

# **Review of the Local Government Rating System**

**Local Government — Draft Report**  
August 2016



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## Invitation for submissions

IPART invites written comment on this document and encourages all interested parties to provide submissions addressing the matters discussed.

**Submissions are due by 14 October 2016.**

We would prefer to receive them electronically via our online submission form <[www.ipart.nsw.gov.au/Home/Consumer\\_Information/Lodge\\_a\\_submission](http://www.ipart.nsw.gov.au/Home/Consumer_Information/Lodge_a_submission)>.

You can also send comments by mail to:

**Review of Local Government Rating System**  
Independent Pricing and Regulatory Tribunal  
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Late submissions may not be accepted at the discretion of the Tribunal. Our normal practice is to make submissions publicly available on our website <[www.ipart.nsw.gov.au](http://www.ipart.nsw.gov.au)> as soon as possible after the closing date for submissions. If you wish to view copies of submissions but do not have access to the website, you can make alternative arrangements by telephoning one of the staff members listed on the previous page.

We may choose not to publish a submission—for example, if it contains confidential or commercially sensitive information. If your submission contains information that you do not wish to be publicly disclosed, please indicate this clearly at the time of making the submission. IPART will then make every effort to protect that information, but it could be disclosed under the *Government Information (Public Access) Act 2009* (NSW) or the *Independent Pricing and Regulatory Tribunal Act 1992* (NSW), or where otherwise required by law.

If you would like further information on making a submission, IPART's submission policy is available on our website.



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## 1 Executive summary

The NSW Government has asked the Independent Pricing and Regulatory Tribunal (IPART) to review the local government rating system in NSW. The purpose of our review is to develop recommendations to improve the equity and efficiency of the rating system, in order to enhance councils' ability to implement sustainable fiscal policies over the long term.

This review seeks to design a rating system that would collect revenue more equitably and efficiently from ratepayers. It includes reviewing the valuation method used to calculate rates, exemptions and rating categories. Our draft proposals are not designed to increase the overall rates collected by councils.

In conducting the review, we have consulted stakeholders, analysed the current rating system, and assessed its performance against the key taxation principles of efficiency, equity, simplicity, sustainability and competitive neutrality. We have also compared the NSW rating system to best-practice policies in other jurisdictions.

We have developed our draft recommendations and we are seeking comments from all interested parties. The main changes designed to give councils more flexibility to better meet the needs of the community, are to:

- ▼ **Integrate the use of the Capital Improved Value (CIV) valuation method into the local government rating system:**
  - **Give councils the option to use CIV as an alternative to Unimproved Value (UV) as the basis for setting the variable amounts in rates.** CIV is generally more consistent with tax principles, and allowing its use would overcome the major shortcoming of the current system – that the mandatory use of UV inhibits councils' ability to equitably and efficiently raise rates revenue from apartments. Importantly, total rates income would remain unchanged irrespective of the valuation method chosen by councils.
  - **Allow councils' general income to grow as the communities they serve grow.** Councils' rates income would increase over time in line with the growth in CIV arising from new residents or businesses. This would mean that rates per household, on average, would not rise in real terms<sup>1</sup> whilst

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<sup>1</sup> Other factors could lead to average rates per household increasing, for example, if a council applied for a special variation to fund improved services to the community.

promoting financial sustainability and encouraging urban renewal. It would allow councils to maintain consistent service levels over time without the need to resort to Special Variations.

- ▼ **Give councils more options to set rates within rating categories:**
  - **Provide councils with more flexibility to set different residential rates within their local area.** Allowing councils with diverse communities to set rates that reflect differences in access to, demand for, and cost of providing council services across their local area would improve equity and efficiency. This would allow councils to better tailor rates to the needs of the local communities. We recommend introducing protections to promote equity and transparency when councils set different residential rates. Also, under this draft recommendation, new councils would have the flexibility to establish new structures for residential rates and transition to them in a fair and timely manner at the end of the 4-year rate path freeze.
  - **Allow councils to make new categories for environmental and vacant land, and new subcategories for business and farmland properties.** This would allow councils to use their rate structures to take account of different costs that arise from different land uses and better encourage urban renewal and growth.
- ▼ **Modify rate exemptions so eligibility is based on land use rather than ownership:**
  - Retain or amend explicit exemptions to be consistent with this general principle.
  - Remove some exemptions on the basis that the land is used for commercial or residential purposes. This would better target exemptions, improving the equity, efficiency and sustainability of the rating system.

We make our draft recommendations to promote a stronger and more sustainable rating system that would benefit both ratepayers and councils.

### 1.1 Integrate the use of the CIV valuation method into the local government rating system

Our draft recommendations recognise that councils need improved options when setting rates to respond to changes in their local area, due to growth, increasing diversity in development, and other factors. Our draft proposals allow:

- ▼ councils to use CIV as an alternative method to UV in setting rates, and
- ▼ councils' general income to grow as the communities they serve grow, as measured by the change in the CIV from new developments.

### 1.1.1 Allow councils to use CIV as an alternative to UV in setting rates

Currently, NSW councils are required to set the variable component of rates (the ad valorem amount) based on the property's unimproved land value (UV). Stakeholders identified this method may inhibit councils from setting equitable and efficient ad valorem amounts for properties with a high capital value and relatively low land value, such as apartments. Given the restrictions on the revenue that can be raised from base amounts, a number of councils have set relatively high minimum amounts to raise sufficient rates revenue from apartments.

Under our draft recommendations:

- ▼ Councils would be able to choose either the UV method or a CIV method that sets a property's rates based on its market value (ie, land value plus capital improvements).
- ▼ Minimum amounts would be removed from the rate structure, as councils would have the option to use CIV there would be no need to retain this fixed rates component in the system.

These draft recommendations will provide councils with improved options to structure their rates within the current constraints on total rates income.

#### Option to use CIV or UV

For many councils in NSW, CIV would be a more efficient and equitable basis for setting the ad valorem component in rates than UV. For a given amount of total rates revenue, the market value of the ratepayer's property, rather than their unimproved land value, will usually better reflect their share of demand for and share of the costs of providing council services. Market value tends to be a more equitable basis for rating, in that it more closely aligns with the benefits the ratepayer receives from council services as well as their ability to pay.

Allowing councils to use CIV would be consistent with international best practice. Over the last 30 years, there has been a consistent shift from UV to CIV in developed countries. Currently, around 85% of these countries use a market value approach such as CIV.

Giving councils the option to use either CIV or UV would be consistent with stakeholders' preferences. In our consultations, a strong majority of councils supported having the option to choose. Although most generally agreed that UV is less equitable and efficient than CIV, many councils wanted the option to choose UV where it better meets their needs. Under our proposal, the total rates collected by a council would remain unchanged irrespective of the valuation method chosen by the council.

## Removing minimum amounts

Minimum amounts should be removed from the LG Act. Using minimum amounts to recover the fixed costs of council services is inefficient and inequitable. It is more appropriate to recover these costs using base amounts, with an ad valorem amount added, as this type of rate structure is more closely related to ratepayers' benefits received and ability to pay.

If our draft recommendation to allow councils to use CIV to set ad valorem amounts is adopted, councils would no longer need to use minimum amounts as a way to raise rates revenue from apartments. The removal of minimum amounts would also simplify rating structures for many councils.

### 1.1.2 Allow councils' general income to grow as the communities they serve grow

As communities grow, councils need to provide more infrastructure and services. Their revenue from rates (or general income) also needs to grow to allow them to meet these needs while maintaining their financial sustainability. Under our draft recommendations:

- ▼ Councils' general income would increase (outside the rate peg) in line with the growth in CIV that arises from new developments in their area.
- ▼ Councils would be able to levy a special rate for new infrastructure that is jointly funded with other levels of government without the need for regulatory approval from IPART under the Special Variation process.

## Allowing general income to increase in line with CIV from new developments

Allowing councils' general income to increase in line with the growth in CIV arising from new developments in their area would promote their financial sustainability and encourage urban renewal. This reform would ensure that over time, a council's rates income could increase to match the increase in its costs caused by servicing more people and businesses. It would also ensure that councils can maintain a consistent level of service over time.

Importantly, this reform would not lead to real increases in rates per household, as a council's total rates income would grow in line with the increase in rateable properties in the area.

In addition, it would reduce the need for councils to apply for Special Variations to their general income as a result of growth. Special Variations would generally only be required when there is a significant shift in the local community's preferences for a higher level of services.

### Levying a special rate for joint delivery of new infrastructure projects

Councils could be given more opportunity to partner effectively with other levels of government to deliver infrastructure that benefits the local community. Allowing councils to levy a new type of special rate for this purpose, without the need for regulatory approval, would facilitate this partnering and reduce red tape.

## 1.2 Give councils more options to set rates within rating categories

In making our draft recommendations, we considered the appropriateness and impact of the current rating categories. To improve the performance of the current system our draft recommendations would provide councils with:

- ▼ more flexibility to set different residential rates within their area, and
- ▼ new categories for environmental and vacant land, and new subcategories for farmland and business properties.

### 1.2.1 Give councils greater flexibility to set different residential rates within their area

Councils require greater flexibility to set different residential rates within their area to better reflect the differences in demand for, and cost of providing, council services. This affects some councils more than others. Under our draft recommendations:

- ▼ Councils would have the option to set different residential rates to reflect differences in access, demand or costs across their area.
- ▼ New councils, formed by the recent mergers, would also be able to choose to keep existing rate structures where there are different communities of interest, or equalise residential rates and transition to the new rates over time.

### Setting different rates to reflect differences in access, demand or costs

Councils are experiencing increasing diversity in residents' access to and demand for council services, as well as the costs of providing them. Councils are becoming larger, and several have a mix of established and growth suburbs as well as diverse strata developments.

Allowing councils to have the option of setting different residential rates within their local areas means they could take account of the differences in access to, demand for and cost of providing council services across their residential ratepayer base. It would also assist them to be more responsive to local needs and reduce any cross-subsidies between areas.

## Equalising residential rates

New councils should also have the option of establishing new and equitable structures for residential rates, and transition to them appropriately. Depending on its specific circumstances, a new council could choose to equalise rates across its pre-merger areas, keep the existing rate structures in each pre-merger area, or move to a different rate structure.

### 1.2.2 Allow councils to use new rating categories

The current rating system includes four rating categories which reflect the primary use of the land - residential, business, farmland and mining. Councils may elect to apply different rate structures to each category. Our draft recommendations are to:

- ▼ Create new categories for environmental and vacant land, to allow councils to take account of differences in costs that arise from different land uses and encourage urban renewal.
- ▼ Allow councils to subcategorise business land as industrial or commercial.
- ▼ Allow councils to subcategorise farmland based on geographic location.
- ▼ Allow councils to determine which category will act as the default residual category for rating property that is difficult to classify.

## 1.3 Modify eligibility for rate exemptions so they are better targeted

Currently, rate exemptions are not well targeted. This means ratepayers without exemptions are paying higher rates than otherwise would be the case. Under our draft recommendations to better target these exemptions:

- ▼ eligibility for exemptions would be based on land use rather than land ownership, and
- ▼ land used for commercial or residential purposes would not be eligible for exemptions.

### 1.3.1 Basing exemptions on land use rather than ownership

Currently, eligibility for rate exemptions is based on who owns the land. Eligibility should be based on the use of the land, regardless of who owns it, to ensure comparable land uses attract the same rating treatment. This would improve the efficiency of the rating system, and more equitably spread the rating burden across the community.

Where land is used for both exempt and non-exempt activities, rates should be based on the percentage used for non-exempt activities.



### 1.3.2 Making land used for commercial activities and residential purposes ineligible for exemptions

Since exemptions are a subsidy from ratepayers, they should be directed at land uses that generate substantial public benefits for the community. Commercial activities and residential uses typically generate private benefits, and not significant public benefits, so land used for these purposes should not be eligible for rate exemptions.

When land is used for commercial activities or residential purposes, it imposes costs on councils. Therefore, it is equitable and efficient for those responsible for these costs to make a contribution by paying rates. It also provides them with an incentive to minimise these costs.

Under the current system, the recent transfer of ownership of residential housing to Public Benevolent Institutions, making it non-rateable, has narrowed the rating base. Our draft recommendation to rate land used for residential purposes would address this, ensuring the rating burden is spread more equitably across local communities.

## 1.4 Other draft recommendations

We have also made draft recommendations to reform other aspects of the current rating system, including:

- ▼ replacing the current pensioner concession with a rate deferral scheme to be operated and funded by the NSW Government
- ▼ using the CIV method as the basis for calculating the Emergency Services Property Levy, when CIV data becomes available state wide, and
- ▼ allowing councils to either purchase valuation services directly from the market or from the Valuer General.

## 1.5 Our process for conducting and completing this review

In conducting this review to date, we have undertaken public consultation, research and analysis. We released an Issues Paper in April 2016, and received 159 written submissions in response to this paper. We also interviewed some councils about aspects of their submissions, and conducted a public hearing in April 2016. In addition, we consulted relevant NSW Government agencies and organisations, and engaged experts in the field to provide input on our approach.

We delivered an Interim Report to the Government on 9 June 2016, in accordance with our terms of reference, on freezing existing rate paths for new councils. This report was publicly released on 1 August 2016 and can be found on our website.<sup>2</sup>

<sup>2</sup> IPART, *Freezing existing rate paths for newly merged councils*, June 2016.

We now invite all interested parties to make written submissions in response to this Draft Report. These submissions are due by **14 October 2016**. Information on how to make a submission can be found on page iii, at the front of this report.

We will also hold public hearings on 19 September 2016 in Sydney and in Dubbo on 10 October 2016 to give stakeholders a further opportunity to comment on the Draft Report.

We will consider all the information and views expressed in submissions and at the public hearing before finalising our recommendations and submitting our Final Report to the NSW Government before the end of the year. Table 1.1 sets out our indicative timetable for completing this review.

**Table 1.1 Timetable for the review**

Milestone	Timeframe
Public hearing - Sydney	19 September 2016
Regional public hearing - Dubbo	10 October 2016
Submissions to the Draft Report	14 October 2016
Final Report	December 2016

## 1.6 Structure of this report

The rest of this report explains the context and approach for our review, discusses our analysis and draft findings in detail, and sets out our draft recommendations. The report is structured as follows:

- ▼ **Chapter 2** provides key contextual information, including a summary of our terms of reference, an overview of the current rating system in NSW and the taxation principles against which we assessed this system.
- ▼ **Chapters 3 to 6** focus on our key recommendations and the analysis that supports them, including:
  - allowing councils to use CIV as an alternative to UV as the basis for calculating the variable amount in rates
  - allowing councils' general income to grow as the communities they serve grow, as measured by the increase in CIV from new developments
  - giving councils greater flexibility to set different residential rates within their local area, and
  - modifying rate exemptions so eligibility is based on land use rather than ownership.
- ▼ **Chapters 7 to 10** discuss our additional recommendations and analysis on:
  - introducing new rating categories for 'environmental' and 'vacant' land uses
  - allowing farmland to be subcategorised based on location

- allowing industrial and commercial subcategories for business rates
- replacing the current pensioner concession scheme with a rate deferral scheme
- using the CIV method as the basis for calculating the Emergency Services Property Levy, and
- allowing councils to either purchase valuation services directly from the market or from the Valuer General.

## 1.7 List of our draft recommendations

### Allow councils to use CIV as an alternative to UV in setting rates

- 1 Councils should be able to choose between the Capital Improved Value (CIV) and Unimproved Value (UV) methods as the basis for setting rates at the rating category level. A council's maximum general income should not change as a result of the valuation method they choose. 26
- 2 Section 497 of the *Local Government Act* 1993 (NSW) should be amended to remove minimum amounts from the structure of a rate, and section 548 of the *Local Government Act* 1993 (NSW) should be removed. 38

### Allow councils' general income to grow as the communities they serve grow

- 3 The growth in rates revenue outside the rate peg should be calculated by multiplying a council's general income by the proportional increase in Capital Improved Value from supplementary valuations.
  - This formula would be independent of the valuation method chosen by councils for rating. 44
- 4 The *Local Government Act* 1993 (NSW) should be amended to allow councils to levy a new type of special rate for new infrastructure jointly funded with other levels of Government. This special rate should be permitted for services or infrastructure that benefit the community, and funds raised under this special rate should not:
  - form part of a council's general income permitted under the rate peg, nor
  - require councils to receive regulatory approval from IPART. 51
- 5 Section 511 of the *Local Government Act* 1993 (NSW) should be amended to reflect that, where a council does not apply the full percentage increase of the rate peg (or any applicable Special Variation) in a year, within the following 10-year period, the council can set rates in a subsequent year to return it to the original rating trajectory for that subsequent year. 53

## Give councils greater flexibility when setting residential rates

- 6 The *Local Government Act 1993* (NSW) should be amended to remove the requirement to equalise residential rates by 'centre of population'. Instead, councils should be allowed to determine a residential subcategory, and set a residential rate, for an area by:
  - a separate town or village, or
  - a community of interest. 60
- 7 An area should be considered to have a different 'community of interest' where it is within a contiguous urban development, and it has different access to, demand for, or costs of providing council services or infrastructure relative to other areas in that development. 60
- 8 The *Local Government Act 1993* (NSW) should be amended so, where a council uses different residential rates within a contiguous urban development, it should be required to:
  - ensure the highest rate structure is no more than 1.5 times the lowest rate structure across all residential subcategories (ie, so the maximum difference for ad valorem rates and base amounts is 50%), or obtain approval from IPART to exceed this maximum difference as part of the Special Variation process, and
  - publish the different rates (along with the reasons for the different rates) on its website and in the rates notice received by ratepayers. 69
- 9 At the end of the 4-year rate path freeze, new councils should determine whether any pre-merger areas are separate towns or villages, or different communities of interest.
  - In the event that a new council determines they are separate towns or villages, or different communities of interest, it should be able to continue the existing rates or set different rates for these pre-merger areas, subject to metropolitan councils seeking IPART approval if they exceed the 50% maximum differential. It could also choose to equalise rates across the pre-merger areas, using the gradual equalisation process outlined below.
  - In the event that a new council determines they are not separate towns or villages, or different communities of interest, or it chooses to equalise rates, it should undertake a gradual equalisation of residential rates. The amount of rates a resident is liable to pay to the council should increase by no more than 10 percentage points above the rate peg (as adjusted for permitted Special Variations) each year as a result of this equalisation. The *Local Government Act 1993* (NSW) should be amended to facilitate this gradual equalisation. 70

### Better target rate exemption eligibility

- 10 Sections 555 and 556 of the *Local Government Act 1993* NSW should be amended to:
  - exempt land on the basis of use rather than ownership, and to directly link the exemption to the use of the land, and
  - ensure land used for residential and commercial purposes is rateable unless explicitly exempted. 76
- 11 The following exemptions should be retained in the *Local Government Act 1993* (NSW):
  - section 555(e) Land used by a religious body occupied for that purpose
  - section 555(g) Land vested in the NSW Aboriginal Land Council
  - section 556(o) Land that is vested in the mines rescue company, and
  - section 556(q) Land that is leased to the Crown for the purpose of cattle dipping. 80
- 12 Section 556(i) of the *Local Government Act 1993* (NSW) should be amended to include land owned by a private hospital and used for that purpose. 81
- 13 The following exemptions should be removed:
  - land that is vested in, owned by, or within a special or controlled area for, the Hunter Water Corporation, Water NSW or the Sydney Water Corporation (*Local Government Act 1993* (NSW) section 555(c) and section 555(d))
  - land that is below the high water mark and is used for the cultivation of oysters (*Local Government Act 1993* (NSW) section 555(h))
  - land that is held under a lease from the Crown for private purposes and is the subject of a mineral claim (*Local Government Act 1993* (NSW) section 556(g)), and
  - land that is managed by the Teacher Housing Authority and on which a house is erected (*Local Government Act 1993* (NSW) section 556(p)). 82
- 14 The following exemptions should not be funded by local councils and hence should be removed from the *Local Government Act and Regulation*
  - land that is vested in the Sydney Cricket and Sports Ground Trust (*Local Government Act 1993* (NSW) section 556(m))
  - land that is leased by the Royal Agricultural Society in the Homebush Bay area (*Local Government (General) Regulation 2005* reg 123(a))
  - land that is occupied by the Museum of Contemporary Art Limited (*Local Government (General) Regulation 2005* reg 123(b)), and 82

- land comprising the site known as Museum of Sydney (*Local Government (General) Regulation 2005* reg 123(c)).
- The State Government should consider whether to fund these local rates through State taxes. 83
- 15 Where a portion of land is used for an exempt purpose and the remainder for a non-exempt activity, only the former portion should be exempt, and the remainder should be rateable. 83
- 16 Where land is used for an exempt purpose only part of the time, a self-assessment process should be used to determine the proportion of rates payable for the non-exempt use. 83
- 17 A council's maximum general income should not be modified as a result of any changes to exemptions from implementing our recommendations. 87
- 18 The *Local Government Act 1993* (NSW) should be amended to remove the current exemptions from water and sewerage special charges in section 555 and instead allow councils discretion to exempt these properties from water and sewerage special rates in a similar manner as occurs under section 558(1). 88
- 19 At the start of each rating period, councils should calculate the increase in rates that are the result of rating exemptions. This information should be published in the council's annual report or otherwise made available to the public. 88

#### Replace the pensioner concession with a rate deferral scheme

- 20 The current pensioner concession should be replaced with a rate deferral scheme operated by the State Government.
  - Eligible pensioners should be allowed to defer payment of rates up to the amount of the current concession, or any other amount as determined by the State Government.
  - The liability should be charged interest at the State Government's 10-year borrowing rate plus an administrative fee. The liability would become due when property ownership changes and a surviving spouse no longer lives in the residence. 92

#### Provide more rating categories

- 21 Section 493 of the *Local Government Act 1993* (NSW) should be amended to add a new environmental land category and a definition of 'Environmental Land' should be included in the LG Act. 99

- 22 Sections 493, 519 and 529 of the *Local Government Act 1993* (NSW) should be amended to add a new vacant land category, with subcategories for residential, business, mining and farmland. 100
- 23 Section 518 of the *Local Government Act 1993* (NSW) should be amended to reflect that a council may determine by resolution which rating category will act as the residual category.
- The residual category that is determined should not be subject to change for a 5-year period.
  - If a council does not determine a residual category, the Business category should act as the default residual rating category 102
- 24 Section 529 (2)(d) of the *Local Government Act 1993* (NSW) should be amended to allow business land to be subcategorised as ‘industrial’ and or ‘commercial’ in addition to centre of activity. 103
- 25 Section 529 (2)(a) of the *Local Government Act 1993* (NSW) should be replaced to allow farmland subcategories to be determined based on geographic location. 104
- 26 Any difference in the rate charged by a council to a mining category compared to its average business rate should primarily reflect differences in the council’s costs of providing services to the mining properties. 105

#### Recovery of council rates

- 27 Councils should have the option to engage the State Debt Recovery Office to recover outstanding council rates and charges. 108
- 28 The existing legal and administrative process to recover outstanding rates should be streamlined by reducing the period of time before a property can be sold to recover rates from five years to three years. 109
- 29 All councils should adopt an internal review policy, to assist those who are late in paying rates, before commencing legal proceedings to recover unpaid rates. 110
- 30 The *Local Government Act 1993* (NSW) should be amended or the Office of Local Government should issue guidelines to clarify that councils can offer flexible payment options to ratepayers. 111
- 31 The *Local Government Act 1993* (NSW) should be amended to allow councils to offer a discount to ratepayers who elect to receive rates notices in electronic formats, eg, via email. 112

- 32 The *Local Government Act 1993* (NSW) should be amended to remove section 585 and section 595, so that ratepayers are not permitted to postpone rates as a result of land rezoning, and councils are not required to write-off postponed rates after five years. 113

#### Other draft recommendations

- 33 The valuation base date for the Emergency Services Property Levy and council rates should be aligned.
- The NSW Government should levy the Emergency Services Property Levy on a Capital Improved Value basis when Capital Improved Value data becomes available state-wide. 116
- 34 Councils should be given the choice to directly buy valuation services from private valuers that have been certified by the Valuer General. 118



## 2 Context

This chapter provides the context for our review of the local government rating system in NSW. It sets out what we have been asked to do. It also outlines the current rating system and introduces the key tax principles we have used to assess and recommend changes to this system.

### 2.1 What we have been asked to do

The NSW Government asked IPART to review the current rating system and recommend reforms that aim to enhance councils' ability to implement sustainable and equitable fiscal policy.

Under our terms of reference, we are required to consider the following additional issues when developing our recommendations. These include:

- ▼ the rating burden across and within communities, including consideration of multi-unit dwellings
- ▼ the appropriateness and impact of current rating categories and exemptions, and mandatory concessions
- ▼ the land valuation methodology used as the basis for determining rates in comparison to other jurisdictions
- ▼ the capacity of a newly merged council to establish a new equitable rating system and transition to it in a fair and timely manner, and
- ▼ the objectives and design of the rating system according to recognised principles of taxation.

Our terms of reference also specify that we must take account of the Independent Local Government Review Panel's Final Report (Panel Report)<sup>3</sup>, the NSW Government's response to this report, and the 2013 NSW Treasury Corporation (TCorp) report '*Financial Sustainability of the NSW Local Government Sector*'.<sup>4</sup> We are required to recognise the importance of the Integrated Planning and

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<sup>3</sup> Independent Local Government Review Panel, *Revitalising Local Government*, October 2013, at <http://www.localgovernmentreview.nsw.gov.au/>, accessed 11 August 2016.

<sup>4</sup> NSW Treasury Corporation, *Financial Sustainability of the NSW Local Government Sector, Findings Recommendations and Analysis*, April 2013.

Reporting framework that allows NSW councils to draw various plans together and understand how they interact.<sup>5</sup>

In addition, our terms of reference require us to take account of the NSW Government's policy of encouraging urban renewal, as well as its commitment to protect residents against excessive rate increases and to provide rate concessions to pensioners.

A copy of our terms of reference is provided in Appendix A. The reports noted above are summarised in Appendix G.

### Interim Report on rate path freeze

Our terms of reference also ask us to recommend a legislative or regulatory approach to achieve the Government's policy that there will 'be no change to the existing rate paths for newly merged councils for four years'.<sup>6</sup>

We provided an Interim Report to the NSW Government on this issue in June 2016. We publicly released this report on 1 August 2016.

## 2.2 The current rating system in NSW

Councils provide a range of infrastructure and services to ratepayers in their local government area. To fund their costs, councils:

- ▼ levy rates on property owners in their area
- ▼ charge fees for the use of specific services (user charges)
- ▼ receive grants from the State and Federal governments
- ▼ generate other revenue, for example, from fines, developer charges and interest, and
- ▼ raise funds through borrowings.

This review only considers rates included in a council's general income.<sup>7</sup>

<sup>5</sup> Office of Local Government, *Integrated planning and reporting*, at <https://www.olg.nsw.gov.au/councils/integrated-planning-and-reporting>, accessed on 12 August 2016.

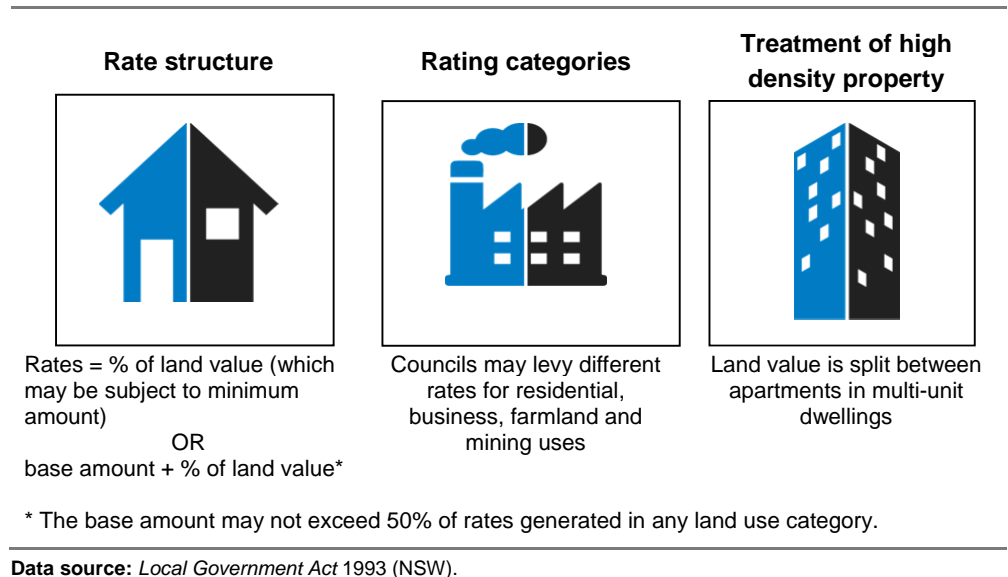
<sup>6</sup> NSW Government, *Media Release – Stronger Councils for Sydney and Regional NSW*, at <http://www.nsw.gov.au/media-releases-premier/stronger-councils-sydney-and-regional-nsw>, 18 December 2015, accessed 12 August 2016.

<sup>7</sup> This is income derived from ordinary rates, special rates and specified annual charges (section 505 of the *Local Government Act 1993* (NSW)). Special rates and charges for water and sewerage are not included in a council's general income.

The system that determines how these rates are currently calculated in NSW is set out in the *Local Government Act 1993* (LG Act).<sup>8</sup>

The following sections outline key features of this system and Figure 2.1 provides an overview of how council rates are set in NSW.

**Figure 2.1 How council rates are set in NSW**



### 2.2.1 Rate structure

Under the LG Act, a rate may consist of:

- ▼ an ad valorem amount (which may be subject to a minimum amount), or
- ▼ a base amount to which an ad valorem amount is added.

In NSW, an **ad valorem amount** is set as a proportion of the unimproved land value (UV) of the rateable property – that is, the value of the property without any buildings, houses or other capital investments.

A **minimum amount**, where applied, is a fixed charge which applies instead of the ad valorem amount, when it is greater than the ad valorem amount.

A **base amount**, where applied, is a fixed charge that is levied equally against all rateable properties within a given rate category, or subcategory of land use, in addition to the ad valorem amount.

<sup>8</sup> For more detailed information on the current rating system, see the LG Act (Chapter 15, Sections 491-607), and the NSW Department of Local Government, *Council Rating and Revenue Raising Manual*, 2007.

There is no restriction on the proportion of revenue a council can generate from the ad valorem amount included in rates. However:

- ▼ revenue generated from the base amount cannot exceed 50% of the total revenue from any particular rating category, and
- ▼ the minimum amount cannot exceed a statutory limit (set at \$506 in 2016-17<sup>9</sup>), unless approved by IPART.<sup>10</sup>

In 2013-14, the ad valorem amount accounted for 75% of all NSW council rate revenue. It is the primary method for raising rating income. Base and minimum amounts accounted for an average of 15% and 10% of council rate revenue respectively across NSW.<sup>11</sup>

### Treatment of high-density property

Where the rateable property consists of multiple units, such as a block of apartments, a single land value is determined for the site as a whole, and the assessed UV for an individual apartment is worked out by dividing the total land value according to each apartment's unit entitlement.

### 2.2.2 Rating categories

Councils may vary the way they calculate rates for different categories of property. For example, they can use a different percentage of the unimproved land value to calculate the ad valorem amounts, apply different minimum amounts, or add different base amounts. There are four main rating categories:

- ▼ residential
- ▼ business
- ▼ farmland, and
- ▼ mining.

Councils may also determine subcategories within each of these four categories, and vary the way they calculate rates for each subcategory. However, the degree of flexibility varies across categories. In particular, the LG Act requires that residential rates for all properties within a **centre of population** are calculated the same way.

<sup>9</sup> This ceiling only applies to ordinary rates. A different ceiling applies to special rates: \$2 (section 548(3)(b) of the LG Act).

<sup>10</sup> Councils that wish to set a minimum amount above the statutory limit are required to submit a minimum rate application to IPART for review and assessment. IPART has been delegated the authority to approve minimum amount variations by the Minister for Local Government.

<sup>11</sup> These are averages and not all councils apply these rates.

Finally, there are also a range of land uses which are currently exempt from paying rates (or exempt from paying a portion of rates). These include national parks, charities and education institutions.

### 2.2.3 Rate peg

The LG Act sets out a process that regulates the amount by which councils can increase their general income. The main component of general income is rates revenue from ordinary and special rates (see section 2.2.6 below).

Each year, IPART determines the maximum percentage by which a council may increase its general income in the coming year, known as the **rate peg**. We calculate this percentage based on the estimated annual change in NSW councils' costs, adjusted for an improvement in productivity. The total amount of general income collected from rates revenue is typically called the **rating burden**.

Councils then set their rates for each rating category so that their annual general income does not increase in percentage terms by more than the rate peg for that year. This gives them some flexibility to vary the increase in rates across categories (eg, to increase residential rates by a higher percentage than farmland rates), as long as the total increase in revenue does not exceed the rate peg.

### 2.2.4 Special variation process

Councils can apply to IPART for a **Special Variation** to allow them to increase general income above the rate peg for a range of reasons, including to provide additional services, to replace ageing assets, or improve financial sustainability.

The **Integrated Planning and Reporting** (IP&R) framework is an important part of the Special Variation process. As part of the IP&R framework, when applying for a Special Variation, councils are required to engage the community on how the funding required will deliver services and infrastructure that meet the community's expectations about service levels.

### 2.2.5 Growth outside the rate peg

Aside from Special Variations, councils can increase their general income 'outside the rate peg' through the **supplementary valuation process**. This involves a new value being assigned to a property due to changes being made to the property. For example:

- ▼ land rezoning (eg, the zoning of a property changing from farmland to residential or detached housing to multi-unit apartments), and/or
- ▼ changes in the number of rateable properties on the property (eg, through an increase in apartments or subdivision).

The growth in general income that results from supplementary valuations is determined by applying a council's current rating structure (ie, ad valorem and fixed charges across categories) to:

- ▼ the new value of the rezoned land (and to a different ratings category, if applicable), and/or
- ▼ the newly rateable properties.

### 2.2.6 Different types of rates

There are two different types of rates included in a council's general income:

- ▼ **Ordinary rates** – councils are required to make and levy an ordinary rate for each year on all rateable land in their area.
- ▼ **Special rates** – councils have the discretion to levy a special rate for:
  - works or services provided or proposed to be provided, or
  - any other special purpose.

Special rates can be levied on subgroups of ratepayers. For example, a special levy could be applied to all properties in a specific area or development, even if it is within a centre of population.

### 2.2.7 Land valuation process

Councils do not undertake the land valuations used to calculate the rates applicable to each property themselves. Instead, they are required to use the unimproved land valuations provided by the NSW Valuer General.

The Valuer General values all land in NSW, and provides services to a range of users including to the NSW Government for the purpose of levying land tax. In comparison, councils in Victoria and Tasmania have the option of using other valuers to estimate property values for the purpose of levying rates.

### 2.2.8 Infrastructure and services funded by rates

Typically, income from rates is used to fund (or partly fund) infrastructure and services that have the characteristics of 'public goods' or 'mixed goods'. Services with the characteristics of 'private goods' are generally funded through user charges (see Box 2.1 for more information.)<sup>12</sup>

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<sup>12</sup> The LG Act recognises this principle in allowing direct charges for services such as water and sewerage (section 501), mandating direct charges for waste (section 496), and not including these user charges in the council's general income for rates purposes (section 505).

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**Box 2.1 What are public, private and mixed goods?**

The infrastructure and services provided by councils fall into three categories:

- ▼ **Public goods:** where one person's consumption does not prevent others from consuming it and it is difficult or not practical to charge consumers to use it. Examples include local roads, footpaths and parks.
  - ▼ **Private goods:** where consumption by one person prevents another from consuming the same unit of that good. Examples include water, sewerage and garbage collection.
  - ▼ **Mixed goods:** that have a mixture of private and public good characteristics, such as libraries and community centres.
- 

## 2.3 Key tax principles

The key tax principles that we have used to assess the current rating system are:

- ▼ efficiency
- ▼ equity
- ▼ simplicity
- ▼ sustainability, and
- ▼ competitive neutrality.

Stakeholders generally agreed with us using these principles for our review. The sections below outline each of these principles.

### 2.3.1 Efficiency

Efficiency comprises two main sub-principles: the benefits principle, and the principle that taxes should minimise changes in behaviour.

#### Benefits principle

The income raised from rates is generally used to fund (or partly fund) infrastructure and services that have the characteristics of 'public goods' (see Section 2.2.8). The benefits principle is that each person's share of funding for public goods should be proportional to the benefits they receive from these goods.<sup>13</sup>

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<sup>13</sup> This is otherwise known as the **Lindahl tax** solution to funding public goods. The efficient level of provision of the public good is determined where the sum of individual benefits from providing an extra unit of the good equals the cost of supplying that extra unit.

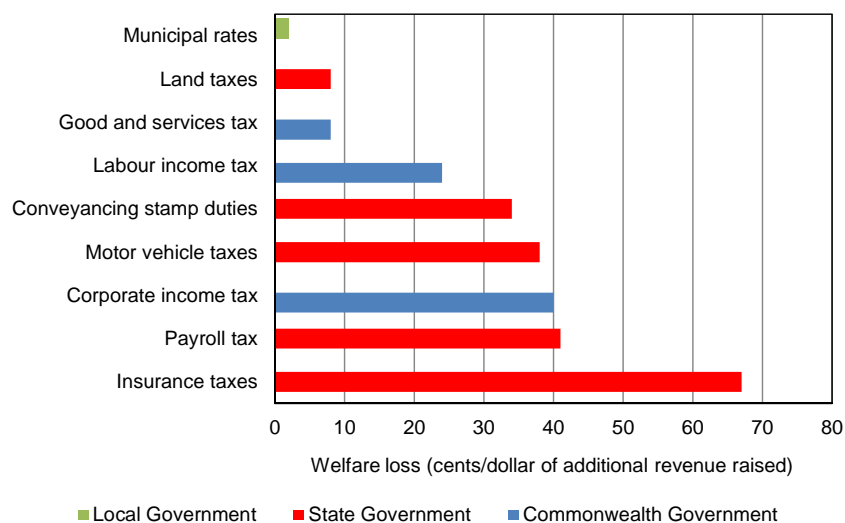
However, the benefits principle is difficult to apply because people generally understate their willingness to pay for the benefits that they receive from public goods.<sup>14,15</sup> In practice, proxies that are correlated with people's willingness to pay for public goods, such as the value of the property they own, are used to estimate benefits received.

### Taxes should minimise changes in behaviour

Taxes that minimise changes to production and consumption decisions are more efficient. The more that taxes that are designed to raise general revenue change behaviour, the greater the welfare loss.<sup>16</sup>

The Henry Tax Review found that local rates were the most efficient of all current taxes used by any level of government, because changes in behaviour from rate taxes are small. It estimated that for every dollar raised through rates, there were welfare losses of just 2 cents (Figure 2.2). In comparison, the welfare losses associated with other State and Commonwealth taxes ranged from 8 to 70 cents per dollar raised. Major State taxes such as payroll tax and stamp duty had an excess burden of 30 to 40 cents per dollar.

**Figure 2.2** Marginal welfare loss from a small increase in selected Australian taxes



**Data source:** Henry K, *Australia's future tax system – Final Report*, May 2010 (Henry Tax Review), p 13.

<sup>14</sup> A person's willingness to pay for goods should generally be equal to the benefits they receive from those goods.

<sup>15</sup> This is due to the **free-rider** problem. People have an incentive to under-state their willingness to pay for public goods, if their stated willingness to pay is then used as the basis on which taxes are levied on them.

<sup>16</sup> The welfare loss of taxation is known as the excess burden of taxation, and is the distortionary cost that taxes cause by reducing the amount of productive activity that would otherwise occur in a free market.



### 2.3.2 Equity

Equity also has three sub-principles: the benefits principle (discussed above), the ability to pay principle and the intergenerational equity principle.

#### Ability to pay

People should contribute to funding public goods according to their ability to pay. **Ability to pay** has two components:

- ▼ The **horizontal equity principle** requires people of equal capacity to pay the same amount of tax.
- ▼ The **vertical equity principle** requires people who are better off to pay more tax than those who are worse off, so the burden of tax is proportional to the taxpayer's means.

Property-based taxes such as rates are generally regarded as equitable, because property value correlates with wealth and ability to pay.

#### Intergenerational equity

Taxes should also be equitable over time. This means the current generation of ratepayers should not solely pay for services that also benefit future generations (and vice versa). It is therefore important that rates income grows over time to meet the costs of servicing new dwellings and a larger population.

This principle was not included in our Issues Paper, however, we have added it in response to stakeholder feedback.<sup>17</sup>

### 2.3.3 Simplicity

Taxes should be easily understood, difficult to avoid and have low costs of compliance and enforcement. If a tax is easy to understand and is fair, compliance is generally high.

Property-based taxes such as rates are generally hard to avoid, as the government holds comprehensive land ownership records.

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<sup>17</sup> See Bega Valley Shire Council, submission to IPART Issues Paper, May 2016, p 2.

#### 2.3.4 Sustainability

To be sustainable, the income generated by a tax should be reasonably reliable, able to withstand volatile economic conditions, and grow over time to support the future needs of government.<sup>18</sup>

#### 2.3.5 Competitive neutrality

Competitive neutrality requires businesses competing with each other to be treated in a similar way. This principle is used to promote fair and efficient competition between public and private businesses.

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<sup>18</sup> Our consideration of sustainability encompasses the requirement of the terms of reference to consider the current financial sustainability of local government in NSW, including the findings and deliberations of NSW Treasury Corporation report *Financial Sustainability of the NSW Local Government Sector*, 2013.

### 3 Allow councils to use CIV as an alternative to UV in setting rates

Currently, the LG Act requires NSW councils to use the unimproved value (UV) method as the basis for setting the variable charge included in a property's rates (the ad valorem amount). It also allows councils to include a base amount, or make the ad valorem amount subject to a minimum amount.

We considered whether changing these provisions would enhance councils' ability to implement sustainable and equitable fiscal policies. The sections below summarise our draft findings and recommendations, then discuss our findings and analysis in more detail.

#### 3.1 Summary of draft findings and recommendations on valuation methods

Councils should be able to choose either the Capital Improved Value (CIV) method or the UV method as the basis for setting the ad valorem amounts in a rating category for the following reasons:

- ▼ **CIV performs better against the tax principles in many circumstances but UV will be better in some circumstances.** In general, CIV is superior in developed areas because it results in rates that correlate more closely with the benefits the ratepayer receives and the cost of providing council services, and is more equitable, sustainable and better understood by ratepayers. UV can be efficient in areas where the level of development is low.
- ▼ **Allowing CIV would address the main drawback of the current system identified by stakeholders** – that UV cannot equitably and efficiently raise revenue from apartments. The proportion of apartments will continue to increase, and without reform, councils will increasingly need to use base and minimum amounts to raise revenue from apartments. This approach is both inefficient and inequitable, particularly the use of minimum amounts which often result in a low-value one-bedroom flat paying the same rates as a three-bedroom penthouse.
- ▼ **Allowing CIV would be consistent with best practice in other jurisdictions.** Internationally, there is a trend towards CIV. Our analysis of 125 countries found that around 85% now use a market value approach, such as CIV, and only five mandate UV.

- ▼ **Providing choice would allow councils to take account of local needs, and is consistent with stakeholder feedback.** A strong majority of councils support being able to choose either CIV or UV.

Importantly, the total amount of rates collected by a council will not change as a result of the valuation method they choose (CIV or UV).<sup>19</sup> They will, however, have improved options to collect these rates more equitably and efficiently.

In addition, provisions to set minimum amounts in rates should be removed from the LG Act, as base amounts are a more equitable and efficient way to recover fixed costs in rates. Currently, the requirement to use UV forces many councils to rely on minimum amounts to recover sufficient revenue from apartments. If they can use CIV, this would no longer be necessary.

### 3.2 Councils should be given the ability to choose either CIV or UV

Draft recommendation

- 1 Councils should be able to choose between the Capital Improved Value (CIV) and Unimproved Value (UV) methods as the basis for setting rates at the rating category level. A council's maximum general income should not change as a result of the valuation method they choose.

To reach our draft recommendation that councils should be given the ability to choose either the CIV or UV method as the basis for setting rates at the rating category level, we:

- ▼ analysed how each method performed against the key taxation principles
- ▼ analysed stakeholders' concern that UV cannot equitably or efficiently raise rates in urban areas with a high share of apartments
- ▼ considered the use of CIV and UV in other jurisdictions, and
- ▼ considered stakeholder views.

Our draft findings and analysis, and our reasons for recommending councils be given a choice, are outlined below. Box 3.1 provides some background on this issue, including the difference between the two methods.

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<sup>19</sup> A council's maximum general income would still be determined by the rate peg and special variation process.

### Box 3.1 Valuation methods and their use in setting rates

As Chapter 2 discussed, a property's rates include an ad valorem amount, which reflects the underlying value of the property. This amount is calculated by multiplying an ad valorem rate (a fixed percentage) by the assessed value of the property.

In NSW, councils are required to use the Unimproved Value (UV) method to assess this value. However, in a number of other jurisdictions, councils have a choice of methods including Capital Improved Value (CIV).

The key difference between the UV and CIV methods is that:

- ▼ UV only considers the underlying land value of a property, whereas
- ▼ CIV considers the underlying land value plus capital improvements.<sup>a</sup>

This difference means the methods produce very different assessed values for properties with significant capital improvements, such as a block of apartments or other high density buildings.

For example, to value an apartment under the UV method, the aggregate land value for the entire apartment block is first determined. Then, the value of an individual apartment is calculated by dividing the total land value according to each apartment's unit entitlement. This often results in values much lower than the combined market value of all the apartments, because the underlying land value is only a small component of the total value of the unit block.

<sup>a</sup> UV is the value of land subject to its highest and best use as permitted under current zoning. The CIV accounts for a property's permitted highest and best use, but also includes the net economic value of capital improvements (which will usually, but not necessarily, be greater than zero).

### 3.2.1 Performance of UV and CIV methods against tax principles

We analysed the performance of UV and CIV against the following tax principles:

- ▼ **efficiency**, including the benefits received principle and minimising changes in behaviour
- ▼ **equity**, including the ability to pay and benefits received principles
- ▼ **sustainability**, and
- ▼ **simplicity**.

Overall, we concluded that CIV generally performs better than UV on the benefits received principle, ability to pay principle, and in terms of sustainability and simplicity. However, UV better minimises changes in behaviour in areas where there are low levels of development.

### CIV is more consistent with the benefits received principle

Our draft finding is that property value (CIV) is generally a better measure than land value (UV) of the benefits that ratepayers receive from council services.

To reach this finding, we analysed whether a ratepayer's property value (CIV) or land value (UV) better reflects their demand for council services, and therefore the benefits they receive. (Box 3.2 outlines our approach for this analysis, and Appendix B explains the analysis in detail.)

#### Box 3.2 Approach for this analysis

To analyse whether a ratepayer's property value (CIV) or land value (UV) better reflects their demand for council services, we took the following steps:

1. Identify the council services that rates fund.
2. Identify the classes of property and different types of ratepayers within a council area.
3. Compare the relationship between the demand for council services to the two valuation methods for each class of property and type of ratepayer.

Table 3.1 provides an indicative breakdown of the services funded by rates, based on 'Net Cost of Services' data from councils' financial reports.

**Table 3.1 Services funded by local council rates**

Council service	Typical share of a rates bill (%)
Streets and footpaths	27.5
Facilities (parks, libraries, pools, etc.)	29.3
Other services (community and environment)	10.7
Governance and administration	32.5

**Source:** IPART analysis; OLG (using council financial statements).

Our analysis indicates that CIV **better** correlates with the demand for most of the services provided by council. This can clearly be seen when comparing the rates for a house and a block of apartments. Take the example of a house and a block of four matching apartments located next door on otherwise identical parcels of land such that their unimproved land value is identical:

- ▼ Under UV, the rates for the house and apartment block would be the same, so the rates for each apartment would be one-quarter of those for the house (on average).<sup>20</sup> However, the four households in the apartments are likely to create higher total demand for council services than the single household in the house.

<sup>20</sup> Assuming that no base or minimum amounts apply.

- ▼ Under CIV, the rates for the house and each apartment would be based on market value, which is likely to provide a better proxy for the demand for council services of each household.

With UV, as the density of the property increases, land value is divided among an increasing number of ratepayers who make a lower overall contribution to council rates. This is less equitable and efficient than using a CIV method.

CIV also better correlates with the demand for council services comparing the rates for two houses, or for two apartments. That is, a ratepayer in a more expensive house should typically have a higher willingness to pay for the public goods funded by rates (eg, they will be willing to pay more for footpaths and street lighting).<sup>21</sup> For two businesses, CIV tends to be correlated with demand for council services, but the arguments are not as persuasive as for residential property. For example, CIV better reflects the higher usage and congestion on local roads created by a multi-floor shopping centre relative to a single storey set of shops.<sup>22</sup>

#### It is not clear whether CIV or UV better promotes the efficiency principle

Our draft finding is it is not clear whether rates based on CIV or UV better promote the efficiency principle overall, as each method impacts on ratepayers' decisions.

In particular, there are two competing effects:

1. A UV method better meets the principle that taxes should minimise changes in behaviour to the extent that taxing capital investments discourages ratepayers from productive investments.
2. A CIV method can be a more efficient method to fund public goods to the extent that increases in capital and people increase the total cost of supplying council services. In this case, CIV more accurately recovers rates according to the benefits received by ratepayers, whereas UV can lead to the under provision of public goods by not capturing the demand for council services from new developments.

<sup>21</sup> Academic literature is consistent with this position, estimating that a 10% increase in income typically leads to an increase in demand for local public goods of between 2%-10% (depending on the good). Borchering and Deacon (1972) estimate the income elasticity of demand for local public goods, finding positive and (generally) significant elasticities between 0.2 and 1.0 (Borchering T and T Deacon, *The demand for the services of non-federal governments*, The American economic review, 1972, pp 891-901). Within apartments, a 10-storey apartment block with, say, 100 residents will have a greater demand for council services than a 5-storey apartment block with 50 residents occupying the same land size.

<sup>22</sup> For farmland properties, the UV and CIV methods should produce a relatively similar outcome, to the extent that the value of buildings and other capital structures relative to land value is fairly low and stable across properties.

Under a UV method, rates do not change if additional capital is invested into a property, and should not influence a ratepayer's decision to make capital improvements or develop their land. In contrast, under a CIV method, rates increase as additional capital is invested in a property, which may act as a disincentive to undertake productive investments.

When land is rezoned, UV also provides stronger incentives to develop property. When rezoning occurs, the UV will increase by at least the same 'dollar' amount as the CIV. However, because land value is typically less than property value, the percentage increase in UV from rezoning is greater than the percentage increase in CIV. This means that rates will typically rise more under UV when land is rezoned to a more valuable use.

As the Henry Tax Review noted, the UV method is only more efficient if an increase in rates will stop people from developing property.<sup>23</sup> In practice, the consensus is that these efficiency costs are small. The Henry Tax Review estimated that for every dollar raised through rates, there were welfare losses of just two cents.<sup>24</sup> The Productivity Commission has previously concluded that neither UV nor CIV "significantly distort economic activity and resource allocation".<sup>25</sup>

Conversely, as new development occurs and population increases, there will generally be an increase in demand for, and in the costs of providing, council services. Not recovering these costs from this development is inefficient because other ratepayers have to fund this burden, which can lead to the inefficient funding and provision of public goods provided by councils because of the narrower tax base.

On balance, we consider which method is superior in promoting efficiency will depend on the characteristics of the local community itself. A UV method will reduce distortions to capital allocation, but may lead to an inefficiently low provision of council services. In areas where there is a high – or rapidly increasing – number of apartments, a CIV method may more efficiently capture the cost of providing the right level of services across the community, with little cost in terms of distorting economic activity. On the other hand, in less built up areas, a CIV method may provide a disincentive to undertake capital improvements.

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<sup>23</sup> Henry K, *Australia's future tax system – Final Report*, May 2010 (Henry Tax Review), p 692.

<sup>24</sup> Henry Tax Review, p 13.

<sup>25</sup> Productivity Commission, *Assessing Local Government Revenue Raising Capacity*, 2008, p 177.



### CIV is more consistent with the ability to pay principle

Our draft finding is that CIV better meets the ability to pay principle than UV, as it is more highly correlated with the ratepayer's income and wealth, and both of these factors influence a ratepayer's ability to pay.<sup>26</sup>

The CIV of a ratepayer's property is more directly correlated to their wealth, because it includes capital improvements as well as land value, and therefore represents a larger component of household wealth. This is particularly important when comparing houses to apartments, as the land itself might be a very small fraction of the overall property value, particularly for apartments. In addition, CIV might be a better measure of ability to pay when comparing farmland to residential properties. This is because the land value for farmland is typically close to its market value, whereas residential land value will generally be materially below market value.

In addition, evidence from the 2007 New Zealand rates inquiry suggests that CIV is more highly correlated with annual household income than UV.<sup>27</sup> Overall, as noted by Abelson (2006), property values or income are both better indicators of ability to pay than are land values.<sup>28</sup>

### CIV is more consistent with the sustainability principle

Our draft finding is that CIV will provide a more sustainable rating base over time than UV. As CIV includes both the value of land and capital, it is a broader tax base.<sup>29</sup> This has two advantages:

1. Over time, as the proportion of high density dwellings increases, the ratio of capital to land increases, and CIV therefore becomes more broadly based relative to UV. The growth in CIV due to new development and land rezoning better approximates the increase in demand for council services. This is consistent with our draft recommendation in Chapter 4 that councils' growth in rates outside the rate peg should be calculated according to the change in CIV due to land rezoning and new development, rather than using UV.

<sup>26</sup> In practice, the two are related. A person's asset-based wealth is related to their expected lifetime income. A person's wealth also reflects their total capacity to pay at any point in time.

<sup>27</sup> New Zealand Local Government Rates Inquiry Panel, *Funding Local Government*, August 2007, pp 125-126.

<sup>28</sup> Abelson P, *Local Government Taxes and Charges*, 2006, p 5.

<sup>29</sup> The Grattan Institute estimates, across, Australia, the total value of capital improvements in 2014 was roughly equal to the total value of land, suggesting that CIV is about twice as broad a taxbase as UV. See Daley J and Coates B, *Property Taxes*, Grattan Institute Working Paper No. 2015-5, July 2015, p 5.

2. The market value of a property should vary less over a property price cycle than its land value. The value of capital improvements should be fairly constant, therefore, sharp changes in property prices will be reflected to a greater extent in the UV of a property than its CIV. As a result, a CIV tax will better withstand economic fluctuations – and the rate in the dollar for CIV will be less volatile than the UV tax rate.

### CIV is simpler to calculate and better understood by ratepayers

Our draft finding is that CIV is simpler and easier to understand than UV.

It is simpler to measure and verify a property's CIV than its UV, because nearly all real estate transactions involve properties that have capital improvements. Over time, the process used to assess UV in NSW has become less transparent, as determining land values has required subtracting the estimated value of improvements in the absence of vacant land sales.<sup>30</sup>

In addition, ratepayers are likely to find CIV easier to understand, as most people have a better understanding of the market value of their property than their unimproved land value.

### 3.2.2 Concern that UV cannot equitably and efficiently raise rates in urban areas with a high share of apartments

One of the key concerns stakeholders raised in our consultations was that the requirement for councils to use UV prevents them from raising rates equitably and efficiently in urban areas with a high share of apartments. Our draft finding is that this concern is justified.

In particular, because the UV of individual apartments is often very low, many councils rely on base and minimum amounts to attempt to reflect the use of council services, which would otherwise be accounted for by setting rates based on CIV. This is neither equitable nor efficient.

Base or minimum amounts (fixed charges), on their own, are not an equitable or efficient way to fund public goods. For example, with a minimum amount, the rates payable for a small one-bedroom apartment are the same as those for a three-bedroom penthouse. Fixed charges can be a simple and efficient way to recover the fixed costs of servicing dwellings such as providing billing services. But they are not, on their own, an efficient means to fund local public goods.

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<sup>30</sup> In most cases, UV is calculated as the residual of the market value less the value of improvements, which means that judgment is required in the analysis and accounting for the added value of improvements. For further details, see Mangioni V, *Transparency in the valuation of land for land tax purposes in New South Wales*, eJournal of Tax Research, 9:2, December 2011, p 145.

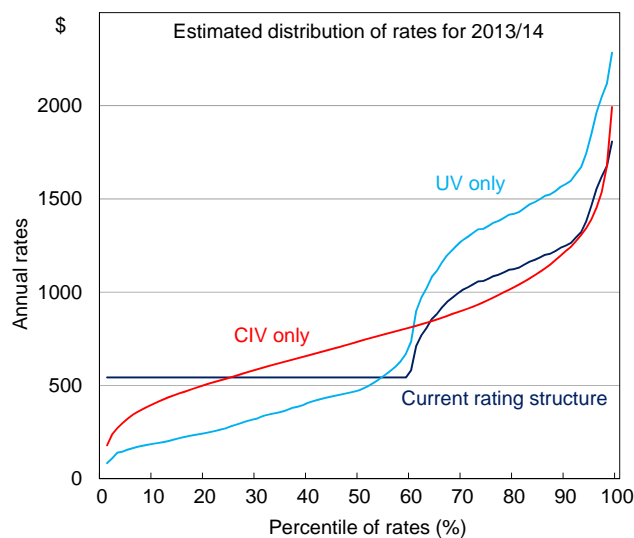
Figure 3.1 illustrates the impact of relying on base or minimum amounts for a Sydney council where around 60% of properties were apartments. Specifically, Figure 3.1 compares what the distribution of rates would look like for this council if it collected the same rates revenue using:

- ▼ a rate comprising an ad valorem rate based on UV (light blue line)
- ▼ the council's actual 2013-14 rating structure comprising a minimum amount and an ad valorem rate based on UV (dark blue line), and
- ▼ a rate comprising an ad valorem rate based on CIV (red line).

This comparison suggests the council is essentially using minimum rates as an imperfect tool to implement what would occur if it could choose a CIV method. It also shows there is no equity or efficiency for the bottom 60% of ratepayers on the current UV rating structure, as they all pay the same rates irrespective of the differences in the benefits they receive from, or their ability to pay for, council services.

This council reflects what many Sydney councils will look like in the future, with over 60% of dwelling approvals being for high density apartments. Currently, 40% of dwellings in Sydney are apartments – the highest of any Australian capital – with this share increasing over time (see Appendix C).

**Figure 3.1 Residential rates for a Sydney Council with a high concentration of apartments**

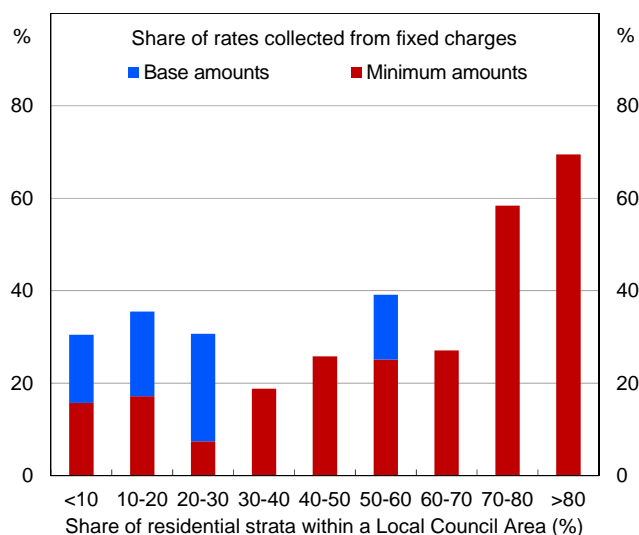


**Data source:** IPART analysis; Land and Property Information (LPI); Office of Local Government (OLG).

Across Sydney councils in particular, as the density increases in a council area, councils are tending to increase the share of rates they collect from minimum rates, to raise a more equitable share of revenue from apartments.

As Figure 3.2 shows, in areas where more than 70% of residential properties are apartments, councils tend to recover more than 60% of rates revenue from minimum amounts. In areas where more than 80% of residential properties are apartments, councils collect 70% of rates from minimum amounts. Overall, in Sydney areas where the council levies a minimum rate, around 40% of residential ratepayers were on this minimum rate in 2013-14.

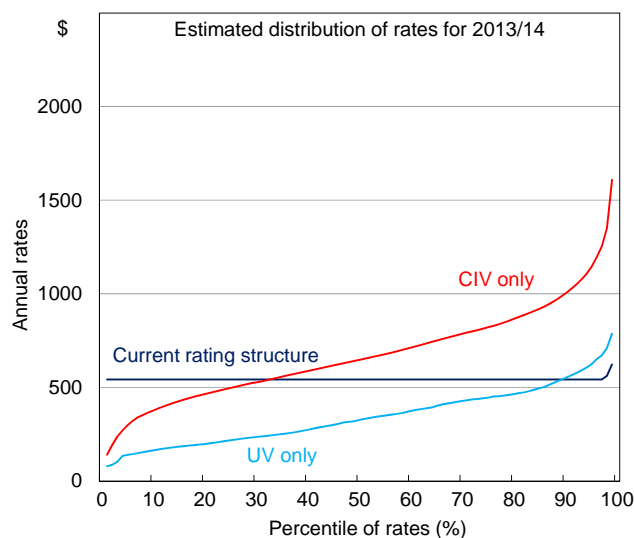
**Figure 3.2 Residential rates across Sydney metropolitan councils**



**Data source:** IPART analysis; LPI; OLG.

In addition, in areas where the share of apartments is high, the majority of apartments are paying the same minimum rate (Figure 3.3). That is, a one-bedroom studio apartment valued at \$200,000 pays the same rates as a three-bedroom penthouse valued at \$1,000,000. This means that minimum rates do not correlate with the per capita drivers of councils' costs, benefits received, or willingness and ability to pay for public goods.

**Figure 3.3 Residential rates for strata apartments in a typical Sydney Council**



**Data source:** IPART analysis; LPI; OLG.

These figures highlight that in areas where there is a high or growing share of apartments, the option to use CIV would likely increase the efficiency and equity of rates. Otherwise, over time as more apartments are constructed, these councils could increase reliance on minimum amounts to recover a greater proportion of their revenue from apartments.

### 3.2.3 CIV is more consistent with international best practice

Our draft decision is that CIV is more consistent with international best practice. Our review found that 85% of countries use CIV (or a similar method based on market value). Out of 125 countries, only five mandate UV (see Appendix D for more details).

In jurisdictions where councils can choose between CIV and UV – such as Victoria, South Australia, Tasmania and New Zealand – councils overwhelmingly opt for CIV over UV. We expect that most NSW councils would move to CIV if given the choice over the long term, consistent with this international experience.

### 3.2.4 Stakeholders support having a choice between CIV and UV

In submissions to our Issues Paper for this review, around 70% of councils supported giving councils the flexibility to choose between a UV and CIV method for determining the ad valorem amount in rates. A further 10% supported mandating a CIV method.

The remaining councils (around 20%) favoured retaining the UV method with little or no change. Most of these councils expressed the view that the cost to them of providing CIV data would be too high, and that a separate residential subcategory for strata apartments could adequately resolve current issues with rating apartments.

In addition to supporting choice between UV and CIV, a number of councils also recommended that councils should have the flexibility to choose between valuation methods at the rating category level.<sup>31</sup>

Stakeholders' feedback on the strengths and weakness of CIV and UV was consistent with our assessment against the tax principles. In particular:

- ▼ Most stakeholders agreed CIV was more consistent with the benefits received principle.<sup>32</sup>
- ▼ Stakeholders expressed mixed views on whether UV or CIV better minimises changes in behaviour. For example:
  - Some said the low level of rates means that neither a UV or CIV method would significantly distort investment. One council noted it did not consider "rates are an effective determinate or influencer of development and usage patterns due to the relative low cost of rates compared to development and accommodation expenses".<sup>33</sup>
  - Other stakeholders put the view that the "disincentive for ratepayers to make capital improvements under a CIV rating system is more relevant to commercial, industrial and farm land"<sup>34</sup> than residential properties.
  - A number of stakeholders considered UV had a clear advantage in encouraging productive improvements to land.<sup>35</sup>
- ▼ Stakeholders consistently agreed that CIV better reflected ability to pay, noting that "increases in market value due to improvements by the land owner correlate to a greater capacity to pay".<sup>36</sup> Some regional councils also said CIV might be valuable in meeting the horizontal equity principle between residential and farmland properties.<sup>37</sup>
- ▼ Most stakeholders consider CIV is more easily understood by ratepayers.<sup>38</sup>

<sup>31</sup> For example, Tamworth Regional Council, p 1, Riverina Eastern Regional Organisation of Councils, p 2, Goulburn Mulwaree Council, p 1, submissions to IPART Issues Paper, May 2016.

<sup>32</sup> For example, Campbelltown City Council, p 1, Blayney Shire Council, p 2, submissions to IPART Issues Paper, May 2016. On the other hand, Yass Valley Council, submission to IPART Issues Paper, May 2016, pp 1-2, did not agree with this assessment.

<sup>33</sup> Wollongong City Council, submission to IPART Issues Paper, May 2016, p 1.

<sup>34</sup> Port Stephens Council, submission to IPART Issues Paper, May 2016, p 5.

<sup>35</sup> See, for example, Urban Taskforce Australia, submission to IPART Issues Paper, May 2016, pp 1-2.

<sup>36</sup> Campbelltown City Council, submission to IPART Issues Paper, May 2016, p 1.

<sup>37</sup> See, for example, Blayney Shire Council, p 1, Coffs Harbour City Council, p 1, submissions to IPART Issues Paper, May 2016.

<sup>38</sup> For example, Warringah Council, p 2, Wingecarribee Shire Council, p 1, submissions to IPART Issues Paper, May 2016.

Several stakeholders also identified that councils would be able to reduce their reliance on either base or minimum amounts if the option to use CIV was available.<sup>39</sup>

### 3.2.5 Giving councils a choice would provide more benefits than mandating a single method

We analysed several alternative options for reforming the valuation method councils should use in setting rates (see Appendix E for more detail). Our draft finding is that giving councils the flexibility to choose between CIV and UV at the rating category is the best option, because:

- ▼ **It allows them to take account of local conditions and therefore is likely to lead to better economic outcomes.** For example, if a council considers using a CIV method would discourage investment in farmland properties but not residential properties, it can use CIV to rate residential property and UV to rate farmland.
- ▼ **It most closely aligns with stakeholder preferences.** As noted above, the large majority of councils support being provided with choice.

This flexibility is unlikely to increase inconsistency in the way rates are set between different properties within a council area. This is because councils already have a high degree of flexibility with the setting of business rates by centre of activity. In addition, our consultation with stakeholders suggests that most councils favour apportioning rates between categories using fixed shares.

#### Collecting CIV is valuable for other purposes

We also analysed the broader benefits and costs of collecting information to calculate CIV (see Appendix F). Our draft finding is that the benefits to NSW of this information are significant, while the costs are small provided CIV is implemented gradually.

Therefore, we consider the introduction of CIV could be structured so that councils are left financially no worse off. We think this is achievable, as our analysis suggests that there are large benefits to CIV that accrue to other levels of government and the financial sector.

CIV data should be collected even in council areas that continue to use UV as the basis for determining rates. This data would be needed if our draft recommendations to calculate growth outside the rate peg using CIV (see Chapter 4), and to levy the Emergency Services Property Levy on a CIV basis (see Chapter 10) are adopted.

<sup>39</sup> For example, Blayney Shire Council, p 2, The Hills Shire Council, p 2, Ashfield Council, p 2, submissions to IPART Issues Paper, May 2016.

### 3.3 Removing minimums from the rate structure

#### Draft recommendation

- 2 Section 497 of the *Local Government Act 1993* (NSW) should be amended to remove minimum amounts from the structure of a rate, and section 548 of the *Local Government Act 1993* (NSW) should be removed.

To reach our draft recommendation that minimum amounts should be removed from the rate structure, and the current provisions in relation to base amounts be retained, we:

- ▼ analysed how minimum amounts and base amounts performed against the key taxation principles
- ▼ analysed NSW councils' current use of these amounts, and
- ▼ considered stakeholders' views and current practice in other jurisdictions.

We concluded that base amounts are a superior method to recover the fixed costs of providing council services, as they better correlate with ratepayers' benefits received and ability to pay.<sup>40</sup> In addition, if our draft recommendation to give councils the choice to use CIV is adopted, the abolition of minimum rates will not financially constrain councils.

We consider minimum amounts should be phased out from 2020-21. This would allow councils sufficient time to move to new rate structures. It would also align with the end of the rate path freeze period for newly merged councils, when these councils would shift to new rate structures.

Our draft findings and analysis are discussed in more detail below. Box 3.3 outlines the current provisions for base and minimum amounts.

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#### Box 3.3 Current LG Act provisions on base and minimum amounts

As Chapter 2 discussed, under the current rate structure, rates may comprise:

- ▼ a variable ad valorem amount, which may be subject to a fixed minimum amount, or
- ▼ a fixed base amount to which an ad valorem amount is added.

The revenue collected from the base amount cannot exceed 50% of the total revenue from any particular rating category. In contrast, the constraint on minimum amounts is not as restrictive. While there is a statutory limit for minimum amounts (\$506 in 2016-17), councils that wish to set minimum amounts above this limit can submit a minimum rate application to IPART for review and assessment.

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<sup>40</sup> A rate structure with a base amount is better correlated with ability to pay because differences in property value are better reflected in the rates paid with a base amount than with a minimum amount.



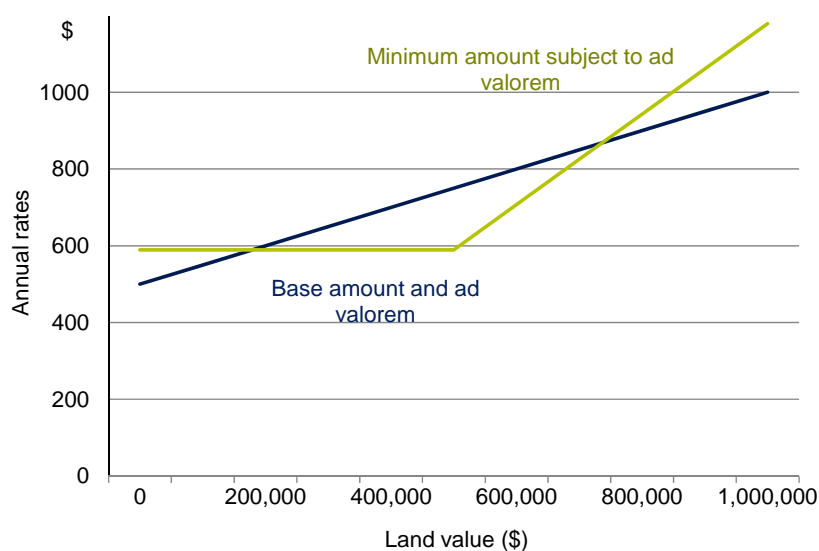
### 3.3.1 Performance of minimum and base amounts against tax principles

Our draft finding is that the use of base amounts is likely to be more efficient and equitable than minimum amounts to recover the fixed costs of servicing dwellings, such as providing billing services. This is consistent with previous research on current NSW rating practices.<sup>41</sup> This is because:

- ▼ Under a minimum amount, all ratepayers below a set threshold of land value pay the same amount. A one-bedroom apartment will face the same minimum rate as a three-bedroom apartment, for example.
- ▼ By contrast, under a base amount (with an ad valorem amount), all ratepayers face the same fixed charge to which an ad valorem amount is added. This means that a one-bedroom apartment will pay lower rates than a three-bedroom apartment, especially where CIV is used to set the ad valorem rate.
- ▼ This means that a base amount plus an ad valorem amount will more closely reflect the benefits received from council services, and differences in ratepayers' ability to pay.

This difference is highlighted in Figure 3.4. It shows that a base amount plus an ad valorem amount rate structure (the blue line) is both more equitable and more efficient than an ad valorem amount which is subject to a minimum amount.

**Figure 3.4 Comparison of base and minimum amounts**



<sup>41</sup> Comrie J, *NSW Government Rating and Charging Systems and Practices*, April 2013, p 9.

However, base amounts should not be set **above** the level required to recover fixed costs. Otherwise, this would not be consistent with tax principles, as base amounts do not reflect ratepayers' benefits received or ability to pay as closely as an ad valorem amount (whether based on CIV or UV).

For example, a dwelling with one occupant pays the same base amount as a dwelling with four occupants, although it is likely that the latter will derive a larger benefit from the public goods that councils provide. Further, base amounts also tend to place a greater burden on less well-off ratepayers, because owners of low value dwellings effectively pay a higher rate of tax than owners of expensive dwellings.

For this reason, we do not recommend any change to the current 50% restriction on revenue collected from base amounts. This will ensure, consistent with tax principles, that property value remains the predominant driver of a ratepayer's council rates.

### 3.3.2 NSW councils' current use of base and minimum amounts

Currently, most regional councils (62%) use a base amount in residential property rates, but most metropolitan councils (74%) use a minimum amount (Table 3.2). As Section 3.2.2 discussed, our analysis and consultations suggest this difference is partly due to a number of metropolitan councils using minimum amounts as an imperfect tool to raise sufficient revenue from apartments, as they are unable to use CIV as the basis for setting the ad valorem amount.

**Table 3.2 Use of base and minimum amounts by metropolitan and regional councils in 2013-14**

Type of rates	Metropolitan councils		Regional councils		All councils
	Number of councils	As a % of total metropolitan	Number of councils	As a % of total regional	
Residential rates					
Base	10	26%	74	62%	84
Minimum	28	74%	45	38%	73
Business rates					
Base	5	14%	63	56%	68
Minimum	30	86%	50	44%	80

**Note:** Includes total number of councils that applied base and/or minimum amounts for residential and business properties in 2013-14.

**Source:** IPART analysis based on revenue data collected by OLG from each council.

If our draft recommendation to allow councils the choice to use the CIV or UV valuation method is adopted, these metropolitan councils would be able to equitably and efficiently raise rates from apartments without the need for minimum amounts. We consider that removing minimum amounts from the LG Act would not have a major impact on regional councils, as the majority of these councils already use a base amount.

### 3.3.3 Stakeholder views on minimum and base amounts and current practice in other jurisdictions

Our draft recommendation to remove minimum amounts from the LG Act, and retain base amounts in the LG Act with no change to the 50% revenue cap, is consistent with stakeholder feedback. In submissions to our Issues Paper:

- ▼ The majority of stakeholders supported retaining some form of fixed charges (eg, base or minimum amounts) for a range of reasons, including smoothing the impact of land valuation on rates.<sup>42</sup>
- ▼ Several stakeholders also noted that base amounts are superior to minimum amounts.<sup>43</sup>
- ▼ Some councils, most in Sydney, supported retaining minimum rates in the rating structure to levy rates on apartments. However, our draft recommendation to allow these councils to use CIV or UV would allow them to do this more equitably and efficiently.
- ▼ Overall, stakeholders considered that the 50% revenue restriction on base amounts is appropriate. While some councils requested an increase to the 50% cap – in part, to resolve the issues with UV and the rating of apartments – the majority put the view that the current 50% threshold is appropriate.

The use of base and minimum amounts in other states varies. Our draft recommendation to abolish minimum amounts is consistent with rating practices in Victoria (Table 3.3). The 50% revenue restriction on base amounts is consistent with other Australian states, with no other state allowing councils to recover more than 50% of revenue from fixed charges.

<sup>42</sup> For example, City of Ryde Council, p 4, Cootamundra Shire Council p 3, Shoalhaven City Council, p 3, Gunnedah Shire Council, p 2, Coffs Harbour City Council, p 2, Western Plains Regional Council, p 3, submissions to IPART Issues Paper, May 2016.

<sup>43</sup> For example, Manly Council, p 1, Yass Valley Council, p 2, Hawkesbury City Council, p 1, Lockhart Shire Council, p 1, Queanbeyan City Council, p 4, submissions to IPART Issues Paper, May 2016.

3 Allow councils to use CIV as an alternative to UV in setting rates

**Table 3.3 Base and minimum amounts in other Australian states**

	Base amounts		Minimum amounts	
	Permitted	Limit	Permitted	Limit
Victoria	✓	20% of revenue	✗	N/A
Queensland	✗	N/A	✓	No restriction
South Australia	✓	50% of revenue	✓	35% of properties
Western Australia	✗	N/A	✓	50% of properties <sup>a</sup>
Tasmania	✓	50% of revenue	✓	35% of properties
<b>NSW (recommended)</b>	<b>✓</b>	<b>50% of revenue</b>	<b>✗</b>	<b>N/A</b>

<sup>a</sup> In Western Australia, no more than 50% of properties can be on a minimum rate if the minimum rate is \$200 or higher.

**Source:** *Local Government Act 1989* (Vic), *Local Government Regulations 2012* (Qld), *Local Government Act 1999* (SA), *Local Government Act 1995* (WA), *Local Government Act 1993* (Tas) and *Local Government Act 1993* (NSW).

## 4 Allow councils' general income to grow as the communities they serve grow

As the local community grows, the LG Act allows councils to increase their general income 'outside the rate peg' as new households and businesses are formed. It also allows councils to apply to IPART for a Special Variation to increase general income above the rate peg to provide additional services or improve financial sustainability.

We considered whether reforming these provisions would enhance councils' financial sustainability and encourage growth and urban renewal. The sections below summarise our draft findings and recommendations, then discuss our findings and analysis in more detail.

### 4.1 Summary of draft findings and recommendations on growth

Councils' rates income should increase over time in line with the growth in Capital Improved Value (CIV) arising from new residents or businesses.

- ▼ This would **promote growth and urban renewal**, and **reinforce a council's financial sustainability**. This is because the increase in a council's general income from new development would more closely match the increase in council's costs caused by servicing more people and businesses. Therefore, we have recommended this formula should apply to councils regardless of whether they choose the CIV or UV method for rating.
- ▼ Calculating growth using CIV would also **reduce the need for councils to apply for Special Variations (SVs)** as a result of growth. SVs would generally only be required when there is a significant shift in the local community's preference for a higher level of services.

Importantly, rates per household would not rise in real terms under our approach, but councils that experience growth would get larger rates income overall to compensate for the higher costs of servicing the larger number of residents and businesses.

We have also made two supporting draft recommendations that would better allow councils to help their communities grow. As councils become larger and more sustainable:

- ▼ they will be increasingly well placed to partner with other spheres of government to deliver infrastructure that benefits the local community. This is why we recommend introducing **a new type of special rate** to allow local councils to better partner with state and federal governments in the **delivery of joint infrastructure projects**.
- ▼ they may be better placed to adapt to short-term changes in the community. This is why we recommend **increasing the scope for councils to adapt pricing policies to short-term changes in their community**, while ensuring long-term financial sustainability.

## 4.2 Allowing general income to increase in line with the increase in CIV from new developments

Draft recommendation

- 3 The growth in rates revenue outside the rate peg should be calculated by multiplying a council's general income by the proportional increase in Capital Improved Value from supplementary valuations.
  - This formula would be independent of the valuation method chosen by councils for rating.

To reach our draft recommendation, we analysed whether the current process that determines the increase in a council's rates from growth in new ratepayers is sufficient to meet the increased demand for council services. We considered whether alternative formulas would better reflect these needs, maintain councils' financial sustainability and protect ratepayers from excessive rate rises.

### 4.2.1 Current practice with changes in rates income from growth

As communities grow, councils need to provide infrastructure and services to new people and businesses in a council area. Therefore, their revenue from rates (or general income) also needs to grow to allow them to meet these needs while maintaining their financial sustainability.

This process is known as 'growth outside the rate peg'. Determining this growth involves two steps.

Firstly, when a property changes, a new land value is determined for the property (or properties) under a 'supplementary valuation'. Changes to property values generally reflect growth and urban renewal, and include:

- ▼ land rezoning (eg, from farmland to residential or low-density housing to multi-unit housing), and/or
- ▼ changes in the number of rateable properties on a block of land (eg, if a block of land is developed into a block of apartments).

See Box 4.1 for more details on this process.

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#### **Box 4.1      The supplementary valuation process and CIV**

When changes to a property are recorded, a Supplementary Notice of Valuation is issued to determine a new land value, outside of the usual three to four year valuation cycle.

Supplementary valuations can occur due to:

- ▼ newly created parcels of land in subdivisions
- ▼ the transfer of part of land which is included in an existing valuation (eg, through strata division of an existing block)
- ▼ the amalgamation of parcels of land into a single valuation
- ▼ changes to zoning, or
- ▼ an error being detected in the valuation process.

In addition, under a CIV method, supplementary valuations would also occur if significant capital improvements are made to property. These could include improvements that occur at the conclusion of a Development Application or Complying Development process, but could exclude minor improvements that occur under the Exempt Development process.

**Source:** NSW Valuer General, *Supplementary Notice of Valuation*, at [http://www.valuergeneral.nsw.gov.au/land\\_values/notice\\_of\\_valuation/supplementary\\_notice\\_of\\_valuation](http://www.valuergeneral.nsw.gov.au/land_values/notice_of_valuation/supplementary_notice_of_valuation), accessed 8 August 2016.

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The second step involves **applying a council's current rating structure** (ad valorem and fixed charges across categories) to:

- ▼ the new value of the land (and to a different rating category, if land rezoning has resulted in a change in rating category), and/or
- ▼ the newly rateable properties.

Under the current UV methodology, the current 'growth outside the rate peg' process results in an increase in general income from new development that is typically much lower than the increase in costs of servicing new residents and businesses. This is because the land value will not increase as apartments are built unless there is land rezoning which increases land value.<sup>44</sup> Therefore, councils will only receive additional income by levying fixed charges (base or minimum amounts) across a larger number of properties.

In other words, if a 10-storey apartment block is built on a block of land, absent base and minimum changes, councils currently receive no increase in their general income to compensate for the larger population they are servicing.

If the change in CIV arising from new development was used to calculate the growth outside the rate peg, the increase in general income would better reflect the increase in costs of servicing new ratepayers. This is because the CIV will increase when additional capital is built, even when the underlying land value does not change.

Box 4.2 outlines the current 'growth outside the rate peg' process as new development occurs, and compares it against the increase in rates that would have occurred under a CIV method, using an actual strata subdivision in Port Stephens Council.

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<sup>44</sup> Furthermore, even if rezoning occurs, the increase in rates from the higher land value will be much lower than the growth in residents and businesses. Put simply, this is because as housing density increases, the land value becomes a smaller share of property value, and less representative of the costs of providing council services to ratepayers.



## Box 4.2 Growth in rates income due to new development

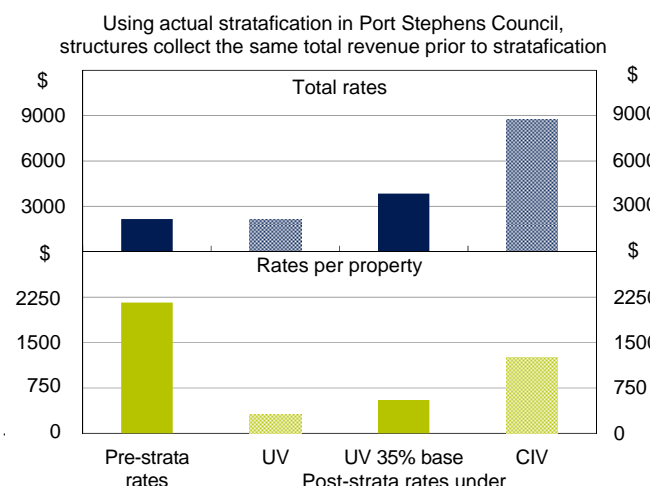
Figure 4.1 examines the change in rates income from a strata subdivision from one residence to seven strata units that occurred in Port Stephens Council. The analysis comes from land value and property sales information provided in Port Stephen's submission to our Issues Paper.<sup>a</sup>

It considers rates income prior to subdivision, and rates income following the subdivision using the following rate structures:

- ▼ an ad valorem rate only using UV as the valuation method
- ▼ Port Stephens Council's current rating policy which uses an UV ad valorem rate with a base amount collecting 35% of residential rates revenue, and
- ▼ an ad valorem rate only using CIV as the valuation method.<sup>b</sup>

The results are in Figure 4.1.

**Figure 4.1 Council rates income under strata subdivision**



This highlights the impact of the valuation method on rates income for strata subdivision. In this subdivision example, unless Port Stephens Council uses a base or minimum amount, it receives no uplift in revenue. Furthermore, even with the council's actual rates structure, the current method only delivers a modest uplift in total income even though the council is now servicing seven times as many households. The rates for the new households are around one-quarter of the rates prior to subdivision.

By contrast, if a CIV method was adopted for calculating the growth in rates from new development, Port Stephens Council's total rates would increase by around \$6000 per annum, roughly matching the increase in costs of servicing six new households.

<sup>a</sup> For further details, see Port Stephens Council, submission to IPART Issues Paper, May 2016, pp 2-6.

<sup>b</sup> The ad valorem and base amounts are set so that the council collects the same total income from residential property prior to the strata subdivision. The rate structures under UV use the current formula for calculating growth in rates outside the rate peg. The structure based on CIV is the basis of our recommended formula for calculating growth in rates income (see Section 4.2.2 for more details).

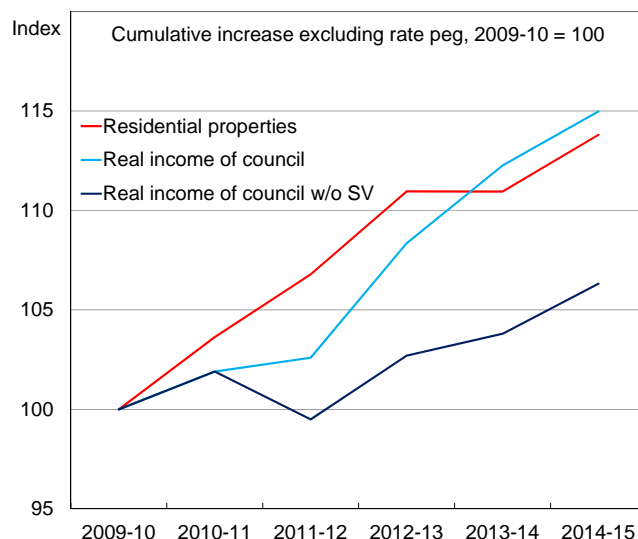
In particular, when land is strata titled, rates per dwelling fall substantially under the current 'growth outside the rate peg' formula. The impact at the council level becomes significant over time.

Box 4.3 compares the growth in residential properties to a Sydney council's real growth in council income with, and without, an SV that the council received. It highlights that the increased income from the SV was only able to match the growth in residential properties, and that the council would have experienced a real reduction in income per ratepayer without the SV. However, our view is the SV process should be used to deliver a higher level of services or new infrastructure, not also to offset losses in per capita revenue due to normal growth and urban renewal.

#### Box 4.3 The current system results in increased pressure to apply for SVs

This box analyses the growth in residential ratepayers against real growth in income for a metropolitan council over the period 2009-10 to 2014-15. Figure 4.2 below shows that the number of residential ratepayers has increased by 15% over this period, while total rates revenue would have only increased by 6% in real terms without an SV.<sup>a</sup>

**Figure 4.2 A metropolitan council's growth in residential properties and rates income**



<sup>a</sup> Real growth in income is calculated by subtracting the rate peg from council income.

Data source: OLG, IPART.

These two examples highlight the key drawbacks of the current system:

- ▼ **The current rating system is not orientated to deliver councils sustainable increases in income over time and pursue growth.** Councils' growth in revenue due to growth and urban renewal – currently based on changes in unimproved land value – does not compensate for growth in population and the increase in councils' cost of delivering services over time. Therefore, under current rate peg arrangements, councils that pursue growth may need to decrease service levels over time, or apply for SVs to maintain current service levels. In summary, the current system undermines council incentives to pursue growth and urban renewal, because they do not receive a commensurate increase in rates revenue to service new developments.
- ▼ **Councils have incentives to maximise base or minimum amounts as part of the rate structure.** This is because fixed charges (base or minimum amounts) to new dwellings are added to a council's rate base, even if the total land value is unchanged. However, fixed charges should mainly be used to capture the fixed costs in servicing all dwellings, not to capture the total increase in costs from servicing additional properties. Hence, the incentive to maximise fixed charges in the rate structure runs contrary to efficiency and equity tax principles.

#### 4.2.2 A better formula for calculating 'growth in rates outside the peg'

**Growth outside the rate peg should instead be scaled by the percentage change in CIV due to supplementary valuations according to the formula:**

$$Income_{Year\ 2} = Income_{Year\ 1} \times (1 + peg) \times (1 + percentage\ increase\ in\ CIV\ due\ to\ supplementary\ valuations)$$

This formula ensures that rates revenue increases in proportion to the increased cost of providing council services over time. As it is more consistent and sustainable, we recommend that this growth factor be applied for all councils in NSW, independent of the valuation method chosen by a council. Hence, information on CIV would need to be collected in all council areas, even for those where UV is used as the basis for rates.

In addition, the benefits of collecting CIV to other sectors of the economy primarily accrue if the information is collected state-wide (see Appendix F). Information on CIV would also be required in all council areas if used as the basis for levying the Emergency Services Property Levy which we recommend (see Chapter 10).

The change in CIV formula we recommend ensures:

- ▼ total rates income for councils increases in line with the growth in costs
- ▼ general changes in property prices (captured through asset revaluations) do not increase a council's rates income
- ▼ councils are not encouraged or discouraged to adopt one valuation method over another
- ▼ the rates structure that a council adopts does not influence the growth in a council's rates income from new developments, and
- ▼ councils receive the appropriate income from changes in land use and zoning.

Our approach would reduce the need for councils to apply for SVs to generate additional income.

- ▼ Councils that experience population growth would not have as much pressure to increase rates through an SV.
- ▼ Reductions in SV applications reduce regulatory costs to councils.
- ▼ Councils would still apply for SVs if there is a change in demand for council services, but not because they are pursuing growth and urban renewal.

This formula would likely be superior to other methods. For example, an alternative formulation could be to scale general income by changes in population, as increases in population account for a large proportion of the increase in the cost of providing council services. While this also approximates growth in demand for council services, it is not as good as the change in CIV that we have proposed because:

- ▼ The change in population only accounts for changes in residential ratepayers, it does not account for growth in the number of businesses over time.
- ▼ CIV can be collected for a range of other purposes. Using population to scale changes in rates income would require relatively precise and timely information on population at the LGA level, which would incur additional cost and would not be as useful for other purposes.

This draft recommendation supports councils' long-term financial sustainability by ensuring that revenue increases match the growth in costs due to population growth and development, while continuing to protect ratepayers from excessive rate increases.

#### 4.2.3 Stakeholder feedback

Our draft recommendation is consistent with stakeholder feedback. While this aspect of our Issues Paper did not receive much feedback, a number of stakeholders identified that the interaction between the UV method and rate pegging arrangements often does not deliver sufficient growth in rates outside the rate peg.<sup>45</sup>

In particular, Port Stephens Council identified that a CIV methodology for calculating growth in rates outside the peg is “beneficial in...overcoming rate income growth constraints caused by the apportioning of land value according to strata unit entitlements.” Furthermore:

This issue potentially affects every council in the State and is not restricted to large metropolitan councils. Any additional rate income growth opportunity afforded to councils with large numbers of strata title properties through the use of CIV should also be given to all councils including those with smaller numbers of strata subdivisions, not just selected LGAs...

What is considered a minor or modest financial benefit to a larger council may be significant to a smaller council, and council size should not be a determinant of whether the financial advantages of CIV are excluded from an LGA.<sup>46</sup>

Our draft recommendation to allow councils to receive the growth in rates outside the peg using CIV will ensure that all councils receive the appropriate growth in rates income over time, regardless of which valuation method is more appropriate to the needs of the local community.

### 4.3 Levying a special rate for joint delivery of new infrastructure projects

Draft recommendation

- 4 The *Local Government Act* 1993 (NSW) should be amended to allow councils to levy a new type of special rate for new infrastructure jointly funded with other levels of Government. This special rate should be permitted for services or infrastructure that benefit the community, and funds raised under this special rate should not:
- form part of a council's general income permitted under the rate peg, nor
  - require councils to receive regulatory approval from IPART.

As councils become larger and achieve long term financial sustainability, they will be better positioned to co-fund joint infrastructure projects with the State and Federal Government that benefit the local community.

<sup>45</sup> Port Stephens Council, pp 2-6, Fairfield City Council, p 1, submissions to IPART Issues Paper, May 2016.

<sup>46</sup> Port Stephens Council, submission to IPART Issues Paper, May 2016, p 2.

Section 495 of the LG Act allows councils to levy special rates on any subset of rateable land within its area to meet the costs of delivering additional services, facilities or activities to ratepayers.

However, the application of the current special rate provisions to joint infrastructure projects might be limited in practice. The application of special rates might be limited to the goods, services and facilities currently outlined in Chapters 5 and 6 of the LG Act.<sup>47</sup> In other words, they cannot be used to co-fund infrastructure or services that fall within another sphere of government's service functions, even if they benefit the local community. For example, City of Sydney Council has levied a special rate to construct infrastructure and services that surround a light rail line, eg, footpaths, as these are within a local council's service functions. However, the special rate was not used to co-fund the rail line itself, as providing rail is a state, or federal, function.

If infrastructure built by the State and/or Federal Government directly benefits the local community then a special rate could be permitted to collect revenue for this explicit purpose, regardless of which level of government constructs the infrastructure. This is particularly relevant as councils develop greater strategic capacity and ability to effectively partner with other levels of government.

The rates used to fund joint infrastructure should be outside a council's general income. This is because the infrastructure being provided is outside the core services for which councils collect rates. This will encourage urban renewal, and better partnering by councils with the State and Federal Government without regulatory burdens. This will also reduce the need for council's to apply to IPART for Special Variations to fund joint infrastructure projects.

#### 4.3.1 Stakeholder feedback

Overall, our draft recommendation to provide additional tools to encourage joint partnering by local councils with other spheres of government is consistent with stakeholder feedback. While the majority of stakeholders were satisfied that the current system sufficiently supports urban renewal, a number of councils supported the view that councils should be encouraged to partner with other levels of government to promote urban renewal.<sup>48</sup>

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<sup>47</sup> While section 24 of the LG Act outlines that "a council may provide goods, services and facilities, and carry out activities, appropriate to the current and future needs within its local community and of the wider public", the LG Act is also fairly prescriptive in the list of council's service functions permitted under the Act (or other Acts such as the *Roads Act* 1993).

<sup>48</sup> For example, Narromine Shire Council, submission to IPART Issues Paper, May 2016, p 1.

A number of stakeholders also identified limitations with the current provisions for special rates under section 495 of the LG Act, for example:

- ▼ Newcastle City Council considered the fact that any income under these special rates is included in councils' general income acts as an impediment to funding urban renewal initiatives.<sup>49</sup>
- ▼ Warringah Council identified urban renewal could be encouraged by reducing the regulatory burden associated with adopting special rates.<sup>50</sup>

Our draft recommendation addresses both of these limitations.

#### 4.4 Increased ability for councils to set rates below the rate peg

Draft recommendation

- 5 Section 511 of the *Local Government Act* 1993 (NSW) should be amended to reflect that, where a council does not apply the full percentage increase of the rate peg (or any applicable Special Variation) in a year, within the following 10-year period, the council can set rates in a subsequent year to return it to the original rating trajectory for that subsequent year.

The NSW local government reforms aim to build “a stronger system of local government in NSW, with councils that are sustainable, well-managed and ready to play an active role in helping communities grow.”<sup>51</sup>

Councils need the ability to adapt pricing policies to short-term changes in their community's ability to pay, while ensuring long-term financial sustainability. This is consistent with the Integrated Planning and Reporting (IP&R) framework which requires NSW councils to prepare a 10-year Long Term Financial Plan that estimates the rates revenue a council expects to generate over this period.

Currently, councils have limited flexibility to set rates below the rate peg. Under the current provisions of the LG Act, a council that sets general income below the rate peg has only two years to return to the same rates trajectory. Our draft recommendation increases the ability for councils to protect ratepayers if the community experiences a short-term downturn, eg, as a result of drought or a downturn in commodity prices, while providing more time for councils to return to their sustainable long-term rates trajectory.

<sup>49</sup> Newcastle City Council, submission to IPART Issues Paper, May 2016, pp 4-5.

<sup>50</sup> Warringah Council, submission to IPART Issues Paper, May 2016, p 6.

<sup>51</sup> NSW Government, *Strengthening Local Government*, at <http://www.fitforthefuture.nsw.gov.au/strengthening-local-government>, accessed 8 August 2016.

#### **4.4.1 Allowing councils the flexibility to set rates that are responsive to local conditions**

The Long Term Financial Planning process under IP&R requires councils to estimate expected rates revenue for the next ten years along with other revenue and expenditure variables. These budgets are designed to be used in strategic expenditure and revenue decision making.

IP&R budgets allow a council to plan for long-term infrastructure spending, and determine the long-term rates trajectory required to fund this spending.

However, if a council decides to levy lower rates than the maximum permissible income in a year, for example, due to a downturn in commodity prices, section 511 of the LG Act only allows the council to recover the lost income within the next two years. Over a longer period, it does not allow a council to recover lost rates income or to return to the same rates trajectory that it planned to follow.

The illustrative example in Box 4.4 highlights the limitations of the current legislation and the benefits of our proposed reform.



#### Box 4.4 The current limitations with setting rates below the rate peg

This box highlights the limitations of section 511 of the LG Act in allowing councils to set rates below the rate peg.

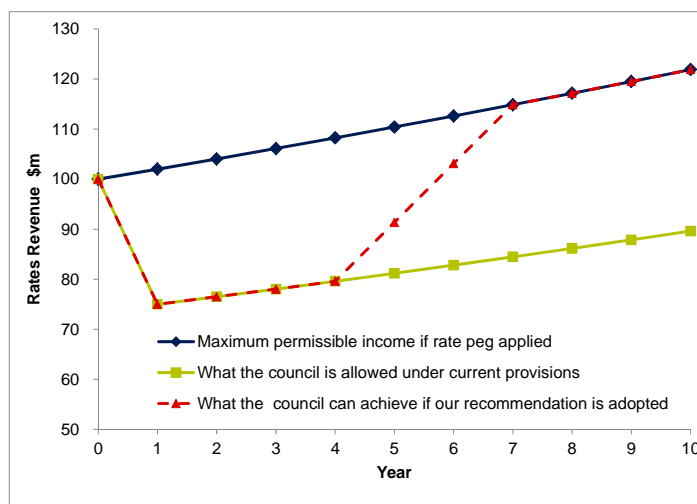
- ▼ In its Long Term Financial Planning Process a council ('Council A') has budgeted for revenues over the next 10 years (Year 1 to Year 10) based on the current year revenue of \$100 million and assumed rate peg of 2%. This revenue also meets Council A's long-term expenditures and ensures financial sustainability.
- ▼ However, in Year 1, Council A decides to collect only \$75 million rates revenue due to a drought in its LGA.
- ▼ In the subsequent 3 years (Year 2 to Year 4), the council applies the rate peg to the previous year's rates income in each year as drought conditions continue.
- ▼ In Year 5, there are no longer drought conditions in the community, and Council A would intend to return to its long-term rating trajectory.

Box 4.3 plots the rating trajectory that the council could follow under the following three scenarios:

- ▼ The revenue that Council A would be allowed to receive if it temporarily set rates below the maximum in Year 2 to Year 4 if our draft recommendation to allow councils a longer period to return rates to its long-term rating trajectory is permitted (red line).
- ▼ The revenue that Council A would be able to recover if it temporarily set rates below the maximum in Years 2 to 4 under the current provisions of the LG Act (green line).
- ▼ Council A's rates trajectory if it had applied the full rate peg percentage in all years (blue line).

Importantly, under the current LG Act, if Council A set rates below the maximum in Year 2 to Year 4, it would not be able to return to its sustainable long-term ratings trajectory without applying for an SV.

**Figure 4.3 Proposed approach to return to rates trajectory**



Under our recommended approach, Council A would be allowed to resume its sustainable long-term rates trajectory in Year 5. Council A would also be allowed to gradually transition back to this path over a few years if it deemed this was more appropriate. Our draft recommendation would help councils balance short-term fluctuations in their community's ability to pay while ensuring they are able to meet long term plans.

#### **The draft recommendation benefits councils with significant farmland and mining properties**

Our proposed reform, while beneficial to all councils, would particularly benefit councils with a substantial level of farmland and mining properties. The communities in their areas are most exposed to drought and changes in commodity prices, and these councils may wish to temporarily deviate from their rating structure to levy lower rates due to local economic factors.

Our draft recommendation would give councils the option, but not the obligation to set general income below the rate peg during periods of droughts or periods of lower commodity prices without having to permanently reduce the level of rates or services in the community. This would allow councils to play a more active role in working with their community, and better set rates and services based on local economic conditions.

### **4.5 The Special Variation process**

The terms of reference for this review require IPART to take account of the NSW Government's commitment to protect NSW residents against excessive rate increases.

As outlined in Chapter 2, councils that wish to increase their general income above the rate peg can apply to IPART for a Special Variation. Table 4.1 shows that since 2011-12 there have been 133 applications for an SV or a minimum rate increase, with around 60% of councils applying for at least one SV or minimum rate increase over this period. Over 90% of SV or minimum rate applications have been fully or partially approved in this period.

**Table 4.1 SV and minimum rate applications**

	Applications		Determinations		
		Full approval	Part approval	Declined	No determination
2011-12	23	9	10	4	0
2012-13	16	10	6	0	0
2013-14	24	21	3	0	0
2014-15	34	30	3	1	0
2015-16	23	22	1	0	0
2016-17	13	9	1	0	3 <sup>a</sup>
<b>Total</b>	<b>133</b>	<b>101</b>	<b>24</b>	<b>5</b>	<b>3</b>

<sup>a</sup> No determination was made by IPART because the 3 councils were dissolved under an amalgamation.

Source: IPART.

However, the SV process incurs a significant regulatory burden on councils and the State Government, which might have deterred some councils from applying for SVs. For example, Wentworth Shire Council noted that the cost of applying for an SV is almost equal to the additional revenue received in the first year of the SV.<sup>52</sup> In its response to the panel, the NSW Government noted that it “supports removing unwarranted complexity, costs and constraints from the rate-peg system”.<sup>53</sup>

Our core draft recommendation, that growth outside the rate peg should be scaled by the change in CIV, should significantly reduce the number of SV applications and reduce the cost of the rate-peg system. This is because rates per dwelling are held broadly constant over time, rather than the current system where rates per dwelling can significantly decline with growth from new developments.

This draft recommendation would also ensure a smoother rates trajectory for individual ratepayers. Ratepayers would potentially avoid sharper increases in rates under an SV, to catch-up a prior period of real rate decreases. This is consistent with the Government’s policy of avoiding excessive rate increases.

Under the proposed approach, a council that determines its base level of rates income using the SV process would no longer need to apply simply to compensate for growth. Councils would generally only need to apply for an SV to fund increases in the level of service to the local community.

<sup>52</sup> Wentworth Shire Council, submission to IPART Issues Paper, May 2016, p 1.

<sup>53</sup> Office of Local Government, *NSW Government Response: Independent Local Government Review Panel recommendations and Local Government Acts Taskforce recommendations*, September 2014, p 5.

In our Issues Paper, we highlighted three options suggested by the Panel Report to further reduce the costs and the constraints of the current SV process:

- ▼ streamlining the application and approval process for SVs
- ▼ introducing earned autonomy, where certain councils demonstrating consistent high performance could earn complete exemption from rate pegging, and
- ▼ replacing rate pegging with rate benchmarking.<sup>54</sup>

We have considered these points. We have concluded that our core draft recommendation, to calculate growth outside the peg using the change in CIV, would directly address the regulatory burden from rate pegging whilst ensuring residents are protected from excessive rate rises, consistent with NSW Government policy. It would do this by significantly reducing the future need for, and size of, SV applications.

#### 4.5.1 Stakeholder feedback

The majority of stakeholders disagreed with current rate pegging arrangements, instead viewing the introduction of IP&R, which requires councils to engage with the community to establish an appropriate resourcing strategy, as providing a sufficient framework to determine the level of rates.<sup>55</sup>

Stakeholders also noted broad support for streamlined rate pegging and earned autonomy.

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<sup>54</sup> Panel Report, pp 42-45.

<sup>55</sup> For example, Hawkesbury City Council, p 3, Queanbeyan City Council, p 6, Lockhart Shire Council, pp 2-3, submissions to IPART Issues Paper, May 2016.

## 5 Give councils greater flexibility when setting residential rates

Many stakeholders consider that the LG Act prevents metropolitan councils from setting different residential rates within their local areas. They have requested it be modified to give metropolitan councils greater flexibility when setting these rates. Rural and regional councils can already set different residential rates, as can councils in other jurisdictions.

We considered whether the current restriction on councils setting different residential rates remains appropriate, or whether it should be changed. The sections below summarise our draft findings and recommendations, and then discuss our findings and analysis in more detail.

### 5.1 Summary of draft findings and recommendations on setting residential rates

**Councils should have more flexibility to set different residential rates within their local areas.** This would allow them to set rates that take account of differences in access to, demand for and cost of providing council services across their residential ratepayer base. It would also assist them to be more responsive to local needs, reduce any cross-subsidies between areas and provide incentives for urban renewal. It would not lead to a change in the overall amount of rates collected, but rather would allow councils to set a more equitable and efficient distribution of the rating burden within their local area.

To manage the risk of ratepayers in some areas being subject to excessively high rates, **new protections to promote equity and transparency in setting different residential rates should be introduced.** These include rules around the maximum difference between the highest and lowest rates within an area, as well as a requirement for councils to provide ratepayers with information on different residential rates.

In addition, **new councils should (at the end of the 4-year rate path freeze) have the flexibility to establish new structures for residential rates, and transition to them appropriately.** Depending on its specific circumstances, a new council should be able to choose to equalise rates across its pre-merger areas, keep the existing rate structures in each pre-merger area, or move to a new rate structure. If it chooses to equalise its residential rates, this should be a gradual process, with rate changes limited to a maximum increase of 10 percentage points above the

rate peg (as adjusted for permitted Special Variations) in any year as a result of this equalisation.

## 5.2 Councils should have more flexibility to set different residential rates

### Draft recommendations

- 6 The *Local Government Act 1993* (NSW) should be amended to remove the requirement to equalise residential rates by 'centre of population'. Instead, councils should be allowed to determine a residential subcategory, and set a residential rate, for an area by:
  - a separate town or village, or
  - a community of interest.
- 7 An area should be considered to have a different 'community of interest' where it is within a contiguous urban development, and it has different access to, demand for, or costs of providing council services or infrastructure relative to other areas in that development.

Currently, the LG Act requires councils to equalise residential rates by setting the same ad valorem rate within a single 'centre of population'. This means that it can only set different rates where it can identify different centres of population within its area.

To assess whether this remains appropriate or should be changed, we examined the current requirement in the context of different NSW councils (including new councils formed by the recent mergers). We also considered stakeholders' comments and the practice in other jurisdictions. Our draft finding is that change is needed for the following reasons:

- ▼ to remove confusion about what the current requirement means
- ▼ to allow councils to tailor rates to local preferences for services, minimise any cross-subsidies, and provide incentives for urban renewal
- ▼ to allow councils to select the most efficient option to fund their services and infrastructure, and
- ▼ to allow councils to choose how to balance key tax principles when setting residential rates.

The analysis that supports this finding is outlined below. Box 5.1 provides further explanation of the draft recommendations above.

### Box 5.1 Further explanation of draft recommendations 6 and 7

Under our draft recommendations the 'centre of population' requirement would be removed from the LG Act, and replaced with provisions to enable a council to make a residential subcategory for an area, provided the area:

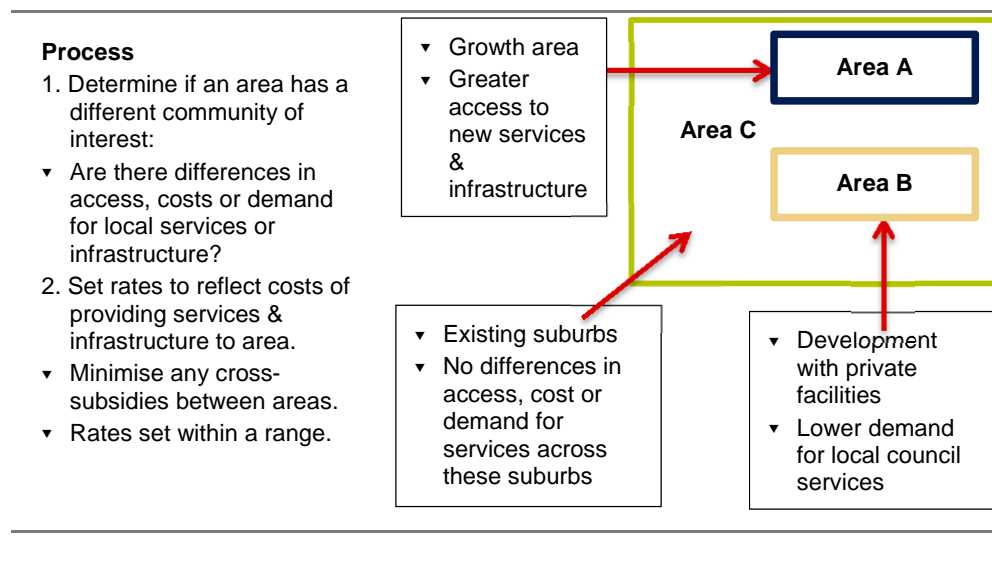
1. is a separate town or village, or
2. has a different community of interest.

An area would have a different 'community of interest' if it is within a contiguous urban development, and it has different:

- ▼ access to
- ▼ demand for, or
- ▼ costs of providing council services and infrastructure (when compared to other areas in that development).

The 'separate towns and villages' subcategory reflects the current OLG guidelines. It should be retained since rural and regional councils use it to set different rates for areas where there is a clear geographic separation between them.

The new 'community of interest' subcategory would provide greater flexibility to metropolitan councils. The figure below outlines how it could be used.



#### 5.2.1 The current 'centre of population' requirement is unclear

The meaning of the current requirement for setting different residential rates by 'centre of population' is not clear. In their submissions, several councils indicated they were confused about its application in urban areas.

Stakeholders generally thought that it prevents Sydney metropolitan councils from setting different residential rates within their local areas. This understanding appears to be consistent with the Office of Local Government (OLG) guidelines. However, a judicial interpretation of the requirement suggests the opposite.

### OLG guidelines

The OLG guidelines indicate that if an area is within a contiguous urban development, it would only constitute a discrete centre of population in very limited circumstances. Namely, the area must be independently serviced by infrastructure and have a separate community of interest.

The guidelines note that setting different residential rates may have limited application within the suburbs of the main urban centres. Further, councils should not use the 'centre of population' requirement to:

- ▼ set different residential rates within homogenous suburbs, or
- ▼ enable rating variations by street or any special feature (eg, proximity to water).

In contrast, the guidelines provide more scope for rural and regional councils to set different residential rates. They indicate that a council might identify discrete centres of population by separate towns or villages.<sup>56</sup>

### Judicial interpretation

The former South Sydney Council determined that the suburbs in its northern area made a disproportionate contribution to rates revenue in comparison with their utilisation of infrastructure. This area comprised 24% of the council's area, 24% of its road length and 12% of its parks, yet contributed 36% of its rate revenue.

The council addressed this disparity by establishing residential subcategories, and setting a different ad valorem rate and minimum amount for each subcategory:

- ▼ Southern Area (eg, Alexandria, Newtown, St Peters): 0.201% AV<sup>57</sup>, \$338 minimum
- ▼ Western Area (eg, Camperdown, Chippendale, Ultimo): 0.165% AV, \$327 minimum, and
- ▼ Northern Area (eg, Darlinghurst, Potts Point, Elizabeth Bay): 0.165% AV, \$327 minimum.

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<sup>56</sup> Department of Local Government, *Council Rating and Revenue Raising Manual 2007*, p 23.

<sup>57</sup> 'AV' means the ad valorem rate per dollar of land value.



It took the following factors into account when making these residential subcategories:

- ▼ the inequity arising from the disparity between contribution to revenue and services received, and
- ▼ whether the land within the proposed subcategories exhibited unique characteristics: community of interest, geographical cohesion, historical, traditional values and requirements.

The Land and Environment Court held that these were legitimate factors for the council to consider when exercising its power to determine ‘centres of population’ and make residential subcategories.<sup>58</sup>

### **5.2.2 Councils should be allowed to tailor rates to local preferences for services, minimise any cross-subsidies and provide incentives for urban renewal**

Most stakeholders requested greater flexibility to set different residential rates. Many of them commented that, within a council’s area, there will be varying degrees of access to and demand for council services, as well as costs of providing those services.

Allowing different residential rates would promote a more efficient rating structure, by minimising any cross-subsidies between these areas. It could also provide incentives for greater private provision of services and urban renewal. It would not lead to a change in the overall amount of rates collected, but rather would allow councils to set a more equitable and efficient distribution of the rating burden within their local area.

#### **Councils are growing**

Larger council areas and growing populations mean more diverse communities, with variations in access, demand and costs across these communities. Some suburbs may have a higher or lower demand for council services compared to other suburbs within the council area. Alternatively, councils may incur relatively higher or lower costs providing services to some of their suburbs (see Box 5.2).

Allowing councils to set different residential rates would improve their ability to respond to local circumstances (ie, these differences in access, demand or costs) as they provide their services and infrastructure.

<sup>58</sup> *The Council of the City of Sydney v South Sydney City Council* [2002] NSWLEC 129.

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### **Box 5.2      Costs may vary because of local conditions**

Compared to the other suburbs in a council area, an area may have higher or lower costs. For example, it may be:

- ▼ a former industrial site, so providing parks may require higher remediation costs
  - ▼ prone to flooding, so building roads there may be more costly (eg, greater drainage requirements), or
  - ▼ in a bushfire zone, so buildings there may have to meet higher standards.
- 

### **Councils may have a mix of established and growth suburbs**

Ratepayers in councils that have a mix of established and growth suburbs may have different levels of access to or demand for council services. For example, growth suburbs may have a younger demographic or fewer facilities. These factors may lead to councils providing them with different services or infrastructure when compared to established suburbs.

Setting the same residential rate across established and growth suburbs may be inequitable. It could result in ratepayers from the established suburbs paying for services or infrastructure provided to the growth suburbs which they are unlikely to access.<sup>59</sup>

### **Councils may want to encourage private service provision, urban renewal and new development**

There are often differences in demand for local services between strata developments. Some strata developments provide significant private open space and facilities for their residents, which are maintained by the strata. In contrast, others do not offer these services, creating additional demand for councils to provide them.

Councils should have the flexibility to provide incentives for strata developments to offer these private services, by setting a lower residential rate. This may also encourage more urban renewal or new development within council areas.

### **Land values do not always address differences in access to services and infrastructure**

In some situations, councils may find that land values take account of differences in access to their services. Ratepayers with better access to council services may have a higher land value and therefore pay higher rates (assuming a uniform ad valorem rate). In this case, differential rating would be unnecessary.

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<sup>59</sup> We note that some of the funding for infrastructure in growth suburbs may come from development contributions under section 94 of the *Environmental Planning and Assessment Act 1979* (NSW).

However, factors other than access to council services are often the drivers of land values, particularly in metropolitan Sydney. These factors include proximity to public transport, beaches or waterways. So there may not always be a strong connection between the benefits received from local services (ie, access) and ad valorem rates paid. In these instances, setting different residential rates may be a useful option for councils.

### Councils can identify the beneficiaries who are likely to access their public goods

As Chapter 2 discussed, rates are used to fund a council's provision of public goods (eg, parks, roads), which are non-excludable (ie, difficult or impractical to charge users for). However, this does not necessarily preclude a council from setting different residential rates to reflect differences in access to these public goods. For example, it could identify a subset of ratepayers who are the likely beneficiaries of the public good, and so recover higher rates from them to account for this higher level of access.

Allowing councils to set different residential rates is consistent with practices in other jurisdictions. For example, Queensland councils can determine different residential rates based on land use, access to or consumption of council services.<sup>60</sup> Box 5.3 outlines the practice in Victoria.

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#### Box 5.3 Different residential rates in Victoria

- ▼ A council may apply a different rate to residential land, as well as other types of land (eg, business). If it does so, the council must specify its objectives of the differential rate, and publish these on its website.
- ▼ The highest rate that the council sets across all types of land (including residential) must be no more than four times the lowest rate.
- ▼ Ministerial Guidelines were introduced in 2013 to reduce complexity and inconsistent application of different rates across councils. For example, councils must provide evidence of assessing the different rates against taxation principles. The Minister has the power to prohibit rates that are inconsistent with the guidelines.
- ▼ The Victorian Government is looking to increase transparency in the levying of different rates. It will require councils to clearly specify how the use of different rates contributes to the equitable and efficient conduct of council functions.
- ▼ While Victorian councils have the flexibility to set different residential rates, they have generally not been used by metropolitan councils.

**Source:** Victorian Government, *Ministerial Guidelines for Differential Rating*, April 2013; Victorian Department of Environment, Land, Water and Planning, *Act for the future, Directions for a new Local Government Act 2016*.

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<sup>60</sup> Queensland Department of Infrastructure, Local Government and Planning, *Rates and Charges*, at <http://www.dilgp.qld.gov.au/local-government/finance/rates-and-charges.html>, accessed 15 July 2016.

### 5.2.3 Councils should be able to select the most efficient option to fund their services and infrastructure

Currently, there are several options available to councils to fund their services and infrastructure. For example, councils can use:

- ▼ user charges, to fund services that have the characteristics of private goods (eg, water, sewerage, garbage collection)
- ▼ developer contributions or special rates, to fund public or mixed goods that benefit a particular group of ratepayers (eg, footpaths, roads, drains)
- ▼ debt, to fund either types of goods, and
- ▼ base amounts, to ensure a fixed amount is recovered from each ratepayer.

Councils are likely to experience increasing variations in access, demand and costs across their communities. Therefore, the existing funding options may not provide councils with sufficient flexibility when determining how best to fund their services and infrastructure.

We noted that the LG Act already includes a provision to allow councils this flexibility to set different residential rates. Further, there may be instances when differential rating may be a more efficient funding option than the alternatives (see Box 5.4).

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#### Box 5.4 Councils can select the most efficient funding option

In the examples below, councils may consider it is more efficient to set different residential rates rather than use special rates or base amounts to address differences in access, demand or costs between areas.

##### Different residential rates vs special rates

- ▼ Where ratepayers in an area are receiving services that are not benefiting the wider council area, councils can currently use special rates to levy those ratepayers.
- ▼ Special rates may not be a feasible option where an area is imposing a lower cost, rather than higher cost, on council. This may occur where the area has a lower demand for services relative to the council area norm (eg, strata developments that provide private services – see Section 5.2.2). In this instance, a different residential rate may be a more efficient funding option.

##### Different residential rates vs base amounts

- ▼ Setting a base amount that all ratepayers must pay (irrespective of land values) allows councils to 'flatten out' the rating structure, which would otherwise be determined by ad valorem rates. It can help to reflect the benefits ratepayers receive from their local services. (See Chapter 3 for our draft findings on base amounts.) Differential rating may be another way of recognising these benefits, without the distortionary effects of base amounts.
-

#### 5.2.4 Councils should be able to choose how to balance key tax principles when setting residential rates

Setting residential rates (uniform or different) may involve a trade-off between key taxation principles – particularly vertical equity and efficiency.<sup>61</sup> Councils are best placed to decide how to balance these principles where they are in conflict, so they should be able to choose which to prioritise when setting their residential rates. In addition, allowing councils to set different residential rates would be consistent with most of these taxation principles.

##### Efficiency vs equity

Giving councils greater flexibility to set different residential rates would allow them to more closely align rates to the local services received by ratepayers. This would reduce any cross-subsidies between areas and thus improve the efficiency of rates. It would also promote the benefits principle, which is one of the dimensions of the equity principle.

To promote another dimension of the equity principle, vertical equity, councils would need to set rates so that ratepayers who are better off pay more than those who are worse off. That is, they would need to make the burden of taxation proportional to the ratepayer's ability to pay.

There is sometimes a conflict between the principles of vertical equity and efficiency. Under the current LG Act, many councils are unable to tailor their residential rates to local preferences. Rather, they must set the same ad valorem rate for residents. Residential ratepayers with higher land values pay higher rates than those with lower land values. This is irrespective of their access to or demand for council services, or the costs of providing them with those services.

In effect, this obliges Sydney metropolitan councils to prioritise the principle of vertical equity over other tax principles when setting residential rates within their areas. A better outcome may be to let councils determine the appropriate balance between equity and efficiency concerns within their diverse communities – through permitting different residential rates – and be accountable to their ratepayers at the ballot box.

Even if a council uses different residential rates, vertical equity issues could still be addressed to some extent. For example, using a single ad valorem rate within an area would ensure that residents with a greater ability to pay do pay higher rates than other residents in that area.

<sup>61</sup> Section 2.3 discusses the key tax principles.

## Sustainability

Differential rating would be a more sustainable approach to rating, compared with having a uniform rate across a council area, especially in larger and more economically varied council areas. Councils can more readily adapt their different rates to changing circumstances (eg, enlarged council areas, different types of strata developments or areas with a mix of established and growth suburbs).

## Simplicity

Having different residential rates would be more complex than having a single residential rate across a council's area. However, imposing transparency requirements on councils (such as those in our draft recommendation 8, discussed below) would improve ratepayers' understanding of different residential rates. This may mitigate any increase in rate complexity that accompanies a move to different residential rates from a single rate.

Differential rating would also simplify issues for new councils by giving them much better flexibility to efficiently and fairly deal with the existing rate structures they have inherited from the pre-merger councils.

For example, provided their pre-merger areas have differences in their access, demand or costs – and so comprise different communities of interest (see Box 5.1) – new metropolitan councils could choose to maintain the existing rate structures. This means that all residents may benefit from merger efficiencies.<sup>62</sup>

In contrast, the current LG Act requires many new councils to set a uniform residential rate across their areas, which may create 'winners and losers'. That is, some ratepayers will experience a decrease in their rates, whilst others will be exposed to rate increases (see Section 5.4.2).

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<sup>62</sup> As part of the *Fit for the Future* process, we assessed most pre-merger Sydney metropolitan councils as financially fit. This implies that these councils are expected over the long term to recover costs within their pre-merger areas. Allowing differential rating means a new council could choose to maintain its pre-merger rate structures (subject to the requirements outlined in Section 5.3) and apportion merger cost savings to all pre-merger areas in a way that ensures all areas benefit from the merger savings.

### 5.3 Protections should be introduced to promote equity and transparency in setting different rates

Draft recommendations

- 8 The *Local Government Act 1993* (NSW) should be amended so, where a council uses different residential rates within a contiguous urban development, it should be required to:
- ensure the highest rate structure is no more than 1.5 times the lowest rate structure across all residential subcategories (ie, so the maximum difference for ad valorem rates and base amounts is 50%), or obtain approval from IPART to exceed this maximum difference as part of the Special Variation process, and
  - publish the different rates (along with the reasons for the different rates) on its website and in the rates notice received by ratepayers.

If councils are allowed to set different residential rates, there is a risk that some ratepayers may be subject to excessive rates. To mitigate this risk, new protections should be introduced to promote equity and transparency.

#### 5.3.1 The highest rate should be no more than 1.5 times the lowest rate across all residential subcategories

We consider the maximum differential (ie, the difference between the highest and lowest residential rates) should be limited to 1.5 times within a contiguous urban development, without the need for regulatory oversight. That is, there can be a maximum of 50% difference between the highest and lowest amounts set by a council for both of the following rate components:

- ▼ the ad valorem rate, and
- ▼ the base amount.<sup>63</sup>

If a council wished to set a different rate that falls outside this range, it could apply to IPART for approval as part of the Special Variation process.

As an example, a council sets rates for Area A, comprising an ad valorem rate of 0.12% and base amount of \$150. It determines that Area B has a lower level of demand for its services. Under our proposed approach, it could set a lower rate structure for Area B. It could decrease the ad valorem rate to 0.08% and base amount to \$100 for Area B. If the council wanted to set an even lower rate structure in Area B – or a higher rate structure in Area A – it would require IPART approval to exceed the maximum 1.5 times limit.

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<sup>63</sup> In Chapter 3, we recommend that minimum amounts be removed from the LG Act. If they are retained, the maximum differential should also apply to minimum amounts.

The range only applies to the areas that are part of a contiguous urban development. This is because differences in access, costs or demand for local services in urban areas are unlikely to vary to the same degree as in rural and regional areas.

We analysed the existing residential rates that new councils have inherited from their pre-merger areas. For most new councils in metropolitan areas, the range between their existing rates was less than 1.5 times.

### 5.3.2 Councils should publish information on their different residential rates

If a council uses different residential rates within a contiguous urban development, it should be required to make these rates publicly available on its website. Further, it should publish on its website the reasons for the different rates, based on the access, demand and cost criteria outlined in Box 5.1. The council should also include this information on the different rates (and the reasons for them) in the rates notice received by ratepayers.

These transparency protections would be in addition to the existing Integrated Planning and Reporting process. Under this process, a council is required to include its proposed rates structure in its draft Operational Plan, which is publicly exhibited for at least 28 days before being finalised. This allows ratepayers to provide comments to the council on the proposed rates.<sup>64</sup> The final Operational Plan (including the different rates) is then made publicly available.

## 5.4 New councils should have flexibility to continue existing rate structures or establish new ones

### Draft recommendation

- 9 At the end of the 4-year rate path freeze, new councils should determine whether any pre-merger areas are separate towns or villages, or different communities of interest.
  - In the event that a new council determines they are separate towns or villages, or different communities of interest, it should be able to continue the existing rates or set different rates for these pre-merger areas, subject to metropolitan councils seeking IPART approval if they exceed the 50% maximum differential. It could also choose to equalise rates across the pre-merger areas, using the gradual equalisation process outlined below.
  - In the event that a new council determines they are not separate towns or villages, or different communities of interest, or it chooses to equalise rates, it should undertake a gradual equalisation of residential rates. The amount of rates a resident is liable to pay to the council should increase by no more

<sup>64</sup> NSW Division of Local Government, Department of Premier and Cabinet, *Integrated Planning and Reporting Guidelines for local government in NSW*, March 2013, pp 120, 122.



than 10 percentage points above the rate peg (as adjusted for permitted Special Variations) each year as a result of this equalisation. The *Local Government Act 1993* (NSW) should be amended to facilitate this gradual equalisation.

After the 4-year rate path freeze expires, new councils formed by the recent mergers should be allowed to establish new structures for residential rates, and transition to them appropriately. If a new council can identify separate towns or villages, or different communities of interest (see Box 5.1), it should be able to choose to:

- ▼ equalise rates across its pre-merger areas
- ▼ keep the existing rate structures in each pre-merger area, or
- ▼ move to a different rate structure.

#### 5.4.1 Proposed process for new councils

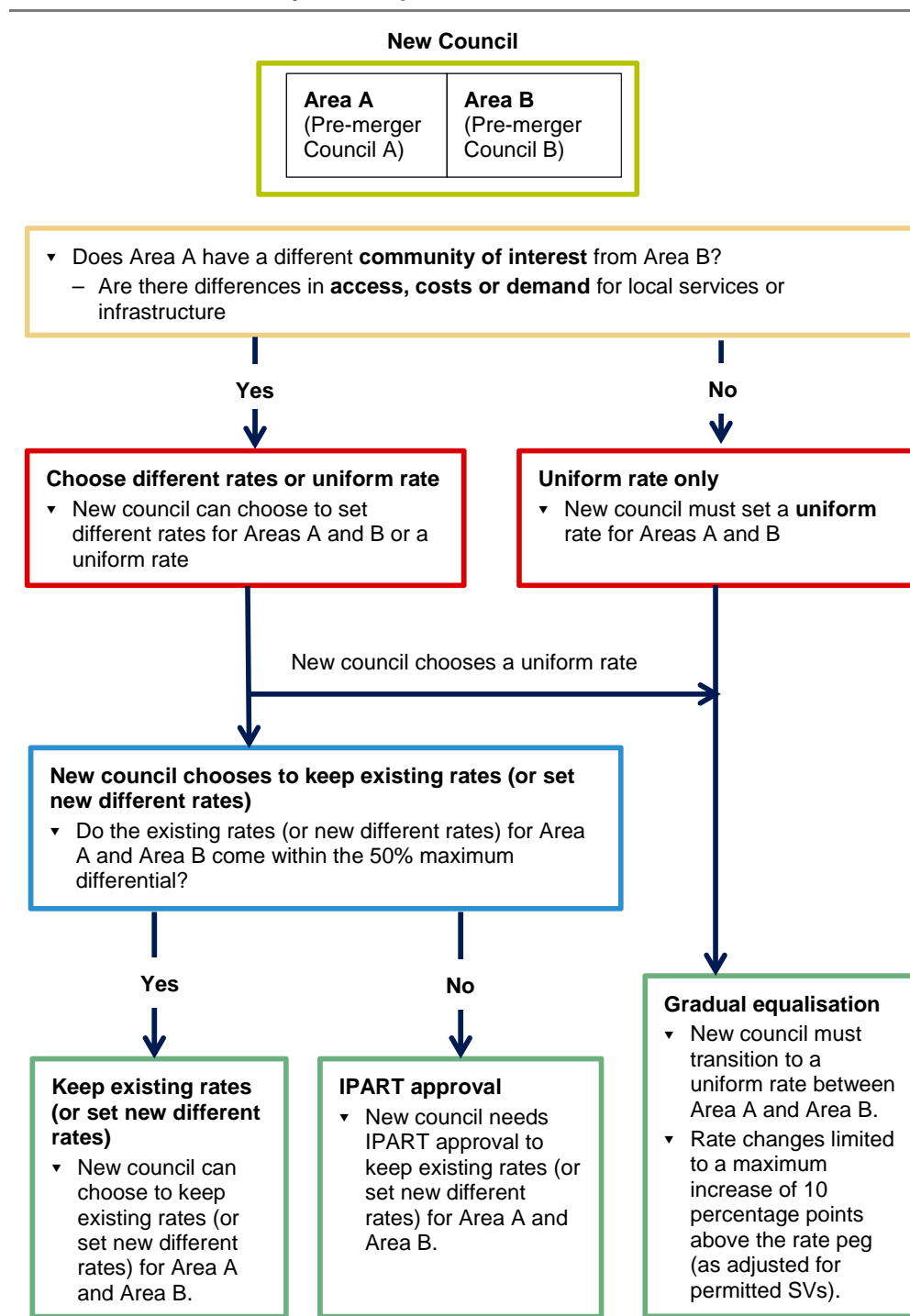
We propose that towards the end of the rate path freeze, a new council would assess whether its pre-merger areas are separate towns or villages, or different communities of interest (ie, they have differences in access, demand or costs).

For example, if a new metropolitan council determines that:

- ▼ Its pre-merger areas are **different communities of interest**:
  - The new council could set different residential rates for them using the existing rates or new different rates, provided these rates are within the 50% maximum differential (see Section 5.3). If the differential is greater than this maximum, the new council would need to seek IPART approval to maintain the existing rates or set the new different rates.
  - The new council could choose to equalise rates across the pre-merger areas, using the gradual equalisation process outlined below.
- ▼ Its pre-merger areas are **not different communities of interest**, the new council would need to undertake a gradual equalisation of rates (eg, transition over time, rates increase by no more than 10 percentage points above the rate peg – as adjusted for permitted Special Variations – each year as a result of this equalisation) (see Section 5.4.2).

This proposed process is outlined in Figure 5.1 and Box 5.5.

**Figure 5.1 Process for new metropolitan councils to set residential rates after the 4-year rate path freeze**



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**Box 5.5 Example of how a new council may choose to set residential rates after the 4-year rate path freeze**

Assume that a new council has been created from the merger of councils A and B (Area A and Area B) in a contiguous urban area.

- ▼ There is a similar land values per dwelling in Area A and Area B.
- ▼ The pre-merger councils set rates at \$1,000 per dwelling in Area A and \$700 per dwelling in Area B, reflecting demand preferences and supply costs in these areas.

**Rate equalisation**

Under the current LG Act, the new council would be required to equalise rates across Areas A and B. That is, it must set rates at \$850 in both areas. This leads to outcomes that may be unfair and inefficient. Either:

- ▼ Area B has to cross subsidise the residents in Area A by \$150 per ratepayer, or
- ▼ the new council starts decreasing service levels in Area A and increasing them in Area B, which may be contrary to the preferences of the respective local communities.

**Rate flexibility**

- ▼ Under our proposed approach, the new council could choose to:
    - keep the existing structure (provided it meets the criteria in Box 5.1)
    - equalise rates (using the gradual process outlined in Section 5.4.2), or
    - move to another rate structure, moving rates higher or lower in the two areas based on local demand preferences, costs of supply and access to council services (provided it meets the criteria in Box 5.1).
  - ▼ The new council may conclude that maintaining the existing residential rates in Area A and B is more efficient, sustainable and equitable than moving to a uniform residential rate (ie, equalising rates).
- 

**5.4.2 Gradual equalisation of rates for new councils**

Under the current LG Act, at the end of the rate path freeze, new councils would be required to equalise their residential rates immediately. This could expose some ratepayers to large increases or decreases in their rates.

If new councils are required to set a uniform residential rate (or choose to set such a rate – see Section 5.4.1), they should gradually equalise rates across their pre-merger areas. The amount of rates a resident is liable to pay to the council should increase by no more than 10 percentage points above the rate peg (as adjusted for permitted Special Variations) each year as a result of this equalisation.

This requirement would protect ratepayers by acting as a 'ceiling' on rate increases due to equalisation. Our analysis indicates it would also mean that most new councils could equalise their rating structures within five years after the rate path freeze expires in June 2020.

Councils would have the discretion to set a resident's rate changes below this ceiling during the equalisation process. While this may extend the timeframe for equalising rates, it would let councils take into account their ratepayers' ability to pay and ensure they are not exposed to excessive rate increases. In particular, it allows councils to factor in the amount of the rate peg (or any permitted Special Variations) when determining whether to go below the ceiling for equalising rates.

## 6 Better target rate exemption eligibility

The LG Act provides for a range of rate exemptions to be made largely based on who owns the land – for example, land owned by the Crown and religious bodies is exempt. We assessed the current exemptions to identify opportunities to improve their efficiency, equity and competitive neutrality. The sections below summarise our draft recommendations, and then discuss each recommendation and our draft findings and analysis in more detail.

### 6.1 Summary of draft recommendations on rate exemptions

Rate exemptions should be better targeted to ensure that ratepayers do not subsidise the costs of providing council services to properties where this is not justified on efficiency and equity grounds, and that properties with comparable uses of land attract the same rating treatment. In particular:

- ▼ **General exemptions should be based on land use not land ownership**, and land used for commercial or residential purposes should not be exempt, regardless of who owns it. This will help to ensure that land used mainly to deliver private benefits is not exempt from rates.
- ▼ **Some explicit exemptions should be retained or amended, as they are consistent with the general exemptions.** For example, these include those for land used by a religious body for that purpose, land vested in the NSW Aboriginal Land Council, and land owned by a hospital and used for that purpose.
- ▼ **Some explicit exemptions should be removed on the basis that the land is used for a commercial or residential purpose.** For example, these include those for land owned or vested in a water authority, land below the high water mark used for the cultivation of oysters, and land used for commercial logging.
- ▼ **Exemptions for land used for both exempt and non-exempt purposes should cover the portion used for exempt purposes only.**

In addition, councils' maximum general income should not be adjusted as a result of any one-off changes in exemption statuses resulting from implementing the above recommendations. Some further changes should also be made to increase the consistency and transparency of exemptions.

## 6.2 General exemptions should be based on land use not land ownership

### Draft recommendation

10 Sections 555 and 556 of the *Local Government Act 1993* NSW should be amended to:

- exempt land on the basis of use rather than ownership, and to directly link the exemption to the use of the land, and
- ensure land used for residential and commercial purposes is rateable unless explicitly exempted.

Rate exemptions mean the broad ratepayer base subsidises the cost of providing council services to those eligible for exemptions. To justify this, exemptions should be granted on efficiency and equity grounds. For example, they could be targeted at land used to generate substantial public benefits and not for land used to generate private benefits (see Box 6.1 for more information).

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### Box 6.1 On what grounds should rate exemptions be granted?

Where an activity provides substantial public benefits to the community, it may be equitable and efficient to exempt it from paying rates. For example, schools and hospitals generate public benefits. Requiring them to pay rates may result in them reducing their services below a socially optimal level.

It may also be equitable to provide exemptions where the organisation has limited ability to pay. For example, granting exemptions to religious or charitable institutions – which may have limited ability to pay rates – could allow them to spend more on public goods such as helping the disadvantaged, which results in better outcomes for society.

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Currently, the LG Act exempts several types of land from paying rates.<sup>65</sup> These exemptions are largely based on who owns the land, rather than how it is used. This has resulted in inefficient and inequitable outcomes, including:

- ▼ Exemptions being granted for land used to generate private benefits – for example, commercial logging in State Forests and commercial oyster farming on land below the high water market (ie, Crown land).
- ▼ Properties with comparable land uses being rated differently – such as a retirement village that is owned by a Public Benevolent Institution (PBI) versus one that is privately owned.<sup>66,67</sup>

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<sup>65</sup> Section 555 of the LG Act exempts certain land from all rates (see Table H.1 in Appendix H). In addition, section 556 exempts certain land from all rates other than water supply special rates and sewerage special rates (see Table H.2 in Appendix H).

<sup>66</sup> A Public Benevolent Institution is a type of charitable institution whose main purpose is to relieve poverty or distress. For more details, see [http://www.acnc.gov.au/ACNC/FTS/Fact\\_PBI.aspx](http://www.acnc.gov.au/ACNC/FTS/Fact_PBI.aspx)

<sup>67</sup> Cootamundra Shire Council, submission to IPART Issues Paper, May 2016, p 7.

- ▼ Cost advantages for exempt organisations that directly compete with the private sector – for example, government enterprises or charitable institutions that provide goods and services at commercial rates.

To improve efficiency, equity and competitive neutrality, we consider exemptions across all rating categories should be determined by land use, irrespective of ownership. In addition, all land used for commercial activities or residential purposes should be rateable, unless it is explicitly exempted.

### 6.2.1 Land used for commercial activities should be rateable

There are several reasons why land used for commercial activities (defined in Box 6.2) should be rateable:

- ▼ First, commercial activities generate private benefits and revenue. Therefore these ratepayers have the ability to pay, and should pay, rates.
- ▼ Second, commercial activities impose costs on council. Therefore, it is equitable and efficient that those responsible for the costs make a contribution to them by paying rates. This would also provide them with an incentive to minimise these costs.
- ▼ Third, granting exemptions for land used for commercial activities gives those conducting the activities a competitive advantage, which is contrary to the principle of competitive neutrality. This may lead to less efficient suppliers entering industries based on a tax advantage, or disadvantage efficient competitors.

In addition, making all land used for commercial activities rateable would be consistent with recent amendments to the LG Act that limited the scope of several exemptions to focus on land use, and exclude commercial use.<sup>68</sup>

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<sup>68</sup> In 2010, the LG Act was amended to limit exemptions granted to religious and charitable organisations. The exemptions available to these organisations would only apply to the parts of their land used for religious or charitable purposes, and not those parts used for commercial purposes.

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### Box 6.2 How we define commercial activity

An activity is considered to be a commercial activity if it:

- ▼ involves the selling of goods and/or services
- ▼ is provided at more than a nominal consideration<sup>a</sup>
- ▼ is undertaken on an ongoing basis
- ▼ is not the provision of a public service.

<sup>a</sup> The Australian Taxation Office (ATO) defines nominal consideration in the context of commercial activities of charities to be below 50% of market value (75% for supply of accommodation). ATO, *GST and non-commercial rules – benchmark market values*, at <https://www.ato.gov.au/printfriendly.aspx?url=/Business/Bus/GST-and-non-commercial-rules---benchmark-market-values/>, 15 June 2015, accessed 16 August 2016.

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#### 6.2.1 Land used for residential purposes should be rateable

Similarly, land used for residential purposes (defined in Box 6.3) should be rateable because this purpose generates a private benefit to the resident, rather than a public benefit to the wider community. Also, residential users impose costs on councils, so its owners should help to fund those costs.

In addition, removing the current exemptions for residential purposes based on land ownership would address a particular concern for councils that have a high proportion of social housing in their local areas.

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### Box 6.3 How we define residential activity

We consider residential purposes to be situations where a property is:

- ▼ predominantly used as a place to live
- ▼ occupied by the same resident continuously for periods of three months or greater.<sup>a</sup>

This would include residences such as Community Housing developments, retirement villages and student accommodation provided on University campuses.

<sup>a</sup> This definition is in place to ensure that genuine public good services such as temporary shelters are not considered residential activities for rating purposes.

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Social housing is rental housing that assists people who are unable to access suitable accommodation in the private rental market.<sup>69</sup> It has been traditionally provided by the NSW Department of Housing, which pays rates on land used for this purpose.

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<sup>69</sup> NSW Government, Family and Community Services, *Social Housing*, at <http://www.housing.nsw.gov.au/social-housing>, accessed 3 August 2016.



In recent years, the NSW Government has been transferring ownership of its social housing to PBIs. Since land owned by PBIs is currently exempt from paying rates (irrespective of whether it is used for residential purposes), any social housing transferred to them becomes non-rateable.

From an equity and commercial neutrality perspective the use of the land for social housing generates both private and broader community benefits. This raises the question of whether wider public policy objectives pursued by the State should be funded by the local community. Further, an exemption provides PBIs with a cost advantage over private providers of social or low cost housing. (see Box 6.4).

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**Box 6.4      Substantial exemptions can arise from PBIs providing social housing**

PBIs are increasingly providing social housing. In areas where social housing is growing, it leads to councils trying to deliver more services with a smaller rate base. This is unsustainable. For example:

- ▼ Sutherland Shire Council has 594 social housing properties in its local area. It indicated that transferring these properties to PBIs would result in an exemption worth \$2 million each year. This equates to an extra \$25 in rates a year for each remaining rateable household.
- ▼ Campbelltown Council has 5,500 social housing properties in its local area and another 350 properties held by community housing providers. It indicated that they currently generate \$6.5 million in rates each year. If these properties are transferred to a PBI and become exempt from rates, the council would have to raise this money from other ratepayers. This equates to \$109 a year for each remaining rateable household.

**Source:** Sutherland Shire Council submission, p 5; Campbelltown Council submission, p 6.

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## 6.2.2 Stakeholder support for basing exemptions on land use

In our consultations for this review, stakeholders broadly supported basing exemptions on land use rather than land ownership.<sup>70</sup> In addition, stakeholders expressed strong support for removing exemptions from land being used for commercial activities. For example, Port Stephens Council noted that:

The rationale for the removal of these (commercial) exemptions is that these land uses operate in a competitive market and so they should not enjoy a competitive advantage over private operators via rate exemptions.<sup>71</sup>

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<sup>70</sup> Warringah Council, Ku-ring-gai Council, Ashfield Council, submissions to IPART Issues Paper, May 2016.

<sup>71</sup> Port Stephens Council, submission to IPART Issues Paper, May 2016, p 10.

Several councils were also highly critical of the current exemptions for residential land use.<sup>72</sup> For example, Liverpool City Council and Campbelltown City Council submitted that the exemption that results from transferring social housing to PBIs is neither equitable nor sustainable.<sup>73</sup>

### 6.2.3 General impact of basing exemptions on land use rather than ownership

If our draft recommendations to base exemptions on land use, not ownership, and make land used for commercial activities or residential purposes rateable were adopted, some land uses would remain exempt, while others would become rateable. Table 6.1 provides examples of the likely impact of our broad recommendations on current exemptions.

**Table 6.1 Impact on current exemptions**

Remains exempt	Becomes rateable
Land used by Universities for educational purposes	Commercial logging in State Forests
Hospitals both public and private	Retirement villages
Land used by government and non-government schools for educational purposes	Child care centres charging market rates
Passenger Rail lines	University student or other residential accommodation
Land occupied and used in connection with religious purposes	Land used by a water corporation
Charities and PBIs where the activity is not residential or commercial in nature	Freight Rail lines
Crown Land not used for commercial purposes or privately leased	Social housing owned by PBIs

## 6.3 Some explicit exemptions should be retained or amended

Draft recommendations

11 The following exemptions should be retained in the *Local Government Act 1993* (NSW):

- section 555(e) Land used by a religious body occupied for that purpose
- section 555(g) Land vested in the NSW Aboriginal Land Council
- section 556(o) Land that is vested in the mines rescue company, and
- section 556(q) Land that is leased to the Crown for the purpose of cattle dipping.

<sup>72</sup> For example, see Ku-ring-gai Council, Narrandera Shire Council, submissions to IPART Issues Paper, May 2016.

<sup>73</sup> Liverpool City Council, Campbelltown City Council, submissions to IPART Issues Paper, May 2016.

**12 Section 556(i) of the *Local Government Act 1993* (NSW) should be amended to include land owned by a private hospital and used for that purpose.**

Some of the explicit exemptions currently included in the LG Act (listed in draft recommendation 11 above) require that the exempted land be used for a specific purpose, which is not commercial or residential in nature.<sup>74</sup> This means that these types of property are unlikely to be affected by our broad recommendations to base exemptions on land use discussed in Section 6.2 above.<sup>75</sup> Therefore, we recommend that they remain in the LG Act in their current form.

In addition, we recommend amending the current exemptions for hospitals to include land owned by a private hospital and used for that purpose.

### **6.3.1 Retaining exemptions for several activities with public and private funding**

The LG Act currently includes several exemptions that are partly funded by the State Government and partly funded by user fees. These include exemptions for non-governmental schools and passenger rail.

We recommend retaining these exemptions, as each of these activities are part funded by government and provide a public service – education and public transport, and so do not meet our definition of ‘commercial activity’ (see Box 6.2 above). In addition, retaining the exemptions for these activities is preferable on tax efficiency grounds, as levying rates is likely to result in a transfer of costs from local government to the less efficient State Government tax base.

For example, levying rates on non-government schools may result in higher fees and students switching back to government schools, or the State Government providing more funding to non-government schools to compensate for the rate payments. Both outcomes would result in the State Government having to raise additional funds through taxation – with a greater welfare loss than is currently the case.

<sup>74</sup> Part 2 Clause 4(2)(a) of the *Aboriginal Land Rights Regulation 2014* contains the stipulation that in order for the land to be exempt from rates under the LG Act that the land cannot be used for commercial or residential purposes.

<sup>75</sup> One exception is the exemption for the residence of a minister of religion. However as a significant part of a minister’s role is being available to the congregation at all times, it is reasonable to conclude that the residence is being used as part of a religious purpose.

### 6.3.2 Exempting private hospitals from paying rates

The LG Act explicitly excludes land owned by public hospitals from rates, but does not exclude private hospitals. We recommend amending this exemption to include land owned by private hospitals and used for this purpose. In general, private hospitals are serving the same population, are often co-located with public hospitals, and provide significant public benefits. In addition, as their activities are comparable to public hospitals, they should be treated the same way for rating purposes.<sup>76</sup>

## 6.4 Some explicit exemptions should be removed

Draft recommendation

13 The following exemptions should be removed:

- land that is vested in, owned by, or within a special or controlled area for, the Hunter Water Corporation, Water NSW or the Sydney Water Corporation (*Local Government Act 1993* (NSW) section 555(c) and section 555(d))
- land that is below the high water mark and is used for the cultivation of oysters (*Local Government Act 1993* (NSW) section 555(h))
- land that is held under a lease from the Crown for private purposes and is the subject of a mineral claim (*Local Government Act 1993* (NSW) section 556(g)), and
- land that is managed by the Teacher Housing Authority and on which a house is erected (*Local Government Act 1993* (NSW) section 556(p)).

We recommend removing these exemptions since in each case the land is being used for commercial or residential purposes, and so should be rateable. For example, water corporations are engaged in commercial operations.

Draft recommendation

14 The following exemptions should not be funded by local councils and hence should be removed from the Local Government Act and Regulation

- land that is vested in the Sydney Cricket and Sports Ground Trust (*Local Government Act 1993* (NSW) section 556(m))
- land that is leased by the Royal Agricultural Society in the Homebush Bay area (*Local Government (General) Regulation 2005* reg 123(a))
- land that is occupied by the Museum of Contemporary Art Limited (*Local Government (General) Regulation 2005* reg 123(b)), and

<sup>76</sup> This recommendation may also reduce State Government healthcare costs, as it will reduce costs for private hospitals which may result in patients substituting to private hospitals.

- land comprising the site known as Museum of Sydney (*Local Government (General) Regulation 2005* reg 123(c)).

The State Government should consider whether to fund these local rates through State taxes.

We recommend removing these mandatory exemptions from the LG Act and Regulation as these institutions are primarily commercial and the public benefits from their activities flow through to the wider community. Therefore, it may be more appropriate for the State Government to fund these exemptions through State taxes if it considers user charges should not be used by these institutions to fund local rates.

## 6.5 Exemptions for mixed-use properties should apply to proportion used for exempt purpose only

Draft recommendations

- 15 Where a portion of land is used for an exempt purpose and the remainder for a non-exempt activity, only the former portion should be exempt, and the remainder should be rateable.
- 16 Where land is used for an exempt purpose only part of the time, a self-assessment process should be used to determine the proportion of rates payable for the non-exempt use.

Some land may be used for a mix of exempt and non-exempt purposes. For example, a church may use one of the buildings on its land for religious purposes and rent another for a commercial activity. Or a Not-For-Profit organisation (NFP) may use a building for its own purpose half of the week, and rent it for a commercial activity during the other half.

In this situation, an exemption should only be granted in respect of the portion of space or time devoted to the exempt activities, and the non-exempt portion should be rateable. This is consistent with the current provisions of the LG Act, which require councils to rate the portion of the land that is not used for an exempt purpose.<sup>77</sup> It is also consistent with our draft recommendation 10, that exemptions should be granted on the basis of land use rather than ownership.

<sup>77</sup> For example, s555(5) of the LG Act: “A parcel of rateable land belonging to a religious body that is partly occupied and used in a manner described in subsection (1)(e), and partly in a manner that would result in part of the parcel not being exempt from rates under this section, is to be valued in accordance with section 28A of the *Valuation of Land Act 1916* to enable those rates to be levied on the part that is not exempt”

In general:

- ▼ Where the land can be divided on a **spatial basis** (ie, divided into parts that are used separately for exempt and non-exempt purposes), rates should be levied on the proportion of **land area** used for non-exempt purposes.
- ▼ Where the land can be divided on a **temporal basis** (ie, used for exempt and non-exempt purposes, but at different times) rates should be levied on the proportion of **time** the land is used for non-exempt purposes.

We have developed a process councils could use when rating this kind of mixed-use land, which is outlined below and summarised in Figure 6.1. Box 6.5 provides some examples of how it would work in practice.

### 6.5.1 Process for rating mixed-use land

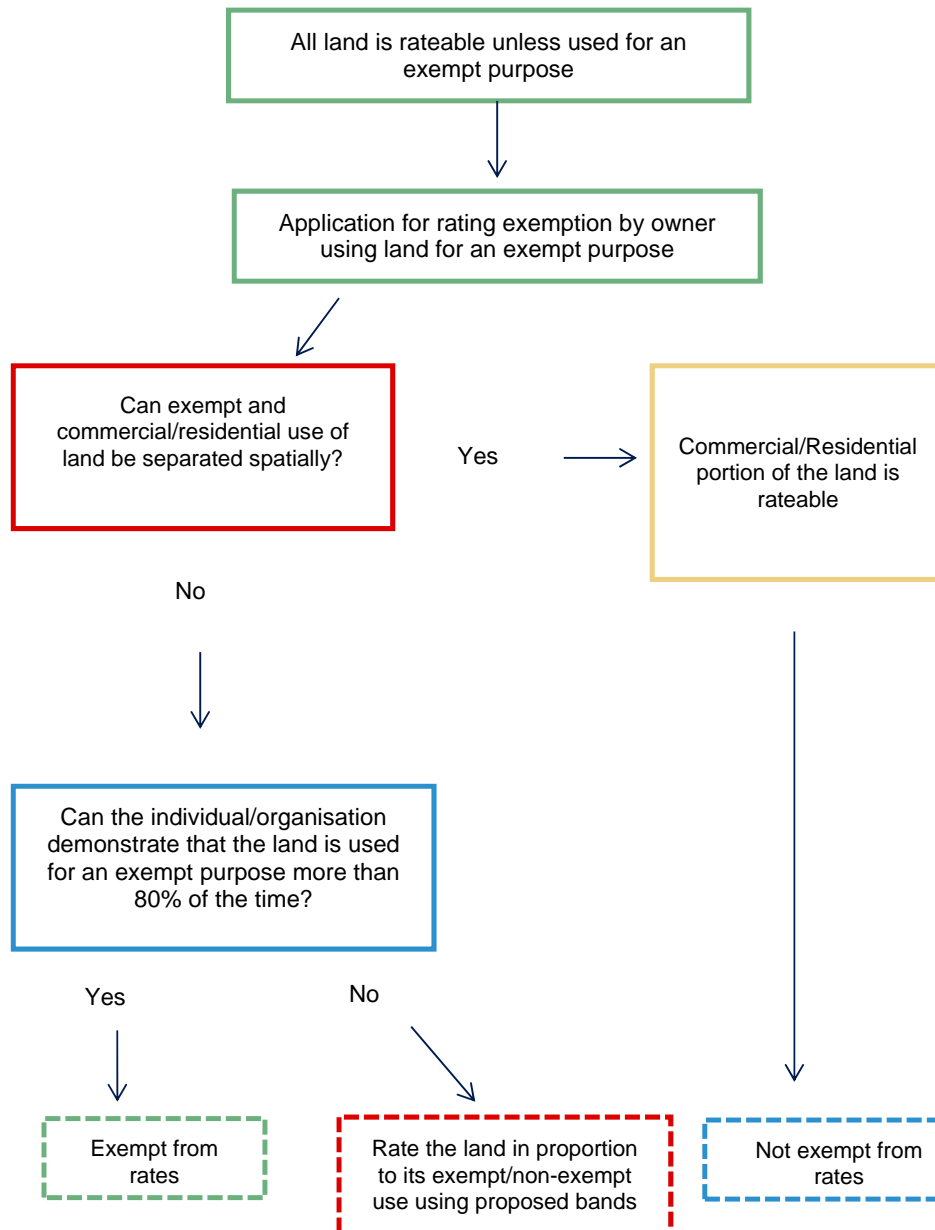
When councils receive an application for a partial rating exemption by a land owner on the grounds that the land is partly used for an exempt purpose, the council should require the owner to provide supporting evidence of exempt use. However, to minimise the regulatory burden, we consider there should be a presumption that specific categories of exemptions are unlikely to be involved, to any great extent, in non-exempt activities.<sup>78</sup> For example:

- ▼ schools
- ▼ Aboriginal Land Councils
- ▼ Hospitals, and
- ▼ non-commercial use of National Parks and State Forests

For other categories, the council should first determine whether the land use can be separated into exempt and non-exempt purposes on a spatial or a temporal basis. Where it can be separated on a spatial basis, it is relatively straightforward: as indicated above, rates would be levied on the proportion of land area used for non-exempt purposes.

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<sup>78</sup> This is only a presumption. The council can, if it determines that the land is being used for non-exempt purposes, treat the property like any other seeking an exemption from rates.

**Figure 6.1 Proposed process for rating mixed-use land**

## Box 6.5 Examples of rating mixed-use land

### Charity with a conference centre

#### *Exempt and non-exempt uses separated on a temporal basis*

A charity has a building which it uses to run its administrative functions that support its charitable activities. The charity rents out rooms in the building on a commercial basis (eg, to training groups) 3 days a week. The charity would pay rates in proportion to the amount of time the building is used for commercial activity.

### Church with a child care centre

#### *Exempt and non-exempt uses separated on a spatial basis*

A local church sits on a 1000m<sup>2</sup> block of land. The church runs a child care centre on a commercial basis which accounts for 25% of the land size (or 250m<sup>2</sup>).

The council could determine the portion of the land that is rateable based on the area of land being used. The council levies rates on the 250m<sup>2</sup> used by the child care centre and due to the religious exemption category, exempts the church from rates.

Where the exempt use can be separated on a temporal basis, we propose councils use a series of bands to determine its rating liability (see Table 6.2). In a council rating year, where land is used for non-exempt purposes:

- ▼ 80% or more of the time, the land would be fully rateable
- ▼ between 50% to 80% of the time, the land would be rated at 65% of its full rating
- ▼ 20% to 50% of the time, land would be rated at 35% of full rating, and
- ▼ under 20% of the time, land would be fully exempt from rates.

**Table 6.2 Proposed bands of council rates for mixed-use exempt land**

% of non-exempt use	80-100%	50-80%	20-50%	0-20%
% of land that should be rateable	100%	65%	35%	0%
Indicative use	Exempt activity is incidental to the main commercial use of the land (even if this commercial activity supports other exempt activities) - ie, a store selling full priced goods to raise funds for a charitable cause	Substantial commercial use/activity may form the majority of the use of the land (eg, community space rented out during the week for private use/regularly scheduled workshops	Moderate commercial use/activity may be ancillary to the primary use of the land	Light commercial use that is incidental to the core purpose and/or once off activities (eg, annual fundraising dinner)



### 6.5.2 Self-assessment where exempt and non-exempt uses are separated on a temporal basis

To minimise compliance costs, land owners could use a self-assessment test to determine which of the above bands their land falls into. This self-assessment has three steps.

1. The property owner seeking an exemption self-assesses their property use, determines the proportion of time land is used for exempt purposes and provides this information to the council.
2. The council uses this information to levy rates on the property in line with the bands set out in Table 6.2.
3. The council conducts random audits of land use to determine the accuracy of property owners' self-assessments.

Using a self-assessment test has several advantages over a council-led process. First, it lowers the day-to-day administrative burden on councils of determining exemptions compared to a threshold test. Councils would generally accept the self-assessments and only conduct investigations on a risk basis or through a randomised audit process.

Second, it involves relatively low reporting and compliance costs for exempt organisations as they should have ready access to information on how much their land is used for commercial or residential activities.

Third, it allows councils to capture a greater proportion of commercial activity as rateable, which improves the horizontal equity of the rate base.

## 6.6 Councils' general income should not be modified as a result of changes to exemptions

Draft recommendation

- 17 A council's maximum general income should not be modified as a result of any changes to exemptions from implementing our recommendations.

Under the LG Act, a council's maximum general income is modified to take into account changes in exempt properties. When a non-rateable property becomes rateable – for example if a charity was to close down and a new owner takes over the land – the council's general income is adjusted to reflect the additional revenue from the new rateable property.<sup>79</sup>

<sup>79</sup> Where the reverse occurs and a property becomes exempt, the opposite should happen and a council's general income should decrease. However, OLG advises that in practice this does not occur as, historically, it is not common for a property to become exempt.

Ordinarily, in any given year, the number of properties that would either become exempt or rateable is a very small percentage of the total rate base. Therefore, such adjustments have only a small impact on the council's general income and a marginal impact on other ratepayers.

However, our draft recommendation 10 is likely to result in a significant change in the number of exempt properties in each local government area. This in turn is likely to have significant implications for each council's general income.

We consider councils should not receive a one-off permanent increase or decrease in their income as a result of our recommendation to base exemptions on land use. The most appropriate mechanism for determining the size of a council's general income is the existing Special Variation process and rate pegging regulations.

If in the future, councils can demonstrate a clear need and community support for additional income, they should use the existing Special Variation process. This approach is consistent with previous changes to exemptions; for example, the 2010 amendments to allow partial rating of commercial leased land owned by charities.<sup>80</sup>

In addition, as a result of these changes and the removal of exemptions, there are likely to be a number of one-off properties that fall into either unique or very narrow business subcategories for the purposes of rates (for example the Sydney Cricket Ground). By limiting the ability of councils to generate new revenue from these properties, this recommendation would help ensure that the Government's policy of protecting against excessive rate increases is maintained. Removing some exemptions means that rates would go down for ordinary ratepayers.

## 6.7 Other changes should be made to improve consistency and transparency of exemptions

Draft recommendations

- 18 The *Local Government Act 1993* (NSW) should be amended to remove the current exemptions from water and sewerage special charges in section 555 and instead allow councils discretion to exempt these properties from water and sewerage special rates in a similar manner as occurs under section 558(1).
- 19 At the start of each rating period, councils should calculate the increase in rates that are the result of rating exemptions. This information should be published in the council's annual report or otherwise made available to the public.

<sup>80</sup> See agreement in Principle reading of the Local Government Amendment (General Rate Exemptions) Bill 2010, May 13 2010 available online at <https://www.parliament.nsw.gov.au/Hansard/Pages/HansardFull.aspx#/DateDisplay/HANSARD-1323879322-77169/HANSARD-1323879322-77102> accessed 26 July 2016.

We have also identified some changes that would improve the consistency and transparency of the exemptions arrangements.

### 6.7.1 Move exemptions from water and sewerage special charges

In regional and rural areas, councils are responsible for the provision of water and sewerage services and charge water supply and sewerage special rates for this purpose. Although they are included in the rates notice, these special rates are a fee for service rather than an ordinary council rate.

Sections 555 and 556 of the LG Act both outline a range of exemptions from council rates. The principal difference between the two sections is that land in section 555 is exempt from all rates, while land in section 556 is exempt from normal rates but not special water and sewerage charges.

Our terms of reference require us to consider the appropriateness of rating exemptions under the LG Act. Given that water and sewerage special rates are a fee for service that has substantial private benefits, it may not be appropriate for certain uses of land to be exempt from paying these fees.

Our recommendation to amend section 555 of the LG Act would remove the mandatory exemption from water and sewerage rates for these types of property. Rather, this recommendation would give individual councils the discretion to exempt particular types of properties from water and sewerage special rates if they consider it appropriate to do so, as occurs currently under section 558(1) of the LG Act.<sup>81</sup>

### 6.7.2 Enable greater transparency on the level of exemptions

Currently, most councils do not have a strong indication of the 'cost' of each exemption. This is because a council's general income is generally not affected by exemptions, but rather any rate exemptions result in ratepayers in the local government area paying higher rates (ie, an increase in their ad valorem rates).

This outcome is contrary to the tax principle of transparency. It is difficult to assess the impact of exemptions on ratepayers without sufficient information.

Under our draft recommendation, councils would be required to calculate the impact of exemptions in their area by calculating the ad valorem rate twice – once with all land being rated and once with the exemptions removed. This would make it possible to determine the actual cost to ratepayers of granting exemptions.

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<sup>81</sup> We note that the water and sewerage exemptions outlined in the Local Government Act are not consistent with those in the *Water Management Act 2000* or the *Sydney Water Act 1994*. However, these other Acts fall outside of our terms of reference.

Councils would also be required to publish this information in their annual reports or otherwise make it available to the public. This would improve public awareness about exemptions, and facilitate assessments about their appropriateness.

## 7 Replace the pensioner concession with a rate deferral scheme

Pensioner concessions are currently provided to eligible pensioners<sup>82</sup> by means of a 50% discount on their combined ordinary council rates and waste service charges, up to a maximum of \$250 per annum. We considered how to improve the equity and efficiency of the current pensioner concession and the long-term financial sustainability of local councils.

In this chapter we discuss the current pensioner concession, and consider its drawbacks. We explain why a rate deferral scheme could provide similar assistance to pensioners, who may own their homes but have limited income, at a lower cost to the State. We also explain how the deferral scheme can remove the cost burden of the concession from ratepayers and local councils.

### 7.1 Summary of draft findings and recommendations on a rate deferral scheme

Our draft recommendation would maintain the NSW Government's commitment to providing concessions to pensioners. It would give the NSW Government more options to better target cash-flow relief to pensioners equitably and efficiently. We consider this would be best done through a rate deferral scheme, rather than a pensioner rebate, as it would:

- ▼ **provide assistance in paying rate bills for income-poor pensioners (even if they may be asset-rich)**
- ▼ **not narrow the rate base, and**
- ▼ **not affect councils with a high proportion of pensioners, or burden ratepayers living in these council areas.**

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<sup>82</sup> Eligible pensioners are residential property owners who hold a pensioner concession card, hold a Gold card embossed TPI (Totally and Permanently Incapacitated), hold a Gold card embossed EDA (Extreme Disability Adjustment), or are a war widow or widower or wholly dependent partner entitled to the DVA income support supplement. See Office of Local Government, *Pensioner Concession Application Form*, 2015, at [http://www.olg.nsw.gov.au/sites/default/files/Pensioner Concession Application Form 2015\\_16 .pdf](http://www.olg.nsw.gov.au/sites/default/files/Pensioner%20Concession%20Application%20Form%202015_16.pdf), accessed 16 August 2016.

Under our draft recommendation, the deferral scheme would be funded by the NSW Government, which would have the option to further reduce pensioners' rates bills by increasing the amount of the deferment, at a much lower cost than the current system.

#### Draft recommendation

20 The current pensioner concession should be replaced with a rate deferral scheme operated by the State Government.

- Eligible pensioners should be allowed to defer payment of rates up to the amount of the current concession, or any other amount as determined by the State Government.
- The liability should be charged interest at the State Government's 10-year borrowing rate plus an administrative fee. The liability would become due when property ownership changes and a surviving spouse no longer lives in the residence.

## 7.2 Analysis of the pensioner concession

In making our draft recommendation that the current pensioner concession be replaced with a rate deferral scheme, we:

- ▼ considered a range of options for pensioner concessions
- ▼ analysed how the current system and these options performed against the objectives of the concession payment and the key taxation principles
- ▼ analysed how the recommended scheme better meets these objectives
- ▼ reflected on who should pay for the scheme
- ▼ considered the pensioner schemes in other jurisdictions, and
- ▼ considered stakeholder views.

Box 7.1 provides some background on the current pensioner concession.

### Box 7.1 The current pensioner concession

Under the current scheme, eligible pensioners are required to apply to their local council to receive a 50% discount on their combined ordinary council rates and waste service charges, up to a maximum of \$250 per annum.

The cost of providing this discount is shared between the NSW Government (55% or about \$78.5 million per annum) and local councils (45% or \$64.2 million).<sup>a</sup>

Calculations based on OLG data suggest that the contribution to the scheme from councils is up to 3% of rates income in some council areas.

<sup>a</sup> NSW Budget estimates 2015-16, *Budget Paper No. 3*, p 8-34, at [http://www.treasury.nsw.gov.au/\\_\\_data/assets/pdf\\_file/0019/128125/Budget\\_Paper\\_3\\_-\\_Budget\\_Estimates.pdf](http://www.treasury.nsw.gov.au/__data/assets/pdf_file/0019/128125/Budget_Paper_3_-_Budget_Estimates.pdf), accessed 16 August 2016.

### 7.2.1 Options for the pensioner concession

There are a number of options that we have considered for pensioner concessions which provide financial assistance to pensioners. These include the following three options.

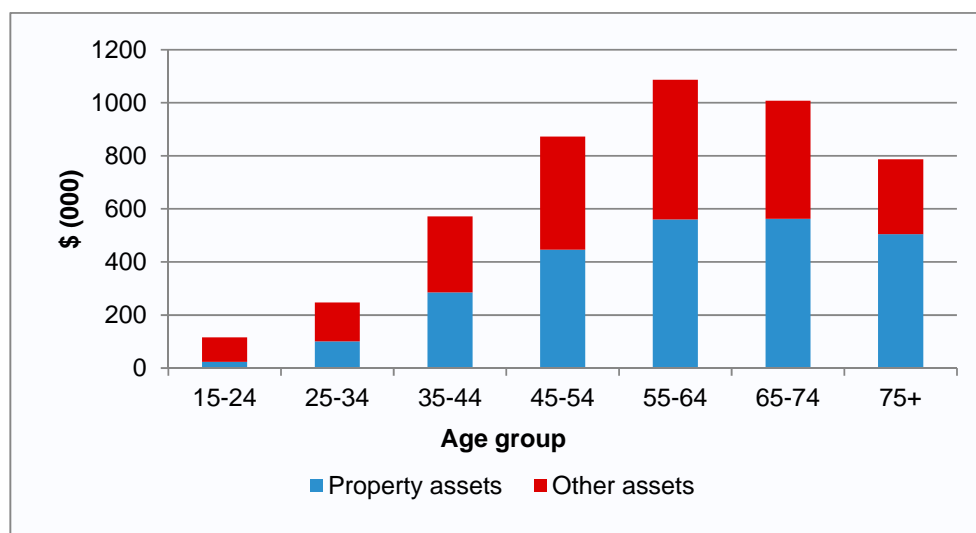
- ▼ **Retaining the current concession scheme** is consistent with the NSW Government's commitment to providing rate concessions to pensioners. However, the current scheme is jointly funded by the State Government (55%) and the local council (45%). This is inequitable in that it requires other ratepayers in the council area to pay higher rates to fund State social policy, and it is not consistent with other Australian states.
- ▼ **A pensioner concession fully funded by State Government** is consistent with a number of other Australian states, and would ensure that other ratepayers are not required to pay higher rates. However, it would increase the burden to the State Government of providing concessions to pensioners. It also provides a subsidy to pensioners who own property and may be well off, but no assistance to pensioners who rent and tend to have significantly lower wealth and income.
- ▼ **A rate deferral scheme** would allow pensioners to defer a portion of their rates until their property is sold. This option is currently offered in South Australia, Western Australia and the ACT. An advantage of this option is that it greatly reduces the cost to the State Government of providing financial assistance to pensioners, whilst allowing cost-effective assistance to be better targeted to pensioners with low incomes who are 'cash poor'.

### 7.2.2 Impacts of the current pensioner concession system

The pensioner concession provides financial assistance to help pay council rates to pensioners who may have limited income and own their own home.

However, it also provides a subsidy to households that on average have higher net wealth. This subsidy is funded by all other households, which is contrary to the tax principle of vertical equity. Figure 7.1 shows that, on average, older households tend to be wealthier than younger households.

**Figure 7.1 Net wealth over a taxpayer's lifecycle**



**Data source:** Australian Bureau of Statistics (ABS), Household wealth and wealth distribution, Australia, 2011-12, Cat. No. 6554.0, Table 24.

The current concession provides no assistance to pensioners who rent property, who on average have significantly lower wealth and income than pensioners who own property.<sup>83</sup> They also incur council rates as indirect costs through their rent.

As noted by the Independent Local Government Review Panel, the current concession also provides an incentive for “relatively affluent retirees” to receive financial advice on structuring their affairs to obtain the pensioner concession.

The impact of the pensioner concession is most prominent in regional areas with a high - and rising - proportion of pensioners. Since local councils are capped on the revenue they can receive (general income), the current pensioner scheme requires other ratepayers in the council area to pay higher rates. These areas are generally lower socioeconomic areas with lower ability to pay. This means that the current pensioner concession scheme is becoming unsustainable as it is imposing additional costs on those least able to bear such costs.

<sup>83</sup> For example, ABS data for 2013-14 suggest that people over 65 who own their own property have 37% higher incomes than people over 65 who rent, on average (ABS, Household Income and Wealth, Australia, 2013-14, Cat. No. 6523.0, Table 10).



By contrast, a rate deferral scheme would be comparatively efficient in providing a concession for ratepayers that use the scheme, whilst reducing the cost to other ratepayers and state taxpayers of providing rate relief to those pensioners. It also better ensures the beneficiaries of the scheme help to fund it over the long term.

### 7.3 Who should fund the deferral scheme?

The pensioner concession is a NSW Government policy. On this basis we consider the NSW Government should be responsible for fully funding the scheme, rather than requiring councils to share this burden.<sup>84</sup>

A State funded scheme would be consistent with the funding of pensioner concessions in other states. It is also consistent with our principle that local council rates should be used to fund local public goods rather than State Government social policy. Councils would also have better incentives to promote take-up of the scheme.

Our draft recommendations also provide the NSW Government with the option to increase the amount of deferment at much lower cost. Under our draft proposal the interest rate on the scheme would be close to the State Government's borrowing rate, which is lower than retail lending rates. The NSW Government's 10-year bond rate averaged less than 3% over the 2015-16 financial year.

The rate deferral scheme would significantly reduce the cost to taxpayers of providing rate relief to pensioners, whilst allowing the Government to potentially increase the current value of the concession to better achieve its objective. For example, if the deferment amount was raised from \$250 to \$500 a year, the costs of the scheme to Government would still be less than 10% of the current cost to the Government, whilst providing twice the cash flow relief to pensioners.<sup>85</sup>

Box 7.2 shows that in all other states the pensioner concession is fully funded by the state or territory government.

<sup>84</sup> Councils would still be free to offer their own rate concessions to pensioners in addition to these provisions.

<sup>85</sup> The current cost of the scheme to the State Government is approximately \$78.5 million per year. The cashflow cost to the State Government of our recommended rate deferral scheme is nearly zero, as ratepayers that utilise the scheme are charged the State Government's borrowing rate plus an administrative fee.

The total social cost of the scheme may be around 20% of the current pensioner concession scheme. This estimate assumes a social cost of capital of 6% for projects of this type, less a State Government bond rate of 3%, and that pensioners on average utilise the deferral scheme for 15 years.

## Box 7.2 Pensioner concession funding in other states

While most other Australian states offer a rate concession for pensioners, the most recent reform to pensioner concessions occurred in South Australia where the Government removed the pensioner concession from rates in 2015. The pensioner concession was replaced with a Postponement of Rates Scheme and a 'cost of living' concession for all pensioners and some low income earners.

	Type of Relief	Value of relief	Funding source
NSW	Concession only	50% discount, up to \$250 pa	55% state 45% council
VIC	Concession only	50% discount, up to \$218.30 pa	100% state
QLD	Concession only	20% discount, up to \$200 pa	100% state
NT	Concession only	62.5% discount, up to \$200 pa	100% NT govt.
TAS	Concession only	30% discount, up to \$425 pa	100% state
WA	Concession or rate deferral	50% discount, up to \$750 pa	100% state
SA	Rate deferral only	All rates in excess of \$500 pa	100% state
ACT	Concession and rate deferral	50% discount, up to \$700 pa, deferral on rates in excess of \$700	100% ACT govt.

**Source:** *Local Government Act 1993* (NSW); OLG, Pensioner Concession Factsheet, 2011; Victorian Department of Human Services, Municipal rates Concession fact sheet; *Local Government Act 1989* (VIC); *Local Government Act 2009* (Qld); *Local Government Regulation 2012* (Qld); *Local Government Act 1999* (SA); *Local Government (General) Regulation 2013* (SA); *Local Government Act 1995* (WA); Western Australia Government, ConcessionsWA; *Local Government Act 1993* (Tas); *Local Government Act 2008* (NT); NTPCCS, Policy Manual, January 2016; ACT Revenue Office, Rates assistance.

The Postponement of Rates Scheme in South Australia allows pensioners living in their primary place of residence to defer all rates in excess of \$500. There are limited restrictions on the minimum property value or percentage of equity held in the property required to defer rates. The interest rate on deferred rates is based on council's borrowing costs (5% in 2016-17). Deferred rates only become due when the property is sold. In particular, a pensioner that moves out of their home is not eligible to defer future rates, but does not need to pay any currently deferred rates until the property is sold.

Rate deferral schemes also operate in Western Australia and the ACT. These schemes are broadly similar, except that there are more restrictions on the minimum value of the property or the minimum equity held in the property. In Western Australia, deferred rates do not incur interest charges.

## 7.4 Summary of stakeholder submissions

Most respondents were of the view that a pensioner concession should remain as any withdrawal of this benefit can adversely affect pensioners, many of whom are already financially vulnerable.<sup>86</sup> Other points raised by stakeholders included:

- ▼ Pensioner rebates should be entirely funded by the State as it is a welfare measure. Sharing this burden with councils decreases their revenue, erodes their capacity to deliver services, and reduces their incentives to promote take-up of the rebate.<sup>87</sup> It also raises the tax burden on other ratepayers, which is inequitable.
- ▼ The pensioner concession should be indexed annually. Submissions noted the rebate has been fixed at \$250 since 1993, whereas rates have been increasing each year. This makes the current concession of up to \$250 insufficient and outdated.<sup>88</sup>
- ▼ Councils (particularly smaller councils), are reluctant to promote rate deferral schemes themselves due to potential liquidity risks, onerous financial costs and resultant negative effects on service delivery.<sup>89</sup>

<sup>86</sup> V. Henwood, submission to IPART Issues Paper, May 2016.

<sup>87</sup> Kempsey Shire Council, Camden Council, Waverley Council, Nambucca Shire Council, Glen Innes Severn Council, Cootamundra Shire Council, Greater Taree City Council, submissions to IPART Issues Paper, May 2016.

<sup>88</sup> Port Stephens Council, Mosman Municipal Council, Kempsey Shire Council, Lachlan Shire Council, Wagga Wagga City Council, Combined Pensioners Superannuants Association, V. Henwood, submissions to IPART Issues Paper, May 2016.

<sup>89</sup> Berrigan Shire Council, Cootamundra Shire Council, Greater Taree City Council, submissions to IPART Issues Paper, May 2016.

## 8 | Provide more rating categories

The current rating system includes four rating categories which reflect the primary use of the land. These are residential, business, farmland and mining. Councils may elect to apply different rate structures to each category.

We considered the appropriateness of the existing rating categories. In this chapter we discuss our recommendations to create new rating categories, as well as changes to the existing ones.

### 8.1 Summary of draft findings and recommendations on rating categories

Our key draft recommendation is to **create new categories for environmental<sup>90</sup> and vacant land**. This allows councils to use their rate structures to:

- ▼ take account of differences in costs that arise from different land uses, and
- ▼ encourage urban renewal to meet the community's housing needs.

In addition, we recommend several changes to existing rating categories.

- ▼ **Councils should determine which rating category should act as the 'residual' category.** They are best placed to decide which existing category is the most appropriate. The chosen category should not be changed for a 5-year period, in order to provide certainty to ratepayers.
- ▼ **Subcategorising business land as industrial or commercial.** This assists councils to set rates based on the costs that businesses impose on them.
- ▼ **Subcategorising farmland based on geographic location.** Councils can use location based rating to set rates that reflect access to their services.
- ▼ **Providing guidance for councils in determining rates for mining land.** Mining rates should reflect the cost of councils providing services to the mining properties.

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<sup>90</sup> Land that cannot be developed due to geographic or regulatory restrictions.

## 8.2 Introducing a new Environmental Land category

### Draft recommendation

- 21 Section 493 of the *Local Government Act 1993* (NSW) should be amended to add a new environmental land category and a definition of 'Environmental Land' should be included in the LG Act.

### 8.2.1 The need for an environmental land category

In many council areas, there is land that cannot be developed due to geographic or regulatory restrictions. At present, land that is undevelopable is categorised under one of the four existing categories for rating purposes.

Undeveloped land typically imposes low costs on councils, which may not be fully reflected by differences in land value. Environmental land will typically impose lower costs on a council than inhabited land of similar value. Hence, councils should have the flexibility to be able to levy lower rates on environmental land to reflect these lower costs.

### Defining environmental land

Land that has limited economic value and cannot be developed with site improvements due to geographic or regulatory restrictions could be classed as environmental land. In general:

- ▼ Geographic factors could include “water areas, mud flats, swamps, marshlands, steep slopes and other terrain on which residential or commercial development is virtually impossible because of physical limitations”.<sup>91</sup>
- ▼ Regulatory restrictions could include laws preventing development of property in order to conserve nature. For example, private land under conservation agreements with the NSW Office of Environment and Heritage might fall under this category.

### 8.2.2 Stakeholder comments

In submissions to our Issues Paper, several stakeholders supported a separate environmental land category.<sup>92</sup> These stakeholders suggested councils should be given the flexibility to categorise undevelopable land, environmentally protected land and land with low development potential.

<sup>91</sup> U.S. Census Bureau, *Geographical Areas Reference Manual*, ‘undevelopable territory’, p G-52, at <http://www2.census.gov/geo/pdfs/reference/GARM/glosGARM.pdf>, accessed 11 August 2016.

<sup>92</sup> Lake Macquarie City Council, p 4, Wingecarribee Shire Council, p 2 Wollongong City Council, p 4, Central Coast Council, p 4, and Armidale-Dumaresq Ratepayers Association, p 1, submissions to IPART Issues Paper, May 2016.

Stakeholders argued that the current categorisation of these properties is not appropriate. For example, land could be zoned residential, however, the land may not be developed as a residential property due to geographic limitations discussed above. Therefore, a separate rating category for these types of property would be beneficial.

The NSW Minerals Council also noted environmental buffer land held by mining firms is charged the mining rate although in many cases the land cannot be developed. The introduction of an environmental land category could also address this concern.

### 8.3 Introducing a new Vacant Land category

Draft recommendation

- 22 Sections 493, 519 and 529 of the *Local Government Act 1993* (NSW) should be amended to add a new vacant land category, with subcategories for residential, business, mining and farmland.

#### 8.3.1 The need for a vacant land category

A separate vacant land category would provide additional flexibility for all councils to tailor their rates to the needs of the local community.

Section 519 of the LG Act provides that vacant land should be categorised under the existing four rating categories. For example, an empty block of land in a residential estate would be charged the same residential rate as the houses in the estate. In general, this results in the residential, business, farmland or mining rates for the council being applied to vacant land.

For many urban councils, where land is scarce, allowing the council to set a higher rate on vacant land may encourage the development and urban renewal that is required to meet the current and future needs of the community. If our draft recommendation to allow councils to use a CIV valuation method is adopted, the need for a separate vacant land category would be of greater importance. Vacant land would typically attract lower rates under CIV as these properties would have lower assessed values compared to land with capital improvements. This could provide an incentive for owners of vacant land to not develop land.

Allowing a council to charge a higher rate for vacant land could provide incentives to develop this land – addressing a main drawback of CIV – whilst ensuring ratepayers still receive the equity and other efficiency benefits of CIV.

By contrast, allowing regional councils the option to levy a lower rate on vacant land to recognise the lower demand and cost of providing council services to these properties might also be appropriate.

### Subcategorising vacant land

The current provisions in the LG Act require vacant land to be categorised as residential, business, farmland or mining by considering the underlying zoning of the land or the predominant categorisation of adjacent land. These concepts could be used to subcategorise vacant land into residential, business, mining or vacant farmland.

In instances where a higher rate is applied to vacant land, guidelines should be introduced to protect ratepayers from excessive rates. For example, consistent with our treatment of residential rates in Chapter 5, a guideline could be issued that the ad valorem rate charged for vacant land should not be more than 1.5 times the highest rate for the council at the category or subcategory level.

### Use of 'Vacant Land' category in selected jurisdictions

A number of other Australian states provide flexibility for councils to charge different rates for vacant land.

- ▼ In Victoria, the *Ministerial Guidelines for Differential Rating 2013* states vacant land is an appropriate category for different rates. In practice, a number of councils – both urban and regional – set a higher ad valorem rate for vacant land to encourage the development of land for residential or commercial purposes.
- ▼ The Queensland LG Act does not specify rating categories. Instead, councils are allowed to determine rating categories, and many councils have adopted a vacant land category.<sup>93</sup>
- ▼ The WA local government legislation allows vacant land to be charged different rates, with a number of councils charging higher rates on vacant urban land.

### 8.3.2 Stakeholder comments

Several stakeholders stated the need for a 'vacant land' category.

- ▼ Some councils, especially Sydney metropolitan councils<sup>94</sup>, were of the view that a separate 'vacant land' category would provide councils with the option to charge a higher rate in order to prevent 'land banking' and encourage urban renewal.
- ▼ Regional councils also supported a 'vacant land' category, as it would allow the application of a lower rate to reflect the lower impost on council services.<sup>95</sup>

<sup>93</sup> For example Cloncurry Shire Council levies 85% of the residential rate on vacant land <10,000m<sup>2</sup>, based on UV valuation method.

<sup>94</sup> For example, The Hills Shire Council, p 2, Sutherland Shire Council, p 3, submissions to IPART Issues Paper, May 2016.

<sup>95</sup> For example, Shoalhaven City Council, p 4, Mid-Western Regional Council, p 1, Byron Shire Council, p 2, WSROC, p 2, submissions to IPART Issues Paper, May 2016.

## 8.4 Councils determining the residual rating category

### Draft recommendation

- 23 Section 518 of the *Local Government Act 1993* (NSW) should be amended to reflect that a council may determine by resolution which rating category will act as the residual category.
- The residual category that is determined should not be subject to change for a 5-year period.
  - If a council does not determine a residual category, the Business category should act as the default residual rating category

### 8.4.1 The need to allow choice in determining the residual rating category

Section 518 of the LG Act specifies that:

Land is to be categorised as business if it cannot be categorised as farmland, residential or mining.

This means properties that do not meet the criteria for categorisation as residential, farmland and mining must be categorised as business properties. For example, a residential car park on a separate title or a jetty would be categorised as 'Business'. The business rate may not reflect the type of use and nature of the properties, and could be contrary to the principles of efficiency and equity.

Councils should be allowed to decide which existing rating category best fits as the residual category.

Before determining the residual rating category, a council should try to categorise all unclassified property into the existing rating categories based on the property's land use (even if these properties do not strictly meet all categorisation criteria). For all remaining property, councils should be allowed to determine one residual rating category after considering the nature of such property.<sup>96</sup>

The residual category that is chosen should not be subject to change for a 5-year period in order to maintain simplicity and provide certainty to ratepayers. This process should allow for a better application of tax principles for these properties.

If a council does not wish to determine the residual category for its LGA, the business category would remain as the default residual category, in line with current practice.

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<sup>96</sup> If a council chooses a different residual category to business, it would need to define what properties fall under the business category in its local area.



#### 8.4.2 Stakeholder comments

Several stakeholders raised concerns about categorising properties that are not commercial in nature as ‘business’ properties.<sup>97</sup> These councils point out that the requirement to categorise a property as business if that property does not meet the categorisation criteria of residential, farmland or mining is not always appropriate.

### 8.5 Subcategorising business land as industrial or commercial

Draft recommendation

- 24 Section 529 (2)(d) of the *Local Government Act 1993* (NSW) should be amended to allow business land to be subcategorised as ‘industrial’ and or ‘commercial’ in addition to centre of activity.

#### 8.5.1 The need for new criteria for business subcategories

At present, councils are able to subcategorise business land according to a centre of activity.<sup>98</sup> This results in councils having to charge a single rate based on the centre of activity, even when business activities within these centres are highly diverse and impose different costs on councils.

When councils have diverse businesses within one location, the centre of activity criteria may not be sufficient for a council to differentiate the rates chargeable for different land uses by businesses.

We propose that councils should be allowed to subcategorise business land as commercial or industrial in addition to the centre of activity subcategory. This subcategorisation of businesses into commercial and industrial uses is consistent with the proposed treatment under the new Emergency Services Property Levy (ESPL).

#### Defining industrial properties

Industrial properties could be defined based on Local Environment Plan (LEP) zonings, as is the case under the ESPL. According to the *Standard Instrument – Principal Local Environment Plan*, industrial activity is defined as follows.

Industrial activity means the manufacturing, production, assembling, altering, formulating, repairing, renovating, ornamenting, finishing, cleaning, washing, dismantling, transforming, processing, recycling, adapting or servicing of, or the research and development of, any goods, substances, food, products or articles for

<sup>97</sup> For example, Shellharbour City Council, p 2, Lachlan Shire Council, p 2, Wollongong City Council, p 4, submissions to IPART Issues Paper, May 2016.

<sup>98</sup> Section 529 of LG Act notes that “... a centre of activity might comprise a business centre, and industrial estate or some other concentration of like activities”.

commercial purposes, and includes any storage or transportation associated with any such activity.

All other business properties that do not fall under the industrial definition could be defined as commercial property. These properties would include office space and retail premises.

### 8.5.2 Stakeholder comments

A few stakeholders stated the need for further subcategories of business land.<sup>99</sup> Some councils suggested that business land should be subcategorised based on LEP zoning for such land.<sup>100</sup> However, we consider allowing commercial and industrial subcategorisation provides sufficient flexibility whilst ensuring policy consistency and simplicity.

## 8.6 Subcategorising farmland based on geographic location

Draft recommendation

25 Section 529 (2)(a) of the *Local Government Act 1993* (NSW) should be replaced to allow farmland subcategories to be determined based on geographic location.

### 8.6.1 The need for new criteria for farmland subcategories

Section 529(2)(a) of the LG Act allows subcategorisation of farmland based on the 'intensity of land use', 'the irrigability of the land' and 'economic factors affecting the land'. Stakeholders expressed concern that these criteria are highly subjective and may prove difficult for councils to assess.

In our analysis of each council's rate structure with farmland properties, we noted that the majority of councils do not subcategorise based on the existing subcategorisation criteria. They apply one rate across the entire farmland area even where there are substantial differences in the intensity of farming across properties. This may be due to the subjectivity of the existing subcategorisation criteria, which makes it difficult to apply in practice.

<sup>99</sup> For example, Narrandera Shire Council, p 2, Port Stephens Council, p 7, The Hills Shire Council, p 2, Liverpool City Council, p 2, Campbelltown City Council, p 2, Tweed Shire Council, p 2, submissions to IPART Issues Paper, May 2016.

<sup>100</sup> For example, Lake Macquarie City Council, p 4, and Gunnedah Shire Council, p 3, submissions to IPART Issues Paper, May 2016.

### 8.6.2 Stakeholder comments

Stakeholders identified shortcomings in the current subcategorisation criteria.<sup>101</sup> In particular, DPI stated:

...there may be difficulties in the sub categorisation of farmland based on intensity of use, irrigated land, or economic factors affecting the land. These factors can vary from property to property and from season to season. It may be labour intensive and costly for councils to assess these variations and ensure the process was equitable.

Several councils believe that subcategorising land based on a geographic area such as a defined locality would achieve a more equitable outcome. These stakeholders argue that a defined geographic location would more directly reflect the productivity of farmland and hence the wealth that the land is able to generate.

These councils further highlighted that residential and business properties are currently subcategorised based on location, and this principle should be extended to the farmland category as well because location based rating can better reflect access to council services.

Councils were confident that they are well placed to identify the different land areas. Councils suggested that they could use the following criteria to create geographic boundaries:

- ▼ geographical markers such as a river bank, or an escarpment, or
- ▼ major infrastructure – eg, state/federal highway.

## 8.7 Mining rates to reflect cost of council services

Draft recommendation

- 26 Any difference in the rate charged by a council to a mining category compared to its average business rate should primarily reflect differences in the council's costs of providing services to the mining properties.

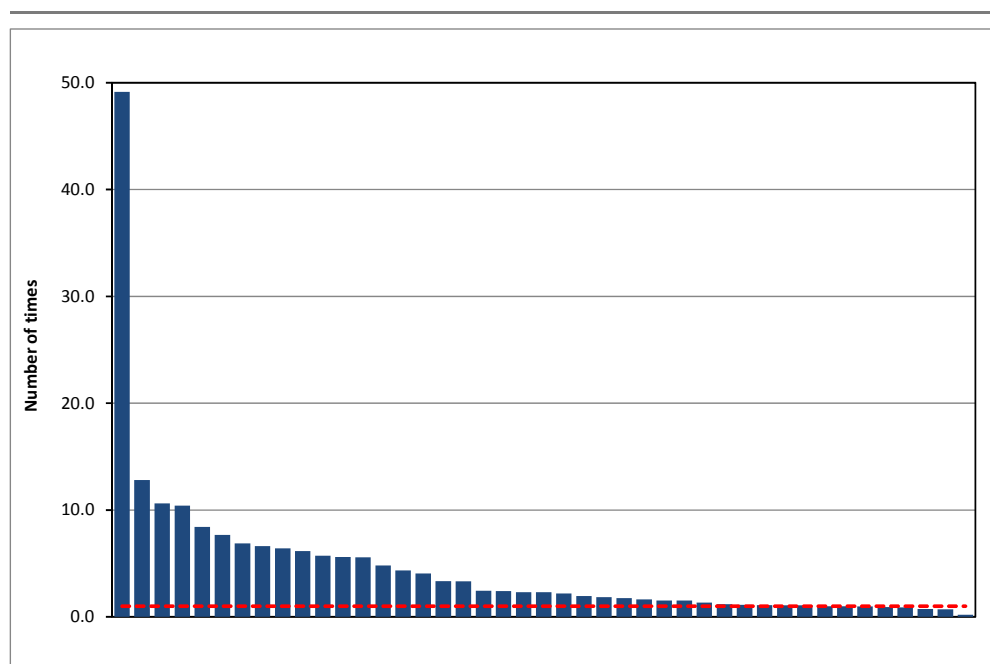
### 8.7.1 Why is this draft recommendation needed?

Our analysis has shown that the rates applied to mining land vary widely. Figure 8.1 presents the ratio of mining ad valorem rates to business ad valorem rates in 2013-14 for all councils with mining properties. These differentials are unlikely to reflect differences in costs of providing council services to these properties.

<sup>101</sup> NSW Department of Primary Industries, p 4, Cootamundra Shire Council, p 5 and Riverina Eastern Regional Organisation of Councils, p 3, submissions to IPART Issues Paper, May 2016.

Mining rates should be set relative to other business categories primarily to reflect differences in the cost of providing council services to these properties. By contrast, the data suggests some councils may be using the mining category as a profits tax to fund local services. Our reform would make the mining rate more cost reflective and promote other tax principles, ensuring the rate is not just based on capacity to pay.

**Figure 8.1 The ratio of Mining ad valorem rates to Business ad valorem rates**



**Note:** The red dotted line indicates a business to mining ad valorem rate of 1:1. Of the 43 councils with mining properties, 35 councils had a ratio above one.

**Data source:** IPART analysis based on OLG data on council revenues.

We propose that mining rates should not be above the business rate for a council unless the council can demonstrate additional costs in providing services to the mining properties, and the higher rate primarily reflects these additional costs.

### 8.7.2 Stakeholder comments

In its submission and subsequent consultations, the NSW Minerals Council stated that mines are generally self-sufficient, and that councils are charging excessive rates on mining properties often based on the maximum tax the council thinks it can extract from the mines.

The Minerals Council suggested that a similar model to Victoria should be adopted to limit the variation in rates. The Victorian LG Act provides that the highest rate cannot be more than four times the lowest rate in an LGA.

## 9 Recovery of council rates

Overdue rates create a large impost on councils, the court system and ultimately the community. However, councils currently have limited options to recover outstanding rates.

We have considered changes to reduce councils' administrative costs through improving council access to different debt recovery options and by improving the rate levying process itself. The sections below summarise our draft recommendations then discuss our analysis in more detail.

### 9.1 Summary of our draft recommendations

This chapter considers the following draft recommendations:

- ▼ councils should have the choice to engage the State Debt Recovery Office (SDRO) to recover outstanding council rates
- ▼ the existing legal and administrative process to recover outstanding rates should be streamlined
- ▼ councils should be able to offer discounts for ratepayers electing to receive their rate notices electronically, and
- ▼ ratepayers should not be able to postpone the payments of rates where land is rezoned.

### 9.2 Recovery of outstanding rates

In 2013-14, overdue rates and charges were \$285 million, which was equivalent to about 7% of NSW councils' total annual rates income. Overdue rates were up to 19% of annual rates income in some local government areas.<sup>102</sup>

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<sup>102</sup> Office of Local Government, *Profile & Performance of NSW Local Government Sector*, June 2015, pg14. <https://www.olg.nsw.gov.au/sites/default/files/Whole%20of%20State%20Report%20-%20June%202015.pdf>

At the same time, councils' court orders for overdue rates impose a major burden on the Local Court system. The Department of Justice found that just over one-third of all civil claims in the Local Court system involve councils pursuing overdue rates.<sup>103</sup> In addition, in the Issues Paper we noted that it appears some councils might pursue relatively lower value claims through the court system. Statistics we received from the Department of Justice suggested that over 80% of court claims were for amounts of \$2,000 or less.<sup>104</sup>

These statistics indicate the need to reform the debt recovery process at the council level to reduce the unnecessary burden on both the court system and local government.

Through our stakeholder consultation process, we have identified a number of measures which should reduce the burden on the community from recovering outstanding rates. Our proposed draft recommendations in this area aim to improve the overall simplicity, efficiency and equity of this process.

### 9.2.1 Councils should be able to use the State Debt Recovery Office

Draft recommendation

#### 27 Councils should have the option to engage the State Debt Recovery Office to recover outstanding council rates and charges.

The SDRO administers the NSW fine enforcement system and is responsible for the receipt and collection of outstanding State Government fines and penalties.

The SDRO also collects unpaid fines and fees issued by commercial entities or local government under contract. For example, the SDRO currently handles the collection of parking fines for the majority of NSW councils through an agreement with each council.

The Office of State Revenue<sup>105</sup> suggests that allowing councils to engage the SDRO could significantly reduce the level of overdue rates and reduce the burden on the Local Court system. The SDRO:

- ▼ has a number of means to match outstanding dues to an individual, with access to a wide range of Government data sources including updated contact addresses, phone numbers and banking details
- ▼ has options to force payment through the use of garnishee requests against financial institutions
- ▼ has the ability to negotiate flexible payment plans for people under financial hardship, operating an internal review process through its 'hardship review board'

<sup>103</sup> Letter from NSW Department of Justice to IPART, 5 April 2016.

<sup>104</sup> Letter from NSW Department of Justice to IPART, 5 April 2016.

<sup>105</sup> Letter from Office of State Revenue to IPART, 22 July 2016.

- ▼ can consolidate all outstanding government fines and dues, so an individual can manage all outstanding debts in a single package, and
- ▼ has data links to both LPI (Land & Property Information, NSW) and local government in place, reducing any costs of transferring the debt recovery process to SDRO.

In its submission, the SDRO noted it has a 75% debt recovery rate, and is currently responsible for the collection of over \$27 billion in taxes and 3.5 million fines, worth \$700 million, each year.

If councils were able to engage the services of the SDRO, the cost of collection would be passed onto the individual ratepayer when debts are recovered (as is currently the case with parking fines).

While engaging the SDRO's services may be an effective way to recover outstanding rates and charges, councils should also have other non-judicial avenues to recover rates before engaging the services of the SDRO (see Section 9.2.3).

### 9.2.2 Streamlining process for sale of land to recover dues

Draft recommendation

- 28 The existing legal and administrative process to recover outstanding rates should be streamlined by reducing the period of time before a property can be sold to recover rates from five years to three years.

The existing local government legislation allows a council to sell any non-vacant land on which any rate or charge remains unpaid for more than five years from the date on which it became payable.<sup>106</sup>

In other states, three years is the most common time period after which a property can be sold to recover outstanding rates.

We recommend reducing the time before a property can be sold to recover rates to three years. This will improve the simplicity of the rating system, bring NSW in line with other states, and is likely to reduce the costs and delays in recovering outstanding rates.

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<sup>106</sup> The provision of sale for vacant land is 1 year, if the total amount of unpaid rates or charges exceeds the value of the property.

### 9.2.3 Councils should have an Internal Review policy for overdue rates

Draft recommendation

**29** All councils should adopt an internal review policy, to assist those who are late in paying rates, before commencing legal proceedings to recover unpaid rates.

Councils have a number of means to assist ratepayers facing financial hardship. See Box 9.1 for a discussion of the common determinants of financial hardship.

According to the NSW Department of Justice, just over half of councils have a hardship policy that is publicly available online. These policies typically include information about alternative payment arrangements for ratepayers suffering financial difficulties. However, analysis suggests the efficacy of these policies is uncertain, because councils that have a hardship policy that is publicly available online tend to have more court filings for overdue rates. Of the top 50 councils filing unpaid rate claims in Local Courts, about 70% have a hardship policy on their website.<sup>107</sup>

For this reason, we recommend that councils should have an internal review policy for the payment of overdue rates. The policy would clearly specify, prior to commencing legal action, the other methods a council will pursue to recover outstanding rates.

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#### Box 9.1 Reasons for financial hardship

The Law and Justice Foundation of NSW, in its review of the Legal Aid NSW Mortgage Hardship Service, identified the following reasons for financial hardship for home owners, resulting in their inability to pay dues including council rates, loan repayments, strata levies etc.

- ▼ 40.6% faced unemployment or reduced employment.
- ▼ 28.6% experienced business failure or reduced income from self-employment.
- ▼ 28.6% suffered from illness or injury.
- ▼ 17.7% were dealing with family breakdown.

**Source:** Law and Justice Foundation of New South Wales, *Managing mortgage stress – Evaluation of the Legal Aid NSW and Consumer Credit Legal Centre Mortgage Hardship Service*, June 2011, p 25.

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<sup>107</sup> Email to IPART from Senior Policy Officer, NSW Department of Justice, 15 July 2016.



### 9.2.4 Guidelines for a flexible payment mechanism

Draft recommendation

30 The *Local Government Act 1993* (NSW) should be amended or the Office of Local Government should issue guidelines to clarify that councils can offer flexible payment options to ratepayers.

Flexible payment options include allowing ratepayers the flexibility to pay rates:

- ▼ on a number of frequencies (eg, weekly, fortnightly, monthly, quarterly or yearly basis), and
- ▼ through a variety of payment options, including direct debit or through Centrelink.

Councils should be able to offer flexible payment options as they allow ratepayers more flexibility to pay rates, which could assist councils' financial management.

However, through stakeholder submissions and consultation, we have identified that there is uncertainty about whether councils can offer flexible payment options. This is because:

- ▼ Section 564 of the LG Act allows councils to "accept payment of rates and charges due and payable by a person in accordance with an agreement made with the person", but
- ▼ Section 562 states annual rates may be paid annually or quarterly.<sup>108</sup>

In stakeholder submissions, only one council (Hills Shire) noted that it offers ratepayers flexible payment plans (including weekly, fortnightly and monthly) along with direct debit and Centrelink payment options under Section 564 of the LG Act.<sup>109</sup>

Given the lack of clarity in the legislation, we recommend either the LG Act be amended or OLG issue guidelines to clarify that councils can offer flexible payment options to ratepayers.

### 9.2.5 Summary of stakeholder submissions

Our draft recommendations are consistent with stakeholder feedback. Suggestions raised by stakeholders included:

- ▼ there should be a single, streamlined process for conducting all debt recovery activities against an individual ratepayer

<sup>108</sup> Note that section 562 of the LG Act does not explicitly prohibit other payment frequencies.

<sup>109</sup> The Hills Shire Council, submission to IPART Issues Paper, May 2016.

- ▼ councils should be able to recover overdue rates through Centrelink or utilising the services of the SDRO<sup>110</sup>
- ▼ councils should be allowed to offer more flexible payment options (including weekly or monthly billing, or direct debit arrangements),<sup>111</sup> and
- ▼ the process for selling properties to recover unpaid rates should be streamlined and the period of time a council is required to wait before selling a property should also be reduced from five to three years.<sup>112</sup>

Our draft recommendations have incorporated this feedback.

Many councils also suggested a move to the New Zealand model which allows outstanding rates to be recovered from a mortgagee after they have been outstanding for more than 12 months.<sup>113</sup>

However this model has a key drawback. Ratepayers with a mortgage who are not meeting council rate payments are also likely to be not meeting mortgage repayments. Adding these rates to the mortgage would effectively increase the Bad and Doubtful Debts of the financial sector. Thus, any extra burden on the financial sector would be passed on by lenders through increased interest rate charges for all borrowers.

Stakeholders also provided reasons why councils may pursue low-value claims of less than \$2000. Stakeholders noted that \$2,000 in unpaid rates can represent up to three years' worth of rates, and that they currently have no other effective solution for recovery other than approaching the courts.<sup>114</sup> Our recommendation to provide councils with the option to engage the SDRO should help councils recover low-value claims without the need to initiate court proceedings.

### 9.3 Improvements in the rate levying process

Draft recommendation

- 31 The *Local Government Act 1993* (NSW) should be amended to allow councils to offer a discount to ratepayers who elect to receive rates notices in electronic formats, eg, via email.

<sup>110</sup> Southern Sydney Regional Organisation of Councils, City of Canterbury-Bankstown, submissions to IPART Issues Paper, May 2016.

<sup>111</sup> North Sydney Council, Lockhart Shire Council, Manly Council, submissions to IPART Issues Paper, May 2016.

<sup>112</sup> Riverina Eastern Regional Organisation of Councils, Upper Lachlan Shire Council, Gunnedah Shire Council, submissions to IPART Issues Paper, May 2016.

<sup>113</sup> Lake Macquarie City Council, Ashfield Council, Mosman Municipal Council, Manly Council, City of Canterbury-Bankstown, Campbelltown City Council, submissions to IPART Issues Paper, May 2016.

<sup>114</sup> Campbelltown City Council, Manly Council, Leichhardt Council, submissions to IPART Issues Paper, May 2016.

### 9.3.1 Current practice

Section 710 of the LG Act requires councils to issue paper based notices to a ratepayer, unless the ratepayer has, in writing, allowed these notices to be sent through other means such as e-mail.

Distributing bill notices and other correspondence only through paper based notices and letters may not be cost effective. In addition, paper based notices may not reach the ratepayer when they change their address (eg, moves interstate or overseas, and councils do not have access to their updated contact details).

### 9.3.2 Serving notices electronically

Providing councils with the option to offer a discount for ratepayers who receive electronic bill notices could result in more efficient delivery of notices and considerable cost savings.

Discussions with councils suggest the average cost of serving a paper bill notice to ratepayers is about \$1 per bill. This cost primarily reflects printing and postage. Most councils mail rate notices quarterly and at least one other council correspondence each year. With over 3 million rateable properties in NSW, **the potential cost saving of going fully paperless could be up to \$15 million per year.**

Our draft recommendation to provide councils with the choice to offer a discount to ratepayers who opt to receive electronic notices would encourage this shift.

## 9.4 Abolishing the postponement of rates due to rezoning

Draft recommendation

32 *The Local Government Act 1993 (NSW) should be amended to remove section 585 and section 595, so that ratepayers are not permitted to postpone rates as a result of land rezoning, and councils are not required to write-off postponed rates after five years.*

Section 585 of LG Act allows a property owner to apply for postponement of rates if:

- ▼ the property is rezoned
- ▼ the rates payable increase after rezoning, and
- ▼ the ratepayer does not intend to redevelop the land according to the new land uses permitted.

The OLG suggests that the process of administering rate postponements is complex, often costing councils more than the postponed rates.

In addition, Section 595 of the LG Act requires councils to write-off postponed rates and accrued interest after five years.

The current arrangements of the LG Act which allow a ratepayer to postpone rates, and require councils to write-off postponed rates after five years, are inconsistent with the tax principles of simplicity, efficiency and equity:

- ▼ In many cases land rezoning substantially increases the value of a property. This land rezoning generally occurs through no effort of the ratepayer, but increases the ratepayer's wealth, regardless of whether the ratepayer intends to sell or develop the property.
- ▼ The increase in rates is a small fraction of the ratepayer's increased wealth from land rezoning.
- ▼ Allowing rates to be postponed and written off if land is not developed provides a disincentive to develop land and does not promote growth and urban renewal.

This draft recommendation would simplify the rating system by reducing councils' administrative burden, provide a better incentive to develop land and ensure a more equitable distribution of the rating burden.

#### 9.4.1 Summary of stakeholder submissions

The majority of councils<sup>115</sup> were supportive of the option to take-up electronic rate notices. Electronic notices were seen as more cost-effective and could result in a higher recovery rate than paper based notices. This is because a ratepayer may not receive a paper rates notice if they change address.

A number of councils supported removing Section 585 of the LG Act because the section is difficult for ratepayers and councils to understand, and imposes an administrative burden on councils.<sup>116</sup>

<sup>115</sup> See, for example, Southern Sydney Regional Organisation of Councils, Shoalhaven City Council, Campbelltown City Council, Kempsey Shire Council, Manly Council, submissions to IPART Issues Paper, May 2016.

<sup>116</sup> Camden Council, New South Wales Revenue Professionals, Greater Taree City Council, Eurobodalla Shire Council, submissions to IPART Issues Paper, May 2016.

## 10 | Other draft recommendations

Our review aims to enhance the ability of councils to implement sustainable and equitable fiscal policy and, to this end, we have made draft recommendations relating to the method for setting rates, exemptions and concessions. Through the course of the review we identified other issues where improvements would enhance the efficiency of the rating system. The sections below discuss our findings and analysis relating to these additional issues.

### 10.1 Summary of other draft findings

We considered a range of other issues that would enhance the efficiency of the rating system, benefit councils and other sectors of the economy. We found that:

- ▼ **The valuation base date used as the basis for collecting revenue for the Emergency Services Property Levy (ESPL) and collecting council rates should be aligned**, to promote simplicity and consistency.
- ▼ **CIV should be used as the basis for levying the ESPL**, when CIV data is available state-wide. CIV is more equitable and efficient (than UV) for levying the ESPL, as the cost of fire and emergency services relates more closely to protecting the capital on a property, rather than the property itself.
- ▼ **Giving councils the choice to purchase valuation services directly from the market** could allow them to obtain the quality of service they require in a more cost effective way.

We do not make any recommendations about the exemptions that councils receive from certain state taxes as we consider that major reforms to the tax exemptions that local government receive from the State Government should be negotiated and changed as part of a broader reciprocal agreement between the two levels of government.

## 10.2 The Emergency Services Property Levy

### Draft recommendation

- 33 The valuation base date for the Emergency Services Property Levy and council rates should be aligned.
- The NSW Government should levy the Emergency Services Property Levy on a Capital Improved Value basis when Capital Improved Value data becomes available state-wide.

We considered the ESPL in light of submissions we received to our Issues Paper. We considered stakeholders' concerns about:

- ▼ how the ESPL would be levied if reforms to the valuation method are introduced, and
- ▼ consistency in application across the State if choice over the valuation method for rates is introduced.

Box 10.1 provides a summary of the Government's announcement on the ESPL.

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### Box 10.1 Emergency Services Property Levy

In December 2015, the NSW Government announced it would introduce an ESPL to fund fire and emergency services. The ESPL will be paid alongside council rates from 1 July 2017, and replaces the Emergency Services Levy on insurance policies.

The new levy would be based on unimproved land values and collected by local government on behalf of the State Government.

**Source:** <https://www.emergency.nsw.gov.au/media-releases/2015/nsw-moves-to-a-fairer-system-for-funding-fire-and-emergency-services.html>

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UV is the only data currently available to set council rates. As the ESPL is to be collected by councils through rates for the NSW Government, it has to be levied on a UV basis. If our recommendations in Chapters 3 and 4 are adopted, CIV data would be collected state wide. This would allow the ESPL to be levied on either a UV or CIV basis. This raises the question as to whether UV or CIV is the better base for levying the ESPL.

Our draft findings and analysis, and our reasons for recommending that CIV should be used as the method to levy the ESPL, are outlined below.

### 10.2.1 How should the Emergency Services Property Levy be levied?

In submissions, councils raised a number of concerns relating to the method for levying the ESPL, including:

- ▼ The potential inconsistency in the valuation date for levying the ESPL and council rates. That is, the valuation base date for the ESPL might not be the same as the valuation date for council rates.
- ▼ The valuation method used. For example, “the ESPL cannot be equitably levied against land values, and complements the use of CIV.”<sup>117</sup>

#### Valuation base date

The valuation base date for the ESPL and council rates should be consistent. Otherwise, a ratepayer will face two different sets of land values for two property-based levies. This is contrary to the tax principle of simplicity. In practice, this means every council will need to adopt the same valuation base date for rating.

#### Valuation method for the ESPL

The cost of fire and emergency services relates more closely to protecting the capital on a property, rather than the property itself. For example, a highly developed block of land with apartments may receive significant benefits from fire protection services whereas a neighbouring block of the same size with a small house receives comparatively little benefit. In this example, under UV, they would pay the same ESPL levy amount which is less equitable and efficient compared to CIV.

A CIV base for the levy is more consistent with efficiency and equity principles than UV, as the benefits received from emergency services increase with market value as new capital is invested. As discussed in Chapters 3 and 4, we recommend CIV information be collected in all council areas. Hence, when CIV information is available state wide, the ESPL should be levied on a CIV, rather than a UV, basis.

#### Other jurisdictions

The ESPL is levied on a CIV basis in other states where CIV information is available, such as Victoria and South Australia. This includes councils where UV is adopted for setting rates. In practice, using a CIV base for the ESPL would not create any additional impost for councils that choose a UV base to set rates. This is because CIV data would be available state-wide and, under the current proposal, councils will be allowed to recover any additional costs of collecting the ESPL, as determined by the NSW Treasury.

<sup>117</sup> Sutherland Shire Council, submission to IPART Issues Paper, May 2016, p 2.

### 10.3 Valuation services

#### Draft recommendation

**34 Councils should be given the choice to directly buy valuation services from private valuers that have been certified by the Valuer General.**

Councils are currently required to use valuations supplied by the Valuer General (VG) for rating property. We reviewed the current methods for providing valuation services. We found the process could be more efficient, and provide a higher quality product, if councils were able to choose between using the VG or purchasing valuation services directly from private valuers.

Private valuers would need to meet standards set by the VG, to ensure consistent valuation standards are met for all users of valuation data. The VG would also need to ensure valuation data quality and be able to recoup these costs.

#### 10.3.1 Allowing councils choice over valuation services

We recommend councils be given choice over how they obtain valuation services. However, it is important to ensure the integrity of the data and to achieve efficiency in the valuation process.

To protect the integrity of the data, we recommend that the VG would retain responsibility for:

- ▼ setting valuation standards
- ▼ certifying valuers that can be engaged to provide valuations by councils
- ▼ maintaining a database of valuations, and
- ▼ requiring that valuations cannot be used for rates, levies or taxes until approved by the VG as generally true and correct.

To ensure that no council is worse off under choice, we also recommend:

- ▼ valuation service arrangements to remain unchanged for councils that wish to continue to use the VG, and
- ▼ a process for ensuring that valuation costs would be shared fairly and efficiently between users of the data.

For councils that continue to use the VG, the valuation process would remain unchanged. This process is outlined in Box 10.2 and Figure 10.1. In particular, the current arrangements that IPART determines the maximum prices the VG can set for councils that do not engage private valuers should remain. These arrangements would also allow the VG to recover the efficient costs of providing services to these councils.



### Box 10.2 Current valuation process

The VG is responsible for providing a list of valuations to councils for rating purposes at least once every four years.<sup>a</sup> Councils typically receive valuations from the VG once every three years. The VG is also currently required to provide valuation information to the Office of State Revenue (OSR) and other minor users of the data.

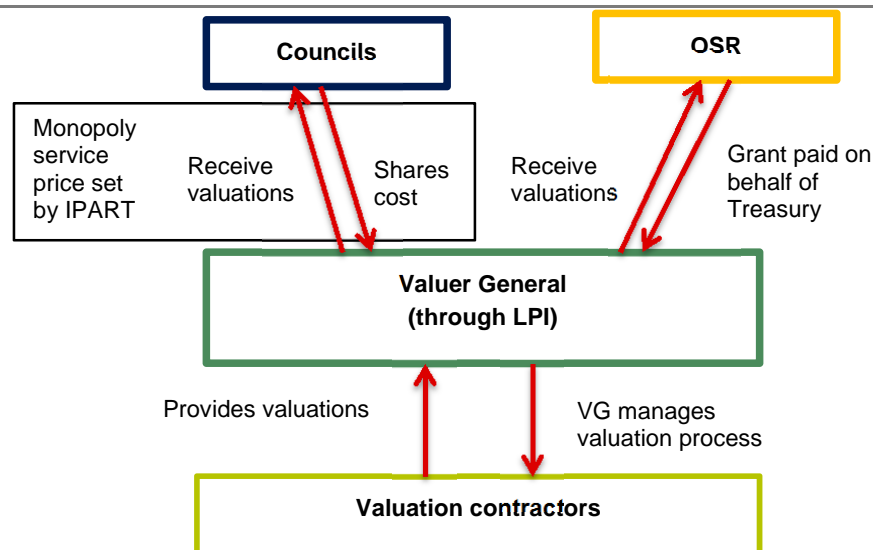
To provide these services, the VG:

- ▼ sets the standards for valuations, and
- ▼ delegates operational responsibilities through a service level agreement with Land and Property Information (LPI).

In turn, LPI manages the valuation system, in particular, managing valuation contracts by engaging external contractors to conduct valuations through a competitive tender process, and maintaining a database of valuations.<sup>b</sup>

Finally, IPART determines the maximum prices for valuation services provided to councils for rating purposes. In IPART's 2014 Determination, we made a decision to allocate 34% of the VG's total costs to councils. The funding from OSR for valuation services is provided with a grant from Treasury, however the price is not determined by IPART. The current process is outlined in Figure 10.1.

**Figure 10.1 Current valuation process**



<sup>a</sup> Under Part 5 of the *Valuation of Land Act 1916*.

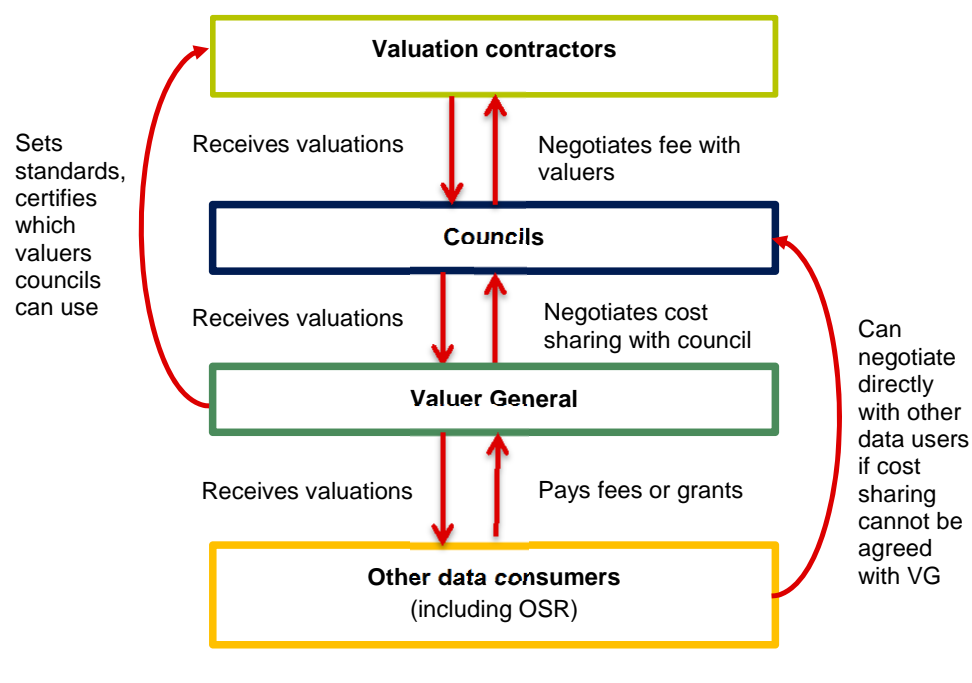
<sup>b</sup> For more details, see IPART, *Review of prices for land valuation services provided by the Valuer-General to councils - Final Report*, 2014, pp 9-10.

For councils that engage private valuers the recommended process is outlined in Figure 10.2. Under this process, councils would:

1. buy valuation information from valuers directly
2. pay for these services, and
3. provide the information to the VG for a fee that is directly negotiated between the parties. IPART benchmark prices could form the basis for this negotiation.<sup>118</sup>

Under this process, the VG would be responsible for setting standards and ensuring the accuracy of the information before councils would be able to use the data for setting rates.

**Figure 10.2 Recommended arrangements for councils directly engaging private contractors**



<sup>118</sup> To ensure efficiency in the valuation process, if a cost sharing arrangement cannot be reached directly with the VG, councils could have the option to directly negotiate agreements with the OSR and other users of the data.

### 10.3.2 Stakeholder feedback on the current system

In our Issues Paper, we asked whether councils should be required to use the VG's property valuation services, or whether they also should be allowed to buy valuation services from private valuation firms (as occurs in Victoria and Tasmania):

- ▼ Around half of stakeholders supported the introduction of choice, so long as the VG retains control over the agreed standards of valuation.
- ▼ A number of councils supported choice because it would allow them to choose the most cost-effective option.<sup>119</sup>
- ▼ A number of other councils supported choice so they could purchase a higher standard of valuation services, for example, more timely access to data and responses to valuation objections.<sup>120</sup>

Other stakeholders were cautious about choice because:

- ▼ allowing choice could lead to inconsistency in valuations, and
- ▼ the VG can exploit economies of scale.

In its submission, the VG noted a move to allow councils to use private valuation firms:

- ▼ would require the VG to establish agreements with councils, and
- ▼ raises the risk of inconsistency in valuation outcomes if there is inconsistency in valuation contracts.<sup>121</sup>

## 10.4 Councils' exemptions from certain state taxes

In our Issues Paper we asked whether the exemptions from certain state taxes (such as payroll tax) that councils receive should be considered as part of a review of the exemptions and concessions for certain categories of ratepayers.

When analysed against the tax principles of competitive neutrality and sustainability, it may be appropriate for councils' exemptions from payroll tax to be removed.

<sup>119</sup> Cootamundra Shire Council, p 2, Manly Council, p 1, Greater Hume Shire Council, p 1, submissions to IPART Issues Paper, May 2016.

<sup>120</sup> Sutherland Shire Council, p 3, North Sydney Council, p 1, submissions to IPART Issues Paper, May 2016.

<sup>121</sup> Office of the Valuer General, submission to IPART Issues Paper, May 2016, pp 8-9.

However, we do not recommend councils pay payroll tax as part of this review. This is because major reforms to the tax exemptions that local government receive from the State Government should be negotiated and changed as part of a broader reciprocal agreement between the two levels of government. This agreement would promote more efficient tax bases for both levels of government and make them both better off.

Our position is consistent with stakeholder feedback. The majority of stakeholders were not supportive of councils paying payroll tax, and were also of the view that council exemptions from state taxes should be considered in the context of a broader taxation review.<sup>122</sup>

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<sup>122</sup> For example, Upper Lachlan Shire Council, p 2, Queanbeyan City Council, p 12, submissions to IPART Issues Paper, May 2016.



**Appendices**



## A Terms of Reference



Dr Peter Boxall AO  
Chairman  
Independent Pricing and Regulatory Tribunal  
PO Box K35  
HAYMARKET POST SHOP NSW 1240



Reference: A1444504

18 DEC 2015

Dear Dr Boxall

Pursuant to section 9 of the *Independent Pricing and Regulatory Tribunal Act 1992*, I am writing to request the Tribunal undertake a review of the Local Government rating system in accordance with the attached Terms of Reference.

The implementation of an efficient and equitable rating system is a key component of the Government's *Fit for the Future* reforms, and will ensure all councils are able to implement sustainable fiscal policies and reforms over the longer-term.

Critically, the Tribunal's review should seek to recommend a legislative or regulatory approach to support the Government's policy of freezing existing rate paths for a period of four years for councils that merge as part of the *Fit for the Future* process.

An interim report outlining options and recommendations to achieve this commitment should be provided to the Minister for Local Government within six months. A final report addressing all aspects of the terms of reference should be provided to the Minister within 12 months.

Should you have any questions or wish to discuss this matter further, please contact Mr John Clark, Executive Director, Local Government Reform on 9228 3570 or [john.clark@dpc.nsw.gov.au](mailto:john.clark@dpc.nsw.gov.au)

Yours sincerely

A blue ink signature of Mike Baird.

**MIKE BAIRD MP**  
Premier

Encl: Terms of Reference, Local Government Rating System in NSW

## Terms of Reference

### The Local Government Rating System in NSW

I, Mike Baird, Premier of New South Wales, approve the provision of services by the Independent Pricing and Regulatory Tribunal (IPART) under section 9 of the *Independent Pricing and Regulatory Tribunal Act 1992* (IPART Act) to the Minister for Local Government for the review of the local government rating system in accordance with these 'terms of reference'.

#### General

IPART is to undertake a review to identify and make recommendations for potential reforms to the rating system for local government in NSW. These recommendations will aim to:

- Enhance the ability of councils to implement sustainable and equitable fiscal policy and
- Provide the legislative and regulatory approach to achieve the Government's policy of freezing existing rate paths for four years for newly merged councils.

In investigating and making recommendations for this review, IPART is to consider:

- a) the performance of the current rating system and potential improvements, including consideration of:
  - the rating burden across and within communities, including consideration of apartments and other multi-unit dwellings;
  - the appropriateness and impact of current rating categories and exemptions, mandatory concessions and rebates;
  - the land valuation methodology used as the basis for determining rates in comparison to other jurisdictions;
  - the impact of the current rating system on residents and businesses of a merged council and the capacity of the council to establish a new equitable system of rating and transition to it in a fair and timely manner.
  - the objectives and design of the rating system according to recognised principles of taxation.
- b) current examples of municipal best practice rating policies and schemes;
- c) the impact of the current and alternative frameworks for the rating system on communities and businesses and their capacity to pay; and
- d) any other matter IPART considers relevant.

In undertaking its review under these Terms of Reference, IPART is to take account of:



- the importance of Integrated Planning and Reporting in determining the revenue required to deliver services and infrastructure;
- the current financial sustainability of local government in NSW, including the findings and deliberations of the NSW Treasury Corporation report Financial Sustainability of the NSW Local Government Sector, 2013;
- the findings and deliberations of the Independent Local Government Review Panel and subsequent Government response;
- the NSW Government's policy of encouraging urban renewal; and
- the NSW Government's commitment to protect NSW residents against excessive rate increases and to providing rate concessions to pensioners.

#### Public consultation

IPART should consult with relevant stakeholders and NSW Government agencies by releasing an Issues Paper and Draft Report for their review on the IPART website. IPART should also consult with the Fit for the Future Ministerial Advisory Group.

IPART may also hold public hearings for the purposes of this review.

#### Timeframe

An interim report with recommendations on the legislative and regulatory approach to achieve the Government's policy of freezing existing rate paths for four years for newly merged councils should be submitted to the Minister for Local Government within 6 months of signing of the Terms of Reference.

A final review report should be formally submitted to the Minister for Local Government within 12 months of signing of the Terms of Reference.

#### Governance

IPART should provide progress briefings at regular intervals or as requested to the Chief Executive, Office of Local Government.

The Minister for Local Government will decide on the timing of release of the final report.

#### Supporting information and recommendations

IPART is to collect relevant material and data to establish the impacts to councils, communities and NSW of the current rating system, and to provide reasons for any recommendations for reform.

## B The demand for council services

This appendix presents our analysis on whether a Capital Improved Value (CIV) or Unimproved Value (UV) rating structure better reflects ratepayers' demand for council services.

The academic literature provides support for a CIV method, as it suggests a higher property value will usually reflect a greater demand for council services. Previous research has shown CIV has a very high correlation with income (and a higher correlation with income than UV),<sup>123</sup> and that increases in income typically lead to an increase in the demand for local public goods.<sup>124</sup>

In Chapter 3 we analysed the relationship between the demand for the services that rates fund and the rates that would be paid under a CIV or UV method. To do this, we identified the services that rates fund, the different rating categories and the types of ratepayers within a category.

If the difference between property values within a rating category, on balance, better reflects the differences in demand for a specific council service, we judged that the CIV method would be a better valuation method. If the difference between land values better reflects the difference in demand, the UV method was considered a better method.

We have assessed whether there is a strong, moderate or weak preference for one method over the other. This is shown in Table B.1 below. For some council services, it is relatively clear cut which method is superior for a given category of ratepayers, but in other cases it is less clear.

In general, we assessed that a CIV method better reflects ratepayers' demand for:

- ▼ The facilities that councils provide and maintain (eg, parks and fields, pools and libraries).
  - The total demand and usage of these facilities from all residents in an apartment block will be greater than the demand from a single household, on average.

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<sup>123</sup> New Zealand Local Government Rates Inquiry Panel, *Funding Local Government*, August 2007, pp 125-126.

<sup>124</sup> Borcharding T and T Deacon, *The demand for the services of non-federal governments*, The American economic review, 1972, pp 891-901.

- CIV will better reflect this demand because, using UV, as density increases on a block of land, the land value is divided among an increasing number of ratepayers who each make a lower overall contribution to council rates.
- ▼ Roads and footpaths.
  - The total demand for, and congestion on, local roads created by a block of apartments will be greater than a house, on average.
  - A wealthier household or unit should have a greater willingness to pay for roads and footpaths.<sup>125</sup>
  - That said, while a block of apartments should, in total, have a greater demand for footpaths and street-lighting than a house, these costs tend to grow at a slower rate per capita as density increases.
- ▼ Other services, such as social protection and environmental services which promote welfare in the community.
  - CIV, which is a better measure of ability to pay, is therefore a better measure to fund these services.

Rates also fund the 'governance and administration' functions of the council. This expenditure may relate in part to the oversight of other council services (ie, roads, parks, etc). In other cases, other governance expenses may be fixed expenditures that benefit all ratepayers. Base amounts could play a role in recovering some of these costs.

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<sup>125</sup> This is because wealthier households tend to spend more on vehicles, and to the extent that vehicle expenditure should proxy the underlying demand for additional road expenditure.

**Table B.1 The relationship between demand for council services and valuation method**

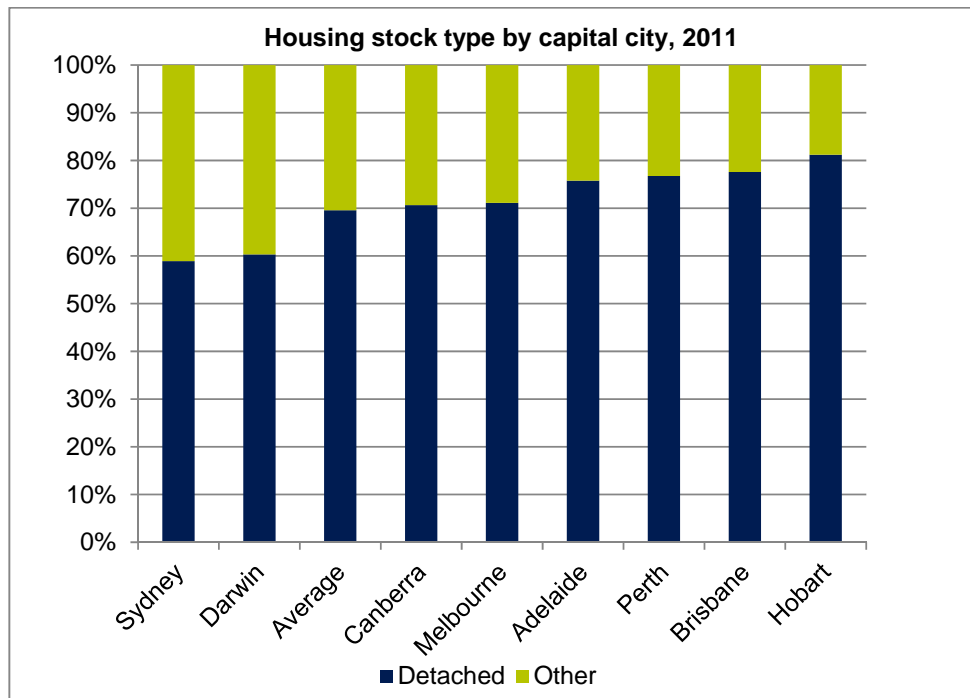
Council service	Share of rates bill (%)	Category of ratepayer					
		Residential ratepayers				Business ratepayers	
		Comparing an apartment to a house		Comparing two houses or two apartments		Comparing a number of small shops to a shopping centre	
		<i>Better valuation method</i>	<i>Strength?</i>	<i>Better valuation method</i>	<i>Strength?</i>	<i>Better valuation method</i>	<i>Strength?</i>
<b>Streets and footpaths</b>	<b>27.5</b>	<b>CIV</b>	<b>Weak</b>	<b>CIV</b>	<b>Weak</b>	<b>Neither</b>	<b>N/A</b>
Roads and bridges	18.5	CIV	Weak	CIV	Strong	CIV	Moderate
Footpaths and streetlights	5.7	CIV	Moderate	UV	Weak	UV	Moderate
Street sweeping	3.3	CIV	Moderate	UV	Weak	UV	Weak
<b>Facilities</b>	<b>29.3</b>	<b>CIV</b>	<b>Weak</b>	<b>CIV</b>	<b>Strong</b>		
Parks and fields	15.5	CIV	Weak	CIV	Strong		
Libraries	7.5	CIV	Weak	CIV	Strong		
Pools	3.0	CIV	Weak	CIV	Weak		
Other	3.2	CIV	Moderate	CIV	Strong		
<b>Other services</b>	<b>10.7</b>	<b>CIV</b>	<b>Strong</b>	<b>CIV</b>	<b>Strong</b>		
Community	7.3	CIV	Strong	CIV	Strong		
Environment	3.5	CIV	Strong	CIV	Strong		
<b>Governance and admin</b>	<b>32.5</b>						

Source: IPART analysis, OLG (using council financial statements).

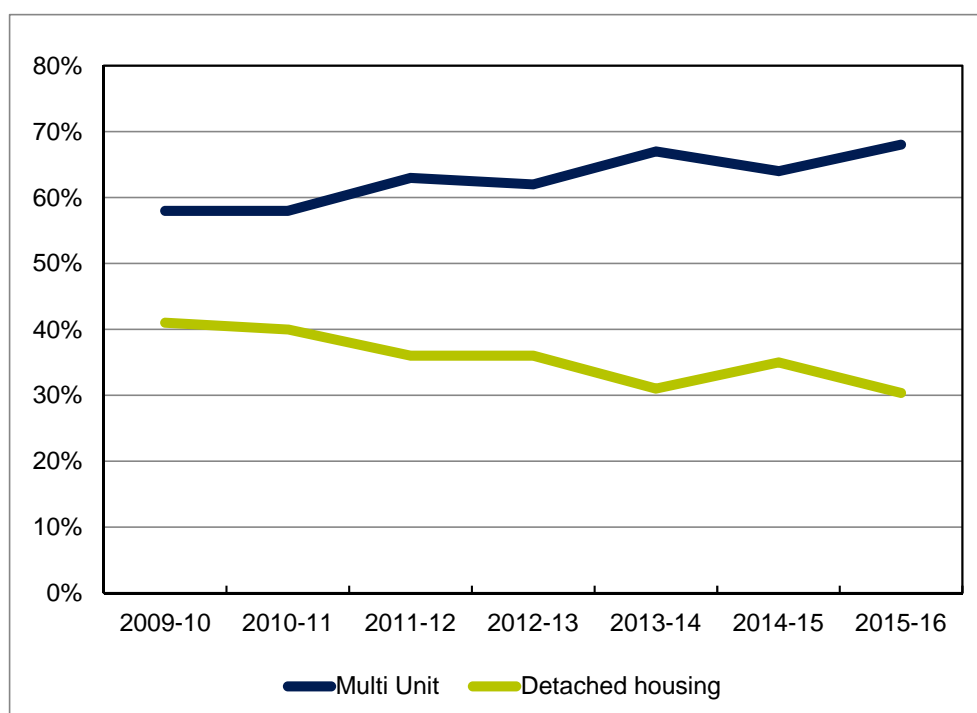
## C Housing composition in Sydney

Figure C.1 shows Sydney has the highest proportion of multi-unit dwellings of Australia's capital cities at 40%, compared with 20% to 30% in other capital cities, and 30% Australia wide.

**Figure C.1 Dwelling type percentages by capital city**



**Data source:** ABS, 2011 Census of Population and Housing.

**Figure C.2 Dwelling approvals by type in Sydney**

**Data source:** Department of Planning & Environment, Annual Report 2014-15; ABS, Building Approvals, Australia, June 2016, Cat. No. 8731.0.

The proportion of apartments in Sydney is rising over time. Figure C.2 shows:

- ▼ In 2009-10, detached housing was 41% of total Sydney approvals and multi-unit dwellings comprised 58%.
- ▼ By 2015-16, detached housing was just 30% of approvals with multi-unit dwellings comprising 68%.<sup>126</sup>

Consequently, the appropriate treatment of multi-unit dwellings in council rate bases will be an increasingly important issue for NSW, and Sydney in particular, because the proportion of apartments is rising over time.

<sup>126</sup> Department of Planning & Environment Annual Report 2014-15, p 30. Multi-unit dwellings include apartments, villas, townhouses, terraces and semi-detached homes.

## D Valuation method chosen in other jurisdictions

A comparison of the valuation methods used in other Australian states and internationally reveals two key patterns:

- ▼ Councils overwhelmingly favour a valuation method based on market value in Australian states where choice is provided.
- ▼ There has been an international trend towards rating on a CIV basis.

In general, two types of property valuation methodologies are used in other jurisdictions:

1. UV type approaches based on the value of land.
2. Market value type approaches, which are based on CIV or Annual Rental Value (ARV).

The ARV approach, which values property based on its rental value, is conceptually similar to a CIV approach.<sup>127</sup>

A summary of valuation methods in Australian states is contained in Table D.2.

In Victoria, South Australia and Tasmania, councils can choose between UV, CIV and ARV. As shown in Figure D.1, **councils in these states overwhelmingly favour a valuation method based on market value.**

- ▼ In Victoria, of 79 councils, 73 currently use CIV and 6 use ARV.
- ▼ In South Australia, 60 out of 68 councils use CIV.
- ▼ In Tasmania, 24 out of 29 councils use ARV, and the remaining 5 use CIV.

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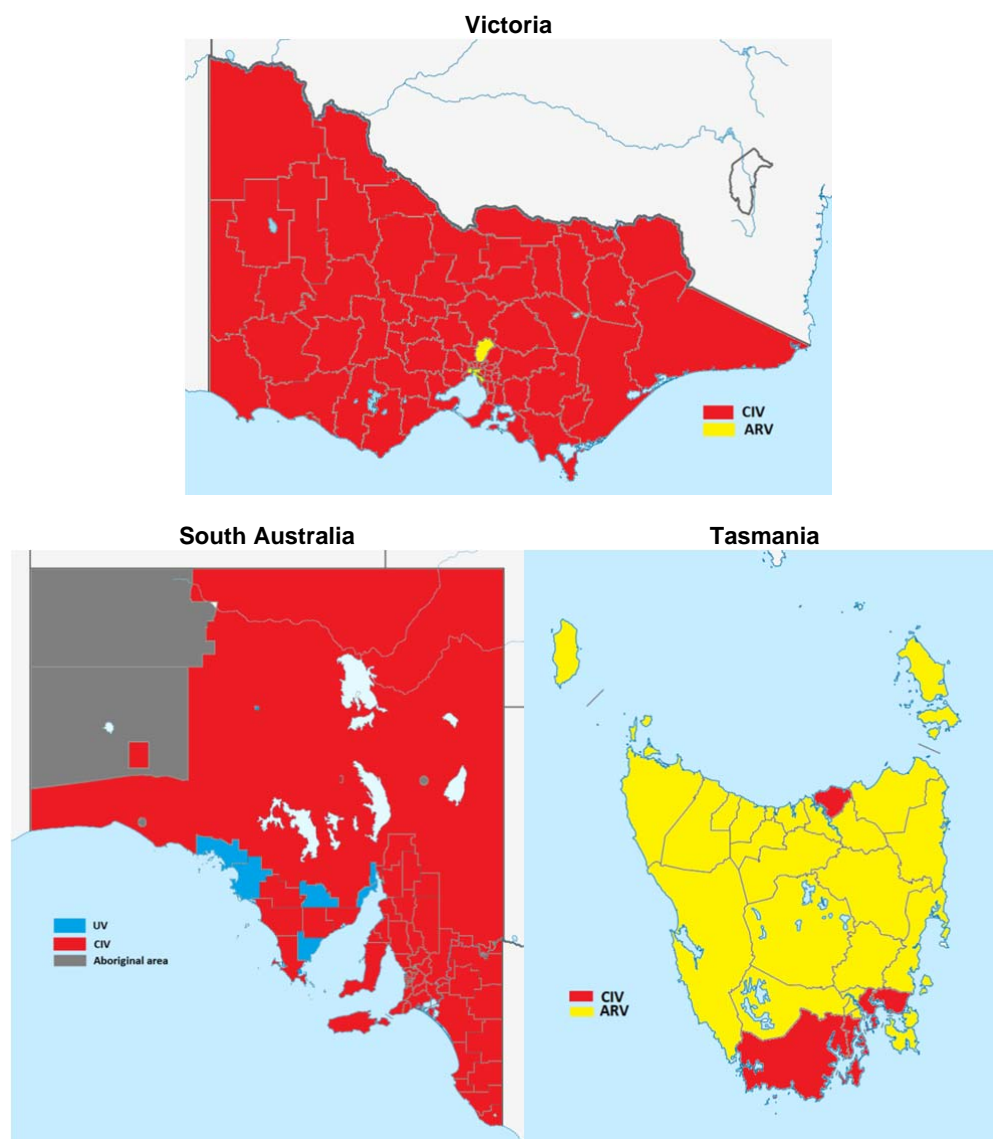
<sup>127</sup> We have not recommended ARV as an additional rating option for NSW as:

- CIV is sufficient to overcome potential weakness with a UV approach
- stakeholders did not want ARV as an additional option to CIV, and
- research has found that a CIV approach is generally superior to ARV-based approaches.

The *Tasmania Valuation and Local Government Rating Review Final Report* (April 2013) found that there was not a strong case to continue to use ARV. In particular, it assessed that an ARV approach was not as simple to understand, more costly to implement and more volatile than a CIV method (p 91).

In Queensland and Western Australia, councils are not provided choice over the valuation method. However, other tools have been chosen to address the rating of apartments. In Western Australia, councils must use the ARV method in urban areas, and the UV method in rural areas. In Queensland, UV is mandated for all councils, but councils have the flexibility to create different subcategories for apartments and houses to reflect the use of council services, which would otherwise be accounted for by using a CIV rating structure.

**Figure D.1 Valuation methods adopted in states where choice is offered**



**Data sources:** IPART analysis; Victorian Department of Transport, Planning and Local Infrastructure, *Valuation best practice*, 2016.



Internationally, a market value type approach is the most common form of valuation method used to levy property taxes (Table D.1). Among countries with taxes based on the value of the property, around 85% of countries use market value, while 15% choose UV. An analysis of 125 countries suggests that only 5 – Saudi Arabia, Taiwan, Papua New Guinea, Jamaica and Fiji – use UV as the sole basis of valuing land for tax purposes.

**Table D.1 International property-based taxes and valuation method<sup>a</sup>**

Region	Number of countries	Method			
		UV	CIV	ARV	Other <sup>b</sup>
North America	3	0	3	0	0
Western Europe	17	0	12	7	0
Oceania	7	6	2	4	0
Asia	24	2	8	11	11
Eastern Europe	20	1	6	0	15
South America	16	2	15	1	0
Caribbean	13	4	6	8	5
Africa	25	1	11	7	21
<b>Total</b>	<b>125</b>	<b>16</b>	<b>63</b>	<b>38</b>	<b>52</b>

<sup>a</sup> The sum of each column is greater than the total number of countries as some jurisdictions allow choice, or use multiple methods to tax property.

<sup>b</sup> Other methods include property taxes that are not based on the value of the property.

**Sources:** IPART analysis;

<http://www.ipti.org/wp-content/uploads/2015/04/IPTI-Xtracts-Belgium-May-2015.pdf>

<http://www.ipti.org/wp-content/uploads/2015/09/IPTI-Xtracts-Finland-March-2016.pdf>

<http://www.skra.is/english/property-valuation/>

<https://www.nordisketax.net/main.asp?url=files/nor/eng/032.asp>

McCluskey, W. and M. Bell. *Rental Value versus Capital Value: Alternative Bases for the Property Tax*. International Center for Public Policy, Andrew Young School of Policy Studies, Georgia State University, 2008 p 8.

Academic literature has concluded there has been an international trend “to move away from land value based systems to the more popular capital improved value”.<sup>128</sup>

- ▼ In South Africa, in the 1990s, the use of CIV and UV was “rather evenly spread amongst municipalities”.<sup>129</sup> However, a CIV method was mandated as the sole basis for property taxes in 2004.<sup>130</sup>

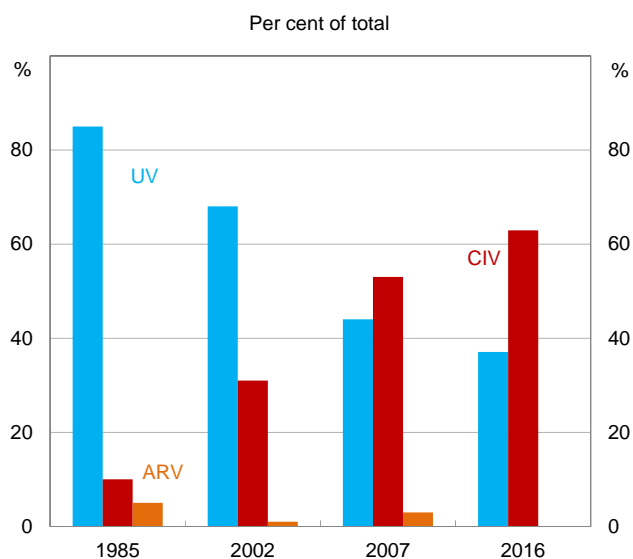
<sup>128</sup> McCluskey, W, L Cheng, and P Davis, *Land Value Taxation: An International Overview*, American Journal of Economics and Sociology 56.2007, 2007, pp 207-214.

<sup>129</sup> Ibid.

<sup>130</sup> Local Government Municipal Property Rates Act 2004, Section 46, at [http://www.saflii.org/za/legis/consol\\_act/lgmpra2004454/](http://www.saflii.org/za/legis/consol_act/lgmpra2004454/), accessed 16 August 2016.

- ▼ In New Zealand, where councils are permitted to choose between UV, CIV and ARV, there has been a strong trend towards CIV. As shown in Figure D.2, in 1985, around 85% of councils adopted a UV method for rates. However, by 2007, the majority of councils had moved to a CIV method for rates, with over 60% of councils currently using CIV for levying rates.
- ▼ Most recently, in 2013 Ireland adopted a property tax based on CIV.<sup>131</sup>

**Figure D.2 Valuation method chosen by councils in New Zealand**



**Data sources:** McCluskey, W, A Grimes and J Timmins, *Property Taxation in New Zealand*, Motu Economic & Public Policy Research Trust, New Zealand, 2002, p 3; New Zealand Local Government Rates Inquiry Panel, *Funding Local Government*, August 2007, p 46; Department of Internal Affairs New Zealand.

<sup>131</sup> Irish Tax and Customs, Local Property Tax (<http://www.revenue.ie/en/tax/lpt/>, accessed 16 August 2016).

**Table D.2 Council rating methodology across Australia**

	NSW	VIC	QLD	SA	WA	TAS	NT
<b>Valuation method</b>	UV	Councils may choose from: <ul style="list-style-type: none"> <li>• UV</li> <li>• CIV</li> <li>• ARV</li> </ul> 73 out of 79 Councils use CIV, the rest use ARV	UV	Councils may choose from: <ul style="list-style-type: none"> <li>• UV</li> <li>• CIV</li> <li>• ARV</li> </ul> 60 out of 68 councils use CIV	<ul style="list-style-type: none"> <li>• Rural land – UV</li> <li>• Non-rural land – ARV</li> <li>• UV mandatory for mining and petroleum interests</li> </ul>	Councils may choose from: <ul style="list-style-type: none"> <li>• UV</li> <li>• CIV</li> <li>• ARV</li> </ul> 24 out of 29 Councils use ARV, the remaining 5 use CIV	Councils may choose from: <ul style="list-style-type: none"> <li>• UV</li> <li>• CIV</li> <li>• ARV</li> </ul> All councils use UV
<b>Base amount</b>	Option for base amounts by land use category, up to 50% of general revenue for that category	Option for 'municipal charge' up to 20% of sum total of general revenue and revenue from municipal charges	No option for base amount	Option for base amount, up to 50% of general rates	No option for base amount	Option for base amount of up to 50% of general rates	Multiple base amounts for different purposes according to land use/location categories
<b>Minimum amount or rate</b>	Option for minimum amount up to a legislated ceiling for ordinary and special rates	No option for minimum amount	Option for differential minimum amount by land use categories	Option for minimum amount application for up to 35% of properties. It cannot be used in addition to a base amount	Option for differential minimum amounts for up to 50% of premises, unless capped at \$200	Option for minimum amount, but it cannot be used on top of a base amount	Option for different minimum amounts according to land use/location categories
<b>Rate categories</b>	Option for differential rates across four land use categories and multiple subcategories	Option for differential rates across multiple land use categories	Option for differential rates across multiple land use categories	Option for differential rates across nine land use categories, with option for specified land location categories	Option for differential rates across multiple land use categories	Option for differential rates across eight land use categories; no restriction on land location categories	Option for differential minimum amounts in addition to fixed charge

**Sources:** IPART analysis, *Local Government Act 1993* (NSW), *Local Government Regulation 2005* (NSW), *Local Government Act 1989* (Vic), *Local Government Act 2009* (Qld), *Local Government Regulation 2012* (Qld), *Land Valuation Act 2010* (Qld), *Local Government Act 1999* (SA), *Local Government (General) Regulation 2013* (SA), *Local Government Act 1995* (WA), *Local Government (Financial Management) Regulation 1996* (WA), *Local Government Act 1993* (Tas), *Local Government Act 2008* (NT).

**Notes:** UV denotes Unimproved Value, CIV denotes Capital Improved Value, ARV denotes Annual Rental Value.

## E | Alternative valuation methods to CIV

This appendix outlines the arguments for and against alternatives to our core recommendation to provide councils with choice between CIV and UV for setting rates. Alternatives to providing choice include mandating CIV, creating a residential subcategory for strata titled properties or making no change.

### Mandating CIV

An alternative to choice would be to mandate a CIV method for all properties, and provide councils the ability to 'opt-out' and retain a UV method if they demonstrate that it is in the local public interest. This approach is similar to the Independent Local Government Review Panel's (the Panel's) recommendation that the move to CIV could be mandated in selected local government areas.

The main benefit of this alternative is that it arguably creates more consistency – or at least comparability – in rating between council areas.

However, this may not outweigh the main costs of mandating a valuation method (ie, that local councils have less ability to tailor rates to local circumstances, and that local councils are best placed to make this decision).

### Residential subcategory for strata

To resolve the rating of apartments, the Panel also suggested the residential land use category could be split into subcategories for detached housing (non-strata titled property) and another for multi-unit dwellings (strata titled property). Apartments could be rated on a CIV basis, as recommended by the Panel, or UV, as recommended by the NSW Valuer General.<sup>132</sup>

The main advantage of a residential subcategory for strata apartments is that it is a lower-effort solution to better balance the **average** rates paid by apartments and houses.

However, the disadvantages with this approach are likely to outweigh the benefits regardless of whether apartments are rated on a UV or CIV basis.

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<sup>132</sup> Office of the Valuer General, submission to IPART Issues Paper, May 2016, pp 9-10.

If apartments are rated on a CIV method, and houses on a UV method:

- ▼ It is difficult to determine the relative rates between houses and apartments because they face different tax bases. What should be the ad valorem rates for a house with a UV of \$500,000 and an apartment with a CIV of \$500,000? In practice, there is unlikely to be a clear answer, and councils might choose arbitrary ratios between houses and apartments, which could increase inefficiency and reduce horizontal equity and transparency.
- ▼ Collecting CIV only for apartments would not necessarily be more cost effective. If CIV is collected for apartments only, data would need to be collected for around 1 million properties, with potentially little benefit outside of council rating. On the other hand, if CIV is collected for all properties, the benefits accrue more widely, and once apportioned will offset the costs to councils (see Appendix F).

Rating both houses and apartments on a UV basis and creating a separate subcategory for apartments will create a disparity in rates between low rise and high rise apartments within a council area. That is, a 2-bedroom apartment within a 5-storey apartment block will, on average, pay more rates than an otherwise identical 2-bedroom apartment within a 10-storey apartment block occupying the same land value.<sup>133</sup>

To resolve this disparity, in practice, a number of subcategories would need to be created according to the number of units, or number of floors, in a strata title. However, this is contrary to the tax principle of simplicity and is likely lead to inefficient outcomes. In Queensland, where councils are permitted to define residential subcategories for apartments, in 2015-16:

- ▼ one council adopted 253 rating categories, including 64 separate subcategories for strata apartments with 2-65 units, while
- ▼ a number of councils adopted over 100 rating subcategories.

Regardless of whether strata units are rated on a UV or CIV basis, a strata subcategory creates an arbitrary rating burden between apartments and houses, which is contrary to the horizontal and vertical equity principles, and rating on this basis is also unlikely to reflect the benefits received from council services.

### No change

A small percentage of stakeholders recommended the current UV method should be retained, with little or no change.

However, we do not recommend this approach, as the current issues in the rating system warrant change for a significant, and increasing, number of council areas.

<sup>133</sup> For further details, see V. Mangioni, submission to IPART Issues Paper, May 2016, p 4.

### Other methods

Almost all stakeholders recommended a valuation method based on CIV, UV, or a mixture of the two. This is consistent with the findings of the Henry Tax Review and the Productivity Commission Review which both find that taxes based on property value are a sound tax base for local government.<sup>134</sup>

However, a small number of stakeholders recommended alternative methods for charging rates.

The Lake Macquarie Ratepayers Association recommended an approach based primarily on the historical purchase price of a property.<sup>135</sup> Analytically, this is quite similar to the property values used in a number of municipalities in the USA which are based on historical values.<sup>136</sup> However, these approaches have three key disadvantages:

1. Properties with the same value will pay very different rates depending on when they were last sold. This is likely to be both inequitable and inefficient.
2. They discourage ratepayers from selling property when property prices rise, arguably exacerbating housing affordability issues. For example, downsizers might be additionally discouraged from buying a smaller, lower cost house if the rates for a newly purchased property are much greater than the rates paid on property with a much lower historical purchase price. This adds to the already large transaction costs in moving houses from factors such as stamp duty.
3. They result in a tax which is procyclical – eg, people who buy property at the top of a property price cycle have to pay higher rates for as long as they own the property.

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<sup>134</sup> Henry Tax Review, p 692.

<sup>135</sup> Lake Macquarie Ratepayers Action Group, submission to IPART Issues Paper, May 2016.

<sup>136</sup> For example, those levied in California. For more information, see Legislative Analyst's Office, *Understanding California's Property Taxes*, at: <http://www.lao.ca.gov/reports/2012/tax/property-tax-primer-112912.aspx>, November 2012, accessed 16 August 2016.

## F Benefits and cost of collecting CIV information

### Cost of collecting CIV is likely to be small if phased over several years

A key theme from submissions was that stakeholders were concerned about the cost of implementing CIV to rate property. However, our analysis suggests that any costs are small and can be contained by:

- ▼ Phasing the introduction of CIV over a number of years as individual 'benchmark' properties are valued. This will greatly reduce costs because for most properties the current valuation process already involves collecting information on the added value of improvements.
- ▼ Allowing the process for creating a database to store CIV data to be conducted through a competitive tender process.

### The benefits of CIV are significant

The benefits to NSW of collecting CIV are significant and accrue to numerous sectors of the economy. In discussions, the NSW Valuer General agreed that the benefits to NSW of collecting CIV information could be significant.<sup>137</sup> CIV data could be used to generate additional revenue, as is the case in other states (see Box F.1). Once the benefits of CIV are apportioned fairly and efficiently, the total cost to councils for valuation services could fall. This could be achieved by ensuring any costs of collecting CIV data are fairly apportioned amongst the beneficiaries.

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<sup>137</sup> Meeting with NSW Valuer General, 2 August 2016.

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### Box F.1 Benefits of CIV

The collection of CIV data requires information on property attributes (eg, land size, number of bedrooms, etc). This information will provide significant benefits to the community, Government and financial sectors.

**Additional use of property attribute information by the public and private sector could greatly offset the cost of providing valuation services to existing consumers of the data.**

#### Public sector benefits

A major public sector benefit of CIV data is it can be used to better tailor future developments to the needs of local communities. Information on property attributes can be used to more accurately forecast dwelling requirements.

In consultation, the Department of Planning and Environment (DPE) noted that it forecasts future dwelling requirements at the local community level by comparing estimates of future housing demand to estimates of current housing supply.<sup>a</sup>

#### *Better planning if CIV data is available*

DPE's current estimates of housing supply – which use a number of public and private sector data sources – are incomplete in two dimensions. First, a significant proportion of the capital stock is often excluded in the data, including secondary dwellings (ie, granny flats) and a range of residences that are not houses or apartments (eg, seniors aged care). Second, the information has limitations in determining the mix of properties in a community – ie, the size and characteristics of apartments and houses – and hence whether these properties are on average under- or over-utilised by residents in the community.

The information on property attributes would increase the accuracy of these forecasts. In particular, it could be used to determine whether current – and future – development is appropriate to the demographic structure within a community.

This information would be important to efficiently and effectively implement the Plan for Growing Sydney and urban renewal.

Discussions with DPE also noted that the spillover benefits could extend to a range of other NSW Government departments.

#### *Better tax data*

The Office of State Revenue may also derive additional benefit from the information on CIV. This information could provide a meaningful cross-check for “off-market” property sales in the assessment of stamp duties. Consultation with experts in valuation and taxation noted that CIV would also be useful for the Australian Tax Office in auditing the amount of money spent on property in the assessment of capital gains tax.<sup>b</sup>



### Private sector benefits

Additional information on property attributes in NSW has a range of potential uses across the private sector, including for use in valuation models in the Banking, Insurance and Self-Managed Super Fund sectors. The real estate sector would also benefit from the availability of this information (eg, in its submission APM PriceFinder noted that it would be valuable if this information is available to data brokers).

In Victoria, information on property – excluding actual valuations – is available for purchase by the private sector through the Victorian Government's Property Sales and Valuations (PSV) database.

### Additional benefits to councils and government

A further benefit of CIV information to councils is that it should be used to calculate growth in rates outside the peg from new development and rezoning in a manner that better approximates the drivers of councils' costs over time (see Chapter 4 for further details). This reform is likely to significantly reduce the number of SV applications councils need to make and the regulatory costs of rate pegging.

As discussed in Chapter 10, CIV is also a more efficient and equitable base to levy the ESPL, compared to UV.

<sup>a</sup> Meeting with DPE, 10 June 2016.

<sup>b</sup> Meeting with Dr Vincent Mangioni, 12 July 2016.

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### Collecting information on CIV

The data collection process for CIV should begin as soon as possible, so that newly merged councils are able to use the new system at the conclusion of the rate path freeze. Council areas that are not subject to a merger would be free to choose a CIV approach once the data has been collected.

In its submission, the Valuer General noted that collecting capital improved values requires “investment to source, collate and maintain built attribute data for all properties in the state”.<sup>138</sup> This involves two main tasks:

1. developing a database to store and maintain attribute data, and
2. populating the database with the relevant information.

On the first task, research has identified that there are a number of firms – both operating in Australia and internationally – who have wide-ranging experience in building valuation databases for both government and banking sectors.

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<sup>138</sup> Office of the Valuer General, submission to IPART Issues Paper, May 2016, p 7.

Additionally, any new system could include inbuilt auditing tools that would reduce the costs of ensuring valuation data quality, and inbuilt integration with other data sources. This suggests that the development of new systems should be conducted through a competitive tender process.

To ensure that the costs of populating a database of information for CIV are minimised, the collection of CIV information could be phased over a period of time, such as five years, as 'benchmark' properties are chosen by contract valuers. This is because the information and attributes required to calculate both market value (CIV) and land value (UV) are collected in this process (see Box F.2).

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### **Box F.2 CIV information is already collected**

Each year, properties are chosen as "benchmark" properties. Movements in the land value for these properties are then applied to other properties. The valuation process for benchmark properties typically involves estimating:

1. the market value of the property based on recent sales
2. the added value of improvements to the property
3. the unimproved value by subtracting (2) from (1).

Essentially, CIV is already collected with steps 1 and 2, and UV is derived by step 3. Hence CIV could simply be collected in NSW over a period with little increase in total costs for the system overall.

**Source:** For more details on the process, see Mangioni, V, *Land Tax in Australia*, 2006, pp 22-24.

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In submissions, a number of stakeholders identified that much of the property attribute information exists to calculate CIV (eg, in council DA applications, water sewage diagrams, and property sales databases).<sup>139</sup> Property sales data for the 150,000 or more sales that occur each year could also be added at little cost to the 'benchmark' properties, creating a much richer data set over time.

The Valuer General noted CIV information is not held in a standardised form and may involve substantial manual effort in the valuation process.<sup>140</sup> Our suggested approach, to gradually phase in the collection of CIV as contract valuers perform benchmark valuations will ensure the costs are contained and standards of valuation are met.

Another option is a self-assessment process where the property owner is responsible for submitting information on their property. This could be used in conjunction with our suggested approach in the initial phase for gathering CIV data. A self-assessment process has been successfully adopted in Ireland when it introduced a property tax based on CIV in 2013.

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<sup>139</sup> For example, Thomson Reuters, p 2, Hometrack Australia, p 2, Sutherland Shire Council, p 2, submissions to IPART Issues Paper, May 2016.

<sup>140</sup> NSW Valuer General, submission to IPART Issues Paper, May 2016, p 7.

## G Reports considered by IPART

### G.1 Independent Local Government Review Panel Final Report (Panel Report)

The NSW Government in April 2012 appointed the Independent Local Government Review Panel to review the NSW Local Government sector, including a review of the local government rating system. The Panel Report contained a number of key recommendations, which are summarised in Box G.1 below.

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#### Box G.1 Independent Local Government Review Panel – key reform recommendations relating to the rating system

- ▼ Set local rates for apartments and other multi-unit dwellings more equitably and efficiently, in order to raise more revenue. Councils could be given the option of using Capital Improved Value (CIV) or the market value of the property to levy residential rates (p 40).
- ▼ Reduce or remove excessive rating exemptions and concessions that are contrary to sound fiscal policy and jeopardise councils' long-term sustainability (p 39).
- ▼ Some concessions for disadvantaged ratepayers are justified, but social welfare should not be a local government responsibility. Arrangements for pensioner concessions should be reviewed (p 40).
- ▼ Streamline the Special Variation process, or provide earned autonomy from rate-pegging for some councils, or replace rate-pegging with a new system of 'rate benchmarking' (p 42).
- ▼ Reduce the number of councils, particularly in Sydney, to create higher capacity councils that can better partner with the State Government in developing Sydney (p 72).
- ▼ The government consider giving larger councils in inner Sydney expanded responsibilities. These councils could use increased rates revenue to contribute more to sub-regional infrastructure and transport projects, freeing up state resources to be spent elsewhere (p 102).
- ▼ Commission IPART to undertake a review of the rating system (p 55).

**Source:** Independent Local Government Review Panel, *Revitalising Local Government*, October 2013.

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### G.1.1 NSW Government response to the Panel

The Government response to the Panel Report's recommendations on the rating system is set out below.

**Table G.1 Government response to selected Panel recommendations**

<b>Recommendation on a review by IPART</b>	Commission IPART to undertake a further review of the rating system focused on: <ul style="list-style-type: none"> <li>▼ Options to reduce or remove excessive exemptions and concessions that are contrary to sound fiscal policy and jeopardise councils' long term sustainability.</li> <li>▼ More equitable rating of apartments and other multi-unit dwellings, including giving councils the option of rating residential properties on Capital Improved Values, with a view to raising additional revenues where affordable.</li> </ul>
<b>Position</b>	Supported
<b>Government Response</b>	The Government notes the issues raised by the Panel in relation to the equity of the current rating system. It remains committed however to protecting ratepayers from unfair rate rises and to providing rate concessions for pensioners. The Government will commission IPART to conduct a rating review to reflect these issues.
<b>Recommendations on current rating system</b>	Either replace rate-pegging with a new system of 'rate benchmarking' or streamline current arrangements to remove unwarranted complexity, costs, and constraints to sound financial management.
<b>Position</b>	Supported
<b>Government Response</b>	The Government is committed to a rating system that protects local ratepayers from unfair rate rises. It recognises however the improvements in council strategic planning under IP&R and therefore supports removing unwarranted complexity, costs and constraints from the rate-peg system, where there is evidence that the council has taken steps to reduce unnecessary costs before seeking to impose an increased burden on ratepayers. The OLG will work with IPART to amend the guidelines to develop a streamlined process for <i>Fit for the Future</i> councils wanting to increase rates above the rate peg, and to offset revenue loss through Financial Assistance Grants redistribution.

**Source:** Office of Local Government, *NSW Government Response: Independent Local Government Review Panel recommendations and Local Government Acts Taskforce recommendations*, September 2014, pp 4-5.

The Government also responded to the Panel's analysis on council mergers by commissioning IPART to conduct an analysis of councils' Fit for the Future (FFTF) proposals. The IPART *Assessment of Council Fit for the Future Proposals* released in October 2015 found 57 councils were fit and 87 councils were not fit. This analysis was used by the Government in its consideration of the council mergers that commenced on 12 May 2016.

## G.2 TCorp Report on Financial Sustainability

Following an assessment of 152 NSW councils, the 2013 TCorp report into financial sustainability of NSW councils<sup>141</sup> made a number of key findings, including:

- ▼ Operating deficits are unsustainable – only one third of councils in 2012 reported an operating surplus. Over the period 2009 to 2012, the cumulative operating deficit of NSW councils totalled \$1.0 billion.
- ▼ The total infrastructure backlog of NSW councils had reached \$7.2 billion by 2012.
- ▼ Financial sustainability is deteriorating with nearly 50% of councils' financial outlook likely to be rated 'weak' or lower by 2016-17.
- ▼ A large asset maintenance gap exists within the sector with a \$389 million deficit in 2012 alone.
- ▼ Councils need to start consulting their communities about ways to either increase revenue, lower existing service levels and or standards, and pursue efficiency savings.

### Fit for the Future council submissions showed improved financial sustainability

IPART assessed FFTF proposals from 144 NSW councils against a number of criteria, including financial criteria, and published its final report, *Assessment of Council Fit for the Future Proposals* in October 2015.

In its FFTF assessments in 2015, IPART only found 27 of 144 councils, or 19%, did not meet the financial criteria because of continuing operating deficits over the next five to 10 years.

In addition, the infrastructure backlog had substantially reduced since the TCorp report. The TCORP backlog of \$7.2 billion in 2012 corresponded to an average backlog ratio of about 13%. By contrast, in their 2015 FFTF proposals councils reported an average backlog ratio of 6.5% in 2014, with councils forecasting this ratio to fall to about 2.5% by 2020.

A major driver for this reduction in the backlog was a re-estimation of depreciation schedules. Councils in FFTF typically used depreciation lives of between 55 to 100 years.

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<sup>141</sup> NSW Treasury Corporation, *Financial Sustainability of the NSW Local Government Sector, Findings Recommendations and Analysis*, April 2013.

### G.3 Integrated Planning and Reporting

The Integrated Planning and Reporting (IP&R) framework<sup>142</sup> requires NSW councils to prepare:

- ▼ a 10-year Community Strategic Plan, which identifies long term priorities
- ▼ a Resourcing Strategy (comprising a Long Term Financial Plan of at least 10 years, an Asset Management Plan and a Workforce Plan)
- ▼ a 4-year Delivery Program, which identifies service and works at a program level that are to be funded, and
- ▼ a 1-year Operational Plan (containing an annual budget).

IP&R enables councils to better achieve community priorities from effective planning, to meet the community's expectations about service levels and funding priorities. IP&R should underpin decisions on the revenue required by each council.

The Special Variation guidelines and IPART's assessment process are based on an expectation councils will have engaged the community in a discussion on the funding required through the IP&R process.

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<sup>142</sup> For further information, please see Office of Local Government, *Integrated Planning and Reporting*, at: <https://www.olg.nsw.gov.au/councils/integrated-planning-and-reporting>, accessed 16 August 2016.

## H Current rate exemptions in the Local Government Act

**Table H.1 What land is currently exempt from all rates?**

Land type	Details
Land owned by the Crown	No rates are payable unless the land is held under a lease for private purposes.
National parks and conservation areas	All land within a national park, historic site, nature reserve, state game reserve, karst conservation reserve, land subject to a conservation agreement and land associated with the Nature Conservation Trust of NSW whether or not the land is affected by a lease, licence, occupancy or use.
Water corporation land	Land within a special or controlled area for Sydney Water or Hunter Water, land vested in or owned by Water NSW for installed water supply works, land within a special area for a water supply authority.
Land belonging to a religious body	Land that belongs to a religious body which is used in connection with a church or other building used for public worship, a residence of a minister of religion, a building used for religious teaching or training.
Land belonging to schools	Land which belongs to and is used in connection with a school inclusive of playgrounds, and buildings occupied as a residence by school teachers, caretakers or employees.
Land vested in an Aboriginal Council	Land vested in an Aboriginal Land Council that is not being used for a residential or commercial purpose, and land that is of spiritual or cultural significance that has been declared so by resolution with the approval of the Minister for Aboriginal Affairs.
Rail infrastructure land owned by a public transport authority	Land vested in or owned by a public transport agency and in, on or over which rail infrastructure facilities are installed.
Land used for oyster cultivation	Land that is below the high water mark used for any aquaculture relating to oyster cultivation.

**Source:** *Local Government Act 1993* (NSW), section 555.

**Table H.2 What land is exempt from all rates, other than water supply special rates and sewerage special rates?**

Land type	Details
Public places	Includes public reserves, cemeteries and free public libraries where they are vested in the Crown.
Mineral claims	Land that is the subject of a granted mineral claim, held under private lease from the Crown.
Land belonging to public benevolent institutions and public charities	Where the land belongs to and is used for the purposes of the public benevolent institution or charity.
Public hospitals and other health purposes	Land that belongs to a public hospital and land vested in the Minister for Health, the NSW Health Foundation and the local health district.
Land vested in universities	Land vested in a university or a university college used solely for its purposes.
Special listed groups	Land vested in the Crown/trust and used for Sydney Cricket Ground, Zoological Parks Board , Royal Agricultural Society, Museum of Sydney and Museum of Contemporary Art.
Cattle dipping	Land leased to the Crown for cattle dipping.
Land vested in a mines rescue company	Land vested in a mines rescue company and used for the purposed of a mine rescue station.

**Source:** *Local Government Act 1993* (NSW), section 556.