainability; a view which is shared and supported by almost all national and state enquiries (Dollery *et al.*, 2012a).

However, these reservations are compounded when one considers small local authorities outside large Australian cities (see, for example, Dollery *et al.*, 2010), and are further complicated in the special case of Australia’s island councils. Of the 556 local government entities in Australia, only three councils can be characterised as non-indigenous island councils⁶:

- 1 Kangaroo Island Council which lies to the south-west of Adelaide, South Australia. The island is located in the Southern Ocean and its closest point to the South Australian mainland is Snapper Point (13.5 kilometres);
- 2 Flinders Island Council which lies to the north-east of Tasmania. The island is located in the Bass Strait and its closest point to the Tasmania mainland is Cape Portland (fifty-four kilometres); and
- 3 King Island Council which lies to the north-west of Tasmania. King Island is also located in Bass Strait and lies roughly halfway between mainland Tasmania and the state of Victoria (approximately 120 kilometres from either mainland).

Unlike their metropolitan mainland counterparts, but in common with remote councils in outback Australia, these island councils provide a variety of additional services outside the customary range of

⁶Indigenous island councils like Palm Island Council, which is situated off the coast of Townsville in Northern Queensland are excluded from our analysis because they operate under vastly different governance structures. For instance, under current arrangements Palm Island Council can levy charges for utilities but cannot levy charges for residential rates.

council services, including aged care services, airport facilities and medical services, for the “simple reason that these services would not otherwise be available” (Dollery *et al.*, 2010, p. 25). It could be argued that island councils manifest the needs of remote communities as a result of their physical seclusion from the mainland. Taking these factors into account, we contend that these three island councils possess such a unique set of characteristics as to be *sui generis* and accordingly not amenable to standard policy measures designed to improve local government efficiency and financial sustainability, like municipal mergers.

In an effort to shed light on the peculiar challenges faced by these three Australian island councils, we empirically examined the financial sustainability of these councils between 2008 and 2013 and considered whether an alternative organisational arrangement may be better suited to their unique circumstances. In investigating these questions, our article contributes to the literature by: (i) providing – to the best of our knowledge – the first systematic analysis of the financial viability of these island councils; and (ii) reflecting on whether these island councils should consider adopting a modified “Rural Council” organisational arrangement developed by the Independent Local Government Review Panel (ILGRP, 2013) for rural shires in western New South Wales.

The article is divided into four main parts. Section 2 provides a synoptic description of the three island councils. Section 3 sets out the data sources and empirical strategy employed in the study to examine the financial sustainability of these island councils. Section 4 presents the results of our financial analysis. The article ends in Section 5 by considering the policy implications of the empirical analysis, including the need for a new organisational structure.

2. Australia's Island Councils

As we have seen, Australian local government currently comprises 556 local government entities (Dollery *et al.*, 2012a). Of this total, only three councils – Flinders, King and Kangaroo – can be characterised as non-indigenous island councils. Formally, the Australian Classification of Local Government classifies Flinders Island and King Island as “Rural Agricultural Small” and Kangaroo Island as “Rural Agricultural Medium.” Although a number of mainland councils manage both inhabited and uninhabited islands off the Australian coast, the “self-managing” island councils of King, Flinders and Kangaroo occupy a truly unique position within the Australian local government landscape. Although these island councils – as a group – face similar social and economic challenges, such as limited access to services and comparatively high freight costs, they also confront local challenges and opportunities which are exclusive to their particular island communities. Table 1 presents summary statistics for these island councils in 2010/2011, along with the relevant state statistics for comparative purposes.

An examination of Table 1 reveals several common themes. In first place, the three island councils are comparatively small in terms of population density compared to their respective state averages. Secondly, the median age profile of island council residents is considerably higher than their comparative state medians. For example, the median age on Flinders Island is 52 years, while the median age for Tasmania is 40 years. For Kangaroo Island, the median age is 46 years, whereas the median age for South Australia is 39 years. Thirdly, the median rent per week across all three island councils is considerably lower than the median rent per week on the mainland. Finally, island council rates per capita and general purpose grants per capita are considerably higher than their respective state averages. For instance, average council rates for Kangaroo Island stand at \$959, which is approximately 1.4 times higher than average rates for South Australia. It is also worth noting that among all Tasmanian councils, Flinders Island and King Island are ranked first and second by per capita general purpose grant funding. Overall, these summary statistics indicate that these island councils are heavily reliant on grant funding in addition to having a relatively narrow property tax revenue base – in the terms of the number of households – on which to levy rates.

While a broad set of demographic and economic themes are common *across* this group of island councils, it is nonetheless important to recognise that significant variation exists *between* these island councils. For example, the unemployment rates on King Island (3 per cent) and Kangaroo Island (four per cent) are considerably lower than the unemployment rates for the entire states of Tasmania

Table 1. Summary statistics on Australian island councils, 2010/2011

	Flinders Island (TAS)	King Island (TAS)	Kangaroo Island (SA)	SA	TAS
Type	RAS [†]	RAS [†]	RAM [†]	State	State
Area (km ²)	1997	1096	4401	984,179	68,018
Total road length (km)	385	436	1363	75,420	147,714
Population	776	1566	4417	1,596,572	495,354
No. of households	346	678	1782	619,041	192,826
Density	0.4	1.4	1.0	1.6	7.3
Median age (yrs.)	52	46	46	39	40
Median household income (\$/week)	830	953	834	\$1044	\$587
Median rent (\$/week)	80	115	159	\$220	\$300
Unemployment rate (%)	6%	3%	4%	6%	6%
Rates (\$/per capita)	\$1157	\$939	\$959	\$668.89	\$592.10
General purpose grant (\$/per capita)	\$655	\$320	\$297	\$64.94	\$64.80
Local roads grant (\$/per km)	\$1434	\$1472	\$846	\$462.22	\$2346.59

Note: [†]Australian Classification of Local Government: RAS = Rural Agriculture Small; RAM = Rural Agriculture Medium. Source: ABS (2011a,b) and DIRD (2013).

(6 per cent) and South Australia (6 per cent) respectively. These lower than average unemployment rates may, in part, reflect the migration of unemployed islanders to the mainland in search of employment. In contrast, the unemployment rate on Flinders Island (6 per cent) is consistent with the Tasmania average (6 per cent). The higher unemployment rate on Flinders Island may, in part, reflect the higher proportion of Indigenous people (16.8 per cent) who reside on Flinders Island. The most recent estimates indicate that the average indigenous unemployment rate currently stands at sixteen per cent (ABS, 2011a,b). In contrast, however, the proportion of Indigenous people who reside on Kangaroo Island (1.1 per cent) and King Island (1.7 per cent) is substantially lower.⁷

It is noteworthy that the median household income per week on King Island is approximately 1.6 times higher than the median income per week for Tasmania as a whole (\$592). One possible reason for this observed difference is that King Island residents may work in multiple jobs in order to meet island living expenses. Unlike Flinders Island and Kangaroo Island, King Island is located a considerable distance from mainland Tasmania (approximately 120 kilometres). Given the greater distance between King Island and the mainland, the freight costs associated with regularly importing and exporting goods and services to and from the island would add significantly to local cost-of-living pressures. Thus, in an effort to partially defray freight costs, King Island has successfully developed and marketed itself as a world class producer of “premium” agricultural products, including beef, seafood, cheeses and creams (King Island Council, 2012). In an analogous vein, Flinders Island is also planning to develop its economy along similar lines through the establishment of “island specific” products and by value-adding and marketing its high-quality agricultural products, which include beef, lamb and wallaby (Flinders Island Council, 2014). Finally, Kangaroo Island is developing and promoting an island-based premium food and gourmet industry. For example, in 2001 Kangaroo

⁷High unemployment rates are one aspect of the socio-economic pattern that reflects the structural inequality borne by Indigenous citizens in Australia (Holmes *et al.*, 2014).

Table 2. *Definition of key performance indicators*

Ratio	Benchmark	Calculation	Definition
Financial flexibility Operating ratio	> -4%	(Operating revenue excl. capital grants and contributions – operation expense)/ (Operating revenue excl. capital grants and contributions)	This ratio measures a council's achievement of containing operating expenditure within operating revenue. This ratio focusses on operating performance and hence capital grants and contributions are excluded
Own-source operating revenue ratio	>60%	(Rates, utilities and charges)/(Total operating revenue incl. capital grants and contributions)	This ratio measures fiscal flexibility. It is the degree of reliance on external funding sources such as operating grants and contributions. A council's financial flexibility improves the higher the level of its own-source revenue
Liquidity Cash expense ratio	> 3 months	(Cash + cash equivalents)/(Total expenses – depreciation – interest costs)*12	This liquidity ratio indicates the number of months a council can continue paying for its immediate expenses without additional cash inflow
Unrestricted current ratio†	>1.5x	(Current assets less all external restrictions)/ (Current liabilities less specific purpose liabilities)	Restrictions placed on various funding sources complicate the traditional current ratio used to assess liquidity of businesses as cash allocated to specific projects is restricted and cannot be used to meet a council's other operating and borrowing costs. The Unrestricted Current Ratio is specific to local government and is designed to represent a council's ability to meet short-term obligations as they fall due

Table 2. (Continued)

Ratio	Benchmark	Calculation	Definition
Debt servicing ability Debt service cover ratio (DSCR)	>2x	(Operating results before interest and depreciation)/(Principal repayments + borrowing interest costs)	This ratio measures the availability of operating cash to service debt including interest and lease payments (income statement) and principal repayments (cash flow statement)
Interest cover ratio	>4%	(Operating results before interest and depreciation)/(Borrowing interest costs)	This ratio indicates the extent to which a council can service its interest bearing debt and take on additional borrowings. It measures the burden of the current interest expense upon a council's operating cash
Asset management Asset maintenance ratio [‡]	>1x	(Actual asset maintenance)/(Required asset maintenance)	This ratio compares actual versus required annual asset maintenance. A ratio >1 indicates that the council is investing enough funds within the year to stop its infrastructure backlog from growing
Building and infrastructure asset renewal ratio	>1x	(Assets renewals [§])/(Depreciation and building infrastructure assets)	This ratio compares the proportion spent on infrastructure asset renewals and the asset's deterioration measured by its accounting depreciation

Notes: [‡]External restrictions include capital commitments. [§]Actual asset maintenance defined as current capital works and required asset maintenance proxied by depreciation of building and infrastructure assets. [§]Asset renewals measured as investment activity in building and infrastructure assets, since Tasmanian councils do not provide detailed information on investments in asset replacement versus asset upgrades. This definition deviates from the TCorp (2013) report, in which asset renewals only capture investment activity in the replacement or refurbishment of existing assets to an equivalent capacity or performance as opposed to the acquisition of new assets or the refurbishment of old assets that increase capacity or performance.

Table 3. Key performance indicators for Australian island councils, 2008–2013

	2008	2013	CAGR (%)	Benchmark	No. of times meeting benchmark (%)	Forecast [†]
Flinders Island Council (TAS)						
Operating ratio	–32%	–25%	–3.8	>–4%	0	–26%
Own-source operating revenue ratio	46%	43%	–1.1	>60%	0	42%
Cash expense ratio	7.7 months	11.6 months	7.1	>3 months	100	12.4 months
Unrestricted current ratio	20.7x	17.2x	–3.0	>1.5x	100	16.7x
Debt service cover ratio (DSCR) [†]	n.a.	n.a.	n.a.	>2.0x	n.a.	n.a.
Interest cover ratio [†]	n.a.	n.a.	n.a.	>4.0x	n.a.	n.a.
Asset maintenance ratio	0.00x	0.07x	9.4	>1.0x	0	0.07x
Building and infrastructure asset renewal ratio	0.23x	0.55x	15.6	>1.0x	17	0.64x
Kind Island Council (TAS)						
Operating ratio	–4%	–25%	35.1	>–4%	17	–16%
Own-source operating revenue ratio	55%	61%	1.9	>60%	17	62%
Cash expense ratio	0.0 months	3.0 months	112.4	>3 months	33	6.3 months
Unrestricted current ratio	3.6x	0.6x	–25.1	>1.5x	33	0.5x
Debt service cover ratio (DSCR)	12.8x	8.8x	–5.9	>2.0x	83	8.3x
Interest cover ratio	38.6x	34.3x	–2.0	>4.0x	83	33.6x
Asset maintenance ratio	0.03x	0.11x	23.0	>1.0x	0	0.13x
Building and infrastructure asset renewal ratio	1.30x	0.90x	–5.9	>1.0x	50	0.85x
Kangaroo Island Council (SA)						
Operating ratio	–14%	–10%	–5.6	>–4%	33	–11%
Own-source operating revenue ratio	59%	73%	3.8	>60%	67	76%
Cash expense ratio	2.6 months	0.9 months	–16.9	>3 months	0	0.7 months
Unrestricted current ratio	–0.8x	–1.3x	7.8	>1.5x	0	–1.2x
Debt service cover ratio (DSCR)	1.8x	0.3x	–27.0	>2.0x	0	0.2x
Interest cover ratio	5.7x	2.6x	–12.6	>4.0x	50	2.2x

council can continue paying for its immediate expenses without additional cash inflow – the following observations are worth noting. To begin with, Flinders Island Council appears to be highly liquid, with an average cash expense ratio twice the recommended benchmark over the previous six years (Figure 2, Panel A). This is not surprising given that Flinders Island Council has been in surplus over the last six years. On the other hand, Kangaroo Island Council appears to have considerable liquidity constraints with an average cash expense ratio of 1.3 months. Put differently, Kangaroo Island Council can only operate for an additional month at its current cash level before it requires a further cash injection.

The unrestricted current ratio was also used to assess the liquidity of these island councils. This KPI may be a more meaningful measure of liquidity since it only considers short-term assets and liabilities. However, the application of this admittedly narrower definition of liquidity still suggests that Kangaroo Island Council suffers from considerable liquidity constraints with a negative unrestricted current ratio of -1.3 in 2013.⁸ While Kangaroo Island Council appears to have identified this potential “liquidity bottleneck,” it is unlikely to meet the established benchmark in the short term. In a similar vein, King Island Council’s liquidity appears to have deteriorated in recent years. While it met the recognised benchmarks in 2008 and 2009, it fell short in the subsequent years. At present, King Island Council’s current liabilities outweigh its current assets by two-to-one, which may be symptomatic of inefficient short-term fund management practices (Figure 2, Panel B).

In contrast, Flinders Island Council is highly liquid with an unrestricted current ratio of 17.2, which is far in excess of the recommended benchmark. In other words, its current assets exceed its current liabilities by 17 times. This substantial deviation from the recommended benchmark may, in part, be indicative of inefficient short-term capital management. However, the compound annual growth rate of -3 per cent may indicate that Flinders Island Council is trying to reduce its idle short-term capital. The effect of this downward trend is limited as evidenced by the forecast unrestricted current ratio of 16.7.

In sum, liquidity means that a council can meet its short-term financial obligations while having sufficient cash reserves to run day-to-day operations smoothly. Thus, any potential liquidity problem may affect the future ability of island councils to provide community services and maintain critical infrastructure. The “liquidity bottleneck” appears to be a considerable problem for Kangaroo Island Council and may also become a problem for King Island Council. However, these “liquidity bottlenecks” appear to be the result of different financial pressures. In the case of Kangaroo Island Council, the liquidity problem is, to a large extent, the result of debt repayments (24.5 per cent of total cash payments made in 2013 were repayments of borrowings), while the decrease in King Island Council’s liquidity appears to be connected to the island’s increase in operating expenditure. In stark contrast, Flinders Island Council does not appear to be efficiently deploying its excess cash reserves.

4.3 Debt Servicing Ability

The following KPIs were used to measure island council *debt servicing ability*: (i) the debt service cover ratio; and (ii) the interest rate cover ratio. Given that the debt service ratio is, in essence, a more refined version of the interest cover ratio we restrict our discussion to the debt service cover ratio (DSCR). The DSCR measures a council’s ability to meet its “interest and principal repayments obligations” within its operating earnings. The first point worth noting is that we were unable to assess the debt servicing ability of Flinders Island Council because the council has been operating a surplus between 2008 and 2013.

In contrast, King Island Council’s debt servicing ability is relatively strong since it meets the established benchmark five times out of the last six years (Figure 3). However, its DSCR has been declining steadily over the past six years with a compound average growth rate of -5.9 per cent. With an increasing operating ratio, this trend may suggest that King Island Council is increasing its level of debt exposure. However, operating profitability will not be negatively influenced since King Island

⁸While current assets and current liabilities are highly unlikely to be negative the negative unrestricted current ratio for Kangaroo Council Island is a result of cash being tied up in short-term (<1 year) capital commitments.

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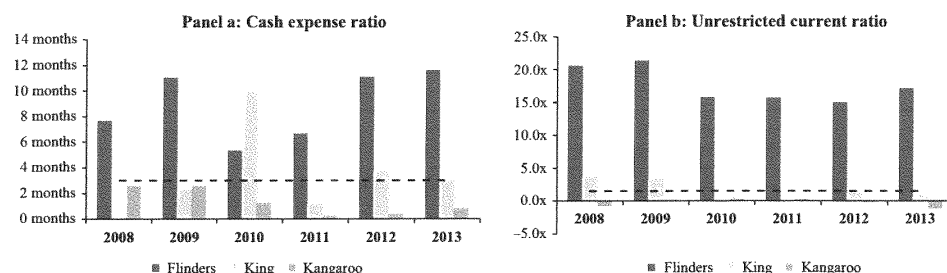


Figure 2. Liquidity for Flinders (TAS), King (TAS) and Kangaroo Island (SA) Councils, 2008–2013

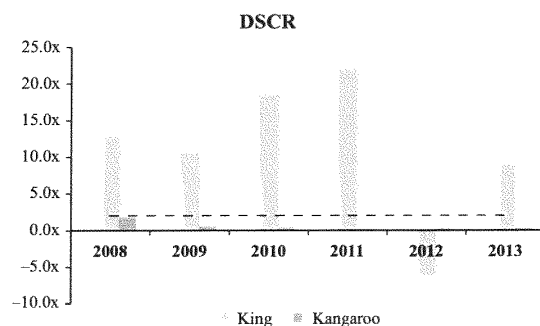


Figure 3. Debt Servicing Ability for King (TAS) and Kangaroo Island (SA) Councils, 2008–2013

Council is able to comfortably meet the required benchmark in the foreseeable future. On the other hand, Kangaroo Island Council's liquidity problem is also evident in its DSCR. Operating profitability is currently insufficient to serve interest and loan repayments, which is clearly financially unsustainable.

4.4 Asset Management

The following KPIs were used to measure island council *asset management*: (i) the asset maintenance ratio; and (ii) the building and infrastructure renewal ratio. An asset maintenance ratio of less than one indicates that a council's infrastructure backlog ratio is growing (Figure 4, Panel A). The key point to note is that none of the island councils are able to constrain their infrastructure backlog from growing. Between 2008 and 2013, the asset maintenance ratio for King Island Council and Flinders Island Council has been constantly below one and Kangaroo Island Council was only able to meet the recommended benchmark in 2009. Put differently, the current capital work does not match the depreciation of infrastructure assets (although the depreciation expenses are likely to be very conservative).

The building and infrastructure renewal ratio compares the actual expenditure of infrastructure assets relative to infrastructure depreciation. While actual maintenance is measured rather conservatively (by only considering capital works), the building and infrastructure renewal ratio measures all capital expenditure related to building and infrastructure assets in relation to the annual depreciation on these assets. According to this less restrictive definition of asset management efficiency, King

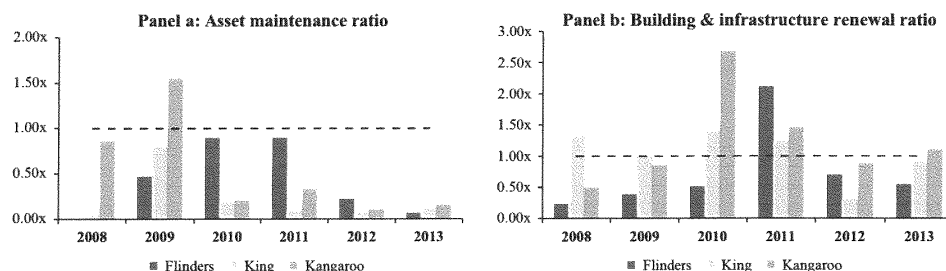


Figure 4. Asset management for Flinders (TAS), King (TAS) and Kangaroo Island (SA) Councils, 2008–2013

Island Council and Kangaroo Island council only meet the established benchmark three out of six years, whereas Flinders Island Councils only meets the benchmark once (Figure 4, Panel B). However, it should be noted that in 2013 only Kangaroo Island Council invested a level of capital in the renewal of infrastructure assets that matched the current rate of depreciation of these assets. According to the short-term forecasts – based on the past trajectory of the renewal ratio – King Island Council and Flinders Island Council will continue to “fall short” in the immediate future.

On balance, these island councils appear to be unable to commit the required resources to provide the adequate level of infrastructure maintenance to their respective communities. It is nevertheless important to stress that the local infrastructure backlog crisis confronts the entire Australian local government sector and is by no means unique to Australia’s island councils (Dollery *et al.*, 2012a).

5. Policy Considerations

In this article, we have examined the financial sustainability of Australia’s island councils with particular reference to their financial flexibility, liquidity, debt servicing ability and asset management capacity. With respect to our financial analysis, a number of findings are worth emphasising. To begin with, our financial analysis confirms that Australia’s island councils have a relatively low rate base and are highly dependent on grant funding to maintain their operations. In addition, the majority of island councils (King and Kangaroo) also face considerable liquidity problems, while one council (Kangaroo) has very limited debt servicing capabilities. All island councils are confronted with critical infrastructure backlog problems. Taken together, these problems cast considerable doubt on the long-term financial sustainability of these island councils. As discussed in the introduction, while island councils exhibit unique council features, their geographic nature renders these councils “remote” by definition. Therefore, examining the financial sustainability of island councils offers stylised insight into the wider policy debate on the financial viability of remote or rural councils in Australia.

Given the distinctive nature of these island councils, several observations should be made. Firstly, local government is of far more importance to these islands than in Australia as a whole, particularly in terms of maintaining the economic and social fabric of these small island communities, and articulating their unusual needs. Indeed, the absence of a local government may well see the decline and ultimate demise of these island communities. Secondly, the services provided by island councils are especially reliant on an intricate local knowledge of local needs; information which would not be available to higher tiers of government. Consequently, service provision on island councils makes local decision making on local resource allocation even more essential than in other remote Australian local authorities. Thirdly, Australia’s island councils deliver a range of services which would ordinarily be provided by state and Commonwealth public agencies. Put differently, in many respects local authorities on the islands represent “government of last resort” to islanders (see, for instance, Dollery *et al.*, 2010). As a result, the absence of these local municipalities would thus place a much greater administrative burden on the Commonwealth and state government to provide the same level of services. Fourthly, the “tyranny of distance” between administrative centres of mainland

councils and low population densities mean that economies of scale are unobtainable in the provision of local government services regardless of which structural arrangements might be imposed on these island councils. Finally, the importance of local leadership in the economic development of island councils can hardly be overstated, given the special circumstances of island inhabitants. Any reduction in locally elected representation would be particularly devastating for island communities where stark differences may exist between the cultural identities of island communities and those on the mainland (see, e.g. Grydehøj & Hayward, 2011).

The characteristics of these island councils suggests that scope for “top-down” reform by the South Australian and Tasmanian state governments is severely limited. In other words, the standard Australian state government policy response to improve the financial sustainability of local government – structural reform through compulsory council consolidation – will inevitably fail since the scale economies on which council mergers are predicated are unattainable for Australia’s island councils, given the distances from the mainland, population size and population densities concerned.

Special cases like Australia’s island councils require special treatment. Given the inherent difficulties facing the financial sustainability of Australia’s island councils, there may be a need to consider a different organisational entity, along the lines of the “Rural Council” model as proposed by the New South Wales (NSW) Independent Local Government Review Panel (ILGRP, 2013). This organisational structure has been developed in an effort to help improve the financial sustainability of rural and remote NSW councils which have the following characteristics: (i) a low rate base and heavy reliance on external grant funding; (ii) long distances from major regional centres; (iii) neighbouring councils also have “small populations and limited resources” and are thus unpromising candidates for council amalgamation; and (iv) may be financially sustainable in the short term, but will have limited capacities to undertake the complete suite of local government functions (ILGRP, 2013, p. 92).

The key features of “Rural Councils” include: (i) a limit of five councillors including the mayor, (ii) a maximum of six full council meetings per year with a highly restricted ancillary committee structure; (iii) a shared administration with a neighbouring council or resource sharing arrangements in an effort to minimise staffing and overhead costs; (iv) streamlined compliance and reporting requirements; (v) regulatory responsibilities handled by a regional centre with the requisite expertise; and (vi) reduced planning, reporting and internal audit requirements (ILGRP, 2013, p. 92).

The “Rural Council” described above implies that such an organisational entity would not only offer a narrower mix of local government services with a varying degree of service quality, but it correspondingly would not require advanced administrative and technical skills. With the notable exception that island councils are geographically separated from mainland Australia by open water, the characteristics of these island councils are strikingly similar to those of the rural and remote councils that occupy outback Australia.

Thus, at first blush, it appears that the proposed “Rural Council” model could be applied to Australia’s island councils, with some modifications, especially with regard to a common shared administration. In particular, an emphasis on administrative resource sharing on an *ad hoc* case-by-case basis depending on the specific local needs of each island council is preferable to a generic shared administration model insofar as it would better facilitate flexibility (see, for example, Dollery, 2003; Dollery & Johnson, 2005). Thus, if such an organisational arrangement were adapted along these lines and adopted by island councils, then island communities would have to accept that the mix and quality of local government services would be somewhat more limited than services and functions performed by larger local authorities on the mainland.

While the “Rural Council” model obviously requires further development and refinement to attune it to the specific needs of individual island councils, it is important to note that a smaller role for island councils may, in fact, adversely affect the critical role that these councils play in stimulating local economic activity. Taking this into account, the “Rural Council” model would need to be carefully designed and implemented to ensure that such an organisational entity does not adversely impact the important role that these island councils play in fostering the economic, social, and cultural facets of these island communities.

While the “Rural Council” model may represent a partial solution to the ongoing financial difficulties facing nearly all rural and remote councils, it is important to stress that supporting small island communities financially through intergovernmental grants from higher tiers of government can be justified on both efficiency and equity grounds. As a starting point, “merit good” arguments can justify the fiscal subsidisation of the provision of services to island councils. For example, national security, nature conservation and environmental protection are likely to be enhanced when the whole of Australia is occupied rather than only mainland regions of the country. Moreover, on equity grounds it can be argued that Australian residents are entitled to the provision of some minimum level of services, regardless of where they live (Dollery *et al.*, 2006).

In summary, we have examined the financial sustainability of Australia’s three island councils. Our financial analysis casts considerable doubt on the long-term financial viability of these island councils. Given the inherent challenges facing these island communities, we contend that an alternative organisational entity, along the lines of a modified version of the “Rural Council” model, as advanced by the ILGRP (2013), may offer fruitful starting point in helping to improve the long-term financial sustainability of Australia’s island councils.

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