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IPART review of the Local Government Rating System

Submission from the Property Council of Australia

13 May 2016

Executive Summary

The Property Council of Australia welcomes the opportunity to comment on the Issues Paper for IPART's Review of the Local Government Rating System (Issues Paper).

The Property Council of Australia has consistently articulated the case for reforms to improve the performance of councils across New South Wales.

The NSW Government's 'Fit for the Future' reform agenda presents a once in a generation opportunity for the State to address the many challenges faced by local government. These challenges include financial instability, infrastructure backlogs, choked revenue and out-dated

We have a keen interest in seeing councils succeed, given the scale of Sydney, and the importance of the industry to driving the State's growth. Our industry depends on the efficient assessment of development applications and prudent spending of property-based taxes.

The review of the rating system is an important part of the reforms being made to local government. The population growth in many New South Wales local government areas has resulted in increased demand for local infrastructure and services that has outgrown the available revenue. In reviewing the local government rating system we support:

- The retention of unimproved land value as the valuation method
- Abolition of the rate pegging system
- Requirements on councils to spend development levies in full, on-time, for the purpose they were collected – and we want poor performers held to account
- Mechanisms which encourage councils to borrow more to finance infrastructure renewal
- Consideration of alternate methods of financing such as growth area bonds

Local government reform will help create stronger, larger councils that are better able to manage their own affairs and meet the challenges of the future.

About the Property Council of Australia

The Property Council of Australia is the nation's peak representative of the property and construction industry.

Our 2,000 member firms and 55,000 active individuals span the entire property and construction industry, which includes all:

- **dimensions of property activity** — financing, funds management, development, ownership, asset management, transaction and leasing.
- **major property types** — offices, shopping centres, residential development, industrial, tourism, leisure, retirement and infrastructure.
- **major regions** of Australia and **international** markets.
- **four quadrants of investment** — public, private, equity and debt.

Our relationship with local government is a critical one. We provide a major source of revenue through the provision of property related services, contributing to the billions collected by councils in rates and charges.

In particular, our members contribute to local government infrastructure through significant development levies. In 2014-15, councils collected $601 million via these levies – with over $1.3 billion in levies sitting unspent in council accounts across Sydney's 39 councils.

We are also a major user of local government services. Our members rely on councils to progress development applications so they can do business. In 2014-15 (the most recent public data), councils approved 90,183 development applications, worth $34.10 billion.

The property and construction industry also underpins the health and prosperity of the NSW economy. The industry:

- generates over **311,000 jobs** - one in ten workers
- provides **$20.3 billion in wages** to workers and their families
- pays **$9.8 billion in State taxes** to the NSW Government – the State's single largest tax payer
- is levied an additional **$7.2 billion** in local council rates and charges annually
- contributes **$54.5 billion directly to Gross State Product** – 11.1 percent of total GSP, and
- creates **$88.3 billion in flow on activity**.

The current status

In April 2013 the NSW Treasury Corporation released a report on the *Financial Sustainability of the New South Wales Local Government Sector*. The report found that the majority of councils report operating deficits, an unsustainable trend. The cumulative operating deficits for all councils over the 2009 to 2012 review period in NSW totalled $1 billion.

The report found that the sustainability position over the short term for nearly 50% of all councils was expected to deteriorate, with 70 of the 152 councils in NSW (46%) expected to be rated as weak or lower within three years.

As at 2012 the infrastructure backlog for councils was $7.4 billion. It is clear that the status quo needs to change.

The NSW Government's *A Plan for Growing Sydney* has a vision for Sydney being a strong global city and a great place to live.

By 2031, Sydney's economic output will almost double to $565 billion a year and there will be 689,000 new jobs. In the 20 years to 2031, Sydney's population will grow by 1.6 million people. Sydney is projected to need around 664,000 additional homes over the next 20 years, which is an extra 33,000 dwellings, per year, on average.

Summary of recommendations

Recommendation 1: **The existing land valuation methodology of unimproved land value should be retained.**

Recommendation 2: **Abolish the system of rate pegging.**

Recommendation 3: **Councils should consider borrowing more debt to finance infrastructure renewal, subject to limits and sound plans.**

Recommendation 4: **It should be mandatory for velopment levies in or the pur s should be seized by the Local Government Grants Commission.**

Recommendation 5: **Growth Area Bonds should be trialled to finance the provision of council infrastructure.**

Recommendation 6: **Local government should review council owned assets with a view to identify those assets that should be corporatised or privatised.**

Retaining valuation based on unimproved land value

Recommendation 1: The existing land valuation methodology of unimproved land value should be retained.

NSW has a taxation system for local government rates that is predicated on unimproved value. It is the role of the NSW Valuer General to provide fair, accurate and consistent land values for rating purposes and the calculation of land tax. Unimproved land value will also form the basis for calculating the proposed Emergency Services Property Levy. It is important that a consistent system is used to assess land value.

The NSW Valuer General oversees the valuation of land system, where over 2.5 million parcels of land are valued as at 1 July each year. The NSW Valuer General, Simon Gilkes, at a recent public hearing held as part of this review noted that the costs involved in transitioning to a capital improved value (CIV) rating system would be in the 'tens of millions of dollars'.

This is because unlike Victoria which has recorded very detailed building descriptions for decades, NSW does not have a database which captures the capital improvements that have occurred on properties. The Victorian database has been in existence since the 1960s. To create such a database would incur substantial and unviable costs to capture the vast amount of data required. Whether these establishment costs are to be passed onto land holders through the rating system (user pays) or funded through general consolidated revenue, we would suggest it would be an unreasonable financial impost.

A move to a CIV rating system would, because of these additional costs, have a substantial inflationary impact across all aspects of the statutory valuation process. Put simply the additional cost of providing CIV in addition to the existing land values (required for the purpose of levying land tax) would ultimately be reflected in the rates and land taxes paid by property owners.

A move to a CIV rating base typically results in a substantial redistribution of the rate burden from Residential to "Business" (industrial, commercial and retail) given the nature of the respective improvements. This shift is typically over and above existing LGA policy in respect of differential rates. For any LGAs who do not apply differential rating i.e. a single general rate for all classes of property, the shift in the rate burden is catastrophic.

In Victoria, where councils are allowed to choose the valuation method on which to apply rates, Monash City Council implemented a shift from site value (similar to unimproved land value) to capital improved value in 2010/11. Monash City Council had a single general rate for all classes of property. The shift from site value to capital improved value resulted in the total rate revenue derived from non-residential property increasing by 75 per cent.

The logical outcome of a shift from unimproved land value to CIV is a substantial redistribution of the rate burden to heavily improved or high value properties. There is a common misconception that this increased rate burden is borne by major property owners. Typically lease

structures facilitate the recovery of council rates from lessees and ultimately the additional burden is shared across property owners, lessees (business) and ultimately the community.

Disproportionate outcomes occur within individual rating categories under an improved rating system. NSW LGAs have the ability to apportion the rate burden under the existing system through differential rating. It is problematic to change a long established rating base without causing substantial inequities amongst ratepayers.

Multi-unit dwellings

ndepende he rating of apartments in Sydney is inequitable. This is because the unimproved value of the land occupied by a block of apartments is split between the owners of individual dwellings (strata titles), such that each is rated on only a small fraction of the total value.

The Independent Panel suggested that moving to CIV would be preferable in selected local government areas. Alternatively it has been suggested that the 'residential' land use category could be split into two new rating categories, one for detached housing and another for multi-unit dwellings. Councils could then use CIV for multi-unit dwellings only.

The Issues Paper uses the example of a block of four apartments and a house with the same unimproved land value, where the rates payable by the owners of each apartment would be 25 per cent of those payable by the house owner, assuming that no minimum or base amounts apply. The example is misleading, however, because valuations take into consideration the most valuable possible use for the whole site; that apartments could be built on the land. Development potential and rezoning will impact on the value of the land. The most valuable possible use may even exceed the current level of development on the site.

The use of CIV acts as a disincentive to make capital improvements to land. The American Institute of Economic Research conducted a study of building activity in Victoria from 1927 to 1951. All of the Councils that had changed from a CIV system to an unimproved valuation system in the 1940s were shown to have experienced marked increases in building activity immediately after the rating change. In suburban areas, construction occurred preferentially in unimproved system rating municipalities.[1]

Harry Gunnison Brown, another U.S. economist, reported as follows:

> *What was the state of building in South Melbourne, Australia, prior to and following the adoption ... of land value taxation, with buildings and other improvements tax-exempt?*
>
> *In the first six months of 1965, under the newly adopted land value tax system, the value of new building permits was 2.4 times what it had averaged for the four preceding six-month periods. The expenditures for alterations and additions to houses were 2.5 times the average in the four preceding six-month periods. Alterations and improvements on*

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[1] Anderson, P. (2006) *Victoria's Municipal Rating System,* Australian Institute of Urban Studies [Victoria Division], Melbourne

commercial buildings were about 50 per cent greater than the average in the four preceding six-month periods. The total value of new office building construction was 4½ times the previous figure. And the value of construction permits for industrial buildings more than tripled.[2]

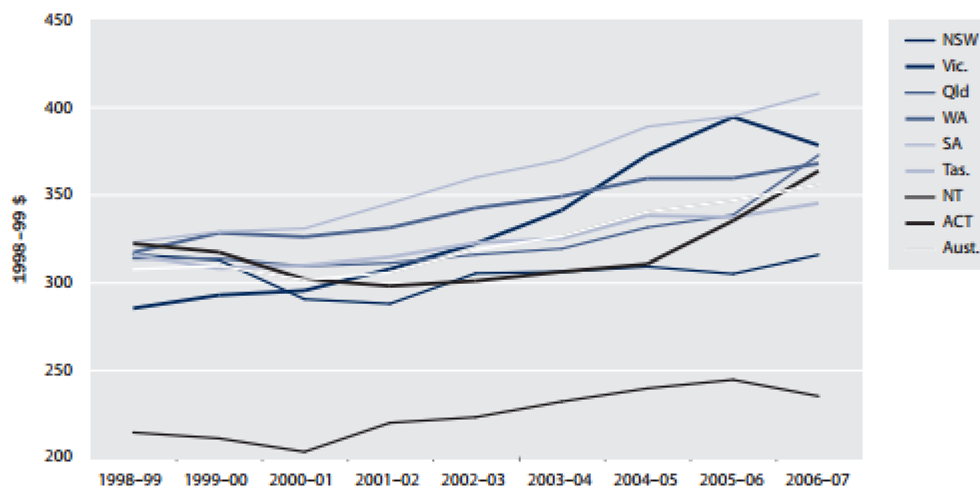
Abolish the rate pegging system

Recommendation 2: Abolish the system of rate pegging.

roduced by the Wran Governme s approach, the NSW ount by w general income. NSW remains the only state in Australia where rate pegging is still in use.

Rate pegging was designed to encourage and indeed force councils to manage their capital and service expenditure in the context of a constrained and relatively inflexible revenue stream. However since its introduction the role and operating environment for councils has changed markedly, driven by strong population growth, community expectations about the provision of a wider range of services and infrastructure and explicit and surreptitious cost shifting to local government.

Local government rate revenue per capita from 1998-99 to 2006-07, expressed in 1998-99 $, by jurisdiction



Source: Department of Infrastructure, Transport, Regional Development and Local Government (DITRDLG) (2007) *2006-07 Local Government National Report*, DITRDLG, Canberra

The above table shows the changes in rate revenue per capita, net of inflation, from 1998-99 to 2006-07 across Australian jurisdictions. As can be seen, over this time the average per capita rate revenue funding gap between NSW and other states has grown, with rate pegging acting as

[2] Brown, H. G. (with Brown, E. R.), "Incentive Taxation in Australia", *American Journal of Economics and Sociology*, vol.26, no.4, p.416 (October 1967)

a constraint on NSW councils' ability to raise revenue. This is despite NSW's relatively strong property market performance in comparison to the rest of Australia.

Despite, the 'cap', councils are able to apply for increases in rates above the rate peg. The below table indicates that though relatively few councils apply for special variations, the great majority of the applications are approved in full or partially – ranging from 85.7 percent in 2011-12 to a high of 100 per cent in 2012-13, 2013-14 and 2015-16.

Total special variation applications submitted and approved, 2011-12 to 2015-16

	2011-12	2012-13	2013-14	2014-15	2015-16
Rate peg percentage	2.8	3.6	3.4	2.3	2.4
Number of applications for special variation received	21	14	23	32	22
Number of applications approved in full	8	8	20	28	21
Number of applications partially approved	10	6	3	3	1
Total number of Councils	152	152	152	152	152

The high degree of approval of special variations applications indicates that the option may be underutilised to the financial detriment of many other local governments across the state. But, by not making special variation applications, councils avoid dealing with the potential (mainly) political problems that arise when they do.

Rate pegging impacts local government in the following ways:

- **Not allowing local government to recover the full cost of delivering services and providing infrastructure**

  This constrains local government's ability to raise sufficient rates to sustainably maintain and renew asset backlog pressures, limits their participation in new infrastructure and brownfield developments and reduces their capacity to deliver basic community services. These operating deficits threaten the financial sustainability of local government and exacerbate the financial stress from expanding services and infrastructure to meet need.

- **Infrastructure backlogs**

  As noted in IPART's report entitled *Revenue Framework for Local Government*, in the period since rate pegging was introduced, councils' aggregate capital expenditure has grown at a slower rate in NSW than in other states. On a per capita basis, the real average annual growth in NSW councils' capital expenditure was 1.9% over the period 1974/75 to 2006/07, compared with 3.5% for the rest of Australia.

In dollar terms, councils' capital expenditure per capita is also lower in NSW than in the other states. In 2006/07, NSW councils spent $273 per person, which was 23% lower than the average of $356 per person spent by councils in the other states.

Low rate revenue has constrained state growth, investment and the renewal of critical infrastructure. The financial impact on local government has prevented many councils and shires from being able to fund a sustainable maintenance and renewal program for community infrastructure and has negatively impacted housing affordability.

[redacted] it has prevented councils from [redacted]juvenation of [redacted]f new and[redacted]

- **Limiting ability to raise debt/loan funds**

  The balance sheets of most councils is exceptionally strong, with very low levels of indebtedness held compared to other levels of government. Local government's inability to generate adequate and stable operating surpluses limits their ability to leverage this asset base and to fund long term infrastructure spending.

- **Incentivising an increase in less regulated ancillary fees and charges**

  As acknowledged by the NSW Treasury[3] 'constraints on general revenue distort revenue raising sources and result in higher user charges'. Rate pegging has resulted in a disproportionate amount of local government funding being raised through less stringently regulated revenue sources such as car parking charges, development levies and permit and access fees. Along with raising the cost of accessing public amenities, this practice increases the cost of developing land, directly impacting the affordability of new housing.

The removal of rate pegging would:

- enhance borrowing capacity to fund community infrastructure programs
- improve housing affordability through the removal of a number of charges and levies
- allow infrastructure backlogs to be addressed
- Increase rate revenue from the uplift in property values, due to better quality infrastructure, services and investment in new community assets
- provide councils opportunities to "partner" in new urban development's both Greenfield and Brownfield projects
- provide the opportunity to plan and fund short, medium and long term projects based upon a sound financial strategy

[3] NSW Treasury (2008) *Submission to the NSW Independent Pricing and Regulatory Tribunal*, NSW Treasury, Sydney.

- improve governance and discourage financial innovation
- promote the principles of democracy and accountability of local government
- Increases flexibility across diverse councils

The freedom that local governments would be afforded by removing rate pegging will need to be balanced with governance requirements that drive improved asset and service management, planning and budgeting.

~~*Greater use of debt financing*~~

Recommendation 3: Councils should consider borrowing more debt to finance infrastructure renewal, subject to limits and sound plans.

Under the 'Fit for the Future' reforms councils are being encouraged to take on additional borrowing. Fit for the Future councils, with a demonstrated capacity to borrow prudently, will be provided with access to low cost loans, saving councils up to $600 million over ten years.

Councils are often cautious in their use of debt to finance infrastructure. Elected officials take pride in their ability to manage their organisation with little debt. The community has a perception that low debt is a reflection of sound financial management. This means that many councils prefer to use current year funding – such as rates or grants – to finance infrastructure. Yet local government has a significant capacity to leverage its balance sheet further and should borrow to finance infrastructure investment.

We support the Independent Local Government Review Panel's view that debt is an appropriate way to fund long-term assets. The funds borrowed could then be used to fund infrastructure backlogs. Rates could then be used to pay off the loan.

Rate pegging is not the ideal system to ensure that councils have sufficient funds to pay back loans. An alternative approach is for IPART to develop modelling which accurately reflects the costs that councils are incurring and takes into account the plans that councils are required to prepare under the Integrated Planning and Reporting (IPR) framework. These are:

- a ten 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 four year Delivery Program, which identifies service and works at a program level that are to be funded, and
- a one year Operational Plan (containing an annual budget).

Councils should be encouraged to use more debt finance for infrastructure, subject to:

- compliance with Integrated Planning and Reporting (IPR) requirements, including the preparation of long-term financial and asset management plans
- Ministerial approval for new borrowings over a certain amount

- upper limits on borrowing based on a considered assessment of the cost and benefit of alternative financing options.

Alternate sources of revenue

Spend development levies

Recommendation 4: **It should be mandatory for councils to spend development levies in full, on-time and for the purpose they were collected. Unspent levies should be seized by the Loca[redacted]s Commission.**

[redacted]ot the onl[redacted]t.

An audit of Section 94 infrastructure levies undertaken by the Property Council for the 2014-15 year concluded that over $1.3 billion was unspent. The amount of unspent levies rose by $237 million in the past year. This represents a 22.1% increase over the last year.

It is reasonable to expect that the levies collected will be used for the purpose which they were collected. The Government should introduce mechanisms to ensure that levies are spent in-full, on time and for the purpose they were collected. Councils should be more transparent and accountable. Poor performers should be held to account and if they don't utilise the s94 levies, lose access to them.

Trial the use of Growth Area Bonds

Recommendation 5: **Growth Area Bonds should be trialled to finance the provision of council infrastructure.**

Key sources of local government revenue include rates and taxes, sale of goods and services, and government grants. However, in NSW there are a number of important limitations that prevent councils from increasing revenue. Rates are pegged by section 506 of the *Local Government Act*. There is often reluctance on behalf of elected representatives to increase rates or fees for services. And councils have limited ability to increase the amount they receive through state and federal grants.

Faced with few options to increase revenue, councils should look to innovative solutions to fund and/or finance infrastructure. There are many alternatives and we recommend the trial of Growth Area Bonds (also known as Tax Increment Financing).

Growth Area Bonds have been used successfully in the US for fifty years and have also been trialled successfully in the UK.

Bonds would be issued by NSW Treasury to fund infrastructure works in a particular council area. The bonds would be repaid from the incremental increases in property taxes that are generated by the new infrastructure in the area. Tax revenues would be land tax and stamp duty, but not council rates.

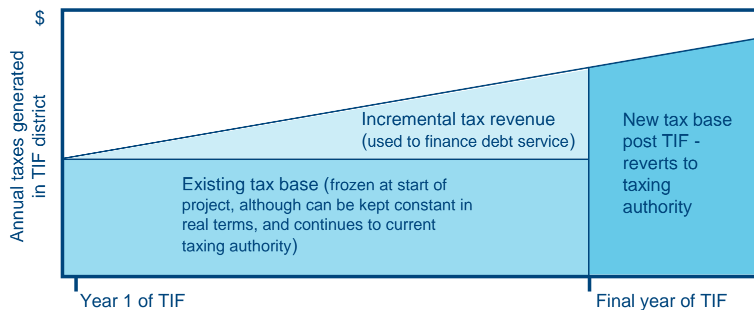
The steps in establishing and operating a Growth Area Bond are:

1. A growth area is defined.
2. A growth/renewal plan for this growth area is created, including the infrastructure and development needs for the area and the costs of capital works.

3. The existing property tax revenues derived from this growth area are estimated.
4. The sponsoring government authority issues bonds to fund the infrastructure works for the area.
5. These bonds are repaid from the incremental increase in property taxes above the pre-growth area base generated by the infrastructure and development plans for the district.
6. At the end of the growth area period the total tax revenue for the area returns to the taxing authority.

The figure below outlines the model.

Figure 1: The Basic TIF Model



Growth Area Bonds provide the following benefits:

- a market test and added rigour around infrastructure selection which enhances efficiency;
- an upfront and sustained commitment to specified infrastructure provision;
- the provision of appropriately timed infrastructure; and
- a transparent approach to infrastructure selection and provision.

Growth Area Bonds should be trialled immediately.

Alternative ownership structures for local government assets

Recommendation 6: Local government should review council owned assets with a view to identify those assets that should be corporatised or privatised.

Some local government assets may be better suited to alternative ownership structures, such as corporatisation or privatisation.

Privatisation would allow councils to access the present value of the future cashflow of a business or asset. Corporatisation would introduce corporate management disciplines to the administration of council owned assets.

Rate path freeze and establishing rates after the freeze

The risk with freezing rates for four years after council mergers is the inability of councils to fund the infrastructure needs of their communities for the duration. The current level of rates is often unrealistic to service infrastructure needs and we already see a backlog of infrastructure under

the current rating system. If the rating system is not reformed to better align rates with infrastructure needs then we would support the proposal for Special Rate Variations during the rate freeze period for new infrastructure.

We strongly support the recommendation that merged councils should not have the discretion to redistribute rate burdens between categories or sub-categories during the freeze period.

We agree that rate equalisation after the rate freeze period could cause excessive rate change. Should residents and businesses in formerly un-merged LGAs experience a significant difference in rates, then transitional arrangements should commence and phase in over a period of time.

This scenario also highlights concerns about inequitable rating of 'sub-category rates'. When councils merge and establish new rating systems, these systems should not disproportionately apply to businesses. In some instances, retail centres in particular are subjected to multiple hundreds of per cent increase over the IPART cap under the current system.

When councils merge, there may be a temptation to defray costs on businesses rather than on residential landowners. We would caution that all landowners should be subject to a fair and equitable system. Businesses are crucial economic contributors and employment generators, and often pay additional levies that residential landowners are not liable for.

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