

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

### ***Response to IPART Issues Paper***

This response to the Issues Paper reiterates and enlarges upon relevant matters raised by the Independent Local Government Review Panel in its October 2013 report *Revitalising Local Government*. In accordance with IPART's terms of reference, which seek consideration of the Panel's broader 'findings and deliberations', reference is also made to research papers commissioned by the Panel and published in its *Volume 2: Supporting Information* (Parts 1 and 2).

No attempt is made to address all the issues raised by IPART, but attention is drawn to some additional matters that warrant consideration as part of the current review.

Unless referenced from *Revitalising Local Government*, the comments made are those of the author, not the Panel.

#### **1. A Starting Point**

Towards the end of its review, the Panel commissioned a report by John Comrie, titled *Roadmap to Financial Sustainability for Local Governments in NSW*. It made the following important observations (pp.9-11):

The reality is that increases in rate revenue are likely to be a key necessary component of strategies to improve financial sustainability of many councils. This needs to be recognised and accepted by all stakeholders....

The financial position and performance of many NSW local governments needs to improve if they are to maintain existing service levels as warranted and also address unfulfilled needs and preferences. The situation is not though as dire as is commonly perceived. There is a clear path through this challenge if stakeholders are willing to undertake the journey.

First and foremost, what is required is a commitment to improve financial and asset management performance and practices...The state has a critical role to play here in facilitating such outcomes with supportive (and often simplifying) related regulatory frameworks.

Even if all the above occurred some councils would still need additional financial support. It may be possible to achieve this through ensuring the methodological basis for the distribution of financial assistance grants better promotes horizontal fiscal equalisation. Any councils adversely affected by such an outcome are likely to be able to weather this impact or take other offsetting actions without undue consequence...

The SA experience has unequivocally demonstrated that councils can make substantial improvements in their financial performance with appropriate regulatory frameworks and guidance support. For example over a period of 10 years SA councils on average went from an operating deficit of more than 10% of operating income pa (which is greater than the current NSW relative operating deficit) to break-even on an ongoing basis. At the same time asset renewal capital expenditure has increased threefold in real terms to about generally recognised warranted levels without an increase in real net debt levels.

Comrie's observations highlight the fundamental points:

- First and foremost, the rating system must be designed and administered in such a way that councils can raise adequate revenues to meet current and projected needs for services, infrastructure and other local government functions, without undue constraints or complexity.
- The system must be flexible and enable councils to respond effectively to changing circumstances (such as in the level and distribution of grants).
- Rating must be considered within the broader policy framework for local government, including other revenue options, expenditure demands, the quality of financial management and the need to ensure long-term financial sustainability.

Thus in undertaking a review of the rating system it is necessary to look beyond just the technicalities to questions about the contribution rates will need to make as part of local government's future revenue mix, and the scope for that contribution to increase – if necessary – to ensure that councils can operate sustainably and effectively in addressing community needs and expectations.

This requires consideration of other key elements in councils' operating environment that should be addressed collaboratively by State and local governments. For example:

- Community needs for services will inevitably change and local government may well be expected to play an expanded role. Its role has already changed dramatically over the past half-century and international trends suggest that a more 'localist' approach to governance and delivery of what are currently state and federal services is quite probable. Therefore policy settings and political rhetoric that imply or encourage expectations of long-term stability, and which suggest that levels of rates can and should be contained indefinitely (even reduced), are unrealistic and unhelpful.
- Local government has thus far emerged unscathed by federal budget cuts – the freeze in general purpose financial assistance grants (FAGs) has been more than offset by increased funding for Roads to Recovery (R2R) – but it cannot be assumed that this situation will last indefinitely. There is no guarantee that the current 'FAGs freeze' will be lifted, nor that the federal government will maintain the present balance between general purpose and specific purpose assistance: statements by Prime Minister Turnbull to the effect that the federal government wishes to 'invest' in infrastructure rather than provide grant handouts may prove significant.
- The same applies to potential implementation of the concept of 'City Deals', based on the UK model. Moreover, such a model would likely involve matching contributions by councils, which could only be funded by a mix of borrowings (to be repaid through by higher rates, albeit over a long period) and special rates. Similarly, the concept of 'value capture' as a means of funding infrastructure improvements may well require higher rates – land tax and rates are ready-made mechanisms for 'value capture' (otherwise known as tax increment financing). And given the ongoing fragmentation of local government areas within metropolitan Sydney and the lower Hunter, 'City Deals' and 'value capture' would likely involve collective action by groups of councils ('combined authorities' in the UK), which may require new mechanisms for setting rates across council boundaries.
- Small (in population) rural-remote councils are especially vulnerable to any reduction in external support: indeed, the Panel's research showed that many require increased support and it is State government policy to redirect – as far as federal legislation permits – a proportion of general purpose FAGs from more affluent urban councils. Unless other steps are taken to improve the

sustainability of rural-remote councils – which have yet to be canvassed by State or local governments – this need to redirect FAGs will persist and increase. During the latest (2012-13) review of FAGs by the Commonwealth Grants Commission, the NSW Local Government Grants Commission advocated reducing or completely removing the current requirement for 30% of general purpose FAGs to be allocated on a per capita basis, thus freeing up a large sum for re-allocation. This would, of course, necessitate significant rate increases in adversely affected urban local government areas – by no means an unreasonable consequence but one that needs to be factored into government policy.

- The advent of widespread road pricing could have major implications. To date, local government has been cast (including by itself) principally as a potential recipient of part of the revenue raised eg to fund the ‘first and last mile’ of heavy vehicle trips that use local roads to access their points of origin and destination. However, GPS technology would seem to make it possible at low cost to price local road use directly, or charges for parking on public roads might be applied much more extensively, generating considerable revenues for local councils.

Thus if the State government believes that rates should be contained, it needs to work with local government to ensure that the broader policy framework and projected revenue mix is appropriate and (as the saying goes) ‘fit for the future’.

## **2. Rates in the System of Taxation**

It is now generally agreed that rates are a tax – and a very efficient one. Along with land tax, capital gains tax and stamp duties, they are one of Australia’s very few – and relatively modest – taxes on wealth. Yet in public and political discourse, and importantly in the way they are calculated and regulated, they are still widely approached as a fee for service – including by many councillors and council managers.

Although levied on property wealth, rates can also be seen as a fairly equitable tax that reflects capacity to pay. This is because property wealth is generally linked to recurrent income. However, that does not always apply and mechanisms need to be in place to assist ratepayers with limited capacity to pay at given points of time, such as pensioners and the unemployed (see section 5 below). *But the system as a whole should not be distorted, and total rate revenues suppressed, as a welfare measure to help out these special cases.*

Unlike other taxes, rates are set each year essentially to raise ‘just enough’ (or all too frequently ‘not quite enough’) revenue to meet projected expenditures. When the tax base (property values) increases, the rate in the dollar is cut, so local government has not enjoyed the equivalent of income tax ‘bracket creep’ or surges in stamp duty collections by state governments. One might ask why?

Constitutionally, rates are a state tax, and local government is part of the state public sector. Yet the State gives the clear impression rates are to be frowned upon, whilst its own means of exploiting the property tax base (notably highly inefficient stamp duties) are apparently acceptable. And by limiting rate revenues through rate-pegging, exemptions and concessions, the State is actually reducing the overall capacity of the public sector to meet community needs and aspirations, and/or placing an unnecessary additional burden on state (and federal) taxpayers: self-defeating populism.

Various reports have favoured the introduction of a broad-based land tax, and as noted above the federal government recently flagged a preference for ‘value capture’ to fund new infrastructure. In

fact, rates are already a broad-based land tax – including the family home – and the rating system could be tweaked to achieve much higher levels of ‘value capture’ (eg through applying special rates to urban renewal areas). Yet these benefits are barely acknowledged.

For most households rates, whether paid directly or through rent, represent a modest impost compared to other taxes, utilities, communications, insurance etc. Accordingly, the Productivity Commission<sup>1</sup> found that in many communities, especially larger urban areas, there is considerable scope to raise additional revenue within reasonable limits of affordability and that, at current service levels, around half of all councils could operate without external funding support.

Surveys consistently find that most people believe rates offer adequate or good value for money, and are willing to pay more to avoid cuts to services, or to receive specified improvements in services and facilities. The Panel concluded that increases of \$1-2 per week (which may amount to as much as 10% of the average residential rate) are likely to prove acceptable. Those who argue that ‘excessive’ rate increases must be avoided need to explain what they mean.

### **3. Independent Panel’s Findings**

The Panel’s findings and recommendations concerning the rating system reflected several key objectives, some of which have already been flagged in the previous sections. They include:

- Ensuring a reasonable level of equity in the amounts paid by ratepayers, according to their wealth and capacity to pay, both within and between local government areas – this requires consideration not only of the incidence of rates but also the distribution of state and federal grants to councils
- Maximising transparency in the way rating systems are obstructed and rates are imposed – as well as in the way revenues are spent
- Enabling councils to raise additional revenues where warranted, and especially where there is under-used capacity to pay – to improve financial sustainability, to generate increased revenues for local and (sub) regional infrastructure and services, and to provide a cushion against any reductions in grants or the need for local government to play an expanded role.

IPART’s Issues Paper documents most, but not all, of the Panel’s findings. Additional points made by the Panel were as follows:

- Councils should be required to prepare rigorous Revenue Policies as a basis for rating, in conjunction with more detailed 4-year Delivery Programs (Recommendation 5)
- There should be ongoing redistribution of grants (federal and state) to support councils and communities with the greatest needs (Rec. 8)
- Councils should make increased use of debt (Rec. 9) – amongst other things this would help to ‘smooth’ the impact of rate increases
- Councils should be encouraged and allowed to make increased use of fees and charges to fund services that are largely ‘private goods’, and limitations on fees for regulatory approvals and inspections should be removed (Rec. 10) – thus reducing the pressure on rates
- IPR guidelines should be amended to require councils to incorporate rolling reviews of services in their Delivery Programs, along the lines of Victoria’s ‘Best Value’ principles (Rec. 21).

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<sup>1</sup> Productivity Commission (2008) Assessing Local Government Revenue Raising Capacity

All these recommendations have a significant bearing on how the rating system should be designed and operate.

#### 4. Revenues, Responsibilities and Equity

Rates are a local tax, calculated on the basis of the revenue-raising capacity and expenditure needs of individual local government areas. It follows that whilst the incidence of rates is fairly equitable *within* LGAs (because property value broadly equates with the owner's capacity to pay), ratepayers in LGAs with high average property values will often pay a lower rate-in-the-dollar than ratepayers in areas where average values are significantly lower. This issue was of concern to the Panel. Table 3 of its report (p.41), partially reproduced below, showed very considerable variations in the percentage of land value paid by ratepayers in different LGAs. This situation is highly inequitable, as typically ratepayers in high value areas have a substantially greater capacity to pay.

Local Government Area	Average Residential Land Value 2011/12 (\$)	Average Residential Rates 2011/12 (\$)	Rates as % of Land Value 2011/12
Woollahra	1,036,898	1,006	0.10
Ku-ring-gai	529,412	591	0.11
North Sydney	366,043	484	0.13
Waverley	563,832	796	0.14
Kogarah	446,270	887	0.20
Penrith	229,634	957	0.42
Blacktown	183,763	808	0.44
Campbelltown	154,348	817	0.53
Bathurst	100,403	810	0.81
Albury	115,128	1,045	0.91
Warrumbungle	30,648	452	1.47
Broken Hill	28,802	674	2.40

The Panel also found, as reported by IPART, that further serious inequity flows from using land value as the basis for rating apartments, because that value is divided amongst numerous strata titles.

There are several dimensions to this problem:

- The rates on a strata title apartment will be much lower than those on a single dwelling with the same market value
- Within a single strata-titled block, it is often the case that all owners pay the same minimum rate to their council irrespective of variations in the market value of their apartments (eg 1 or 2 bedroom, upper vs lower floors, prized vs 'ordinary' views etc)
- Use of minimum rates also means that rates paid by owners in a 'prestige' block will often be no more than those payable on much lower value apartments
- The more housing supply becomes dominated by apartments, the more revenue is foregone and the more inequitable the rating system becomes.

Moreover, where apartments are concentrated in a local government area, such as the City of Sydney, that can generate large revenues from sources other than residential rates, two further concerns arise:

- All residential ratepayers, and especially apartment owner, pay much less than they might otherwise
- The opportunity to use increased rates revenue to fund a wider range of functions is lost.

The Panel’s response to these issues was twofold:

- Move from land value to capital value as the basis for rating in selected LGAs, either for all residential properties in those areas, or for multi-unit dwellings only
- Increase the expenditure responsibilities of councils that will be able to generate substantial additional revenues in this way, in order to free-up State funds for use in more needy areas.

Those two elements should be seen as a package. Although the Panel did not say so, any move to capital value would need to be mandatory in order to ensure equity.

The Panel obtained informal advice from the then Valuer General on the likely complexity and cost of switching to capital value. It concluded that provided the move was restricted to residential properties, and preferably to multi-unit dwellings only, the initial cost of new valuations could be recouped from increased revenue within the first year or two.

As noted earlier, the Panel also strongly favoured – as a further measure to improve equity – a substantial redistribution of grants away from councils with significant under-utilised revenue capacity. There is simply no case (except ‘entitlement’) for councils in affluent, high value areas such as the northern, inner and eastern suburbs of Sydney to receive general-purpose financial assistance. Allocating scarce resources in this way makes it even more difficult to achieve meaningful fiscal equalisation across local communities in accordance with the Commonwealth’s stated objectives, and places an unnecessary burden on the federal budget.

As well, consideration might be given to a surcharge on rates paid on all high value properties – a ‘metropolitan improvement levy’ – to help fund essential infrastructure and facilities in less affluent areas in western Sydney experiencing growth pressures. This would be somewhat akin to a broad-based land tax. Perth has had such a levy for decades.

## 5. Exemptions and Concessions

Table 2 (p.39) of the Panel’s report, reproduced below, suggested an approach to revising current rating exemptions and concessions, based on the Deloitte Access Economics report commissioned by Local Government New South Wales (LGNSW).

Type of Land	Possible Way Forward
Commercial activities of various statutory authorities	Remove or modify current exemption (eg commercial forestry in State forests and commercial activities in National Parks)
Land used for certain religious, charitable and educational purposes	Modify current exemptions and/or switch to a minimum rebate with the option of additional concessions at councils’ discretion

Oyster cultivation and cattle dipping; land leased for granted mineral claims	Remove exemption (little justification on efficiency or equity grounds)
Various listed groups	Remove exemption (largely commercial purposes eg Royal Agricultural Society, Sydney Cricket Ground, Museum of Sydney)
Land used for health and safety; Aboriginal land; cemeteries, public places, libraries	Retain exemption

As IPART notes, the Panel also raised questions about current arrangements for pensioner concessions and proposed they be reviewed against principles of equity and sustainability. Consideration needs to be given to alternatives such as rates postponement, and to whether some form of concession should be granted to all low-income households, not just those on pensions. The Panel was advised that in New Zealand the national government funds rates relief for all low-income households as a welfare measure. This might well be an appropriate course of action for the federal government in Australia.

## 6. Rate-Pegging

Since it has been effectively linked to the requirements for Integrated Planning and Reporting (IPR), rate-pegging in NSW seems to be working quite well, and as a general rule councils with a robust financial plan that have adequately consulted their community can now expect to receive approval for ‘special variations’ above the annual index. However, the system remains costly to administer and continues to act as a political barrier to sound financial management in those cases where councillors fear a community backlash and electoral consequences – or subscribe to the view that rates (and taxes) are somehow inherently ‘bad’ and should be minimised regardless of the consequences.

The Panel’s preferred approach was therefore to move away from the ‘application to vary’ approach to what it described as ‘rate benchmarking’, which it defined in Box 11 of its final report (p.43).

### Box 11: Rate Benchmarking

- More rigorous Delivery Programs (see Box 9) and Revenue Policies, certified by the Mayor and General Manager as meeting all applicable requirements
- Proposed rate increases and associate expenditures must be subject to community consultation when preparing Delivery Programs
- IPART publishes and justifies an annual Local Government Cost Index
- Annual audits (under the aegis of the Auditor General) check whether revenues in excess of the cost index have been expended in accordance with the Delivery Program
- IPART publishes benchmarking data on increases in revenues and expenditure efficiency
- Minister can intervene if the evidence warrants corrective action.

The author has since undertaken further work as an adviser to local government on the introduction of rate-capping in Victoria, and as part of the current review of the Victorian Local Government Act. This work has defined the desirable elements of ‘rate benchmarking’ as an integral component of better financial management and budgeting in general. The suggested approach is shown in the figure below. Importantly it includes a specific ‘reserve power’ for the minister (or an agency acting on his/her behalf) to intervene in instances where a council’s financial management and rate-setting

process is clearly deficient, or it can be shown that rate increases are more than would be required for sound financial management. However, such intervention would be on a council-by-council basis and based on solid evidence drawn from benchmarking data and audit findings.



As noted in section 3, critical new elements in NSW would be for councils to prepare more rigorous Revenue Policies and to undertake regular reviews of services, applying principles similar to those for 'Best Value' in Victoria. Principles for service reviews were set out in Box 16 in the Panel's report (p.56). The Panel's recommendation to place local government audits under the auspice of the Auditor General is also relevant, as this strengthened oversight should give communities confidence that their council's financial management is satisfactory.

### Box 16: Proposed Principles for Service Reviews

- A council must achieve continuous improvement in the provision of services and seek to ensure that its services are equivalent to 'best on offer' in its region
- All services provided by a council must meet defined performance outcomes and quality and cost standards developed by the council in consultation with local communities and key stakeholders
- As part of service reviews, a council must explore the potential for partnerships with adjoining or nearby councils, as well as other public or private service providers
- Service reviews must take into account the importance of maintaining and where possible increasing local employment opportunities
- Each service provided by a council must be accessible to those members of the community for whom the service is intended
- A council must report regularly to its community on its achievements to these principles.



## **7. Special Rates and Cost Recovery**

Regardless of whether rate benchmarking is introduced or rate-pegging is 'streamlined' instead, particular consideration needs to be given to excluding from the annual cap special rates and various areas of expenditure that should be funded on a cost-recovery basis. The whole purpose of special rates is to deliver an additional service or benefit to a targeted group of ratepayers, so provided there has been full consultation (and preferably broad agreement) before a special rate is introduced, it is impossible to see why this revenue should be seen as 'general income' – unless the real but unstated purpose of rate-pegging is to suppress council revenue-raising regardless of sound principles of financial management. The same applies to annual charges of whatever sort, provided they are calculated to achieve appropriate cost recovery.

## **8. Rating Paths for Amalgamated Councils**

The Government's policy to freeze the current rating path for former LGAs within a new amalgamated area makes little sense. Rate-pegging already safeguards against 'excessive' increases in the total revenue take of amalgamated councils. Coupled with rate-pegging, implementation of the Panel's proposals for more rigorous Delivery Programs and Revenue Policies would ensure that changes to the incidence of rates between ratepayers in the new areas are soundly based and reasonable. Allowing those changes to be phased-in over several years would avoid sudden shifts in the amount of rates paid. The Government will presumably need to legislate to permit phasing-in at the end of the 4-year 'freeze', so why defer inevitable change and obstruct timely delivery of the claimed benefits of amalgamations?

Precisely because rates are a relatively modest impost, in most cases adjustments following an amalgamation are unlikely to amount to more than a few dollars per week. This makes it all the more difficult to understand why ratepayers – especially affluent owners of high value properties – need to be protected by a 'freeze' as opposed to phased adjustments. It would appear that fear-mongering and special pleading during the amalgamation 'debate' has exerted undue influence.

IPART's options for implementing the government's policy involve legislation that may well fail to pass the Legislative Council. In any event, it is questionable whether legislation – unless with a watertight sunset clause – should be used to facilitate a one-off transition. IPART's preferred option of giving the Minister a new, perhaps loosely-defined power to prescribe the rating methodology to be used by amalgamated councils could open a Pandora's Box of opportunities for arbitrary and ill-conceived interventions.

The Government's policy can be implemented to the extent warranted with a mix of existing powers and mechanisms. The Chief Executive of the Office of Local Government can issue guidelines under s. 23A of the Local Government Act. These are not mandatory but can be backed up by the Minister's current array of powers to intervene in councils' affairs (eg performance improvement orders). Rate-pegging can be applied in the normal way. And audits can be used to detect any questionable aspects of rating and broader financial management.

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